

CHAPTER 1. BUDGET OVERVIEW

1.1 ECONOMIC OUTLOOK

In line with the global economic recovery, world commodity prices have continued to rebound from the large falls observed in late 2008 and early 2009. These stronger prices have been positive for the PNG economy, translating into improved profitability for businesses and higher Government revenue. Commodity prices have recently experienced a strong surge with some prices moving into record uncharted territory and others back to peak levels prior to the global financial crisis. However, commodity prices remain volatile as financial markets seek clear directions from an unusually uncertain global environment.

Domestically, the PNG economy is expected to rebound and grow very strongly at 7.1 per cent in 2010, driven by the commencement of the PNG LNG project, supported by improvements in the global environment. The PNG LNG project is already having a positive impact on the economy, particularly in the transport and construction industry. Indirectly, other sectors are benefiting through the provision of goods and services to the contractors and through an increase in consumer spending. The outlook for 2011 is very positive, with the PNG economy forecast to grow by 8.0 per cent, which represents 10 years of uninterrupted economic growth. The forecast acceleration in growth is largely driven by the expected ramp up in PNG LNG construction activity and stronger mining and agricultural production in 2011.

Over the medium term, economic growth is projected to ease, especially in 2013 when the PNG LNG construction phase winds down. In addition, the declining production from the maturing oil fields and the slowdown of activity at Ok Tedi as it moves to closure in 2014 (pending expansion plans) will have a negative impact on growth. In 2014 and 2015, LNG production is expected to come on line, providing a very large boost to GDP growth.

The economy is increasingly seeing signs of capacity constraints after a long period of economic expansion with national infrastructure such as roads, ports and utilities strained by increased use and poor maintenance in the past. Businesses are also facing increasing difficulties in finding suitable labour and land. This is now translating into bottlenecks, with strong wages growth and a rapid increase in the cost of using and developing land. Inflation is at a relatively high level with inflation forecast to be 6.0 per cent in 2010. Inflation is then estimated to rise to 8.2 per cent in 2011, with substantial risks to the upside. This is largely driven by the ramp up in PNG LNG construction activity and high Government expenditures, which are expected to put additional strains on scarce resources in the economy.

The following factors present a risk to the economic and fiscal outlook presented in the Budget:

- The fragility of the global economy poses a key risk to PNG in terms of its impact on the demand for PNG exports and commodity prices.
- Delays to the PNG LNG and other mining projects due to land owner issues.
- The Government diverting from fiscal discipline and adding to already strong inflationary pressures.
- On the upside, there are currently a number of mining and gas projects (such as the second LNG project) which are currently under active consideration. Should these

projects proceed, this would provide a significant boost to economic growth in the near term, and a more positive revenue outlook over the longer term.

1.2 2011 BUDGET STRATEGY AND FISCAL OUTLOOK

Fiscal Strategy

The 2011 Budget is framed against a background of global economic recovery and strong domestic economic growth.

With the PNG economy in a transition phase during the construction phase of the PNG LNG project, the Government has decided on a balanced budget for 2011 to provide a stable macroeconomic and fiscal environment. This is consistent with the current high economic growth and also adheres to the existing overarching frameworks – the Medium Term Fiscal Strategy (MTFS), the Medium Term Debt Strategy (Debt Strategy), the Development Strategic Plan 2010 - 2030 (DSP), the Medium Term Development Plan (MTDP) and the *Fiscal Responsibility Act 2006*.

Both the recurrent and development budgets are focused on MTDP enablers to support the Government's aim of **Building the Foundation for Economic Growth and Prosperity** commencing 2011.

Revenue

Total revenue and grants in 2011 is estimated at K9,328.1 million. This is K1,083.6 million or 13.1 per cent higher than the 2010 revised estimate. This is primarily attributable to higher tax revenue of K850.0 million or 13.1 per cent from the revised 2010 estimate. Higher tax revenue is largely due to higher personal income and company taxes, which are increasing due to strong domestic economic growth and the ramp up in PNG LNG activity.

Expenditure

Total Expenditure and Net Lending in 2011 is estimated at K9,328.1 million. This is K1,048.7 million or 12.7 per cent higher than the 2010 revised estimate. These increases are allocated to funding MTDP enablers in the recurrent and development budgets, and unavoidable obligations such as outstanding court orders, superannuation and industrial award wage increases.

2010 Supplementary Budget

The Government also announced an additional expenditure of K653.3 million in the 2010 supplementary budget. The key expenditure items are funding for the UBSA commitments to support the LNG project and increases in road infrastructure.

1.3 STATUS OF TRUST ACCOUNTS

Trust accounts contain funds appropriated through Additional Priority Expenditure (APE), Supplementary Budget Expenditure (SBE) and Annual Budgets, predominantly from additional mineral revenue from the commodity boom of 2005 to 2008.

As at 30 September 2010, a total of K951.1 million was held in trust accounts, with outstanding appropriations for trust from the 2010 Budget of K415.0 million, K40.0 million from the 2010 Budget reappropriation and a further K552.3 million paid into trust from the

2010 Supplementary Budget. A total of K723.2 million is appropriated for trust accounts in the 2011 Budget. Total payments from trust accounts from 1 January to 30 September 2010 were K736.6 million.

1.4 PUBLIC DEBT

Total public debt increased slightly to K6,944.1 million at the end of 2009 as a result of a small budget deficit. However, debt as a per cent of GDP fell from 32.1 per cent to 31.3 per cent reflecting moderate growth in GDP.

By the end of 2010, total public debt is expected to decrease slightly due to exchange rate movements to K6,914.3 million or 26.8 per cent of GDP.

Over the 5 years to 2010, the debt to GDP ratio fell significantly and is approaching a sustainable level.

1.5 TAXATION MEASURES

The 2011 Budget introduces a number of taxation policy measures. The Government will undertake a further but modest tariff reduction program (TRP), with the aim of promoting an internationally competitive and efficient private sector, and update housing tax concessions which have been substantially eroded over time by house price inflation.

The Government will also seek to improve environmental and social outcomes by allowing tax deductions for environmental protection and clean-up costs, and reduce the alcohol content of beverages which receive concessional excise treatment.

Other taxation measures will enhance Retirement Savings Accounts and seek to improve compliance in the remittance of salary and wages taxes.

There are also a number of minor policy and technical amendments to clarify the law and administrative procedures, strengthen enforcement activities, increase administrative efficiency and correct technical errors.

There are no new taxes introduced in this budget.

1.6 ECONOMIC REFORMS

Papua New Guinea continues to benefit from past reforms. These reforms have contributed to sustained economic growth that shielded the economy from the worse effects of the recent global financial crisis and has provided a conducive environment for investment as seen with the PNG LNG project.

The Government will ensure that development policies and strategies, including existing and any new reforms in 2011, will be closely aligned with key objectives of the Vision 2050 and the Papua New Guinea Development Strategic Plan (DSP) 2010 - 2030 and Medium Term Development Plan (MTDP). This will require a clear and consistent commitment by the Government to address the underlying issues that affect service delivery and impede private sector investment and growth.

In 2011, the Government will demonstrate its commitment to public sector reform by exploring opportunities to improve service delivery and continuing with the existing public sector reform initiatives to improve the efficiency, effectiveness and affordability of the public

sector. The Government will also continue with its longstanding Public Expenditure Review and Rationalization (PERR) program.

The Government supports the development of a competitive and dynamic private sector that underpins economic growth. In recent years, the Government has undertaken various initiatives in this regard to promote and provide a conducive environment for businesses to invest and generate growth. In 2011, the Government will monitor existing reforms to ensure they achieve their objectives and explore areas for further reform. In order to provide a stable investment climate that promotes a competitive and dynamic private sector, the Government will continue to remove impediments to doing business and investment in PNG.

1.7 DEVELOPMENT STRATEGY

The 2011 Development Budget is the first annual budget of the Development Strategic Plan (DSP) 2010-2030 and the Medium Term Development Plan (MTDP) 2011-2015. The DSP is the Government's strategy for realizing long term goals and visions as enshrined in the Constitution of Papua New Guinea.

The MTDP is the first of four five-year plans to implement the DSP and it is the country's first action plan, explaining what will be done over the next five years in order to pursue the DSP goals. Following alignment of plans, sector funding will be based on implementing agencies and provincial Governments, annualising their programs and activities to achieve the desired deliverables detailed in the MTDP. Implementing agencies, sub-national Governments, and development partners will be held accountable to achieve the desired targets. As such, MTDP promotes results-based monitoring and a performance based culture throughout the public service.

The 2011 Development Budget targets high impact and productive investments aimed at providing access and opportunities to the rural majority and improving progress towards achieving the MDGs. Expenditure under the 2011 Development Budget will be directed towards all sectors of the economy however particular focus will be given to the MTDP *enablers*. Investment in the enablers will address current supply-side and absorptive capacity constraints and facilitate growth and development.

Fixed commitments, totalling K794.4 million must also be met through the Development Budget. The Development Budget strategy prioritises the remainder of Government direct financing across all sectors of the economy, with particular focus on the seven enablers. Crucially, the approach to achieve a sound foundation and progression towards becoming a middle income country by 2030 is structured around ensuring the Budget is *policy* driven and in line with MTDP priorities.

Effective implementation of the MTDP requires a significant proportion of the Budget to be allocated to MTDP priorities, and crucially to the enablers' policies. In 2011, 80.0 per cent of Government expenditure (i.e. direct financing, tax credit and loans) under the Development Budget will be expended on interventions implementing the first year of the Medium Term Development Plan. Of this percentage, 70.0 per cent will be allocated to the enablers' MTDP priorities: land, law, justice and order, transport, higher and technical education, primary and secondary education, utilities and health. Non-MTDP expenditure in 2011 includes payment of the constitutional grants, development grants, and aid administration.

Over the next five years, to fully implement the MTDP 2011-2015, the Government will strive to increase the proportion of the Budget allocated to MTDP policy objectives. To achieve this

requires Government to reduce the funding of expenditure items which are not detailed in the MTDP and closely align the Recurrent and Development Budget. Crucially, from 2011 onwards, the Government will ensure that the allocation of resources through the Development Budget is driven by policy and respective sector strategies and no longer purely expenditure driven or on an ad-hoc basis.

1.8 ECONOMIC AND FISCAL ANALYSIS OF THE PNG LNG PROJECT

The PNG LNG project will be the largest and most expensive investment in PNG to date; however, the extent of the impact on Gross Domestic Product (GDP) depends on how much of the economic activity actually occurs in PNG. Much of the project construction material will take place offshore, which does not add to the size of the domestic economy.

The major economic impact from the PNG LNG project will be felt in the first year of full production, which is expected to be 2015, providing a very large boost to GDP. Once production begins, the direct impact on GDP will be very large, as all of the value added from the project is recorded as taking place in PNG. Over the length of the project, annual gross value added is estimated to average around K2 billion in real terms. Over the peak production phase, this represents an additional 20 to 25 per cent of GDP per year, although the relative impact is expected to decline over time as the economy increases in size and as production declines towards the end of the project's life.

The project's total impact on the economy is the sum of the direct and indirect impacts. The total impact on real GDP is estimated to average around K3 billion to K3.5 billion in real terms (an increase of around 25.0 to 30.0 per cent) over the peak production phase of the project, and average around K2.0 billion to K2.5 billion per annum in real terms over the life of the project.

The major benefit of the PNG LNG project to the National Government, provincial governments and landowners is from distributions of company tax (reported as mining and petroleum tax revenue or MPT), mining royalties (including the development levy) and dividends on equity. Government revenue is expected to increase rapidly during the first 10 years of production, as the benefits of accelerated depreciation (a form of tax concession) are gradually exhausted. Revenue is then expected to be relatively stable until production starts to decline later in the life of the project.

1.9 THE ESTABLISHMENT OF A SOVEREIGN WEALTH FUND

The development of the PNG LNG project and the prospect of others will not only transform our economy and improve living standards. However, it is likely that the emergence of LNG as a major revenue source, will give rise to macroeconomic pressures which are more likely to be prevalent when a country relies heavily on commodity based revenues.

The Government has recently considered and agreed to a joint Cabinet Submission reflecting both the joint Treasury-Bank of Papua New Guinea Working Group's work and the separate work undertaken by the Department of Public Enterprises on alternative arrangements to help manage the significant revenues arising from this project to be used for PNG's development needs whilst promoting macroeconomic stability.

As a consequence, the Government has decided to establish a Sovereign Wealth Fund (SWF) consisting of a consolidated pool of offshore funds with three coordinated and integrated funds with all expenditures being through the budget process:

- A Stabilization Fund (Stabilization SWF);
- A Future (Savings) Fund; and
- An Infrastructure Fund (Infrastructure SWF).

To oversee the establishment of the offshore Sovereign Wealth Fund for PNG, the Government has established a Secretaries Committee on Sovereign Wealth Funds which will take all necessary steps to establish this important undertaking .