Budget Strategy Paper - 2012

Presented by the

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Budget Strategy Paper - 2012

A. INTRODUCTION

This Budget Strategy Paper (BSP) provides an early indication from the Government to the people of Papua New Guinea (PNG) of the priorities for the 2012 Budget. These priorities are based on the announcements of the new Government and the development goals outlined in the PNG Development Strategic Plan (DSP) 2010-2030, the Medium Term Development Plan (MTDP) 2011-2015 and the Vision 2050. This BSP places these announcements and development goals in the context of PNG's challenging economic situation.

The 2011 Supplementary Budget and the 2012 Budget will have a special focus on delivering the Government's commitment to tuition free education to Grade 10 and subsidising school fees from Grade 11 to tertiary level. It will also invest in health, infrastructure, land and law and justice sectors. This Budget Strategy commits to significantly increase funding for these five key areas in the 2011 Supplementary Budget and the 2012 Budget. The 2012 election must also be funded. The Government will meet these commitments while maintaining a balanced budget.

The booming economy creates risks such as inflation. Inflationary pressures continue to increase and have now reached 9.6 per cent. Without a balanced budget, inflation is likely to increase further, sparking increases in interest rates and cuts in the availability of credit for families and PNG businesses. This Government is committed to good macroeconomic management which means that there should not be budget deficits when the economy is booming and inflation is high.

The strategic budget goals set out in this document are an important component of the Government's approach for better management of public finances in PNG. This Budget Strategy indicates that the level of Government expenditure is expected to increase by nearly 50 per cent in two years - from K6.7 billion in 2009 to an estimated K9.9 billion in 2011 and continue at that level in 2012. The Government will ensure this increased funding is focused on meeting the needs of PNG people. Strengthened budget processes are set out later in this document including ensuring the Development Budget is better integrated into budget processes.

In summary, the 2012 Budget Strategy will be for a balanced budget, focused on delivering the Government's commitments to increasing funding for key MTDP enablers such as education, health, infrastructure, land and law and justice, and ensuring that all public monies are spent well.

This document has been made available to the public, consistent with the Government's approach to improve public transparency and accountability. The document is required under the Papua New Guinea Fiscal Responsibility Act 2006.
The recently released Mid-Year Economic and Fiscal Outlook (MYEFO) report provides the basis for the Budget Strategy as it provides an update on estimates for the PNG economy. However, the fiscal data included in the MYEFO and BSP are indicative only. The macroeconomic and fiscal forecasts will be updated closer to the 2012 Budget to reflect any changes in economic and financial conditions.

B. PURPOSE

The BSP's purpose is to assist public understanding of the fiscal situation and the Government's proposed budget strategies. It contains:

- the principles that will guide the 2012 budgetary process;
- the broad fiscal parameters for the 2012 Budget and the key Government strategies and policies for the management of revenues and expenditures;
- a discussion of risks to the budget parameters and the Budget Strategy;
- the medium-term outlook for government revenues and expenditures;
- a discussion of how the Budget Strategy relates to the Medium Term Fiscal Strategy (MTFS) and MTD; and
- a framework for the preparation of departmental ceilings for budget estimates and for developing detailed budget policies.

C. 2012 BUDGET STRATEGY

C.1 Background

The 2012 Budget will be framed amid unusually high degree of uncertainty in the global economy. The recovery from the global financial crisis of three years ago has been unbalanced, with sluggish growth in the advanced economies offset by continuing strong growth in the emerging and developing countries. Continuing volatility in international markets can be expected.

*International conditions*

In advanced economies, concerns regarding European sovereign debt and pervasive financial irregularities in the US remain. In addition, fiscal and financial sector imbalances continue and growth remains below potential. The IMF predicts annual growth to be 2.5 per cent for advanced economies in 2011 and 2012. Further, the significant drop in global share markets and the highly unusual decision by the Japanese government to intervene in the foreign exchange markets highlights the current degree of uncertainty.

In contrast, signs of overheating are becoming evident in developing and emerging countries. The IMF reports that global inflation has risen from 3.5 per cent to 4 per cent in the first quarter of 2011, with most of the inflation being attributed to emerging economies. Inflationary pressures in these economies are increasingly broad based, reflecting accelerating demand
pressures and a high share of food and fuel in consumption baskets. The IMF forecasts annual growth of 6.5 per cent for emerging and developing countries in 2011 and 2012. This continuing rapid economic growth in China and India in particular has underpinned a continuing demand for commodities, leading to high but volatile commodity prices.

Domestic conditions

Domestically, if commodity prices remain at current levels, it will support significant additional revenue in 2012 and 2011 (including the 2011 Budget and the 2011 Supplementary Budget). The activities associated with the construction of the PNG LNG project has a big impact on the PNG economy and is expected to drive domestic economic growth for the remainder of 2011 and in 2012. The forecast for real economic growth is 5.6 per cent in 2012, following very high growth of 9.3 per cent projected in 2011. The moderation in the growth rate reflects the easing of the construction activity of PNG LNG project from its peak in 2012. Non-mining GDP is expected to grow by a strong 5.5 per cent in 2012.

C.2 2012 Budget Framework

The 2012 Budget will be guided by Vision 2050, the Development Strategic Plan 2010-2030 (DSP), the Medium Term Development Plan 2011-2015 (MTDP), the Medium Term Debt Strategy (Debt Strategy), the Medium Term Fiscal Strategy 2008-2012 (MTFS), and the Papua New Guinea Fiscal Responsibility Act 2006 (FRA).

The FRA states that the Government should produce a budget that is affordable, sustainable and balanced over its term. In addition, the FRA requires the Government not to raise the overall level of debt as a share of GDP during its term, or in any event above 30 per cent of GDP. While the overall Kina amount of debt has not decreased, it has fallen significantly as a share of GDP. It is expected to remain below 30 per cent of GDP due to expected prudent fiscal policy and high rates of economic growth.

With strong growth in domestic economic activity and investment, inflation has also gained momentum. The economy is facing significant capacity constraints, particularly in the construction sector and in accessing skilled labour. In this environment, additional Government spending risks driving inflation up further without adding to the overall level of economic activity or development. To avoid very high rates of inflation, coordinated and prudent management of fiscal and monetary policies are necessary. Accordingly, fiscal restraint is appropriate at this time for an economy that is experiencing high rates of economic growth, high inflation and capacity constraints.

The Government has committed to important deliverables. These are set out in the “Expenditure Priorities” section below. There will be significant costs associated with these commitments. This means that there will be a need to reprioritise expenditures within the estimated level of revenues expected in 2011 and 2012. The Government has already committed to reducing
government costs through the transfer of the Falcon jet and centralising Ministerial expenditures under a revived Office of Ministerial Services. Trust Funds will be examined and where appropriate, funds will be reallocated to these higher priority activities. Previous Government announcements will also need to be re-examined as total expenditure pressures significantly exceed any additional revenue that may be generated in 2012 and over the medium term. These unfunded pressures amount to K4 billion - K5 billion prior to the change of Government. It is impossible to fund all known pressures without running an extraordinarily high budget deficit which would be economically damaging and highly imprudent. The budget process will inform the choices that need to be made.

A balanced budget in 2012 strikes a balance between the need to fund a large number of expenditure pressures and the economy suffering from high inflation and significant capacity constraints. A budget deficit to fund development pressures would add further stimulus and inflationary pressures to the economy, exacerbating existing pressures.

Capacity constraints in the private sector mean that a significant further increase in development expenditure at this time is unlikely to be effective, as it will bid up the cost of projects and displace other development projects and/or private investment, rather than increasing the overall level of development and investment.

The MTFS decomposes mineral revenue into normal mineral revenue and additional mineral revenue. Normal mineral revenue is the amount of mineral revenue expected in an average year in the absence of a commodity boom, and is defined to be 4 per cent of GDP. Mineral revenue in excess of 4 per cent of GDP is considered to be additional mineral revenue.

Total mineral revenue is expected to be K1,958.5 million or 6.0 per cent of GDP in 2012. This comprises of K1,305.9 million in normal mineral revenue (4 per cent of GDP) and K652.6 million in additional mineral revenue (2 per cent of GDP).

The MTFS suggests that 70 per cent of additional mineral revenue be used to pre-fund public investments in line with development priorities, and 30 per cent of additional mineral revenue be used to repay debt or other Government liabilities. However, as government debt (which is below 30 per cent of GDP, excluding contingent liabilities) is now at a more sustainable level, the PNG Development Strategic Plan (2010-2030) calls for all additional mineral revenue to be directed to pre-fund public investment expenditure. The Government may satisfy the MTFS rule through payment of superannuation liabilities, but beyond that it will devote all additional mineral revenue in 2012 through the development budget to pre-fund public investments.

Under the MTFS, total spending of additional mineral revenue (including revenues from previous years saved in trust accounts) is limited to 4 per cent of GDP. Given the significant pressure on the economy and inflation, it is
critical that Government spending of additional mineral revenue (including expenditure from trust funds) does not exceed the MTFS target. Given the proposed direct spending of 2 per cent of GDP of additional mineral revenue, spending of mineral revenue from trust accounts in 2012 will need to be limited to 2 per cent of GDP. This will ensure that aggregate expenditure of mineral revenue does not exceed 8 per cent of GDP, consistent with the MTFS.

In addition, expenditure from trust accounts adds a fiscal stimulus to the economy. In order to maintain a neutral fiscal policy position, any expenditure from trust accounts will need to be offset by deposits into trust accounts from the 2012 Budget, so that the aggregate balance of trust accounts is maintained. This approach will help to avoid further fuelling inflation and crowding out private sector investment. Treasury in collaboration with Department of Finance and Bank of PNG will closely monitor trust account spending in 2012 and, if required, consider ways to exercise expenditure control on trust accounts.

Over the medium term, there will be increasing fiscal pressures from 2013 until the time that significant tax revenues flow from production at the PNG LNG project. This reflects projected declines in non-LNG mineral revenue and a substantial pipeline of planned Government expenditure. However, concerns about the macroeconomic and inflationary effects of Government investment expenditure are expected to ease by 2013, as construction of the PNG LNG project nears completion and the very high rates of growth in the construction industry moderate. This would be a more appropriate time to increase development funding as it should lead to more effective and lower cost development expenditure.

C.3 Implications for Expenditure in 2012

In 2012, total expenditure and net lending is estimated to be K9,909.4 million (including project grants), comprising K5,894.0 million of Recurrent expenditure and K4,015.4 million of Development expenditure. Of the total expenditure and net lending, the total Government of PNG expenditure in 2012 is estimated to be K8,529.0 million. This represents an estimated increase of K726.8 million in total Government of PNG expenditure from the 2011 Budget.

Expenditure Priorities

The Government will introduce tuition free education up to Grade 10 and subsidise school fees from Grade 11 to tertiary level in 2012. The Government is committed to funding this commitment through the 2011 Supplementary Budget and the 2012 Budget. The Government has also committed to deliver major impact projects such as a nationwide restoration and maintenance of run-down education and health institutions, create a centralised national medical supplies base, attend to repair, rehabilitation and maintenance of key highways, and support key port and airfield infrastructure. The Government will also provide funds to support the very important 2012 national election.
Further, the Government will also provide funding to support the creation of an independent Commission against Corruption.

Against this background, the Government is committed to increasing funding for education, health, infrastructure and law and justice. These priorities align with the enabling priorities of the MTDP: Health, Education (Primary, Secondary and Higher), Land, Infrastructure (Transport and Utilities) and Law and Justice. The 2011 Budget was the first year of the implementation of MTDP 2011-2015. In the 2011 Budget, there were significant increases in funding for: Health (K101.3 million); Education (K149.1 million); Law and Justice (K132.6 million) and Transport (K46.7 million). This support will continue in the 2012 Budget with funding for these activities forming the basis of the 2012 Budget with appropriate indexation being applied.

The MTDP was designed to refocus Government priorities from those contained in the 2006-2010 Medium Term Development Strategy (MTDS). Under this plan, there had been a very significant decline in the share of the Development Budget going to the revised enablers (see Chart 1).

**Chart 1: Per cent of Development Budget to Key MTDP Enablers (Health Education, Infrastructure, Land and Law and Justice)**

<table>
<thead>
<tr>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
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<tr>
<td>75</td>
<td>70</td>
<td>65</td>
<td>60</td>
<td>55</td>
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Source: Department of Treasury and Department of National Planning and Monitoring

The Government will commit to ensure the funding for key MTDP enablers do not decline further, but increase over the medium term. This commitment applies not only to the 2012 Budget and future budgets, but also for any possible Supplementary Budgets. The education policy announced by the Government is a major step in delivering this commitment.

The pressure to support MTDP enablers will remain over the medium term. Funding for these activities will be increased over the medium term. However, revenue growth will be insufficient to meet all outstanding pressures and will require difficult decisions to fund critical and necessary expenditures.
Projected population growth or likely flow-on costs of current policies, such as the full implementation of the National Health Plan, the Universal Basic Education and road maintenance, will require additional funding. Given the ongoing nature of the Recurrent Budget, funding once committed cannot be easily reallocated to other priorities in subsequent years.

Without significant additional revenue, meeting these obligations, or improving services, is not achievable. In the medium term, the Government will need to balance the allocation of additional funding between funding Development Budget priorities identified in the MTDP including funding the implementation of the National Health Plan and the Universal Basic Education.

To address this, the Government will encourage stronger linkages between the Development and Recurrent Budgets, to reduce duplication of funding and wastage.

In addition, the Government will seek to ensure that all MTDP enablers under the Development Budget are focused on improving service delivery. It is critical that the Government’s investment is well managed and appropriate outcomes are achieved. Improved discipline and effective management within the Public Service will provide significant service delivery improvements at minimal cost.

**Service Delivery**

While funding for service delivery has increased in recent budgets, poor management practices within agencies continues to limit improvements. Service delivery will not improve without significant reform of poor work practices across the public service. Poor performance by staff contributes to a culture of poor service delivery. The Government will ensure that the Heads of agencies exercise their managerial powers to effectively address these issues and hold them accountable for poor performance.

The Government is also committed to ensure the well performing departments or agencies with proven tangible results are adequately supported to enhance service delivery.

Further, duplication of roles by government departments or agencies has contributed to wasteful spending and confusion. The government will seek to merge departments or agencies with duplicated roles to minimise costs and improve service delivery.

**Spending Controls**

Persistent overspending by agencies (especially Provincial Governments) on Personnel Emoluments continues to risk the Budget. Overspending is often the result of poor forecasting of the impact of staff salary increments and a failure to exercise appropriate controls over expenditure and establishment. In 2010, overspending on Personnel Emoluments was K100.8 million, of which K77.0 million was attributable to Provinces.
Overspending of this nature is made possible by the lack of hard limits on agency spending. This has meant that agencies have paid staff well in excess of their annual appropriations without reference to the availability of funding in the Budget. This situation is untenable in the long term. In addition to the control measures already announced, the Government will carefully consider the option of recovering such overspends from agency appropriations in subsequent years and surcharging responsible officials.

D. Economic Developments and Outlook

In 2011, the PNG economy is expected to grow at a very high rate of 9.3 per cent. Growth has been revised upward from the 2011 Budget forecast of 8.0 per cent, largely driven by higher levels of economic activity in the non-mining sectors. Non-mining GDP is expected to grow at 10.2 per cent in 2011, two percentage points higher than the budget estimate of 8.2 per cent. However, significant capacity constraints in the economy, a shortage of inputs such as skilled labour and land, and rapid economic growth over the last two years has continued to place significant pressure on prices over 2011.

Inflation is estimated to be around 9.0 per cent in 2011. This has been revised upwards from the budget estimate of 8.2 per cent. The upward revision reflects higher food and fuel prices, higher than expected GDP growth and capacity constraints. These effects are partly offset by the appreciation of the Kina against major trading partners, which lowers the cost of imported goods.

D.1 2012 Economic Outlook

In 2012, real GDP growth rate is expected to moderate to 5.6 per cent. This is attributed to the expected slowdown in the growth of construction activity for the PNG LNG project as construction activity eases from its peak, lower projected production at Porgera, and declining production of oil from maturing Kutubu, Moran and Gobe oil fields. This is offset by higher production projected from agriculture projects, especially palm oil and coffee.

Inflation for 2012 is projected to be 7.2 per cent. This projected easing of the inflation rate reflects the expected moderation in economic growth, expected effective and coordinated monetary and fiscal policies and a moderation of commodity prices from prices well above long term historical averages.

E. Current Fiscal Developments and Outlook

The Budget outcome for 2010 was a surplus of K186.3 million or 0.7 per cent of GDP, due to lower than expected development expenditure.

As outlined in the MYEFO, the fiscal outlook for 2011 is expected to be a surplus of K606.8 million compared to an estimated balanced budget in the 2011 Budget. This is attributed to stronger commodity prices, and the continued robust state of the domestic economy.
This surplus provides an opportunity for Government and Parliament to address some of the expenditure pressures and to relieve pressure on the 2012 Budget. As already announced, this Government will have a 2011 Supplementary Budget. The Supplementary Budget will allocate these funds to priority areas, especially providing an initial payment to ensuring tuition free education to Grade 10 and subsidies for higher levels of education in 2012.

E.1 Fiscal Parameters for the 2012 Budget

The fiscal parameters for the 2012 Budget are based on current forecasts of revenues and expenditures.

- Total Revenue and Grants is estimated to be K9,909.4 million, of which Total Government of PNG Revenue (plus Infrastructure Tax Credits) comprises K8,529.0 million.
- Total Expenditure and Net Lending is estimated to be K9,909.4 million, of which total Government of PNG Expenditure is estimated to be K8,529.0 million.
  - Total recurrent expenditure is estimated to be K5,894.0 million.
  - Total development expenditure is estimated to be K4,015.4 million.

A budget balance is projected, in line with the overall budget framework.

E.2 Revenue

Total Government of PNG revenue in 2012 is estimated to be K8,529.0 million representing an increase of K726.8 million or 9.3 per cent from the 2011 Budget. The moderate increase in total revenue is driven by stronger non-mineral revenue which is slightly offset by lower mineral revenue.

Non-mineral revenue is expected to be the main driver of total revenue growth in 2012, increasing by K759.2 million from K5,751.2 million in 2011 to K6,510.4 million in 2012. This solid growth reflects a significant projected growth in personal income and company taxes, taxes on international trade, and higher GST collections. The projected growth in the nominal economy is expected to underpin robust growth in wages, employment and business profitability which will further support growth in these revenue heads.

Mineral Revenue is expected to decline from K2,597.7 million in 2011 to K1,958.5 million or 6 per cent of GDP in 2012. This is largely due to lower production expected at Ok Tedi and declining production of oil from maturing oil fields as well as the assumed moderation of commodity prices in 2012 compared to 2011. This also reflects slightly lower mining and petroleum dividends and dividend withholding taxes. Additional mineral revenue (the portion of mineral revenue which is in excess of 4 per cent of GDP) in 2012 is expected to be around K652.6 million or 2 per cent of GDP (see Chart 2).

Grants

Project grants in 2012 are estimated at K1,380.4 million. This represents a decline of K145.6 million from K1,526.1 million in 2011, due to a fall in
contributions by some aid donors and the effects on an appreciation of the Kina against the Australian and US dollars. However, this estimate is based on incomplete data, and does not include an expected increase in grants from Australia. A more accurate estimate of grants will be provided in the 2012 Budget.

E.3 Expenditure

The MTFS and the MTDS are the key policy documents that have guided the Government’s funding decisions in past budgets. As of 2010, Vision 2050 and the PNGDSP 2010-2030 has provided the overarching development plan, while the MTFS sets out the resource envelope available for recurrent and development expenditure.

E.3.1 Recurrent Expenditure

The 2012 Recurrent Budget will have dual priorities. Firstly, the delivery of Government announcements on education, health, infrastructure as outlined above, as well as funding the 2012 national election. Secondly, the Government will ensure existing legally binding obligations and commitments are given attention. The pressures on the 2012 Budget are extensive and will limit the capacity of the Government to fund commitments beyond those already identified. Basic services such as Education, Health and Infrastructure will command attention for increased and more targeted funding.

The Vision 2050, PNG DSP, MTDP, MTFS and the FRA continue to support the framing of the budget. Meeting these priorities will limit the Government’s capacity to fund other priorities. As in past years, the Government will require agencies to live within their appropriations.

Payroll expenditures by some agencies and provinces again exceeded appropriations in 2010; this added further pressure to the recurrent budget. In the 2011 Budget, appropriations for a range of agencies and provinces were increased (re-based) to address under-funding. These increases are reflected in the 2012 ceilings.

Where appropriate, Salaries and Allowances ceilings for agencies covered by the agreement between the Government and Public Employees Association will be increased. Funding to meet expenditure pressures associated with expired agreements for workers not covered by that agreement will be budgeted centrally pending negotiation of new agreements. The Government will not increase personnel emolument expenditure ceilings for agencies not covered by the agreement with the Public Employees Association.

Expenditure ceilings for goods and services for National Departments will be increased with a partial indexation of 6 per cent to reflect CPI increase. This funding cannot be transferred to meet Personnel Emoluments expenses and will provide agencies with greater service delivery capacity. Expenditure ceilings for Commercial and Statutory Authorities will be increased at a lower
level in recognition of the revenue raising capacity of those agencies. Therefore a partial indexation of 4 per cent will be applied to Statutory Authorities in 2012 to reflect CPI increase.

The Organic Law on Provincial and Local Level Governments (LLG) was amended in 2008 to provide new funding mechanisms for provinces and LLGs. The Review of Inter-Government Financing Arrangements (RIGFA) provides that a single Goods and Services ceiling for all provinces and LLGs, excluding Bougainville and NCD, must be set at a fixed percentage of Net National Revenue (NNR) in the two years prior to the Budget year. Under this arrangement, funding for Provinces will be provided on a sustainable basis that will keep pace with growth in the National Government’s revenue.

*Limits on Budget Participation:* The proposed 2012 indexation arrangements will provide most agencies with additional funding in 2012. However, experience has shown that agencies will likely seek funding beyond these levels. In the 2011 Budget process funding for Commercial and Statutory Authorities grew by K40 million from the issue of ceilings until the Budget was finalised. The equivalent increase for National Departments was K529 million.

In preparing for the 2012 Budget, the Government will require all Commercial and Statutory Authorities to remain within their 2012 ceilings. The Government will ensure that any request by a National Department for additional funding will be assessed on the basis of it being good value for money and delivering meaningful improvements in services.

*Requiring Reductions to spending on Travel/Consultancies/Vehicle Purchases:* The Government requires that all agencies spend their appropriations in an efficient and effective way. Containing spending on non-essential items will not affect service delivery and will be thoroughly investigated as part of the 2012 Budget.

*Enhancing (Protecting) the Revenue Base:* Effectively managing spending is only part of responsible Budget stewardship. Enhancing and protecting the Revenue base is equally as important. In preparing the 2012 Budget, the Government will consider measures to improve revenue collection.

**E.3.2 Development Expenditures**

The 2012 Development Budget will be the second annual budget of the MTDP and the PNG DSP.

The PNG DSP identifies the key enablers that will establish PNG on a path towards prosperity. These are the Government’s key development focus areas for the period of the first MTDP. The Government’s development priorities in 2011-15 are:

1. Unlocking land for development;
2. Improving law and justice;
3. Establishing quality national transport corridors that connect rural populations to markets and services;
4. Higher and technical education to redress the severe skills shortage within PNG's labour force;
5. Universal access to quality primary and secondary education;
6. Provision of key utilities of electricity, clean water and sanitation and communications; and
7. Improving health outcomes.

These seven aspects of the PNG DSP will be given considerable emphasis in the first MTDP and in the 2012 Development Budget. These enablers for growth will lay the foundation for PNG to progress toward middle income status by 2030. As such the 2012 Development Budget will channel funds into projects and programmes aimed at easing structural impediments to growth and development. Furthermore, building on the 2011 Development Budget, the 2012 Development Budget will be a policy driven Budget. Funds will be allocated to projects and programmes which will contribute to the achievement of the desired sector deliverables detailed in the MTDP.

The Development Budget will continue to fund fixed commitments including constitutional grants (e.g. District Support Grants), fixed grants (e.g. MoAs) and the Government's renewed financial development package of K500 million to ABG over five years, of which K100 million is to be allocated annually commencing in 2012. Moreover, the Government will continue to use its Expenditure Sequencing Strategy and Matching Funds Strategy to ensure that expenditure is prioritised efficiently within the MTDP enablers.

E.4 Financing

The Government is not expected to increase net borrowings in 2012. However, it may continue to engage with international financial institutions for limited external borrowing on concessional terms, as long as the expenditures are consistent with government priorities, are within the Budget ceiling, and are consistent with the Papua New Guinea Fiscal Responsibility Act 2006 and the Government's Debt Management Strategy. No net commercial borrowing should be required.

During 2012, the Government will continue with the inscribed stock program in order to lengthen the maturity structure of government debt and to reduce rollover and interest rate risk. Together with previous reductions in external debt, which reduces foreign exchange risk, this should considerably strengthen the Government's financial position and help to insulate the Budget from short-term economic volatility.
F. 2012 Economic and Fiscal Risks

Economic risks

The International Monetary Fund (IMF) projects global economic growth to be 4.5 per cent both in 2011 and 2012, slightly above 4.2 per cent projected at Budget. There continues to be large divergences in the global economic recovery between the sluggish growing advanced economies, and the robust growth in emerging and developing economies. The risks to the downside continue to outweigh the upside risks. The main economic risks for the domestic economy include:

- Potential disruption to the global economic recovery;
- Potential disruption to construction of the PNG LNG project;
- Potential disruption to existing agricultural, mining and petroleum production;
- Inflation increasing further, particularly in light of capacity constraints; and
- Loss of fiscal discipline given high expenditure pressures.

Fiscal risks

The residual risks from the global financial crisis, volatility of commodity prices and the possibility of a more rapid reduction in prices from historic highs all present risks to revenue forecasts. Also, any interruption to mining projects – especially construction of the PNG LNG project – or agriculture production may also have a material effect on the revenue outlook.

Risks pertaining to personal emoluments expenditure could arise from the flow-on effect of implementation of the new 2011 to 2013 Public Employees Association (PEA) Pay Fixation Agreement and increases in the senior public service contract officers’ allowances. There is a likelihood that other agencies will seek pay rises, including uniform personnel officers (defence, police, fire and correctional services); judicial services; and other state funded agencies. These pose a risk to the cost of recurrent expenditures.

The devolution of Human Resources Management powers from Department of Personnel Management to agencies also presents additional risks to personal emolument expenditures. For example, there has been overspending on personal emoluments in recent years by some national and provincial departments, which presents further risks to the expenditure estimates.

PNG LNG project landowner issues and other additional funding requests outside of budgetary allocations from Departments and provinces also pose a risk to Government expenditures.
The Government has very large contingent liabilities related to the PNG LNG project. These include:

- The Independent Public Business Corporation’s borrowing for the State’s equity share of the PNG LNG project (estimated at around 13 per cent of GDP); and

- Contingent liabilities arising from State entity guarantees of the PNG LNG project debt during construction (estimated at up to 19 per cent of GDP).

A significant disruption, delay or, in a worst case, rethink of the PNG LNG project, however remote, could have enormous adverse fiscal implications for the Government.

In 2010, the Government operationalised a requirement for all submissions to NEC to contain advice from the Treasury in relation to the financial implications of the proposal. This has allowed Cabinet to have better information on the fiscal impact of decisions made outside the budget process. However, additional funding requests outside of budgetary allocations from Departments and Provinces continue to pose a fiscal risk as indicated by the quantum of expenditure pressures.

**G. Medium Term Economic and Fiscal Outlook**

*2013 to 2015 Economic Outlook*

Economic activity from 2013 to 2015 is largely underpinned by the construction of the PNG LNG project. Growth is projected to decelerate from 2013 to 2014 as PNG LNG construction activity winds down, before ramping up significantly in 2015 when the project commences full production.

Economic growth in 2013 is supported by robust growth in the mining and quarrying sector, reflecting the ramping up of production at Ramu Nickel following legal issues in 2010. This is expected to be followed by negative growth in the mining and quarrying sector in 2014 and 2015, due to the expected cessation of production at Ok Tedi. Lower production from maturing oil wells continues to be a drag on expected economic activity over this period.

From 2013 inflation is projected to ease to around 6.3 per cent and 5.0 per cent for 2014 and 2015 respectively, assuming credible monetary policy and restrained fiscal policy.

However, in the near to medium-term there is a potential for more inflationary pressures to be exerted on the economy, for example from increased Government spending or investments in new mining and LNG ventures.
Table 1: Economic Parameters

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<td>GDP (%)</td>
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<td>7.6</td>
<td>9.3</td>
<td>5.6</td>
<td>3.9</td>
<td>6.4</td>
<td>21.3</td>
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<tr>
<td>Non-Mining GDP (%)</td>
<td>7.0</td>
<td>8.5</td>
<td>10.2</td>
<td>5.5</td>
<td>3.5</td>
<td>3.4</td>
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Inflation

| Year Average (%) | 7.0 | 6.0 | 9.0 | 7.2 | 6.3 | 5.0 | 5.0 |
| Dec on Dec (%)    | 5.7 | 7.2 | 7.9 | 7.0 | 5.6 | 4.5 | 4.5 |

Interest Rate

| T/Bills (Year Average) | 7.3 | 5.5 | 6.0 | 7.0 | 7.0 | 7.0 | 7.0 |
| Inscribed Stock (3 year yield) | 9.2 | 8.1 | 9.0 | 9.0 | 9.0 | 9.0 | 9.0 |

Mineral Prices

| Gold (US$/oz) | 973 | 1225 | 1440 | 1350 | 1150 | 980 | 800 |
| Copper (US$/ton) | 5100 | 7538 | 8870 | 7800 | 6950 | 6150 | 5300 |
| Oil (Kutubu: US$/barrel) | 62 | 79 | 92 | 89 | 80 | 70 | 60 |

Source: Department of Treasury

2013 to 2014 Fiscal Outlook

Fiscal pressures are expected to mount prior to revenue contributions from the production phase of the PNG LNG project. This is due to an expected decline in mineral revenue and the pipeline of planned development expenditure under the MTDP including the National Health Plan and Universal Basic Education.

Mineral revenue is expected to decline prior to revenues arising from the PNG LNG project in 2015, as presented in Chart 2. This reflects the depletion of oil and copper reserves and an assumed moderation of commodity prices back to long-term levels.

While the first gas production from the PNG LNG project is expected in late 2014, tax revenue from the project is not expected until 2015. Once this occurs, mineral revenue collections are expected to rise, as revenue from the PNG LNG project replaces diminishing revenue from other mineral projects. However, larger tax revenue collections from the PNG LNG project are not expected until closer to 2025, after the project has written off (depreciated) the initial construction cost.

Total revenue is expected to grow modestly over the medium term, driven by solid continued growth in non-mineral revenue (partly offset by lower mineral revenue), as shown in Chart 3.
The additional revenue over the medium term will enable the Government to fund some of the planned pipeline of expenditure. The expenditure pipeline includes MTDP expenditure programs including the key MTDP enablers (such as health, education, infrastructure, land and law and justice) and outstanding fixed Government commitments including PNG LNG related commitments (UBSA/LBSA/IDG). The budget is expected to be in balance over the medium-term as presented in Chart 4 (the balanced budget in 2011
also includes a balanced budget for the 2011 Supplementary Budget, consistent with the 2011 Budget Strategy).

However, any significant funding pressures over the medium term will require expenditure reprioritization, or new sources of revenue.

**Chart 4: Budget Balance over the Medium Term**

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual</th>
<th>Projection</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>2.5</td>
<td>2.0</td>
</tr>
<tr>
<td>2003</td>
<td>4.5</td>
<td>5.0</td>
</tr>
<tr>
<td>2006</td>
<td>6.5</td>
<td>7.0</td>
</tr>
<tr>
<td>2009</td>
<td>8.5</td>
<td>9.0</td>
</tr>
<tr>
<td>2012</td>
<td>10.5</td>
<td>11.0</td>
</tr>
<tr>
<td>2015</td>
<td>12.0</td>
<td>12.0</td>
</tr>
</tbody>
</table>

Source: Department of Treasury

**H COMPLEMENTARY POLICIES**

The Government's complementary policies and reforms have supported the PNG economy to achieve sustained economic growth. The Government will continue to monitor and evaluate economic reforms to ensure they achieve their intended objectives and to explore new opportunities for reform in 2012.

**H.1 A competitive and dynamic private sector**

The Government remains committed to growing and building an economy that is robust and resilient to external shocks. An essential part of this involves creating an environment that is conducive to the development and growth of a dynamic and competitive private sector. As part of the ongoing effort and commitment, the Government will monitor, review and realign existing policies, including the introduction of new policies to promote private sector growth.

The provision of an effective public infrastructure is essential for boosting economic activity and contributing to the global fight towards alleviating poverty amongst its citizens. This is through policy initiatives and reforms such as secured lending, microfinance, electricity policy and the Public Private Partnership (PPP). The Public Private Partnership (PPP) policy is expected to enhance infrastructure and service delivery by utilizing private
sector capital, management, innovation, technology and other resources. In 2011, it is expected that a PPP bill will be submitted to Parliament after which it will be possible to establish a fully operational PPP centre.

The microfinance and lending reforms aim to make finance more accessible to citizens to engage in economic activities so that they can achieve an improved living standard.

Telecommunications competition has been one of PNG’s most successful reforms. It has been a major driver of economic growth and employment growth, it has brought modern communications to the vast majority of people in PNG, and it has lowered the cost of doing business. All of this has been achieved largely without the need for government expenditure. The government will seek opportunities to repeat this success story in other sectors, such as electricity or shipping. In particular, proposed reforms and policy initiatives in the electricity industry will enable more competition to take place in the power generation segment, which will lead to electricity being made more accessible, reliable and affordable to the public.

Furthermore, the Government remains committed to the National Land Development Program (NLDP), which aims to free up land for development. In 2011, the NLDP has supported major improvements to the Land Information System that will lead to improvements in land administration in the Department of Lands. Previously, NLDP led work to reform the legislation that governs the registration of Incorporated Land Groups (ILGs) and customary land. These legal reforms are designed to unlock the economic potential of customary land whilst ensuring that the customary rights of landowners are protected. Implementation of these reforms is expected to commence in 2012.

Progress with implementing the NLDP will also assist with the implementation of the Housing review recommendations by the Independent Consumer and Competition Commission (ICCC). These recommendations should assist in addressing issues with the rising cost of housing and also ensure there is adequate housing provided for all under a properly regulated housing industry.

H.2 Public sector reform

*Strengthened Budget Processes*

The Government is committed to improving management of public funds. A key component of this is ensuring a strong budget process. In previous years, decisions on the Development Budget were not well integrated into the overall budget process. Specifically, Development Budget proposals were not subject to appropriate examination by the Budget Screening Committee which includes all central agencies, and the subsequent Ministerial processes. From 2012, to improve budget integration, proposals for spending under the Development Budget will require the same level of examination through the Budget Screening Committee as the Recurrent Budget.
Public Expenditure Review and Rationalization (PERR)

The Public Expenditure Review and Rationalization (PERR) program of 2003 is an ongoing Government initiative which has helped improve and sustain fiscal performance by streamlining public sector resource allocations under the public sector reform program. Whilst good progress has been made in achieving the PERR objectives, the Government is now undertaking measures to improve implementation in those areas where progress has been lagging.

The Department of Prime Minister and NEC is currently reviewing all reform programs and Treasury has contributed its input on PERR with options of efficient approaches.

District Treasury Roll-out Program

Since the inception of the District Treasury Roll-out Program in 2004, to date 58 out of 86 District Treasuries have been fully commissioned and made functional. Apart from three District Treasuries in National Capital District, the remaining 28 are planned to be opened in 2012 fiscal year.

Major services which will be established include the establishment of post offices, power supplies, and the installation of VSaTs for email and telephone services in all the District Treasury Offices to improve communication, coordination and management.

Implementation of Public Service Pay Fixation Agreement 2011 to 2013

The 2011-2013 Pay Fixation Agreement was agreed and signed in early 2011 for the Public Employees Association (PEA), Senior Contract Officers Allowances, Papua New Guinea Teachers Association (PNGTA), doctors and nurses.

While the increase in the individual base salary by 7.5 per cent per annum commencing 2011 to 2013 has been agreed, the proposed “buy out” of the housing allowance for K500 remains outstanding, with the PEA instead proposing a K250 per fortnight housing allowance. The parties have agreed to deal with this clause separately from the 2011-2013 PEA Pay Fixation Agreement. However, Department of Personnel Management (DPM) has gone ahead and factored in a K500 one off increase in base salaries for 2011. The PEA has proposed to take the housing matter to PNG Public Services Conciliation and Arbitration Tribunal for consideration. The implementation of the Pay Fixation Agreements in 2011 will cost the Government approximately K192 million.

Further, pay agreements are outstanding for those agencies whose pay arrangements are provided through separate agreement or other legal instruments. These agencies include uniform personnel officers (defence, police, fire and correctional services); judicial services; and other state funded agencies.
Automation of State Share Superannuation Contribution

In accordance with sections 4 and 76 of the Superannuation (General Provisions) Act 2000, the State is obliged to make a mandatory superannuation contribution of an agreed 8.4 per cent of the gross salary per employee, to the Nambawan Super Limited.

However, due to no budgetary allocations in some fiscal years, the State had incurred superannuation arrears. The total unfunded State Share Superannuation liability was K2,060.0 million as at end 31 December 2010, which excludes payments that will be made in 2011.

Currently, the State raises cheques to pay for its superannuation contributions through a payment process that is cumbersome and administratively obsolete.

The Departments of Finance and Treasury will roll-out the ‘Automation of the State Share Superannuation Contribution Program’ this year. This program will enable the State to make its annual mandatory superannuation contribution through the government payroll system on a fortnightly basis. Superannuation liabilities from previous years will need to be paid off manually.

H.3 Sovereign Wealth Fund

Given the opportunities and economic challenges that the emergence of the LNG sector presents, it is important to have in place a robust fiscal framework to support the management of windfall revenues to underpin social and economic development in PNG.

The Government agreed to the proposed structure and policy framework for a Sovereign Wealth Fund (SWF) to manage these significant revenues as recommended by the Department of Treasury and Bank of Papua New Guinea Working Group and the Department of Public Enterprises in 2010.

The importance of fully integrating the SWF with the budget and fiscal framework is to ensure that all revenues (including dividends) from the PNG LNG project and the timing of all expenditures can be most effectively used to advance PNG’s social and economic development. Integration with the budget and fiscal framework is essential for the Government to retain control over fiscal policy, to achieve macro-economic stability and lower inflation, and to help manage the potential adverse risks from the mineral boom (including so-called Dutch Disease). These processes can also help ensure funds are accounted for and managed in a transparent and coordinated manner. Hence, all revenues and expenditures should be reported through the Budget, with the drawdown from all funds being considered by Government in the annual Budget process.

The SWF Secretaries Committee established by the NEC and with the support of the Interdepartmental SWF Working Group is developing the PNG SWF
framework. The PNG SWF framework with its legislation is expected to be tabled during the 2012 Budget session.

I. Conclusion

The above set of policies has the specific endorsement and approval of the Cabinet and will guide and direct central agencies and departments in the preparation of the 2012 Budget.

[Signature]

Hon. Don Pisinger MP
Treasurer and Minister for Finance