

# **2005 NATIONAL BUDGET**

## **VOLUME 1 ECONOMIC AND DEVELOPMENT POLICIES**

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**ON THE OCCASION OF THE PRESENTATION OF THE 2005 NATIONAL BUDGET**

# FOREWORD

The 2005 Budget is the cornerstone of Government's economic and financial management plan for next year and into the medium term. The 2003 and 2004 Budgets established the broad strategic direction of Government policy and introduced policies to promote those objectives. The 2005 Budget builds on this platform, progressing Government's fiscal strategy and providing detailed plans for managing public finances in 2005 and beyond.

The 2005 Budget is framed against a backdrop of improving economic and financial conditions, and substantial progress of the Government's ambitious reform agenda.

The benefits of strong economic management and reform are now becoming apparent. Economic growth has picked up and employment is increasing. Inflation has fallen sharply and interest rates have declined, providing substantial scope for the Government to provide expanded and improved services to the people of Papua New Guinea. The exchange rate is more stable and external conditions have improved. The fiscal situation has improved markedly. It is likely that 2004 will be the first time for many years that Government has been able to reduce its debt.

However, these are only the first tentative steps on a long and difficult journey. The recovery must be sustained and policies put in place to promote stronger growth and to ensure that the benefits of stronger growth are shared by all. Continued strong macroeconomic and financial management is necessary for this to occur.

The 2005 Budget is a pro-growth financial management plan, combining prudent expenditure management, with policies to promote economic growth.

It outlines the Government's plan to achieve economic growth through sustained reform, designed to achieve:

- A stable investment climate;
- An efficient, effective and affordable public sector; and
- A competitive and dynamic private sector.

The broad policy framework for the 2005 Budget continues to be the *Medium Term Development Strategy 2005-2010*, which provides strategic direction for Government's development policy, and the *Medium Term Fiscal Strategy*, which ensures that government spending is affordable and sustainable. Together, these plans provide the strategic policy direction for the 2005 Budget.

The main elements of the fiscal strategy for 2005 are:

- A continuation of the commitment to reduce the deficit over the period to 2007, with a balanced budget thereafter;
- A phased reallocation of spending to high priority programs, particularly rehabilitation and maintenance of transport infrastructure, basic education, primary and preventive health care (including HIV/AIDS prevention), development oriented adult education, law and justice, and programs that directly promote export-driven growth and income earning opportunities;
- Significant reductions in known outstanding liabilities;
- No new taxes and no increases to existing taxes; and
- Sustained institutional and policy reform.

These policies, if managed well, will support sustainable economic growth and will improve the wellbeing of the Papua New Guinea people.

I commend the 2005 National Budget to the Honourable Members and the people of Papua New Guinea.

**Hon. Bart Philemon, MP**  
**Minister for Finance and Treasury**

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# BUDGET OVERVIEW

The 2005 Budget establishes a framework for stronger economic growth in Papua New Guinea. It builds on the reforms of the past two years, combining fiscal prudence with an increased allocation of public resources to priority areas.

The 2005 Budget is framed against improving economic and fiscal conditions. Economic growth has picked up, employment is rising, inflation has fallen sharply, interest rates have fallen, the exchange rate has been steady and the external position is healthy.

Fiscal conditions have also improved with strict expenditure control ensuring that expenditures remain within the budget ceiling and strong, albeit temporary, increases in commodity prices boosting revenues. A stable exchange rate and prudent fiscal management have seen interest rates fall sharply, reducing interest payments on government debt, and allowing increased spending on priority areas. The fiscal balance for 2004 is likely to be a small surplus and the ratio of debt to GDP is expected to fall in line with Government's deficit and debt reduction strategy.

The 2005 Budget builds on this solid foundation, locking in the gains from existing reforms, and pushing ahead with the Government's pro-growth reform agenda.

The 2005 Budget is framed against a number of guiding principles (Box 1). It is consistent with the *Medium Term Fiscal Framework*, which maps out a fiscal adjustment path to ensure that public spending is affordable and sustainable and with the *Medium Term Development Strategy 2005-2010*, which sets out the Government's medium-term development priorities. It supports Government's broader reform program as promoted under the *Strategies for Supporting Public Sector Reform 2003-2007* and the *Public Expenditure Review and Rationalisation* process.

The *Medium Term Fiscal Framework* was established following broad agreement that public debt levels in Papua New Guinea were excessive and unsustainable. Under previous policies, unrestrained borrowing had seen public debt climb to over K8 billion by the end of 2002 with interest payments on the debt costing over K700 million in 2003. The high interest burden reduced funds available for spending in priority areas. To address this problem the *Medium Term Fiscal Framework* sets out a measured and phased reduction in the fiscal deficit over a number of years, moving towards a balanced fiscal position in 2008.

Consistent with that framework, the 2005 Budget targets a deficit of 1 per cent of GDP. This reinforces the steady and responsible adjustment path that the Government has been following for some time. This will be the third year in succession that the Government has promised, and will deliver, a Budget deficit in line with, or better than, that planned in the *Medium Term Fiscal Strategy*.

The 2005 Budget draws heavily on the *Medium Term Development Strategy (MTDS) 2005-2010*, which sets out Government's medium-term development priorities. The *MTDS* has been developed as a core development strategy guiding the Government's resource allocation, as implemented through the budget. The core strategy is based on the Government's *Agenda for Recovery and Development* and revolves around the three pillars of good governance, export-driven growth and rural development and poverty reduction through human resource development.

The strategy emphasises the importance of increased spending on priority areas: rehabilitation and maintenance of transport infrastructure, basic education, primary and preventive health care and HIV/AIDS prevention, development oriented adult education, law and justice, and programs that directly promote export-driven growth and income-earning opportunities. These priorities are reflected in the 2005 Budget.



**Box 1: Budget Guiding Principles**

Budget preparation is underpinned by several medium-term guiding principles:

**Framework:**

- Government will live within its means by producing a budget that is affordable and sustainable.
- Government will not add to debt in the medium-term.
- Budgetary expenditures will be consistent with agreed national and sectoral priorities.
- Government will limit its participation to core areas where there is a clear rationale for public intervention.
- Government will provide a regulatory framework that encourages and supports the private sector.

**Implementation:**

- Government will exercise tight fiscal controls by closely monitoring all expenditures and by enhancing revenue collection.
- Budget plans will be adhered to and departments will be held responsible and accountable for managing their allocated expenditures.
- Government will ensure that any mid-year proposals outside the budgetary process will be matched by compensating savings within the department or agency.
- The Government will work towards increasing the transparency of public finances by the release of timely budgetary information.

The 2005 Budget also builds on other strategic plans that promote better public sector management. The *Strategies for Supporting Public Sector Reform 2003-2007* promotes strategies that, among other things, reduce the costs of government, control spending, improve fiscal management and eliminate waste. The *Public Expenditure Review and Rationalisation* (PERR) maps out a path to restoring fiscal stability, reducing civil service size and payroll, restoring the integrity of budget systems, expenditure adjustment and prioritisation and service delivery in health and education.

Together, these broad strategies provide the strategic overview for the Budget.

Specifically, the 2005 Budget:

- Delivers a maximum budget deficit outturn in 2005 of K137.7 million or around 1 per cent of GDP, as part of the ongoing fiscal adjustment strategy of moving to a balanced budget over the medium term.
- Initiates a program of expenditure adjustment that sees relatively less non-priority recurrent expenditure in 2005.
- Reallocates spending to high priority programs, particularly rehabilitation and maintenance of transport infrastructure, basic education, primary and preventive health care and HIV/AIDS prevention, development oriented adult education, law and justice, and programs that directly promote export-driven growth and income-earning opportunities.

- Rebalances the proportion of recurrent expenditure spent on salaries and goods and services by continuing the public sector rightsizing program, supported by substantial structural adjustment expenditures.
- Continues to improve budget strategy and processes, and public financial management, particularly with respect to expenditure controls.

Impediments to business will be addressed through increased funding of priority areas and through ongoing public sector reform.

More money is provided for law and justice (including police), education, health (including HIV/AIDS prevention) and transport infrastructure. Provision has also been made for a salary increase for public servants, increased contributions to the superannuation of public sector employees and a reduction in known public sector liabilities.

There are no new taxes or tax increases in the 2005 Budget.

The Government's total net financing requirement in 2005 – the Budget deficit – and the net reduction in external debt will be financed from domestic sources.

During 2005 the Government will continue with the inscribed stock program to lengthen the maturity structure of government debt and to reduce rollover and interest rate risk. Together with the reduction in external debt, which reduces foreign exchange risk, this should considerably strengthen government's financial position and enhance macroeconomic stability.

# CHAPTER 1. ECONOMIC DEVELOPMENTS IN 2003 AND 2004

## 1.1 OVERVIEW

Papua New Guinea's economy grew by a higher than expected 2.8 per cent in 2003, following three years of decline. It was driven by strong growth in the mining and petroleum sectors, but also reflected growth of 1.7 per cent in the non-mining economy. This improvement in economic activity continued in 2004. The non-mining economy is estimated to have grown by 2.8 per cent in 2004. With a fall in petroleum production, overall economic growth is estimated to have declined slightly to a still solid 2.6 per cent.

Importantly, the Government has laid out a platform for sustaining and building on this solid economic performance. Continued fiscal discipline, sustained reform and political stability should see economic growth progressively increase over the medium to long term.

**Table 1: Principal Economic Indicators**

	2000 Actual	2001 Actual	2002 Actual	2003 Estimate	2004 Projection
Real GDP (%)	-2.5	-0.1	-1.0	2.8	2.6
Real Non-Mining GDP (%)	-2.1	1.9	1.5	1.7	2.8
Inflation (TTY)	10.0	10.3	14.8	8.5*	3.7
Treasury Bill rate (%)	18.0	12.6	13.3	18.3*	9.0
World Economic Growth (%)	4.7	2.4	3.0	3.9*	5.0
Oil Price (US\$)	29.5	26.2	24.0	27.4*	37.3

\* Actual

Sources: National Statistical Office, IMF and Treasury Department

Formal private sector employment continues to recover strongly. Non-mining sector employment increased by 3.8 per cent through the year to the March quarter of 2004. Mining sector employment grew by 11.7 per cent over the same period. That said, the share of the population formally employed remains low by international standards, reflecting a range of structural impediments to economic activity, including law and order problems, land tenure issues and inadequate physical infrastructure.

Inflation, as measured by the Consumer Price Index (CPI), has fallen sharply in 2004. Inflation in the year to the September quarter of 2004 was 1.5 per cent, compared with rates close to 20 per cent in early 2003. The lower than expected inflation rate for 2004 reflects the prudent management of fiscal and monetary policies by the Government.

With lower inflation outcomes, interest rates have fallen sharply in 2004, to be well below their peaks of early 2003. Treasury Bills fell to below 6 per cent in October 2004. As a result, public sector domestic interest outlays have been substantially below the levels forecast in the 2004 Budget, with these savings redirected to increased spending in priority areas.

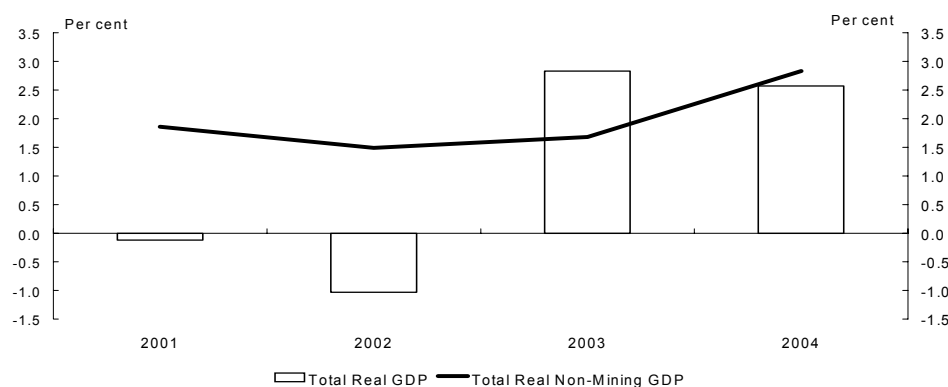
The stability of the exchange rate in 2003 has continued into 2004. In the first ten months of 2004, the Kina has appreciated against most major trading partner currencies, including the US and Australian dollars, the British pound sterling and the Japanese yen. The stability of the currency reflects the Government's sound economic management and increased international prices of our key commodity exports.

Gross international reserves are currently over US\$550 million, which provides 7 months of non-mineral import cover. This is one of the strongest external positions the country has been in since Independence. This level of reserves should provide a good buffer against external shocks and will help to reduce volatility in the exchange rate.

## 1.2 GROSS DOMESTIC PRODUCT

Total real GDP grew by 2.8 per cent in 2003 after contracting by 2.5, 0.1 and 1.0 per cent in 2000, 2001 and 2002 respectively. This positive outcome reflected increased production from the mining and petroleum sectors with mining growing 15 per cent and petroleum up 1.4 per cent. The agricultural sector responded to higher prices, growing by 3.5 per cent in 2003. Most other sectors of the economy also recorded solid growth in 2003, with the non-mining economy growing by 1.7 per cent.

**Figure 1: Economic Growth: 2001-2004**

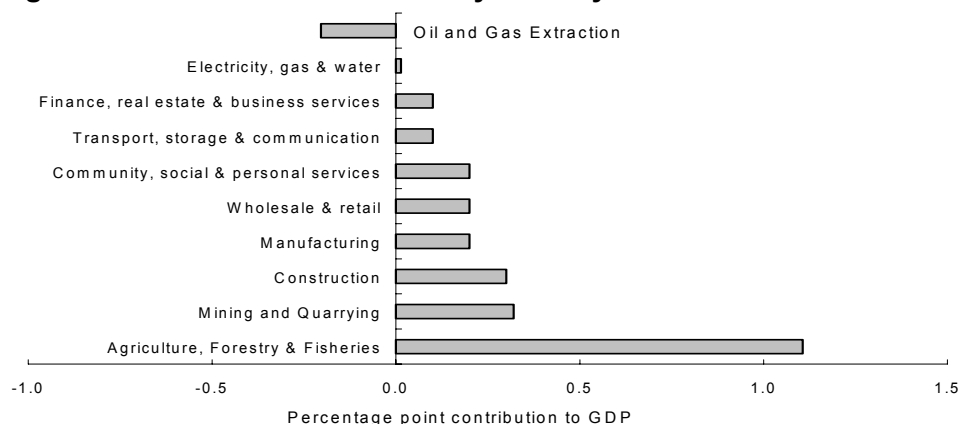


Sources: NSO and Department of Treasury

This improvement in economic activity continued in 2004. The non-mining economy is estimated to have grown by 2.8 per cent in 2004, reflecting continued solid growth of 3 per cent in the agricultural sector. Increased business investment flowed through to increased growth in the construction, transport and manufacturing sectors, with growth of 3.2, 3.0 and 2.8 per cent respectively.

However, with a 5.8 per cent decline in production of the petroleum sector, the rate of overall economic growth is estimated to have declined slightly to a still solid 2.6 per cent in 2004.

**Figure 2: Contributions to Growth by Industry in 2004**



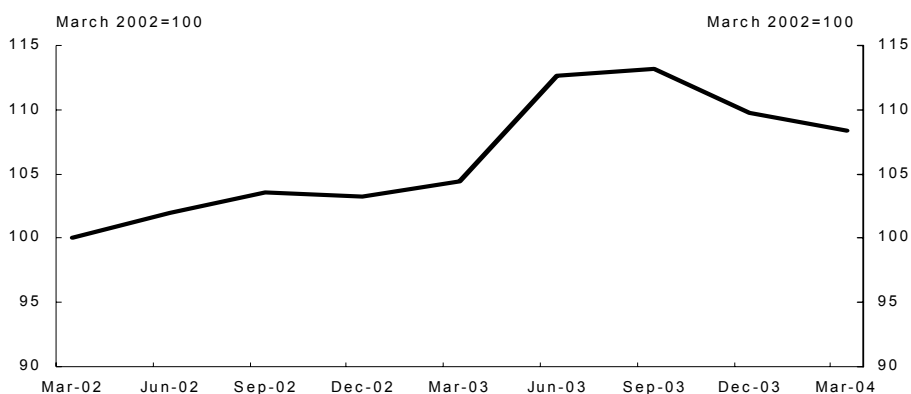
Source: Department of Treasury

### 1.3 LABOUR MARKET

Total non-mining sector employment increased by 7.5 per cent in 2003, while mining sector employment declined by 1.2 per cent. The increase in formal employment was due to high growth in employment in the construction and manufacturing sectors, which offset lower employment growth in the other sectors.

Preliminary estimates in the March quarter of 2004 indicate that, compared with the March quarter of 2003, total private non-mining formal sector employment rose by 3.8 per cent while mining sector employment increased by 11.7 per cent. The growth in the non-mining formal sector was due to higher employment in all sectors except the finance and business services sectors, and in all regions with the exception of the National Capital District and Morobe.

**Figure 3: Index of non-mining employment**

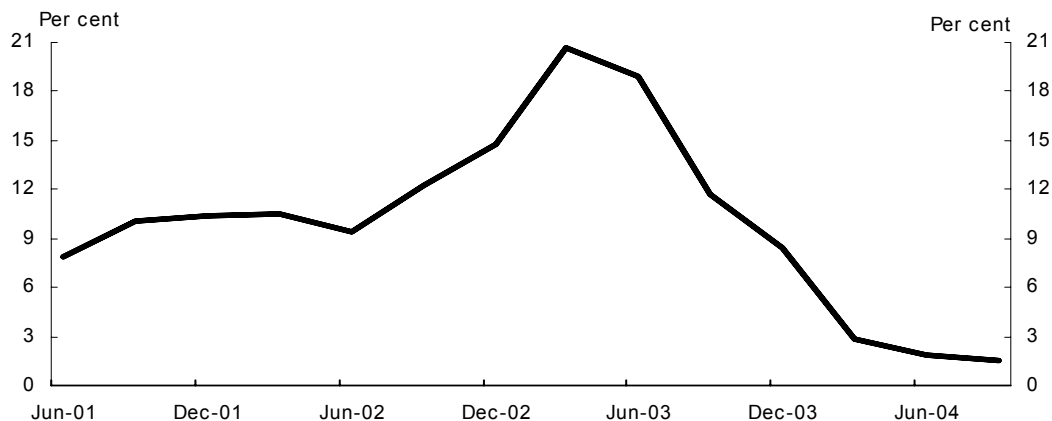


Source: BPNG

### 1.4 PRICES

Inflation declined sharply in 2004, largely as a result of sound macroeconomic and fiscal management and improved commodity prices, which saw the exchange rate stabilize.

**Figure 4: Inflation\* 2001 – 2004**



\*Through the year change in CPI.

Source: NSO

Headline inflation was 1.5 per cent in the year to the September quarter of 2004, compared with 11.9 per cent for the year to September 2003. The year-on-year (average) inflation to September 2004 was 3.6 per cent compared with 16.4 per cent in September 2003.

The underlying inflation rate (which excludes seasonal factors, excise taxes and price control items) in the year to the September quarter of 2004 was 1.5 per cent compared with 14.5 per cent in the year to the September quarter in 2003.

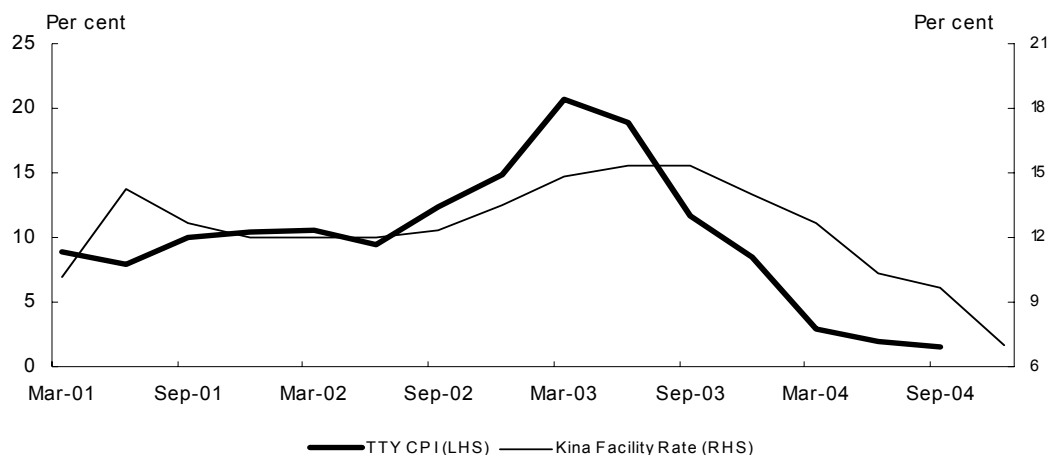
Low inflation is likely to continue to the end of the year and into 2005. But a key risk is that the current spike in oil prices will continue for an extended period, lifting both fuel prices and producer prices generally.

## 1.5 MONETARY DEVELOPMENTS

Monetary policy has been progressively eased over the course of 2004. The Kina Facility Rate (KFR) – the interest rate targeted by the Bank of Papua New Guinea (BPNG) – has been reduced by 7 percentage points so far in 2004, from 14 per cent at the start of the year to 7 per cent in October 2004.

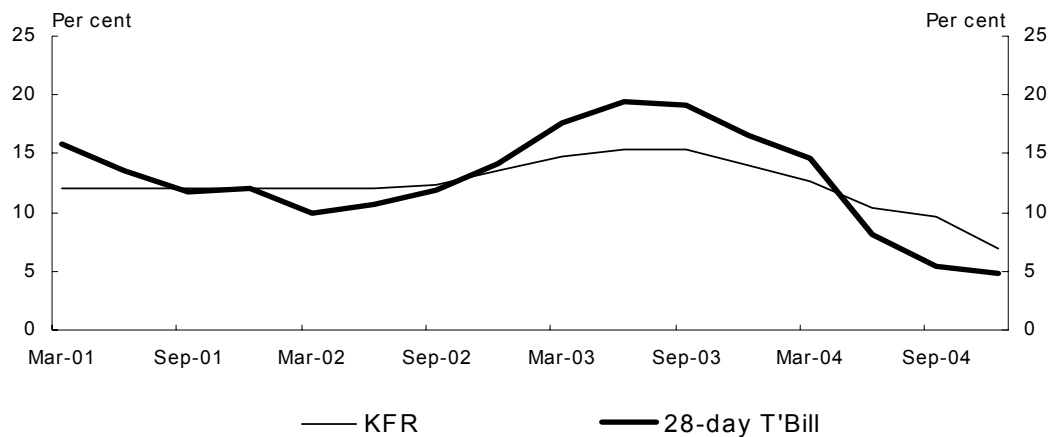
This reduction in interest rates has been made possible by the Government's sound fiscal and monetary management. In particular, by maintaining tight control over its expenditure, the Government has reduced pressure on the money market, helped stabilize the currency and seen a decline in inflation. A more stable political and economic environment is also likely to have been reflected in a lower risk premium. Together, these factors have seen market interest rates fall significantly.

**Figure 5: Kina Facility Rate (KFR) and CPI \***



\*Through the year change in CPI.  
Source: NSO and BPNG

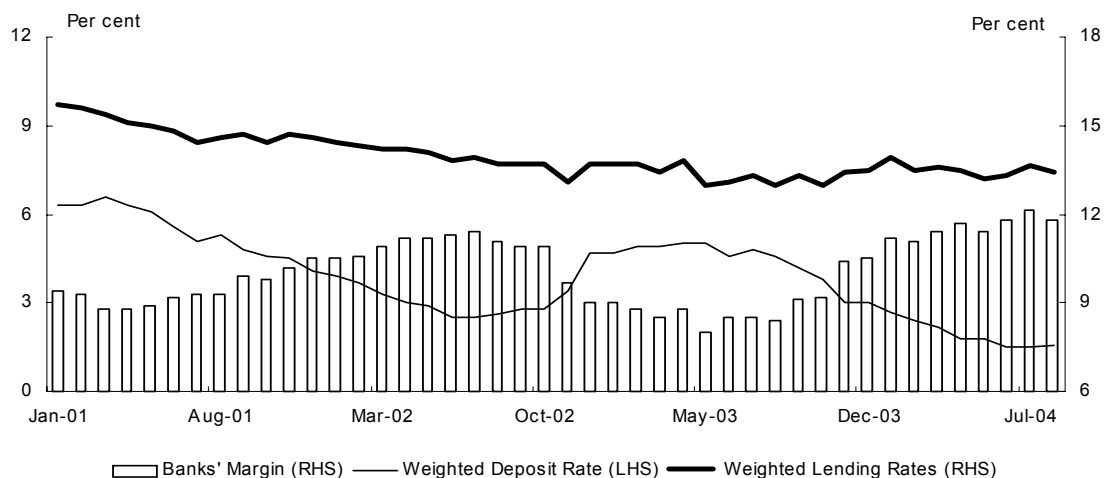
A key objective of the 2005 Budget is to maintain and build on the investor confidence that comes from macroeconomic and political stability. This will help to lock in lower interest rates. Yields on Treasury Bills have declined across all maturities over the course of the year. Treasury Bill yields have fallen more sharply than the KFR over the course of 2004, with excess liquidity in the market. The yield on 28-day Treasury Bills has declined by over 10 percentage points so far in 2004, from nearly 16 per cent at the start of the year to below 5 per cent in October 2004.

**Figure 6: Monthly 28 day T'Bill yield and KFR rates**

Source: BPNG

Total liquidity of the banking system increased by 4.4 per cent in the first six months of 2004, reflecting sustained foreign exchange inflows and central bank intervention in the foreign exchange market. BPNG withdrew much of this excess liquidity through the sale of Treasury Bills.

The money supply (M3\*) grew by 5.4 per cent in the year to June 2004, mainly reflecting an increase in net foreign assets, which more than offset net credit to the Government.

**Figure 7: Monthly deposit and lending rates**

Source: BPNG

Despite the decline in interest rates, lending by commercial banks to the private sector remained depressed over the first half of 2004. There are several possible explanations for this. Most likely, it takes time for business to develop new investment proposals in response to the stimulus of reduced interest rates. Further, many factors other than high interest rates have impeded business investment. Indeed, this Budget continues the Government's focus on reducing impediments to business activity and on the provision of the essential infrastructure for economic development.

That said, 2004 has seen a significant increase in the difference between the rate that banks charge on their loans and that which they provide on deposits. This is indicative of a lack of competition within the banking sector. The Government is pursuing initiatives to increase competition in the financial services industry, including the development of markets for secondary trading in government securities.

## 1.6 BALANCE OF PAYMENTS

The current account recorded a surplus of K198 million in the first six months of 2004, compared with a surplus of K19 million in the corresponding period of 2003. The surplus in the current account was attributed mainly to further improvements in the merchandise trade and net income accounts, which more than offset a higher deficit in services trade and lower net transfer receipts.

**Table 2: Balance of Payments**

	2003 First Half	2004 First Half	Change
Current Account Balance	19	198	+179
Balance of Trade in Goods and Services	547	705	+158
Balance of Income and Transfers	-528	-507	+21
Capital and Financial Account*	+30	-216	-246
Net Errors and Omissions	-50	+18	+68

\*Includes changes in official reserves.

Source: BPNG

The merchandise trade account recorded a surplus of K1975 million in the first six months of 2004, compared with a surplus of K1758 million in the same period in 2003, reflecting higher merchandise exports and lower merchandise imports.

The value of merchandise exports rose by 4.1 per cent to K4074 million in the first six months of 2004 from the corresponding period of 2003. The increase was due to higher values of minerals, coffee, tea, copra, copra oil, palm oil and other non-mineral exports. This more than offset lower export receipts from crude oil, logs, cocoa, rubber and marine products.

The value of merchandise imports fell by 2.6 per cent to K2099 million in the first six months of 2004 compared with the corresponding period in 2003. The decline was due to lower values of general and petroleum sector imports, which more than offset an increase in mining sector imports.

The deficit in services trade was K1270 million in the first six months of 2004, compared with K1211 million in the same period in 2003, reflecting higher services imports and lower services exports. Services imports rose by 3.4 per cent in the first six months of 2004 compared with the same period in 2003. This was due to increased payments on travel, other financial, computer and information, communication, government services and other services more than offsetting lower payments for transportation and insurance (associated with lower merchandise imports), education, other business, refining and smelting and construction services. Over the same period, service exports fell by 36.2 per cent in the corresponding period of 2003.

Overall, the balance of trade on goods and services recorded a surplus of K705 million in the first six months of 2004, up from a K547 million surplus in the corresponding period in 2003.



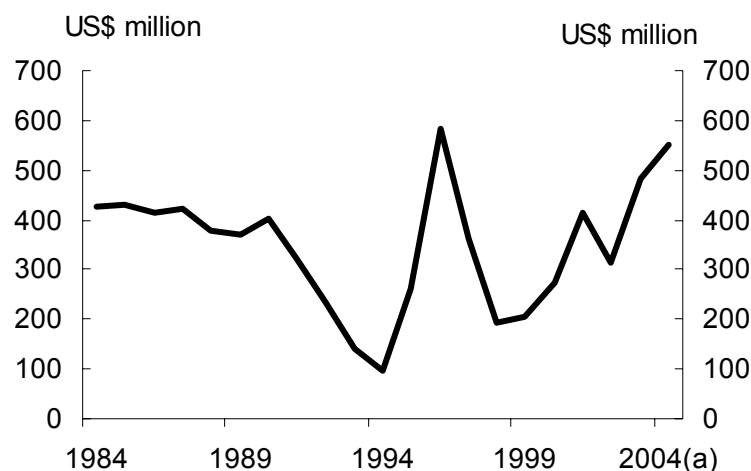
The balance on the income account was a deficit of K901 million in the first half of 2004, compared with a deficit of K1092 million in the corresponding period of 2003. This outcome was due to lower payments for dividend and interest on foreign loans by the Government and mineral companies, which more than offset higher compensation of employees and lower income receipts. This decline is a function of a very high payment in the June quarter of 2003, rather than indicating a trend decline in income payments.

The transfers account recorded a surplus of K394 million in the first half of 2004, compared with a surplus of K564 million in the same period of 2003. The lower surplus reflected increased payments for family maintenance, gifts and grants and licensing fees. This combined with lower transfers more than offset lower superannuation and tax payments.

The capital and financial account recorded a deficit (net outflow) of K216 million including reserves in the first half of 2004, compared with a surplus of K30 million in the same period in 2003. This decline reflected an increase in the net outflow of other investments to K267 million, reflecting the build-up in foreign currency account balances of the mineral companies, higher loan repayments by the Government and an increase in net foreign assets of the commercial banks.

Holdings of gold and foreign exchange reserves held by the BPNG at the end of the June quarter of 2004 were K1750 (US\$550) million. This was sufficient to provide for 5 months of total and 7 months of non-mineral import cover.

**Figure 8: Foreign reserves<sup>(a)</sup>**



<sup>(a)</sup> Includes reserve levels up to June 2004

Source: BPNG

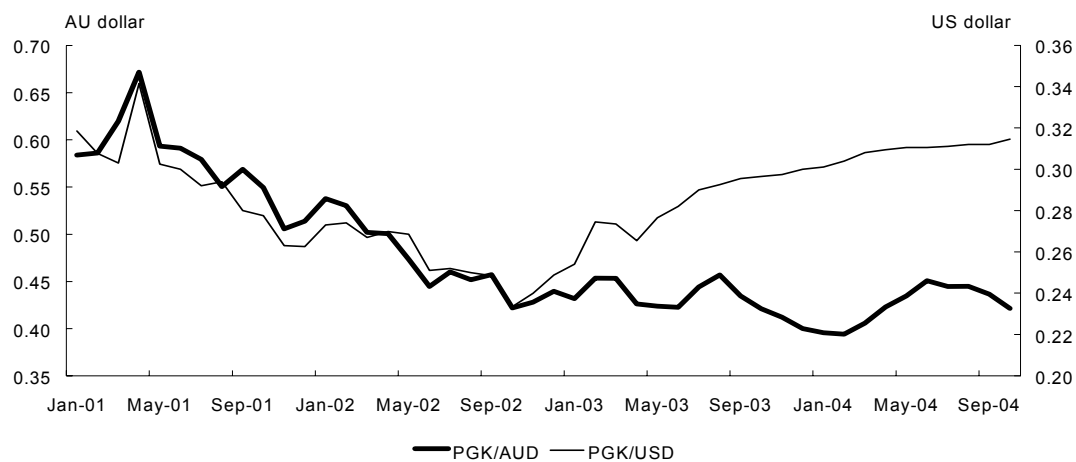
## 1.7 EXCHANGE RATE DEVELOPMENTS

In 2003, the Kina rose against the major trading partner currencies following two years of significant declines. The exception was the Australian dollar, which appreciated against all major currencies.

Against the US dollar, the Kina appreciated 20 per cent over the course of 2003. This compares with declines of 19.4 and 5.2 per cent in 2001 and 2002 respectively. Over the course of 2004, the Kina consolidated and built on these gains. The Kina has performed well against all the major trading partner currencies in 2004. The Kina appreciated by 3.3 per cent against the US dollar from 30 cents at the start of the year to 31 cents at the end of October. It is likely that 2004 will be the first year since 2000 that the Kina has averaged above 30 cents against the US dollar. The Kina has appreciated by 5.3 per cent against the Australian dollar, from 40 cents to 42 cents over the same period.

The most important factor in the stability of the exchange rate over the first ten months in 2004 was the maintenance of sound expenditure control by the Government. That said, the Kina was also supported by higher international prices of key commodity exports and continued recovery of agricultural exports.

**Figure 9: Exchange Rate Movements: Monthly**



Source: BPNG

## 1.8 PUBLIC DEBT

Total public debt decreased by K450.9 million (5.5 per cent) over 2003 to K7732.0 million. As a percentage of GDP, total public debt fell by 9.8 percentage points to 59.7 per cent by the end of 2003. This decline in public debt was due to the significant appreciation of the Kina over the course of the year.

With fiscal restraint and continued currency appreciation, total public debt has declined further so far in 2004. As at the end of August 2004, total public debt was K7502.1 million or 54.7 per cent of GDP.

### 1.8.1 Domestic Debt

As at the end of 2003 the stock of domestic debt was K3022.9 million, an increase of K434.6 million or 16.8 per cent over the previous end-year level. This increase reflected the financing of the budget deficit through additional issuance of Treasury Bills.

The stock of total domestic debt at the end of August 2004 was K3085.3 million, an increase of K62.4 million over the end of 2003. This reflects an increase in net borrowing mainly in the form of Inscribed stock.

At the end of 2003, the composition of domestic public debt was 91.1 per cent Treasury Bills, 5.8 per cent Inscribed Stock, and 3.1 per cent in Other Standard Domestic Loans.

In 2004, the Government reinvigorated its Inscribed Stock Issuance Program with the objective of lengthening the maturity structure of public domestic debt, thereby reducing the rollover and refinancing risk associated with large amounts of short-term debt.

Under the Inscribed Stock Issuance Program in 2004, K300.5 million was targeted to be issued and K500 million to be switched from Treasury Bills to Inscribed Stock. As at end-August 2004 a total of K200 million was issued while Treasury Bills totaling K382.5 million were retired. An additional K100.5 million under Inscribed Stock was issued and K250 million of debt switched at the end of October in 2004. Another K250 million will be switched at the end of November. Public tenders were announced prior to the actual auction dates as part of the strategy to create confidence and certainty and to promote transparency of debt management operations.

The success of the Inscribed Stock program is reflected in the changed composition of the public domestic debt stock. At the end of August 2004, Treasury Bills comprised 87.4 per cent of total domestic debt, with 11.1 per cent in Inscribed Stocks and 1.5 per cent in Other Standard Domestic Loans.

### **1.8.2 External Debt**

Total public external debt at the end of 2003 was K4709.1 million. This represented a decline of K885.5 million or 15.8 per cent from the level at the end of 2002, reflecting net repayments and valuation effects associated with the appreciation of the Kina.

Papua New Guinea's total public external debt has declined by a further K292.3 million or 6.6 per cent, to stand at K4416.8 million at the end of August 2004. The decline is attributed to the further appreciation of the Kina against major currencies in the debt portfolio in 2004 and significant net repayments.

The total public external debt stock is comprised predominantly of debts to multilateral and bilateral creditors, which accounted for 96.4 per cent of external debt as at August 2004. Commercial and other loans accounted for the remaining 3.6 per cent. As at August 2004 60.7 per cent (K2679.2 million) of external debt was owed to multilateral donor agencies, 35.7 per cent (K1576.4 million) to bilateral creditors, and 3.6 per cent (K161.2 million) to commercial creditors.

The principal external creditors to Papua New Guinea are the governments of Japan and Australia, the Asian Development Bank and the World Bank. As at end-August 2004 the currency composition of external debt was largely denominated in Japanese yen (36.1 per cent), US dollars (33.8 per cent) and Special Drawing Rights (SDR) 18.7 per cent.

The principal repayments on external debt were K276.7 million by end-August 2004 and are estimated to total K432.4 million by the end of the year.

## **1.9 CENTRAL GOVERNMENT FISCAL OPERATIONS**

The budget balance for 2004 is now projected to be a surplus of K154.6 million or 1.1 per cent of GDP, compared with the original deficit target of K195.6 million or 1.5 per cent of GDP. This is a turnaround of K350.2 million.

**Table 3: Budget Balance 2003 – 2004 (Kina Millions)**

	2003 Actual	2004 Budget	2004 Revised	Change
Total Revenue and Grants	3650.1	3837.9	4283.7	+446.7
Total Expenditure and Net Lending	3774.5	4032.6	4129.1	+96.5
Deficit (-)/Surplus (+)	-124.3	-195.6	154.6	-350.2
% of GDP	-1.0%	-1.5%	1.1%	2.6

Source: Department of Treasury.

**1.9.1 Total Revenue and Grants**

Total Revenue and Grants for 2004 are estimated to be K4283.7 million, an increase of 11.6 per cent or K446.7 million from the 2004 Budget projection of K3837.0 million.

Tax revenue is expected to be 12.1 per cent (K338.2 million) higher in 2004 than the Budget projection of K2791.7 million. The increase in tax revenue largely reflects higher tax on income and profits, with smaller increases in other areas.

**Table 4: Tax Revenue 2003 – 2004 (Kina Millions)**

	2003 Actual	2004 Budget	2004 Revised	Difference
Tax on Income and Profits	1786.6	1821.2	2139.4	+318.2
Domestic Taxes on Goods and Services	596.0	603.7	613.5	+9.8
Taxes on International Trade	295.3	366.8	377	-10.2
Tax Revenue	2677.9	2791.7	3129.9	+338.2

Source: Department of Treasury.

Tax on income and profits is now expected to be K2139.4 million, K318.2 million or 17.5 per cent higher than expected in the 2004 Budget. This increase largely reflects an upward revision to estimated mining and petroleum taxes of K245.6 million, from K357.4 million in the 2004 Budget to K603.0 million.

The reason for this stronger than expected revenue is the surge in the international prices of key mining and petroleum commodities. In particular, copper and oil prices are now expected to average US\$1.23 per pound and US\$37.3 per barrel, 64 per cent and 46 per cent higher respectively than assumed in the 2004 Budget.

The surge in profitability in the mining and petroleum sector has also been reflected in dividend withholding tax, which is now expected to return K130 million in 2004, up K36.3 million from the 2004 Budget. Personal and company income tax are expected to increase by K12 million and K25 million respectively, reflecting both improved economic conditions and improved compliance. On the other hand, interest withholding tax is expected to fall by K8.7 million, reflecting lower interest rates.

Domestic taxes on goods and services are now expected to be K613.5 million, K9.8 million higher than expected in the 2004 Budget. While excise revenue has improved in line with the economy generally, the mining levy was lower than expected, reflecting revisions to the 2003 outcome.

Taxes on international trade have had a mixed outcome in 2004. The temporary import levy was more successful than expected in raising revenue, with combined import duty raising K16.9 million more than expected. Similarly, excise duty on imports raised K12 million more than expected, reflecting strength in the economy. On the other hand, duty on exported logs was K18.7 million lower than expected and nearly 16 per cent below collections in 2003.

Non-tax revenue is estimated to increase by 24.5 per cent or K47.9 million to K243.5 million in 2004, compared with K195.6 million estimated in the 2004 Budget. The increase is attributed to higher than anticipated mining and petroleum dividend receipts, in line with stronger commodity prices.

Grants remain at K849.7 million, as estimated in the 2004 Budget.

### 1.9.2 Total Expenditure and Net Lending

Total Expenditure and Net lending in 2004 is now projected to be K4129.1 million, an increase of K96.5 million or 2.4 per cent on the 2004 Budget estimate of K4032.6 million.

In 2004, the Government continued to deliver on its track record of restraining spending to limits in Budget appropriation bills. The Government's fiscal restraint, and the related fall in inflation, has seen a steady decline in interest rates on Government securities. As a result, in 2004 the Government is expected to have saved around K275.7 million from the original Budget estimate of K692.4 million in interest payments and fees.

The Government allocated K177.8 million of these savings to meet pressing obligations. In particular, the Government provided significant additional funds to clear various prior-years arrears, court orders, make additional provision for redundancy payments, and provide additional funds to the Development Budget, including for the Highlands Highway.

The Government allocated additional funds to reduce the amount of court orders and deed of release claims. The continued issuance of significant default judgements against the Government reduces its capacity to adequately fund priority areas and to maintain salary and wages of its employees at a reasonable level.

**Table 5: Recurrent Expenditure 2003 – 2004 (Kina Millions)**

	2003 Actual	2004 Budget	2004 Revised	Difference
Salary and Wages	1122.2	1152.7	1186.0	+33.3
Goods and Services	664.8	727.3	976.9	+249.6
Interest Payments and Fees	739.6	692.4	416.7	-275.7
Transfers to Statutory Inst.	178.4	187.6	187.6	-
Net Lending to CSAs	-9.6	-4.0	-4.0	-
Recurrent Expenditure	2695.5	2756.0	2763.3	+7.3

Source: Department of Treasury.

The overall recurrent expenditure in 2004 is now estimated to be K2763.3 million, or K7.3 million more than expected in the 2004 Budget.

The overall Development Budget is now expected to be K1365.8 million in 2004, up from the K1276.6 million projected in the 2004 Budget estimate, reflecting the allocation of some of the savings on interest outlays to Highlands Highway maintenance and other priority spending in the Development Budget and the inclusion of imputed tax credit expenditures in the figures. Domestic funds allocated to the Development Budget were increased by a further K33.0 million through the year, as it became clear that the targeted level of draw downs from concessional loans would fall short of the Budget appropriation.

### **1.9.3 Financing**

A Budget surplus of K155 million or 1.1 per cent of GDP is now expected in 2004. In line with the requirements of the Public Finances (Management) Act, 90 per cent of the higher than expected petroleum and mining revenues have been used to reduce Government debt.

Net external financing for 2004 is estimated to be an outflow of K155.9 million compared with the outflow of K70.1 million projected in the 2004 Budget. This is due to principal amortization payments of K432.4 million exceeding drawdowns on new loans of K276.5 million.

Net domestic financing is now estimated to be K67.0 million, compared with the K265.7 million inflow estimated in the 2004 Budget.

## CHAPTER 2. 2005 BUDGET

### 2.1 OVERVIEW

The 2005 Budget establishes a framework for stronger economic growth in Papua New Guinea. It builds on the reforms of the past two years, combining fiscal prudence with an increased allocation of public resources to priority areas.

The *Medium Term Fiscal Framework* maps out a fiscal adjustment path to ensure that public spending is affordable and sustainable. Consistent with that framework, the 2005 Budget targets a deficit of 1.0 per cent of GDP. This will be the third year in succession that the Government delivers a Budget deficit in line with, or better than, the *Medium Term Fiscal Framework*.

**Table 6: Budget Balance 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Revised	2005 Projection	Change
Total Revenue and Grants	3650.1	4283.7	4639.7	+356.0
Total Expenditure and Net Lending	3774.5	4129.1	4777.4	+648.3
Deficit (-)/Surplus (+)	-124.3	154.6	-137.7	-292.3
% of GDP	-1.0%	1.1%	-1.0%	-2.1%

Source: Department of Treasury

The 2005 Budget is framed against improving economic and fiscal conditions. Economic growth has picked up, employment is rising, inflation has fallen sharply, interest rates have fallen, the exchange rate has been steady and the external position is healthy.

**Table 7: Key Economic Assumptions 2004 – 2005**

	2003 Actual	2004 Revised	2005 Projection
Real GDP growth	2.8	2.6	2.9
Real Non-Mining GDP growth	1.7	2.8	2.8
Inflation (year ended December)	8.5	3.7	4.2
Oil Price (USD per barrel)	27.4	37.3	35.0
Interest rates (Treasury Bills)	18.3	9.0	9.0

Source: Department of Treasury

The 2005 Budget proposes no new taxes and no increases in tax rates. It also honours the Government's commitments on tax reduction, with the temporary import levy ceasing in 2005 and the phased reduction in the mining levy continuing as scheduled.

Consistent with the *Medium Term Development Strategy (MTDS) 2005-2010*, the Budget allocates increased spending to agreed national and sectoral priority areas. The 2005 Budget also builds on other strategic plans that promote better public sector management, particularly the *Strategies for Supporting Public Sector Reform 2003-2007* and the *Public Expenditure Review and Rationalisation (PERR)* program.

In 2005, the Budget will:

- Deliver a maximum budget deficit outturn in 2005 of 1.0 per cent of GDP, as part of the ongoing fiscal adjustment strategy of moving to a balanced budget over the medium term.

- Reallocate spending to high priority programs, particularly rehabilitation and maintenance of transport infrastructure, basic education, primary and preventive health care and HIV/AIDS prevention, development oriented adult education, law and justice, and programs that directly promote export-driven growth and income-earning opportunities.
- Rebalance the proportion of recurrent expenditure spent on salaries and wages and goods and services by continuing the public sector rightsizing program, supported by substantial structural adjustment expenditures.
- Continue to improve the budget strategy and processes, and public finance management, particularly with respect to expenditure controls.
- Reduce outstanding liabilities significantly, whilst moving towards fully funded superannuation.

## 2.2 FISCAL STRATEGY

The 2005 Budget is framed against improving economic and fiscal conditions. Fiscal conditions have improved with strict expenditure control ensuring expenditures remain within the budget ceiling and strong, albeit temporary, increases in commodity prices boosting revenues. A stable exchange rate and prudent fiscal management has seen interest rates fall sharply, reducing interest payments on government debt, and allowing increased spending in priority areas. The fiscal balance for 2004 is likely to be a surplus and the ratio of debt to GDP is expected to fall in line with Government's deficit and debt reduction strategy.

The 2005 Budget builds on this solid foundation, locking in the gains from existing reforms and pushing ahead with Government's pro-growth reform agenda. The Government aims to lock in the gains of the past two years by maintaining the momentum of the reform process in 2005. Hence, the theme of the Fiscal Strategy for 2005 is "***Building the Economy through Sustained Reform***".

The 2005 Budget is framed against a number of guiding principles (Box 1).

The Budget is consistent with the *Medium Term Fiscal Framework (MTFF)*, which maps out a fiscal adjustment path to ensure that public spending is affordable and sustainable.

The *MTFF* was established following broad agreement that public debt levels in Papua New Guinea were excessive and unsustainable. To address this problem the *MTFF* sets out a measured and phased reduction in the fiscal deficit over a number of years, moving towards a balanced fiscal position in 2008.



**Box 1: Budget Guiding Principles**

The Budget preparation is underpinned by a number of medium-term guiding principles:

**Framework:**

- The Government will live within its means by producing a budget that is affordable and sustainable.
- The Government will not add to debt in the medium term.
- Budgetary expenditures will be consistent with agreed national and sectoral priorities.
- The Government will limit its participation to core areas where there is a clear rationale for public intervention.
- The Government will provide a regulatory framework that encourages and supports the private sector.

**Implementation:**

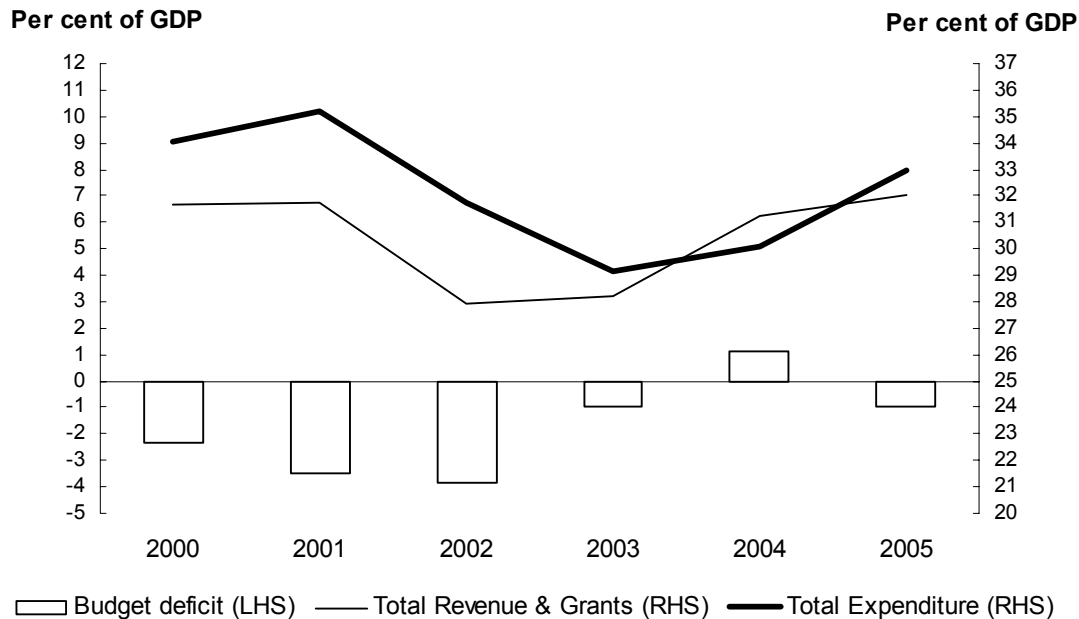
- The Government will exercise tight fiscal controls by closely monitoring all expenditures and by enhancing revenue collection.
- Budget plans will be adhered to and departments will be held responsible and accountable for managing their allocated expenditures.
- The Government will ensure that any proposals during the year that are outside the budgetary process will be matched by funding options and compensating savings within the department or agency.
- The Government will work towards increasing the transparency of public finances by the release of timely budgetary information.

Consistent with that framework, the 2005 Budget targets a deficit of 1.0 per cent of GDP. This reinforces the steady and responsible adjustment path that the Government has been following for some time.

The 2005 Budget draws heavily on the *Medium Term Development Strategy (MTDS) 2005-2010*, which sets out the Government's medium-term development priorities.

The strategy emphasises the importance of increased spending on priority areas: rehabilitation and maintenance of transport infrastructure, basic education, primary preventive health care, HIV/AIDS prevention, development oriented adult education, law and justice, and programs that directly promote export-driven growth and income-earning opportunities. These priorities are reflected in the 2005 Budget.

Together, these broad strategies provide the strategic overview for the Budget.

**Figure 10: Expenditure, revenue and budget deficit as a percentage of GDP**

Source: Department of Treasury

### 2.3 REVENUE AND GRANTS

The 2005 Budget imposes no new taxes and no new increases in tax rates. It also honours the Government's commitments on tax reduction, with the temporary import levy ceasing in 2005, and the phased reduction in the mining levy continuing as scheduled. The focus of the Government's revenue efforts in 2005 will be to improve compliance with existing laws, ensuring everyone pays their fair share of tax.

Total Revenue and Grants are expected to be K4639.7 million, an increase of K356.0 million or around 8.3 per cent on the estimated level for 2004. As a share of GDP, Total Revenue and Grants is projected to increase to 32.0 per cent in 2005, from a revised 31.2 per cent in 2004.

**Table 8: Revenue and Grants 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Tax Revenue	2677.9	3129.9	2984.9	-145.0
Non-Tax Revenue	239.2	243.5	260.8	+17.3
Project Support Grants	693.0	849.7	1283.1	+433.4
Total Revenue and Grants	3650.1	4283.7	4639.7	+356.0

Source: Department of Treasury

The increase in Grants of K433.4 million is largely associated with the implementation of the police component of the Enhanced Cooperation Program with Australia.

These increases more than offset a projected K145.0 million or 4.9 per cent decline in tax revenue, due to lower projected (although still high) oil and copper prices, the removal of the temporary import levy and the phased reduction in the mining levy.

### 2.3.1 Tax Revenue

Tax Revenue is projected to be 20.6 per cent of GDP in 2005, below the revised 22.8 per cent in 2004 and around the same level as a percentage of GDP as in 2003.

The decline in Tax Revenue in 2005 reflects declines in Taxes on Income and Profits and Taxes on International Trade, which offset increased collections from Domestic Taxes on Goods and Services.

**Table 9: Tax Revenue 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Tax on Income and Profits	1786.6	2139.4	2072.0	-67.4
Dom. Taxes on Goods and Services	596.0	613.5	621.4	+7.9
Taxes on International Trade	295.3	377.0	291.5	-85.5
Tax Revenue	2677.9	3129.9	2984.9	-145.0

Source: Department of Treasury

#### 2.3.1.1 Taxes on Income and Profits

Taxes on Income and Profits are expected to decline by K67.4 million (or 3.1 per cent) in 2005 to K2072.0 million compared with the revised 2004 estimate of K2139.4 million.

**Table 10: Taxes on Income and Profits 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Personal Income Tax	758.4	827.0	865.5	+38.5
Company Tax	334.5	380.0	394.8	+14.8
Dividend Withholding Tax	117.2	130.0	124.3	-5.7
Mining and Petroleum Taxes	396.5	603.0	487.3	-115.7
Interest Withholding Tax	41.4	31.8	30.7	-1.1
Other Direct	55.3	77.5	74.1	-3.4
Gaming Tax	83.3	90.0	95.3	+5.3
Tax on Income and Profits	1786.6	2139.4	2072.0	-67.4

Source: Department of Treasury

Personal Income Tax receipts are expected to increase by K38.5 million (4.7 per cent) to K865.5 million in 2005 compared with the revised estimate of K827.0 million in 2004. This increase reflects wage increases and moderate employment growth.

Corporate Income Tax receipts are forecast to increase by K14.8 million (3.9 per cent) to K394.8 million compared with the K380.0 million estimated for 2004. This increase reflects estimated growth in non-mining economic activity after adjusting for one-off receipts in 2004.

Dividend Withholding Tax collections are expected to decline by K5.7 million (4.4 per cent) to K124.3 million from the revised estimate of K130.0 million projected for 2004. The projected decline in dividend withholding tax reflects the expected decline in oil and copper prices in 2005.

Mining and Petroleum Tax revenues are projected to decline by K115.7 million (19.2 per cent) to K487.3 million against the revised estimate of K603.0 million in 2004. This decline reflects the expectation of lower prices of key commodities in 2005. The international prices of copper and oil are projected to decline by 19.2 per cent and 6 per cent respectively in 2005.

Interest Withholding Tax receipts are projected to decline by K1.1 million (3.5 per cent) to K30.7 million in 2005 compared to the K31.8 million now estimated for 2004. This reflects continued low interest rates.

Other Direct Tax receipts are expected to decline slightly to K74.1 million from the revised 2004 level of K77.5 million. This reflects a projected increase in underlying revenue in line with improved economic conditions, adjusted for one-off receipts in 2004.

Gaming Tax is projected to increase by K5.3 million (5.9 per cent) to K95.3 million in 2005, in line with economic conditions.

### 2.3.1.2 Domestic Taxes on Goods and Services

Domestic Taxes on Goods and Services are expected to increase by K7.9 million (or 1.3 per cent) in 2005 to K621.4 million compared with the revised 2004 estimate of K613.5 million.

**Table 11: Domestic Taxes on Goods and Services 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Excise	174.7	190.4	202.2	+11.8
GST	311.8	317.0	332.4	+15.4
Mining Levy	101.8	105.6	86.3	-19.3
Other Indirect	7.8	0.5	0.5	-
Dom. Taxes on Goods and Services	596.0	613.5	621.4	+7.9

Source: Department of Treasury

Excise collections are expected to increase by K11.8 million (6.2 per cent) to K202.2 million in 2005 compared with the revised estimate of K190.4 million in 2004. This increase reflects the resumption of indexation of excise rates and continued growth in domestic demand.

The National Government's share of Goods and Services Tax (GST) is expected to increase by K15.4 million (4.9 per cent) to K332.4 million in 2005 compared with the revised estimate of K317.0 million in 2004. This increase reflects projected growth in economic activity, combined with moderate inflation outcomes.

Collections from the Mining Levy are expected to decrease by K19.3 million (18.3 per cent) to K86.3 million in 2005 compared to the revised estimate of K105.6 million in 2004. This decrease reflects the continued phased reduction in the Mining Levy.

### 2.3.1.3 Taxes on International Trade

Collections from Taxes on International Trade are expected to decrease by K85.5 million (or 22.7 per cent) in 2005 to K291.5 million compared with the revised 2004 estimate of K377.0 million.

**Table 12: Taxes on International Trade 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Import Duty	73.7	73.5	74.6	+1.1
Temporary Import Levy	-	72.0	-	-72.0
Export Duty	111.8	94.2	76.6	-17.5
Excise Duty on Imports	109.8	137.3	140.2	+2.9
Taxes on International Trade	295.3	377.0	291.5	-85.5

Source: Department of Treasury

Import Duty receipts are expected to increase by K1.1 million (1.5 per cent) to K74.6 million in 2005 compared with the revised estimate of K73.5 million in 2004. The moderate growth in import duty receipts reflects the restricted range of imports subject to import duty, as a result of the Tariff Reform Program.

The 2.0 per cent Temporary Import Levy ceases as promised at the end of 2004, resulting in a K72.0 million reduction in collections in 2005 compared with 2004.

Export Duty on logs is projected to continue its decline, falling to K76.6 million, K17.6 million (18.7 per cent) less than collected in 2004. To some extent this reflects the industry's projection for a decline in exports of raw logs in 2005. However it may also reflect a trend towards exports of minimally processed and semi-processed logs, and compliance issues.

Excise Duty on Imports is projected to increase to K140.2 million in 2005, up K2.9 million on the much stronger than expected K137.3 million collected in 2004.

### 2.3.2 Non Tax Revenue

Non Tax Revenue receipts are projected to increase by K17.3 million (7.1 per cent) to K260.8 million in 2005 compared with an estimated K243.5 million in 2004.

**Table 13: Non Tax Revenue 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Property Income	159.7	161.0	183.0	+22.0
Non-Mining Dividends	85.7	61.0	83.0	+22.0
Mining and Petroleum Dividends	74.0	100.0	100.0	-
Interest and Fees from Lending	4.3	5.0	5.0	-
Other Non Tax Revenue	75.2	77.6	72.9	-4.7
Non Tax Revenue	239.2	243.5	260.8	+17.3

Source: Department of Treasury

Property Income is projected to increase by K22.0 million to K183.0 million in 2005 compared with the revised estimate for 2004.

In 2004, K50.0 million of the total K61.0 million in non-mining dividends was received from the Bank of Papua New Guinea (BPNG). A similar dividend from BPNG has been assumed for 2005, along with a substantial dividend from the National Fisheries Authority. The estimate for non-mining dividends in 2005 includes a conservative estimate of non-mining dividends from the Independent Public Business Corporation (IPBC).

Mining and petroleum dividends are projected to be K100.0 million in 2005, primarily from the Government's share in Ok Tedi, with a more moderate dividend assumed from Oil Search. Although the Government's interest in Oil Search is held in the IPBC, it is assumed that this dividend will be passed on in full to Consolidated Revenue.

Other Non Tax Revenue, reflecting revenue from departments, is projected to decline marginally to K72.9 million in 2005 from the K77.6 million estimated for 2004. This decline partly reflects the fact that in 2005 housing rentals will be paid direct to the National Housing Corporation, rather than transferred directly to Consolidated Revenue.

### 2.3.3 Grants

Project Support Grants for 2005 are expected to increase to K1283.1 million, a significant increase over the K849.7 million estimated to be received in 2004.

The projected increase largely reflects an increase in grant funding from AusAID, reflecting around K388 million in additional funding associated with the police component of the Enhanced Cooperation Program. It also reflects a substantial increase in projected JICA grants.

**Table 14: Grants By Source (Kina Million)**

Donor	Amount (K million)
AusAID	1,053.0
JICA	110.4
European Union (EU)	77.5
New Zealand	23.2
Others	19.0
<b>Total</b>	<b>1,283.1</b>

Source: Department of National Planning and Rural Development

## 2.4 EXPENDITURE

Total Expenditure and Net Lending has been set at K4777.4 million, an increase of K648.3 million or 15.7 per cent over 2004. This is consistent with the Government's 2005 deficit target of 1.0 per cent of GDP (K137.7 million). This increase includes the additional grant-funded expenditure for the police component of the Australia-PNG Enhanced Cooperation Program.

**Table 15: Total Expenditure and Net Lending 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Recurrent Expenditure	2695.5	2763.3	2889.1	+125.9
Development Expenditure	1079.0	1365.8	1888.3	+522.5
Total Expenditure and Net Lending	3774.5	4129.1	4777.4	+648.3

Source: Department of Treasury

Total Recurrent Expenditure is projected to be K2889.1 million in 2005, an increase of K125.9 million (4.6 per cent) over 2004. Total Development Expenditure is expected to be K1888.3 million in 2005, an increase of K522.5 million (38.3 per cent) over the expected outcome in 2004. The increase is partly due to the police component of the ECP.

## 2.4.1 Recurrent Expenditure

**Table 16: Total Expenditure and Net Lending 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Salaries and Wages	1122.2	1186.0	1294.6	+108.6
Goods and Other Services	664.9	913.9	920.1	+6.2
National Departments	574.3	884.3	817.3	-67.0
Provincial Departments	90.5	92.7	102.8	+10.1
Transfers to Stat. Inst.	178.4	187.6	197.9	+10.3
Interest Payments and Fees	739.6	416.7	480.5	+63.8
Recurrent Expenditure	2695.5	2763.3	2889.1	+125.8

Source: Department of Treasury

### 2.4.1.1 Salaries and Wages

Salaries and Wages for National and Provincial Departments, including teachers, are estimated to grow to K1294.6 million in 2005. This includes provisions for moderate wages and salaries increases for both national and provincial staff, increased Government funding for employee contributions to public servants' superannuation provisions and increased numbers of teachers, but a net reduction in overall numbers of public servants.

**Table 17: Salaries and Wages for National and Provincial Departments and Teachers 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
National Departments*	618.0	671.1	769.3	+98.2
Provincial Staffing Grants	165.2	166.9	171.0	+4.1
Teachers	339.0	348.0	354.3	+6.3
Salaries and Wages	1122.2	1186.0	1294.6	+108.6

Source: Department of Treasury

\*Includes provisions for superannuation contributions, retirement payments and future pay rises for both national and provincial government employees, including teachers.

The Budget process highlighted a number of critical vacant positions. Nevertheless, the Government remains committed to a reduction in the size of the Public Service. Around 600 unattached officers are expected to be made redundant over the course of the year. In addition, nearly 400 defence personnel will be retrenched during 2005.

At the same time, the Government will be conducting a review of all departments to examine structures and functions through the process of public sector rightsizing exercise in 2005.

The Budget also allows for moderate growth of 2.0 per cent in the number of school teachers, to enable schools to cater for the expected net increase in student enrolments.

Another factor behind the public sector wage bill increase in 2005 is the progressive shift to full funding of superannuation contributions for Government employees. In 2005, the Government will be funding superannuation contributions of 4.2 per cent, up from 2.1 per cent in 2004.

The above estimates also include provision for the anticipated agreement on pay outcomes for public servants and teachers.

#### 2.4.1.2 Goods and Other Services: National Departments

The total allocation for National Departments, excluding salaries and wages, is projected to be K817.3 million in 2005, a decline of K67.0 million from the revised 2004 level of K884.3 million. This decline is mainly due to additional appropriation in 2004 to meet various long outstanding State liabilities.

**Table 18: Goods and Other Services 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Goods and Other Services	514.3	729.3	675.6	-53.7
Education Funding	29.9	40.0	41.1	+1.1
Pre-March 2003 Arrears Payments	20.6	33.1	35.0	+1.9
Structural Adjustment Payments	9.7	81.9	65.6	-16.3
Total	574.3	884.3	817.3	-67.0

Source: Department of Treasury

Goods and Other Services to National Departments is projected to be K675.6 million in 2005, a decrease of K53.7 million over the revised amount provided in 2004.

The spending includes a significant amount for payment of court orders (which are a large and increasing cost for government) and some allowance for the 2005 30<sup>th</sup> Independence anniversary activities. There is a modest increase in other goods and services spending. In part, this increase reflects the disproportionate burden borne by this category in the previous two years of expenditure restraint.

In 2005, K35.0 million has been provided to cover pre-March 2003 arrears payments. This allocation is expected to be sufficient to cover remaining obligations incurred before 1 April 2003, when amendments to the Public Finances (Management) Act and the Claims By and Against the State Act came into effect.

Structural Adjustment Payments of K65.6 million are expected in 2005, largely reflecting provision for meeting obligations to individuals made redundant through the continuation of the public sector rightsizing process. Provision has been made for the roll-out of the new integrated human resource and payroll system and the Service Improvement Program undertaken by the Public Sector Reform Management Unit (PSRMU), which will continue in 2005.

#### 2.4.1.3 Goods and Other Services: Provincial Departments

The total allocation for Provincial Departments, excluding salaries and wages, is projected at K102.8 million, an increase of K10.1 million or 10.9 per cent from the 2004 level of K92.7 million.

**Table 19: National Total Expenditure and Net Lending 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Goods and Other Services	61.4	62.1	67.4	+5.2
Conditional Grants	29.1	30.6	35.4	+4.9
Total	90.5	92.7	102.8	+10.1

Source: Department of Treasury

Goods and Other Services to Provincial Departments is projected to be K67.4 million in 2005, an increase of K5.2 million over the amount provided in 2004.



The increased allocations to Provincial Departments recognise the important role they play in the delivery of essential services.

Conditional Grants to Provincial Departments are projected to be K35.4 million in 2005, an increase of K4.9 million over 2004.

These figures include the provision of K5.0 million to the Bougainville Government, the second half of the one-off establishment grant of K10.0 million. (The first K5.0 million was provided in 2004.)

Allocations to individual provinces are based on the recommendations of the National Economic and Fiscal Commission (NEFC). It is expected that in 2005 the NEFC will make recommendations to the Government on reforms to the Organic Law on Provincial and Local-Level Governments (OLPLLG).

#### **2.4.1.4 Other Recurrent**

Transfers to Statutory Institutions are estimated to increase by K10.3 million (5.5 per cent) to K197.9 million in 2005 compared with the expected 2004 outcome of K187.6 million. This increase mainly reflects additional resources to sectoral priorities consistent with the *MTDS*.

Total interest and other fee payments are projected to be K480.5 million in 2005, an increase of K63.8 million over the 2004 estimate of K416.7 million, but well below the 2003 outcome of K739.6 million. This figure is comprised of K347.1 million in domestic interest costs and K133.4 million in external interest payments.

Domestic interest payments are forecast to rise from K285.0 million to K347.1 million, as the stock of domestic debt grows (financing the budget deficit and net external debt repayments) and interest rates return to more sustainable levels. External interest payments and other fees are projected to rise only slightly, from K131.7 million in 2004 to K133.4 million in 2005. This reflects the higher global interest rates anticipated by futures markets offsetting the scheduled net repayments of external debt in 2005.

#### **2.4.2 Development Expenditure**

The Development Budget for 2005 is projected to be K1888.3 million, an increase of K522.5 million (38.2 per cent) on the expected level of development expenditure in 2004. This represents 13.0 per cent of GDP, compared with an expected 2004 outcome of 9.9 per cent of GDP. This significant increase reflects a substantial increase in Government spending on development projects (in 2004 and 2005) as well as additional grant funding associated with the Enhanced Cooperation Program.

**Table 20: Development Expenditure: Sources of Funds 2003 – 2005 (Kina Millions)**

	2003 Actual	2004 Estimate	2005 Projection	Change
Government				
Domestic Funding	207.3	292.0	281.0	-11.0
Infrastructure Tax Credit	40.0	60.6	110.9	+50.3
Loans	138.7	163.5	213.3	+49.8
Concessional	82.8	136.6	198.7	+62.1
Commercial	55.9	26.9	14.6	-12.3
Donor Project Grants	693.0	849.7	1283.1	+433.4
<b>Total</b>	<b>1079.0</b>	<b>1365.8</b>	<b>1888.3</b>	<b>+522.5</b>

Source: Department of Treasury

Highest priority has been given to development spending that provides the greatest contribution to the Government's export driven growth and development strategy, including rehabilitation and maintenance of transport infrastructure, basic education, development oriented adult education, primary and preventive health care, HIV/AIDS prevention, law and justice, and programs that promote income earning opportunities.

The 2005 Development Budget supports projects and programs that increase economic activity in the provinces. The primary mechanism for achieving this is the government-funded Provincial Economic Impact Program. However, other projects and programs that facilitate economic activity, particularly those with a focus on increasing smallholder activity and productivity, are also a priority in the 2005 Budget.

In particular, priority has been given to transport rehabilitation and maintenance programs. In line with this, the recently endorsed District Roads Improvement Program (DRIP) will receive both government and donor funding.

As noted above, Project Grants from donors are expected to increase in 2005 to K1283.1 million, a significant increase over the K849.1 million estimated to be received in 2004.

The projected increase largely reflects an increase in grant funding from AusAID, reflecting around K388 million in additional funding associated with the police component of the Enhanced Cooperation Program (ECP). It also reflects a substantial increase in projected JICA grants.

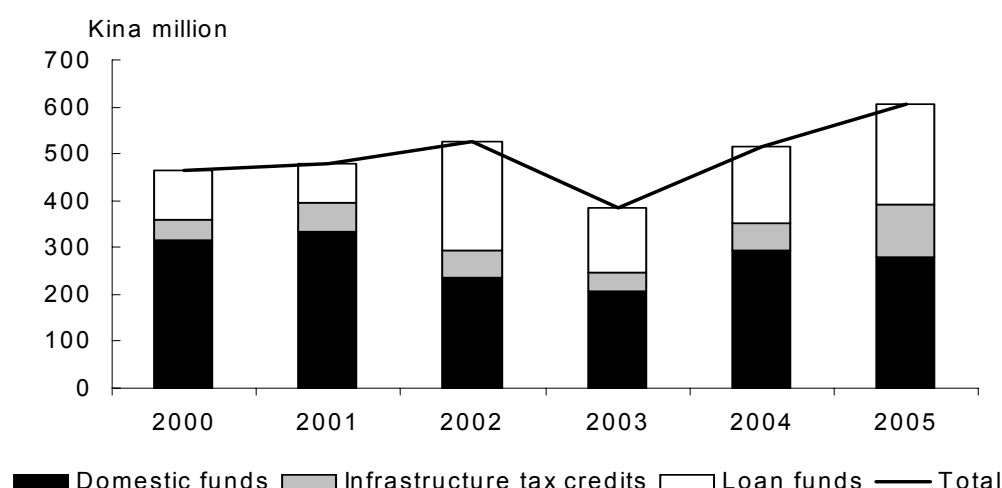
The Government's cash contribution to the Development Budget for 2005 will be K281.0 million. This represents an increase of K50.6 million (21.9 per cent) on the original level of K230.4 million in 2004. However due to the substantial one-off additions to the 2004 Development Budget, the Government funded element increased from K230.4 million to a revised K292.0 million, which is K11.0 million above the 2005 appropriation.

The Government expects to draw down combined concessional and commercial project loans of K213.3 million in 2005, up from the estimated K163.5 million in 2004. This increase reflects the Government's plans to increase the level of draw downs on existing loans in order to progress significant infrastructure projects.

Although the overall level of expenditure funded by loans will increase over the expected 2004 outcome, the level of 'other loans' that is commercial loans, is expected to decline in 2005. 'Other loans' drawn down in 2005 are expected to be K14.6 million, allowing for the completion of Phase One of the Yumi Yet bridge project.

The Government also contributes to development through providing tax credits for infrastructure expenditure. It is estimated that infrastructure tax credits of K110.9 million will be utilized in 2005. This contribution is included in the development expenditure.

The Government's total commitment – cash contribution, loans drawn down and infrastructure tax credit – to the Development Budget is K605.2 million in 2005, up 17.3 per cent on the K516.1 million in 2004.

**Figure 11: Government Contribution to Development Budget**

Source: Department of Treasury

Of the K281.0 million in domestic funds for 2005: K57.5 million is allocated to District Support Grants, Members' Non-discretionary Funds and Less Developed District Grants; K65.8 million to donor counterpart funds; K15.7 million to Special Support Grants and MOA commitments (in relation to mining and petroleum project agreements); K2 million to ongoing contract commitments; and K140 million to other Government-funded projects.

In allocating the Government's cash contribution to the 2005 Development Budget, priority is also given to meeting the Government's counterpart funding obligations under agreements with concessional loan providers and donors, in order to ensure that all projects and programs can be carried out in a timely manner in 2005.

The sector distribution of the 2005 Development Budget is shown in Table 21 below. One of the largest shares of the Development Budget is allocated to the infrastructure sector, comprising, in the main, road maintenance and upgrading programs. Administration includes a number of large projects managed by DNPRD, such as Agro-industry development, the Provincial Economic Impact Program and the Forestry and Conservation Project. Overall, the sector distribution is consistent with the Government's development strategy and the priorities identified within the *MTDS*.

**Table 21: Sectoral Distribution of the 2005 Development Budget**

Sector	2005 Kina million	2005 %
Infrastructure	504.5	26.6
Social	321.5	17.0
Economic	134.0	7.5
Admin/Governance	282.1	14.9
Provinces	130.2	6.9
Law and Justice	515.9	27.3
<b>Total</b>	<b>1888.3</b>	<b>100.0</b>

Source: Department of National Planning and Rural Development

### **2.4.3 Financing**

#### **2.4.3.1 Overview**

The Government's total net financing requirement in 2005 will be K137.7 million. The net external financing will be an outflow of K190.2 million. The Government's net domestic financing – the Budget deficit and net external outflows – will be K327.9 million, or 2.3 per cent of GDP.

Consistent with the Medium Term Debt Strategy, the key elements of the Government's financing strategy in 2005 are:

- Shifting the balance in the domestic debt profile from short term financial instruments to longer term instruments.
- Shifting the balance in total public debt from external to domestic debt.
- Matching currency denomination of external debt with foreign reserve assets.

The Government's financing strategy is an important element of its overall strategy for achieving macroeconomic stability over the medium term.

#### **2.4.3.2 External Financing**

New external borrowing of K213.3 million will be undertaken in 2005. This is comprised of K198.7 million in concessional loans and K14.6 million in commercial loans.

The Government will continue to engage with international financial institutions for limited external borrowing on concessional terms, as long as the expenditures are consistent with government priorities and are within the Budget ceiling. In doing so, the Government will seek to match the currency denomination of external loans more closely with that of foreign currency reserves. No commercial borrowing is required, except for a completion of an outstanding loan in relation to Phase One of the Yumi Yet Bridge Project.

This new borrowing will be more than offset by amortisation on existing loans of commercial, concessional and extra-ordinary loans of K20.4 million, K217.8 million, and K165.4 million respectively. As a result, there will be a net external outflow of K190.2 million in 2005.

#### **2.4.3.3 Domestic Financing**

The net domestic funding required in 2005 to fund the outflows in external financing will be K327.9 million, or around 2.3 per cent of GDP. This consists of K936.4 million in new borrowing and amortization of K608.4 million.

No receipts from asset sales have been factored into financing of the 2005 Budget. Any proceeds from sales that take place in 2005 will be used to retire public debt and rehabilitate State assets.

The Government is confident that the net domestic funding required will be able to be met by the domestic market without an appreciable increase in interest rates. Nevertheless, the size of the domestic funding task highlights the importance of maintaining the confidence of investors in the Government's commitment to fiscal discipline.

During 2005 the Government will continue with the inscribed stock program to lengthen the maturity structure of government debt and to reduce rollover and interest rate risk. Together with the reduction in external debt, which reduces foreign exchange risk, this will further strengthen the Government's financial position and further enhance macroeconomic stability.

Gross new domestic borrowing of K936.3 million is comprised of K179.3 million in new Treasury Bills and K757.0 million in new Inscribed Stocks. These figures include:

- The issue of K300.0 million in new Inscribed Stock over the course of the year.
- Switching K457.0 million in Treasury Bills to Inscribed Stock over the course of the year.

Domestic debt amortization in 2005 is estimated at K608.4 million, including the planned switch of K457.0 million in Treasury Bills into Inscribed Stock.

## **CHAPTER 3. 2005 BUDGET TAXATION MEASURES**

### **3.1 OVERVIEW**

There are no increases in tax rates and no new taxes in the 2005 Budget. In 2005, the Government will provide an increase in the infrastructure tax credit rate for agriculture projects and will renew the tax credit for the Highlands Highway for a further three years. In addition, there are several technical amendments to the provisions of the Income Tax Act and Customs legislation. In line with the announcement in the 2004 Budget, the twelve month freeze on excise increases on alcohol and tobacco will cease on 30 November 2004 and from 1 December 2004, the scheduled indexation will recommence and excise rates will be increased by 2.5 per cent every six months.

The Internal Revenue Commission (IRC) will focus on improving tax compliance in 2005 with assistance from the Enhanced Cooperation Program and the World Bank Institutional Strengthening Project.

### **3.2 RENEWAL OF THE HIGHLANDS HIGHWAY TAX CREDIT**

In 2002, a special 1.25 per cent tax credit was provided for approved expenditure on the Highlands Highway. This allowed resource companies to spend up to 1.25 per cent of their 2002 assessable income over the three years from 2002 to 2004 on maintenance work on the highway.

Expenditure on the Highlands Highway is a key Government priority in improving PNG's infrastructure. Mining and petroleum companies have proved that they can spend quickly and efficiently on Highlands Highway projects. The Government has therefore decided to renew the tax credit in 2005. A tax credit of 1.25 per cent of 2005 assessable income will be provided, to be claimed for expenditure on approved Highlands Highway projects over the period 2005-2007.

The expected cost of this measure is K50 million spread over the three years to 2007.

### **3.3 INCREASED TAX CREDIT RATE FOR AGRICULTURAL PROJECTS**

Under the *Income Tax Act*, companies can spend up to 0.75 per cent of their assessable income on approved infrastructure projects and receive a tax credit that can be claimed over three years.

Last year, the Government announced a number of incentives to stimulate investment in the agriculture sector. One initiative that was not implemented at the time was to increase the tax credit for approved infrastructure projects in the agriculture sector.

In 2005, it is proposed to increase the tax credit for the agriculture sector to 1.0 per cent. This increase will be affordable but will provide some stimulus to economic activity in the sector. The greatest use of the tax credit would be expected in the oil palm and sugar industries.

The cost of this concession is expected to be around K4 million per annum.

### 3.4 REVISED CREDIT ARRANGEMENTS FOR THE PNG-AUSTRALIA GAS PROJECT

The *Income Tax Act* provides a 1.25 per cent tax credit for expenditure by a gas project company on behalf of the State on the construction, upgrading or repair of a road listed in the Gas Agreement between the State and the companies undertaking the PNG-Australia Gas Project.

At the time this provision was introduced, the intent was that the expenditure would be undertaken only when there was a clear commitment (“project sanction”) to proceed with construction of the PNG-Australia Gas Project. However, the effect of the provision as drafted has been to allow gas project companies to claim tax credit expenditure immediately. The Government has therefore decided to prevent the further accumulation of the PNG-Australia Gas Project tax credit in the period before project sanction. Section 219C(8) of the *Income Tax Act* will be amended to ensure that from 2005 onwards, gas project companies will be unable to claim or accumulate new credits until project sanction occurs.

The State is currently providing a significant amount of funding for the construction of the Gobe-Samberigi Road, which is one of its commitments under the Gas Agreement and the Gobe MOA. The Government has therefore decided that in the period before project sanction, PNG-Australia Gas Project tax credits already accumulated will be prioritized to approved expenditure on construction of the Gobe-Samberigi Road. Following project sanction, the tax credit will be available for expenditure on all approved Gas Agreement roads.

### 3.5 AMALGAMATION PROVISIONS OF THE INCOME TAX ACT 1959

In 1998, the Income Tax Act and the Stamp Duties Act 1952 were amended to clarify the tax consequences of amalgamations. These amendments were intended to ensure that normal company amalgamations could take place in a tax-neutral way, with the new entity suffering no tax advantage or disadvantage as a result of the amalgamation.

The amalgamation provisions of the Income Tax Act do not specifically set out the consequences of an amalgamation for accrued infrastructure tax credits or undeducted balances of Allowable Capital Expenditure (ACE) and Allowable Exploration Expenditure (AEE).

There are no tax policy grounds for denying carry-over of infrastructure tax credits and ACE and AEE balances to an amalgamated entity. For that reason, an amendment to the amalgamation provisions will be made to ensure that accrued infrastructure tax credits and undeducted balances of ACE and AEE can be carried over from amalgamating companies into the newly amalgamated entity.

This amendment will be effective from the date of introduction of the legislation.

### 3.6 DEFINITION OF “EXPLORATION EXPENDITURE” IN INCOME TAX ACT 1959

Under the current mining and petroleum provisions of the *Income Tax Act*, exploration expenditure is defined in section 155(1) as:

*Exploration activities for the purpose of discovering **petroleum** in Papua New Guinea, and includes geophysical analysis and geophysical surveys, exploration*

*drilling and appraisal drilling and appraisal in relation to such petroleum or minerals...*

That is, the current definition of exploration activities does not clearly include activities that have the purpose of discovering minerals.

The intent of the legislation is to set out the tax treatment of expenditure on exploration both for petroleum and minerals. The definition will therefore be amended to include mineral exploration.

### **3.7 DEDUCTION OF ALLOWABLE CAPITAL EXPENDITURE (ACE) AND ALLOWABLE EXPLORATION EXPENDITURE (AEE)**

Until 2001, the *Income Tax Act* placed a special cap on the amount of ACE and AEE expenditure that could be claimed as a deduction by mining and petroleum projects in any one year. The cap prevented ACE and AEE deductions being used to create tax losses. As a result, many mining and petroleum projects could not fully deduct their ACE and AEE over the life of the project and finished with a residual pool of undeducted ACE and AEE, which could then be transferred to offset tax in a new project.

In 2001, an amendment was introduced that removed the loss-limiting cap. The intent of the amendment was to allow ACE and AEE deductions to create tax losses in the early, revenue-negative years of a project, which could then be used to defer tax once income began to flow.

However, one effect of the new provision is that all ACE or AEE must be deducted during the life of the project and no balances of undeducted ACE and AEE can remain when the project finishes. In effect, ACE and AEE that would have remained undeducted under the old provisions is now converted to a tax loss by the time a project finishes. Tax losses cannot be transferred under the ring-fencing provisions of the *Income Tax Act* and so effectively expire at the end of a project, because there is no longer any income from the project against which they can be claimed. This acts as a disincentive for some new projects, particularly those with a short life.

The Government will therefore introduce amendments to the *Income Tax Act 1959* to restore the effect of the previous provision limiting the maximum deduction for Allowable Capital Expenditure or Allowable Exploration Expenditure in any year to the assessable income remaining after all other deductions have been made.

This measure will result in a small short-term revenue gain and a small but longer-term revenue loss.

### **3.8 REMOVAL OF THE TAX EXEMPTION FOR INTEREST ON LONGER-TERM INSCRIBED STOCKS AND BONDS**

Section 35(2)(a) of the *Income Tax Act* provides a tax exemption for the interest income derived by any person from a long-term bond, defined as a fixed interest security issued by the Government or a resident corporation or society with a maturity date not less than five years from the date of issue.



The PNG Government does not currently issue securities with a maturity of five years or more and there is no domestic private sector bond market in PNG. However, as part of the debt restructuring exercise, the Government is moving a portion of PNG's public debt into longer-term debt instruments. Recent tenders for two and three year Inscribed Stocks have been successful. In the future, longer term Inscribed Stocks or bonds may be issued. The existence of the tax exemption will complicate the issuance of long-term Inscribed Stocks and bonds and the development of the domestic government securities market. In addition, it is not appropriate to provide an effective interest subsidy to private sector borrowing.

The exemption provision will therefore be repealed with effect for securities issued after the date of announcement.

### **3.9 EXTENSIONS IN 2005 OF THE CURRENT GST DISTRIBUTION FORMULA**

When an agreement was reached with the provinces on the distribution of GST revenues in 2003, it was determined that:

- (i) the provinces would receive 60 per cent of inland GST collections or an amount equal to their 2003 distribution, whichever was larger; and
- (ii) The national government would receive 40 per cent of inland collections (from which any top up payments would be made) and would retain 100 per cent of collections on imports.

It was agreed that this formula would apply in 2004 but that the National Economic and Fiscal Council would review the distribution of GST revenues and make recommendations to the Government during 2004 on the appropriate distribution for 2005 and future years.

In a meeting of Provincial Governors on 13-15 October 2004, it was agreed that the 2004 distribution formula would be extended for a further year. During 2005, a working group of Governors will develop options for a new distribution in 2006.

### **3.10 LIMITING TAX AVOIDANCE THROUGH OVERSEAS MANAGEMENT FEES**

Overseas management fees are often used as a means of tax avoidance. Instead of paying dividends, which are not tax deductible, companies remit profits in the form of tax deductible 'management fees'. The Income Tax Act has provisions to control this: fees that can be remitted are limited, and a small withholding tax is payable in some cases.

However there are minor technical problems with the legislation relating to the treatment of such fees in double tax treaties. These problems will be resolved by deeming all management fees paid overseas by PNG companies to have a PNG source.

In addition, it has become clear that in some cases payments are being misnamed as 'consultancy fees' to avoid the current provisions. In those cases where the Commissioner-General determines that consultancy fees are misnamed as such purely to avoid tax, they will be deemed to be management fees.

The Income Tax Act presently limits the deductibility of overseas management fees payable by companies in the mining and oil industry to 2.0 per cent of income under their own specific provisions. However for companies in other industries the limit is set at 15 per cent. This anomaly will be corrected by setting the limit for all industries at 2.0 per cent.

### **3.11 SALE OF SEIZED GOODS**

The IRC has the right to seize goods on which the value, for duty purposes, has been under declared, or where there has been an attempt to defraud customs. The importer has the right to attempt to recover those goods through appeals or legal action.

That process can take two to three years to complete. In the meantime the goods are held at the wharf or in container storage areas. In those places the goods are often stolen before the cases are finalised, or deteriorate to a valueless state through heat and humidity. In addition the IRC incurs high storage costs.

The Customs Act will therefore be amended to allow IRC the right to sell those goods by public auction and then to place the proceeds into a trust account, to be held until the case is finalised. If the importer wins, the proceeds held in trust will be payable to the importer in substitution for the goods. If the IRC wins, the proceeds held will then be paid into consolidated revenue.

### **3.12 INCREASED DUTY FREE LIMITS FOR SPIRITS AND PERFUME**

The Customs (Personal Effects) Regulation presently allows incoming passengers to bring in one bottle of spirits and 0.5 litres of perfume free of duty. This limit will be brought into line with most other countries in the region, by increasing the allowance to two bottles of spirits and one litre of perfume. This measure will result in a small loss in revenue.

### **3.13 TAX EXPENDITURES**

Tax Expenditures (tax concessions or exemptions) data are again provided in the 2005 Budget, updated for the latest available data.

Provision of Tax Expenditure data in the Budget helps increase the transparency of government assistance through the tax system.

The 2005 Budget updates Tax Expenditure data relating to tax exemptions from indirect taxes (import duty, import excise and VAT/GST) administered under the Customs Act. Other Tax Expenditures data includes tax exemptions and deferrals administered under the Income Tax Act.

Data on Tax Expenditures are provided in Appendix One.

#### **3.13.1 Infrastructure Tax Credit Scheme**

The overall tax credit expenditure projection for 2005 is estimated at K110.9 million. This amount is expected to be incurred on approved Infrastructure Tax Credit (ITC) projects in 2005. The detailed break down of this expenditure is not yet available thus it is not possible to allocate these expenditures by sectors and provinces.

However, the total tax credit projection for 2005 is comprised of the following:

- (i) General credit available for 2005
- (ii) Unused credits carried over from 2004
- (iii) Additional credit for agricultural projects; and
- (iv) Special credit for Highlands Highway.

The actual expenditure for 2005 may not be equal to the projection as the amount to be spent is subject to the discretion of the individual companies concerned. Therefore, any credits not utilized in 2005 would be carried forward to 2006.

### **3.13.2 Tax Exemptions from Indirect Taxes**

The total revenue forgone by the State through tax exemptions from indirect taxes from 2000 to 2003 (up to 30 September 2004) amounts to K120.6 million. A substantial amount of the total revenue forgone was in 2003 through the Goods and Services Tax and the Import Duty exemptions. The total revenue forgone in 2003 alone is about 4.2 per cent of total tax revenue and 0.4 per cent of total indirect tax collections in the same period.

### **3.13.3 Tax Exemptions and Deferrals from Income Tax**

Total revenue of K187.3 million has been forgone over the last three years through tax exemptions and deferrals under the Income Tax Act. However, due to data limitations, revenue forgone under various provisions of the Income Tax Act at different years is not captured.

## **3.14 TAX ADMINISTRATION**

In 2005, institutional strengthening and capacity building will continue in the Internal Revenue Commission (IRC), assisted by the ECP and the World Bank Institutional Strengthening Project in the resource monitoring sector. The aim of this activity will be to increase the capacity of the IRC to enforce tax compliance and to ensure that IRC resources are deployed in the highest priority areas.

### **3.14.1 Funding of ASYCUDA ++ System**

The ASYCUDA ++ System will receive funding of K1.2 million in 2005 to upgrade the system in PNG's major ports. The upgrading of the system has become critical as it is used to record details on imports to facilitate trade and import monitoring. The upgraded system will have the benefit of improving revenue collections and reducing business costs by accelerating customs clearances.

### **3.14.2 IRC resource review and restructuring**

The IRC will engage a human resource consultant in 2005 to review the allocation of resources within the IRC. The consultant will provide advice on possible restructuring options that would re-allocate resources to high priority areas and examine means of retaining staff with specialised skills and experience.

## **CHAPTER 4. BUILDING THE ECONOMY THROUGH SUSTAINED REFORM**

### **4.1 OVERVIEW**

The 2003 and 2004 Budgets established the broad strategic direction of the Government's policy and introduced specific policies to promote those objectives. The 2005 Budget builds on that platform, progressing the Government's policies for managing and strengthening the economy to support broad-based economic growth to improve living standards.

Government's approach to fostering stronger growth in the economy is to push ahead with a range of mutually supporting policies and reforms that, together, will lead to stronger broad-based growth.

These policies are already starting to pay dividends. Economic growth has picked up over the past two years, employment is growing and confidence is increasing. Inflation has fallen to low rates and interest rates have declined sharply. The exchange rate has stabilized.

Despite the improvement, however, the current rate of growth is only just keeping pace with the rate of population growth. More needs to be done to provide sufficient economic growth to allow for a sustained improvement in the living standards of Papua New Guineans.

Macroeconomic stability is an important pre-requisite to economic growth, but by itself is not enough. There are many factors impeding economic growth in Papua New Guinea. These are well known: political instability, law and order problems, corruption, poor quality public service delivery, and weakness in basic economic infrastructure such as roads, telecommunications and utilities. There is no 'quick fix' to these problems and no one policy that will work in isolation. Stronger broad-based economic growth will only come from sustained efforts on a number of fronts.

The Government's strategy is to create an enabling environment that will support private sector growth. There are three main elements to this strategy:

- (i) creating a stable investment climate,
- (ii) providing an efficient, effective and affordable public sector, and
- (iii) creating a competitive and dynamic private sector.

A stable investment climate requires several things: a stable political environment, a stable macroeconomic environment and a stable policy environment. The 2005 Budget continues the prudent fiscal policy of the past two years, with a deficit target of 1 per cent of GDP (as foreshadowed in the 2004 Budget), a steady reprioritization of expenditures in line with the *MTDS*, and the continuation of a stable tax regime.

An efficient, effective and affordable public sector requires affordable and prioritized resource allocation, efficient service delivery mechanisms, and effective review and oversight controls. Improved public sector resource allocation is needed to ensure that resources are going to those priority areas which support economic growth and which are consistent with community needs.

Accordingly, the 2005 Budget foreshadows a major policy initiative to be undertaken during 2005. The 'Rightsizing Program', which follows from the Public Expenditure Review and Rationalization (PERR) work that has been occurring in 2004, will review the structure of government agencies with a view to making service delivery more affordable and more efficient. The review will focus government activities on its core business, reducing administrative overheads through removal of costly duplication and unaffordable expenditures in non-priority areas. Recommendations from the review will be incorporated into the 2006 Budget.

The improved institutional structure of government will be supported by ongoing improvement in financial and human resource management systems and governance reforms to help improve the accountability of the public sector. There has been considerable progress on these fronts in 2004 and more work will be undertaken in 2005. The Human Resource Integrated Payroll system will be fully implemented in 2005, following good progress in 2004. Another major initiative, the Financial Management Improvement Program (FMIP) will continue to be implemented. This reform program is the most significant single reform of financial management ever undertaken by the Government.

A competitive and dynamic private sector requires, in addition to a sound operating environment and an efficient public sector, a supportive institutional and regulatory framework, and the removal of impediments to doing business. Institutional and regulatory reform is needed to improve the functioning of markets. The removal of impediments to business increases private sector investment, productivity and employment.

Government has been working with the business community, through the Impediments to Business and Investments Committee (IBIC) and the Consultative Implementation and Monitoring Council (CIMC) to find solutions to a range of issues that have been identified as impediments to business.

## **4.2 A STABLE INVESTMENT CLIMATE**

A stable investment climate comes from stability and certainty in many aspects of government. The Government has started to address concerns of political instability through introducing Limited Preferential Voting to provide more stable and broad-based support for elected officials as well as enacting the Political Parties and Integrity Act to improve the stability of parliament.

The Government is addressing three further key aspects of ensuring a stable investment climate: prudent fiscal management by government, a responsible debt management policy and an affordable wages policy.

### **4.2.1 Prudent Fiscal Management**

The 2005 Budget is consistent with the *Medium Term Fiscal Framework (MTFF)*, which maps out a fiscal adjustment path to ensure that public spending is affordable and sustainable. The *MTFF* was established following broad agreement that public debt levels in Papua New Guinea were excessive and unsustainable. Under previous policies, unrestrained borrowing had seen public debt climb to over K8 billion with interest payments on the debt costing over K700 million per year. The high interest burden reduced funds available for spending in priority areas. To address this problem the *MTFF* sets out a measured and phased reduction in the fiscal deficit over a number of years, moving towards a balanced fiscal position in 2008.

Consistent with that framework, the 2005 Budget reinforces the steady and responsible adjustment path that the Government has been following for the last two years.

The higher level fiscal settings have also been complemented by a range of other measures to improve budgetary processes. An Annual Budget Calendar guides the preparation of the budget. An annual Budget Strategy paper is now developed ahead of the National Budget setting out the details of the proposed budget. It outlines the economic and fiscal backdrop, the budget strategy, proposed policy changes and the detailed fiscal parameters. A Budget Screening Committee now assesses budget submissions by agencies and negotiates budget outcomes. Agencies' budgetary performances are now assessed and reviewed quarterly with a review of each agency's spending against its budgetary appropriation and the review is provided to the Central Agencies Coordinating Committee (CACC).

#### **4.2.2 Public Debt Management Policies**

Low levels of public debt and prudent management policies increase the stability of the economy, by reducing its vulnerability to shocks.

The Government will continue to implement its debt management strategy in 2005. The domestic debt strategy aims to lengthen the maturity of debt to reduce rollover and interest rate risks, while the external debt strategy aims to reduce the composition of the external to domestic debt ratio and to restructure the currency of external debt in order to reduce foreign exchange risk.

In line with the deficit reduction strategy, it is anticipated that the level of external debt will fall from current levels of around 32 per cent of GDP in 2004 to around 26 per cent of GDP in 2008, in line with the *MTFF*.

The Government will also reduce external debt in 2005 as well as implement a number of other risk management initiatives, including establishing a benchmark for determining concessionality of new loans from bilateral and multilateral sources.

In its management of domestic debt in 2005 the Government will continue with the Inscribed Stock program to lengthen the maturity structure of government debt. Financial institutions and investors will be given a pre-announced schedule of Inscribed Stock tenders for the financial year.

The Government will continue with the debt-switching program as part of its debt management strategy in 2005. Under this program, holders of Treasury bills will be allowed to switch to new Inscribed Stocks at the weighted average market yield bid at the auction. The switching program aims to lengthen the maturity structure of public debt, thereby reducing rollover and financing risks.

In addition, the Government has taken a more active role in meeting its other outstanding obligations in 2004, which will continue in 2005. It expects to settle outstanding state share liabilities to the Public Officers Superannuation Fund (POSF) by the end of 2004. A large amount of arrears have been settled in 2004, and the 2005 Budget provides for the removal of the remainder in 2005. Many outstanding court orders have been settled in 2004, and provisioning made in the 2005 Budget.

Together, these initiatives should considerably strengthen the Government's financial position in 2005.

### 4.2.3 Affordable Wages Policy

The other major area which is critical for sound macroeconomic and fiscal management is wages policy. In the past, wages policy has tended to rely heavily on increasing wages in line with the consumer price index. This has not been successful, since successive wage increases have been eroded over time by widespread price increases.

The only way for sustained increases in wages to occur is if they are paid in recognition of improved productivity. Higher productivity increases the capacity of the economy to supply more goods and services. This means that more goods and services can be made available to meet the increased demand that comes from salary increases. Without higher productivity, salary and wage increases simply push up prices, eroding the value of the increase.

In 2004 the Government considered and negotiated future salary and wage arrangements for government employees. There is now broad agreement with the negotiated outcome, providing good income support for government's employees, while being affordable and sustainable. Importantly, there is agreement on the need to explicitly recognize the importance of productivity and work performance as a basis for salary increases.

Formal agreements with the Public Employees Association (PEA), between the Teaching Service Commission and the Papua New Guinea Teachers Association, and pay arrangements for Police salaries are expected to come into force in late 2004.

## 4.3 AN EFFICIENT, EFFECTIVE AND AFFORDABLE PUBLIC SECTOR

### 4.3.1 Improved Public Sector Resource Allocation

The 2005 Budget draws heavily on the *Medium Term Development Strategy (MTDS) 2005-2010*, which sets out the Government's medium-term development priorities. The MTDS has been developed as a core development strategy guiding the Government's expenditure program, as implemented through the recurrent and development budgets. The core strategy operationalises the Government's Agenda for Recovery and Development based on the three pillars of good governance, export-driven growth, rural development, poverty reduction and human resource development.

These priorities are increasingly being reflected in public spending, both at a sectoral level and within agencies. As an example of this, in 2005, over 77 per cent of the national public sector workforce will be engaged in the high priority service delivery sectors of: education, health, law and justice, and infrastructure, with others involved in central core agencies providing valuable functions. Improved allocation of resources to priority areas will support economic growth.

The 2005 Budget foreshadows a major policy initiative to be undertaken in 2005. The 'Rightsizing' program, which follows from the Public Enterprise Review and Reform work that has been occurring in 2004, will review the structure of government agencies with a view to making service delivery more affordable and more efficient. The review will focus government activities on its core business, reducing administrative overheads through removal of costly duplication and unaffordable expenditures in non-priority areas. Recommendations from the review will be incorporated in the 2006 Budget.

The project will also include a review of oversight and governance arrangements of statutory authorities. Statutory authorities, while enjoying considerable operational independence, still need to be accountable to the national government for the way in which public resources are used and disbursed. With sizeable financial resources and considerable powers to collect revenues, some of the authorities also have a capacity to contribute to the Government's fiscal position.

Improved budgetary oversight will ensure that the Government and the wider community receive the appropriate level of service at realistic costs, allow Government to accurately assess revenue and finance impacts of the authorities in the Budget and ensures that authorities' forward work programs accord with broader government objectives. Several major statutory authorities participated in the 2005 Budget Screening Committee negotiations to this end.

#### **4.3.2 Provincial Resource Allocation**

The 2004 Budget contained changes to sub-national grant funding arrangements. These measures were primarily designed to direct funding specifically to the core priorities of basic education, primary health and transport infrastructure maintenance (through Function Grants), to help lay the foundation for the implementation of the *MTDS*. The three other key objectives of these changes are to take into account all sources of provincial revenue, including internal revenue, to introduce a Less-Developed District Grant to make funding more equitable between provinces; and to bring the grant formulas back within affordable limits.

The 2005 Budget keeps these arrangements on funding core priorities in place, through: the Function Grants; Discretionary Block Grants; Derivation Grants paid at 0.75 per cent of the value of eligible exports; Staffing and Teachers' Grants; and Rural Local Level Government Grants and Town Services Grants. The expected amendments to legislation to ratify such arrangements were not presented to Parliament during 2004. The continuation of current arrangements is contingent on Parliament passing the amendments in 2005.

It is anticipated that these changes will remain in place while the National Economic and Fiscal Commission (NEFC) finalises proposals for more substantial improvements to the system of intergovernmental fiscal relations. To inform its proposals and recommendations to the Government, the NEFC is undertaking a number of major activities and studies. The key aim is to identify the current functions, roles and responsibilities of all levels of government, as they are currently understood by all stakeholders.

A process for agreeing on the distribution of responsibilities across policy, operational and funding aspects for all services has been established. This is to help overcome the current confusion in this area and to help improve the allocation of resources to priority tasks. There has been wide consultation to clarify the existing sub-national taxing powers, to overcome the present legal and administrative confusion, and to assess the appropriateness of the allocation of these powers in light of the potential for sub-national taxes to expand in different regions.

The work will also investigate the impact of current system of grants and transfers to sub-national governments form proposals for their redesign; and cost the expenditure responsibilities of different sub national governments, to determine how much provinces and Local Level Governments need to fund their responsibilities. Importantly, this study is identifying differences in the cost of providing a given set of public services in different parts of Papua New Guinea.



#### 4.3.3 Improved Governance and Accountability

In 2005, the Government will continue to promote good governance by continuing to strengthen the management, structure and oversight of the public service, including the transparency of government processes and the accountability of senior public servants. The reforms will continue to strengthen the legal oversight mechanisms to detect and prosecute cases of fraud and corruption. The reforms seek to improve accountability, compliance, and leadership, improve fiscal management, and improve service delivery. The reforms continue to be guided by the *Strategies for Supporting Public Sector Reform 2003-2007*.

The Government will continue to strengthen the oversight agencies. The revitalizing of the Parliamentary Public Accounts Committee to review budgets and expenditures of public bodies has improved the agencies accountability and compliance with the procedures and processes of the government accounting system. In addition, a National Anti-corruption Alliance, including the Ombudsman Commission and the Auditor-General, is operating to detect and investigate possible cases of corruption. The Government continues to support the independence and funding of these oversight agencies.

The Government is moving positively to improve compliance and accountability and to create a performance-oriented public sector.

All department heads and provincial administrators are being appointed on merit and are to be placed on performance-based contracts. The new process will be applied to all heads of government organisations in 2005, including statutory authorities.

The objectives of this reform are twofold - to secure a more stable level of leadership across the public sector and to ensure that the best person is appointed. Removing the uncertainty of tenure for competent leaders means that they can now concentrate on the long-term process of building their organisations into efficient and effective service providers.

This reform is being supported by the revitalization of the Public Service Commission. The Commission will be further strengthened in 2005.

The Performance Management System should also support increased accountability. Under this system, all departmental heads are required to furnish their departmental corporate plans for each year and their respective annual reports.

The Government has also carried forward reforms in government procurement to introduce good governance practices and better control of expenditure. The *Public Finances (Management) Act* (PFMA) has been amended to require provincial and local level governments to submit annual financial statements to the Minister for Finance and Treasury and the Minister for Provincial and LLG Affairs.

Amendments have also been made to the PFMA to overhaul the Government Supply and Tender Board to: (i) achieve new procedures to ensure appointment on merit and impartial behavior of board members; (ii) consolidate all national boards under Central Supply and Tenders Board (except Bougainville, Gazelle Restoration Authority and Pharmaceuticals); and (iii) undertake institutional and structural changes to improve transparency, equity, accountability and value for money.

Financial Controllers have been appointed to the big spending departments and agencies, Provincial Authorities to Pre-Commit committees have been established, and reporting systems have been improved to record accurate trust account data. Tighter controls have been placed on accounting systems used for trust accounts and tighter restraints have been introduced on the issuance of cheques.

In 2005, the government will continue to strengthen government procurement practices including through a review of all trust accounts.

#### **4.3.4 Civil Service Size and Payroll Reform**

In 2005, the Government will continue with its public sector reform program, to make the public sector more affordable and efficient. An important part of the reform strategy is to rationalise the public service payroll, through improved administration, better management of human resources and a rationalisation of public sector structures.

The Human Resource Integrated Payroll system has been successfully installed, with the coverage of all national departments and provinces. A significant number of payroll anomalies, including ghost names, unentitled payments and overpayments have been addressed through the first stage of data cleansing. A number of major business processes relating to reporting and payroll transactions will be reviewed in 2005. This will be further complemented by implementation of the budget module. The information available from the new system should be increasingly available to agencies in 2005, helping them manage their payroll more effectively.

##### **4.3.4.1 Employment Control**

In 2004, the Government established a Treasury and Department of Personnel Management (DPM) Joint Committee to monitor the public service recruitment processes and to provide better oversight and control of agency spending on wages and salaries. This Committee has worked with agencies during 2004 to help them reform their staffing practices and to bring greater consistency into endorsements by Treasury and DPM on matters relating to staffing commitments, such as recruitment and restructuring. The Committee will continue its role in 2005.

Ceilings for staff numbers for agencies are provided in the 2005 Budget (See Table 5 of Volume 2 Part 1). These are binding upper limits on staff numbers, and they are supported by realistic, but equally binding appropriation limits.

Payroll control will be further strengthened with the introduction of a Funding Secured Certificate on 1<sup>st</sup> January 2005. This mechanism will certify the availability of funds for the current year for the purposes of recruitment and agency restructure. No approval will be granted without the Funding Secured Certificate.

Some rationalization of the public sector payroll occurred in 2004 and it will gather pace in 2005. In 2004 all non-essential casuals were removed from the payroll. In addition, a large number of unattached officers were removed from the payroll, including officers from Civil Aviation Authority (CAA) and the Department of Works. Further funding has been made available in the 2005 Budget to remove the remaining unattached officers, nearly 600, from the payroll of national departments.

### **4.3.5 Improving Financial Management**

#### **4.3.5.1 Enhancing Financial Systems**

During the Public Expenditure Review and Rationalisation (PERR) exercise in 2003, it was revealed that Papua New Guinea has one of the better finance management and accounting systems in the developing world, a comment echoed by the World Bank and other international financial institutions. However, proper management and implementation of these systems were lacking.

Substantial progress has been made in 2004 in improving financial management. In 2005, the Government will undertake further work to develop, implement and maintain sound financial systems.

The strategies are to: (i) maintain sound financial systems to process and account for government expenditure and revenue; (ii) provide efficient and effective accounting for all government revenue and expenditure in accordance with the Public Finances (Management) Act, financial policies and instructions; (iii) procure and implement an integrated financial management system (IFMS); (iv) assist and support the implementation of the new human resource and payroll system to improve budgeting, establishment and occupancy management; (v) strengthen payroll processing, accounting and improved personnel expenditure control; (vi) maintain and develop government information technology and communications systems; and (vii) develop a government-wide area network to operate the financial systems of government.

#### **4.3.5.2 Improving Expenditure Control**

Addressing expenditure control issues is critical to restoring the integrity of budget institutions and systems and returning Papua New Guinea to fiscal sustainability.

The Government is committed to improving budget management and accountability at the Provincial level, including reforming public expenditure systems and procedures at the provincial and district levels. The reform agenda requires (i) the National Government to mandate minimum spending on priority sectors by provinces and Local Level Governments (LLGs); (ii) a sound balance between recurrent and capital spending; (iii) full disclosure of provincial own-source revenues in their respective budgets; (iv) incentives for minimizing staffing levels; (v) enforcing the system for quarterly review by the Department of Treasury for expenditures; and (vi) effective audit and penalties for transgressions.

The new Authority to Pre-Commit (APC) has ensured that no contracts above K100,000 are entered into without confirmation that the proposed purchase or project has been budgeted for. Implementation and awareness across the country has been effective through the efforts of the National APC Committee. Compliance has been ensured as no Supply and Tenders Board in the country can now accept a tender submission without proof of funds availability, as evidenced by an approved APC.

#### **4.3.5.3 Appointment of Financial Controllers**

One of the key objectives of the Government is on expenditure control and instilling fiscal discipline. Amongst other initiatives being undertaken in expenditure control is the appointment of Financial Controllers to big spending departments and agencies, including, the Department of Health, Education, Correctional Services, Police and Defence. Financial controllers will be placed in other departments and agencies in 2005. So far, twelve Financial Controllers have been appointed.

As an ongoing process to appoint financial controllers in the Government and State owned enterprises, scoping studies are being undertaken to determine the requirements for Financial Controllers in Forestry, Fisheries, Civil Aviation Authority and the Department of Works. It is proposed to engage outside consultants to determine the scope of works for long-term engagement of Financial Controllers.

In addition, the Papua New Guinea Government Accounting System (PGAS) has been modified to give Financial Controllers final control over cheque authorizing and processing after all financial and procurement guidelines are satisfied under the PFMA.

A new weekly reporting format was initiated in August 2004 for monitoring the performance of Financial Controllers. This report summarizes for each department the claims/payments reviewed and the savings made by the Financial Controller.

#### **4.3.5.4 Non-Tax Revenue Maximization**

The Revenue Division in the Department of Finance will enhance effective monitoring and collection of non-tax revenue. A full review has been completed of all non-taxation revenues. Most fees and charges have been reviewed and recommendations have been made to address cost recovery, pricing and collection matters in 2005.

#### **4.3.5.5 Rationalization of Trust Accounts**

The Government's efforts to further maintain greater fiscal control have been enhanced through the trust account review and rationalization initiative.

Trust accounts operated by Government have been reviewed through data cleansing of the General Ledgers of all Trust Accounts. Accounts with debit balances, dormant accounts, and recurrent revenues will be written off or closed. The review has recommended the closure of over 300 trust accounts. The next phase of the review is to establish the legality of the trust accounts as to whether these have been reported in the overall Accounts.

Further work will be undertaken with the provinces and statutory bodies to further rationalize trust accounts.

#### **4.3.5.6 Roll out of District Treasuries**

Establishment of District Treasuries is in accordance with Section 112 of the Organic Law on Provincial and Local Level Governments. A recent amendment to Section 10 of the PFMA provides for three separate Public Accounts for the three levels of government. Hence there is a need to help create District Treasuries to maintain the Local Level Government Accounts and produce separate annual financial statements in compliance with law. The roll-out of District Treasuries complements the Government's stance to provide financial accounting, reporting and monitoring services, support to LLGs and Wards closer to the people.

There are a total of 89 Districts in the country. Of this, 83 District Treasuries are planned. A total of 23 District Treasuries are now completed, and work is in progress in 26 other districts.

#### **4.3.5.7 Strengthening of Audit Cells**

The Government has already begun strengthening the capacity of internal audits cells in 2004 through a professional development program for government internal auditors. An Audit Committee has already been established in the Department of Health and preliminary meetings have already been held with the Police, Defence and Works Departments with a view to establishing audit committees and strengthening of internal audit cells. In 2005, the program will be extended to other government departments and agencies.

The Audit Committee's duties and responsibilities will involve the review of the internal control systems, the administration of an internal audit plan and a review of financial reporting capability to meet the requirements of the Government.

#### **4.3.5.8 Control on Claims and Arrears**

The Government has responded to serious concerns about poor control over spending by individual agencies on goods and services, where orders were issued outside of the Government's Accounting System (PGAS). It has begun re-instituting the use of Integrated Local Purchase Order (ILPOC) as a system of payment by Government. The ILPOC system ensures that orders issued without the generation of an ILPOC will not be paid.

The amendments to the PFMA and the *Claims By and Against the State Act* in 2003 have meant that no legally enforceable arrears can be generated. However, it is important that these amendments continue to be actively enforced, to ensure that irregularities do not occur.

#### **4.3.5.9 Financial Management Improvement Program**

The Financial Management Improvement Program (FMIP) will continue to be implemented. FMIP is an integrated reform program of financial management at all levels of government, and is the most significant single reform of financial management ever undertaken by the Government.

The FMIP objective is to implement best practice and transparency in Government financial management within and between National, Provincial and Local-level Governments. The Program will improve the financial management system.

A mid-term review of the FMIP was conducted by the Asian Development Bank leading to a Memorandum Of Understanding being signed by the Government and ADB to proceed with the next phase commencing October 2004. The review emphasized a shift in focus from the preparation stage to implementation.

In order to facilitate the shift in focus as a result of the review, the FMIP Implementation Committee is now replaced by a non-executive Consultative User Group. The purpose of the Consultative group is to provide a forum to ensure key stakeholders are kept abreast of developments within FMIP.

#### **4.3.6 Enhanced Cooperation Program (ECP)**

Public sector performance will be enhanced through the full Enhanced Cooperation Program in 2005, under the initiative developed by the Papua New Guinean and Australian Governments. The program will involve substantial assistance in law and order, good governance, sound financial administration and public sector capacity building. Under the program, which commenced in 2004, there will be:

- Up to 36 economic and public administration specialists working with central economic agencies (Treasury, Finance, Internal Revenue Commission, Prime Minister and NEC, and Personnel Management) and national agencies.
- Up to 18 legal specialists working with the Solicitor General's Office, Prosecutor's Office, National and Supreme Courts, the Department of Justice and correctional institutions.
- Up to 10 officials working in border protection and transport security agencies (Immigration, Customs, Civil Aviation).
- Up to 230 police officers working with the Royal Papua New Guinea Constabulary.

This initiative should improve the capacity of the public service to provide good quality policy advice and implementation, and improve the capacity of the police force.

### **4.4 A COMPETITIVE AND DYNAMIC PRIVATE SECTOR**

The engine of growth in any economy is a competitive and dynamic private sector. The factors necessary to enable and foster private sector growth are well known: political, macroeconomic and policy stability; strong institutions, particularly in the law and justice sector; an efficient public sector; supportive infrastructure; and solid, but not overly burdensome, regulation.

At times, targeted incentives can also support the private sector, but more often they are ineffective. Sustained broad-based growth can only come from improving the overall business environment. Policy measures to support this have been introduced in this year's budget.

#### **4.4.1 Removing Impediments to Economic Growth**

##### **4.4.1.1 APEC Peer Review of PNG's Individual Action Plan**

Upon joining the APEC in 1996, PNG agreed to liberalize 14 areas: tariff; non-tariff measures; services; investment; standards and conformance; customs procedures; intellectual property; competition policy; government procurement; deregulation/regulatory review; WTO obligations (including Rules of Origin); dispute mediation; mobility of business people; and information gathering and analysis. This was on a voluntary and non-binding basis to achieve free and open trade and investment.

APEC member countries, including PNG, submit their Individual Action Plans (IAPs) which contain a record of actions to be taken by each member economy on the 14 APEC areas on an annual basis. A Peer Review is conducted on the IAPs by APEC after the member country requests one. PNG's IAP will be reviewed in 2005 during the First APEC Senior Officials Meeting (APEC SOM I) in Korea. The Peer Review process will provide an opportunity for PNG to present its progress report on the implementation of its IAP and demonstrate to the business community in the APEC region that PNG has undertaken some of the fundamental and necessary reforms to facilitate trade and investment.

A number of specific policies liberalizing trade and investment have been examined in 2004 and will be reflected in policy changes in 2005.

Trade liberalization, through the Tariff Reduction Program, will continue as planned. Lower tariffs reduce input costs for businesses and also encourage businesses to become more efficient and competitive. Consistent with this, the temporary 2 per cent import levy imposed in 2004 will be removed as planned.

The Government is actively working with the PNG business community, through the Impediments to Business and Investments Committee and the Consultative Implementation Monitoring Committee (CIMC) to find solutions to a range of issues that have been identified as impediments to business, including those that have already been raised in APEC. The work has focused on a range of issues including the removal of bureaucratic red tape, simplifying processes for immigration and work permits, removing the Reserved Activity List, streamlining foreign exchange controls on overseas remittances and increasing the efficiency of customs clearances.

The Government has agreed to streamline the PNG immigration and work permit system. These initiatives will include the removal of requirements for localization plans, and extension of long-term work permit periods from 3 years to 10 years, a new permanent residency category for long-term residents particularly for skilled employees and business people and the implementation of APEC Business Travel visa to facilitate travel within the APEC region by businesses.

The Bank of Papua New Guinea is currently reviewing PNG's foreign exchange controls and will release the results of its review later this year. It is anticipated that changes resulting from this review will significantly reduce the regulatory burden on business people.

Funding has now been allocated to the Internal Revenue Commission to allow implementation of ASYCUDA ++ customs clearance and tracking system at the ten major ports by end-2005, with the remainder to follow in 2006. This should increase the efficiency of customs processes and revenue collection.

#### **4.4.1.2 Privatization Program**

The Government, through the Independent Public Business Corporation (IPBC), is continuing with its program for rehabilitating and, where appropriate, partially or fully privatising public enterprises and other State assets. At present, the telecommunications, electricity and transport infrastructure is inadequate and is impeding business investment.

Following an unexpected withdrawal of Korea Telecom from negotiations for the sale of a 51% interest in Telikom PNG in December 2003, the IPBC entered into extensive negotiations for the sale of this asset to a joint venture of African based companies, Econet Wireless Group and Allied Technologies Ltd. A sale was agreed with the joint venture, subject to Government approval, in mid 2004. Given the crucial importance of the telecommunications sector to the broader functioning of the economy, the Government has given very careful consideration to the sale agreement, including by commissioning an independent review of aspects of the sale process and of the proposed terms of the sale. A decision on the proposed sale is expected shortly.

The Government remains committed to facilitating the very substantial and much needed new investment in upgrading PNG's telecommunications infrastructure, including the extension of services to all rural districts. This will provide a major impetus to future economic growth and will yield significant broader social benefits in terms of facilitating greater access for the population to community services.

Good progress continued to be made also in rehabilitating other major Government enterprises. The financial performance of most of the major enterprises vested with the IPBC, and with whom the IPBC has been able to work closely, improved appreciably over the past year. The most notable of these are Post PNG and Air Niugini who are now realising solid profit growth.

After years of neglect, nevertheless, organisations such as PNG Power, PNG Water Board, Eda Ranu and PNG Harbours will be required to undertake very substantial new investment over the next few years to rehabilitate and expand their existing infrastructure and improve delivery of their services. Funding this required new investment would present major challenges for the Government going forward.

A sale of a controlling interest in the Government-owned Motor Vehicles Insurance Ltd is also well advanced and should be concluded in the near future. The IPBC in January 2004 concluded the sale of Revenue Haus, a major office building in Port Moresby, for K27 million.

The Independent Consumer and Competition Commission (ICCC), which was established in 2002, is now fully operational. As the Government's single competition regulator, it is responsible for the regulation of utility monopolies and administering the State's anti-competitive conduct legislation. During 2004 the ICCC has released reports into a number of regulated industries and price controlled products including telecommunications, post, refined petroleum products, and water and sewerage services. Further reviews are scheduled for 2005. Supported by the Australian Competition and Consumer Commission, the ICCC will continue to strengthen its investigative capabilities in the area of anti-competitive conduct and abuse of market power during the next year.

#### **4.4.2 Financial Sector Reform**

##### **4.4.2.1 Improving Access to Credit**

Historically, the Rural Development Bank (RDB) has been a central vehicle through which governments have sought to extend the availability of credit to mainly small and medium scale activities in both rural and urban areas. However, years of poor lending performance culminated in the RDB becoming insolvent in early 2004 with the result that it has been forced to cease all new lending activity.



In response, the Government appointed a new Board and Managing Director of the RDB and commissioned an accounting firm to investigate the specific causes of its failure and to advise on a potential financial recovery plan. Based on the findings and recommendations of the report, the Government will be looking over the remainder of 2004 and in 2005 to implement a comprehensive overhaul of the RDB's operations with a view to sustainably improving governance, financial management and re-establishing its lending activity.

In the interim, the new management of the RDB is continuing aggressively to seek recoveries from its extensive existing non-performing loan portfolio and to improve the general management of the organization.

The Government will continue to explore and support microfinancing programs in 2005. Since November 2001, the Microfinance and Employment Project has been implemented as part of the Microfinance Policy of the Government. The objective of the Project is to provide microfinance services and facilities to viable, small and medium size enterprises. The Project has three main components.

The microfinance competence centre provides training and technical assistance for capacity building of existing and new microfinance institutions. New courses will continue to be offered in 2005. The new savings and loan products component develops, tests and implements innovative microfinance products and delivery methods. Under the component, a Micro Banking Pilot Scheme has been designed, established, and is in operation in Wau. Five new loan products and four savings products have been designed and tested at the Wau Micro Bank. A Revolving Finance Facility has been established at the Bank of Papua New Guinea, so that beyond 2005 the Facility will provide loan funds to support microfinance institutions so they can expand their loan portfolios and outreach in a sustainable way.

#### **4.4.2.2 Superannuation and Life Insurance**

In recognizing the importance of maintaining a sound financial management system, the Government will continue to support and strengthen the reforms to the Financial Sector that were introduced in 2000. Most of the reforms have almost been completed, with the expected completion of the superannuation and life insurance reforms by mid 2005.

The reform of the superannuation industry to introduce prudential supervision of the industry has been successful. The prudent management of fund assets and investment strategies as required by the prudential guidelines, and the 'fit and proper person' requirements to appoint directors and trustee members should ensure member funds are protected against mismanagement. These reforms will be further strengthened in 2005 with the review of the effectiveness of the administration and prudential management of the regulatory regime established by the Superannuation Act.

In 2005, mandatory employer and employee contribution rates for the private sector will increase by 0.7 per cent and 0.5 per cent respectively from the current levels of 7.0 per cent and 5.0 per cent to the new rates prescribed in the table below.

**Table 22: Mandatory Employer and Employee Contributions (per cent)**

<b>Year</b>	<b>Employer</b>	<b>Employee</b>
2002 - 2004	7.0%	5.0%
2005 - 2007	7.7%	5.5%
2008 onwards	8.4%	6.0%

Source: Superannuation Regulation 2002

The increase in the private sector contribution rates will marginally increase retirement benefits for private sector contributors, although it will not be fully adequate to provide a reasonable level of replacement income after retirement.

The phasing upwards of the private sector contribution rates to be in line with the public sector contribution rates will also result in a unified mandatory contribution rate for all accumulation funds, given that employer portability is allowed under the Superannuation Act.

The contribution from the State, as an employer, will also increase from 2.1 per cent to 4.2 per cent in 2005, in line with a transition to fully funded system by 2009. The move, mandated by the Superannuation Act, towards progressively fully funding future government superannuation obligations is an important step towards restoring confidence in the superannuation industry.

As confidence is restored, and preservation improves, funds under management will grow quite strongly. Under professional management, some of these increased savings will flow overseas, to diversify risk and improve returns for contributors.

More importantly, there will also be a growing pool of savings. These savings will support genuine investment opportunities in the country, including those arising from the Government's privatization program.

#### **4.4.2.3 Insurance Complaints and Disputes Tribunal**

The provisions of the General Insurance Act, 1995, require the Office of the Commissioner of Insurance to establish an Insurance Complaints and Disputes Tribunal. The Tribunal, once established, by both the Office of the Commissioner of Insurance and the Papua New Guinea Council of Insurance will assist insurance policyholders to resolve their complaints and disputes on general insurance policies promptly and satisfactorily with insurance companies.

The resolution of complaints and disputes will operate on a three-tier system. Firstly, complaints and disputes from policyholders will be dealt with by the Internal Disputes Resolution (IDR) system of the insurance companies. In the event this fails, the disputes will be referred to the Office of the Insurance Commissioner to resolve. The disputes will only be referred to the Tribunal if they cannot be resolved at both industry and Office of Insurance Commissioner levels.

The main issues for the draft Terms of Reference have been resolved with the industry. An inter-agency Task Force has evaluated a draft TOR prepared by the Insurance Council and it has been forwarded back to the Council for a revision of the draft. The TOR will be finalised in early 2005 and the Tribunal established soon thereafter.

#### **4.4.3 Supporting Rural Growth**

##### **4.4.3.1 Agricultural Tax Support**

The proposed 2005 Budget does not propose any new taxes or tax increases, providing a stable tax regime for rural income earners.

There are, in addition, new and continuing tax incentives to help promote income-earning opportunities in rural areas. The Highlands Highway supplementary tax credit will be extended to support road maintenance, providing better transport infrastructure to facilitate the distribution and marketing of rural products.

The infrastructure tax credit for agricultural activities will be increased from 0.75 per cent to 1.0 per cent, to provide increased support for agricultural road maintenance.

Continuing incentives include:

- the 150 per cent tax deduction for approved agricultural research and development;
- the 150 per cent tax deduction for approved agricultural extension services;
- the 20 per cent income tax rate (reduced from 30 per cent) for new primary production projects commencing between 1 January 2004 and 31 December 2006 where certain conditions are satisfied;
- the excise duty exemption (reduced from 10 per cent) for tractors imported for use in agricultural and forestry work; and
- the 50 per cent reduction in excise on diesel used by commercial fishing vessels.

A review of the forestry revenue system is proposed for 2005 to ensure that forestry taxation arrangements are cohesive and effective.

#### **4.4.3.2 Improving Forestry Management**

The Government recognises that sustainable management and conservation of forest resources and bio-diversity are of paramount importance, since forestry resources play a key role in the livelihood of the rural population and the nation as a whole. It is crucial that balance is found between the objectives of income generation and forest conservation, so that Papua New Guinea's forest resources can be planned and managed in a transparent and sustainable manner, in order to provide rural communities and the rest of the country with necessary raw materials, and long-term employment and income-earning opportunities from harvesting, processing and conservation of the resource.

The Forestry and Conservation Project, which was agreed with the World Bank at the end of 2001, and became operational from mid-2002, was designed to implement a broad range of participatory processes for landowners in forestry management and to strengthen the functions and processes of the PNG Forestry Authority, as well as other institutions with responsibilities over the sector, such as the Department of Environment and Conservation. The project also encompasses grant funding from the Global Environment Facility, and other donors, for the Mama Graun Conservation Trust Fund, which provides an endowment fund, for supporting long-term conservation initiatives in priority areas.

The Government is fully committed to bringing the forestry sector into compliance with the Project requirements, and has given clear directions to resolve the outstanding matters as quickly as possible. Lifting of the suspension will allow both the Forestry and Conservation Project and other stalled World Bank funded projects (e.g. the Highlands Highway support project) to proceed.

During the past year, independent reviews have been undertaken of existing forestry projects and also of the procedures undertaken to allocate various new projects and project extensions. The reviews identified some areas for improvement and also identified a need to revise the project implementation plan for the Forestry and Conservation Project. The government is considering these reviews with a view to improving implementation in 2005.

## **CHAPTER 5. PAPUA NEW GUINEA'S DEVELOPMENT STRATEGY AND EXPENDITURE PRIORITIES**

### **5.1 PAPUA NEW GUINEA'S DEVELOPMENT CHALLENGES**

The key challenge faced by Papua New Guinea is to achieve broad-based economic growth that involves the participation of ordinary Papua New Guineans and leads to sustainable improvements in living standards. This includes the improvement of development indicators such as life expectancy, literacy, and infant and child mortality.

In order to effectively address this challenge, the Government must work in partnership with all stakeholders in the development process, including international development partners, the private sector and non-governmental and community-based organizations. In so doing, the Government must concentrate on its core functions, limiting its activities to the provision of goods and services that underpin effective development.

### **5.2 THE AGENDA FOR RECOVERY AND DEVELOPMENT**

The Agenda for Recovery and Development was announced by the Government in August 2002. It is based on the three pillars of:

- good governance;
- export-driven growth; and
- rural development, poverty reduction and empowerment through human resource development.

The Agenda represents the overall development objectives of the Government and so provides the basis for development policy, as reflected in the *MTDS* 2005-2010.

### **5.3 THE MEDIUM TERM DEVELOPMENT STRATEGY (2005-2010)**

The *MTDS* 2005-2010 has three main roles. These are:

- To provide the overarching development strategy for Papua New Guinea;
- To provide the policy and expenditure framework for the implementation of the Agenda for Recovery and Development; and
- To help strengthen the public expenditure management framework in Papua New Guinea.

The principle objective of the *MTDS* is to engender broad-based economic growth and improve the standard of living of ordinary Papua New Guineans. This means not only funding projects and programs that facilitate the export-driven growth process, but also addressing the key social issues in Papua New Guinea, such as increasing access to basic education and health care, with a view to improving literacy rates and reducing infant and maternal mortality.

In attempting to achieve these objectives, the Government recognizes that it faces considerable challenges, including population growth, urbanization, HIV/AIDS, land utilization and dysfunctional service delivery systems.

The population has been growing at an annual rate of 2.7 per cent and until recently has been outstripping economic growth and the capacity of government to provide services. Fostering increased participation in the workforce, more employment and increased productivity is necessary to ensure that service delivery keeps pace with the needs of a growing population.

Within the *MTDS*, urbanization is recognized as an inevitable phenomena of development. As such, it is approached through the adoption of multi-sectoral policies and legislation that aims to protect those living in the peri-urban settlements and to improve their standard of living, including access to basic education and health facilities. The ultimate goal of the Government is to integrate these urban settlements into the wider urban area.

The *MTDS* recognizes that HIV/AIDS is now a critical development issue that could undermine development efforts of the Government if left unaddressed. HIV/AIDS could potentially have a very serious adverse effect on the standard of living of ordinary Papua New Guineans, both through the impact of the illness on infected individuals and the knock-on impacts on carriers, family, orphaned children, society and the economy as a whole. The epidemic could severely undermine PNG's growth and development prospects. As such, the *MTDS* outlines the approach that the Government will take in addressing the issue over the medium term, including integrating HIV/AIDS awareness into all development policies and strategies.

Customary land tenure is firmly entrenched in the nation's culture and it is recognized under our laws. Customary owned land, however, is also widely viewed as a major constraint to economic development. As a general rule, customary owned land cannot be used as collateral by landowners seeking investment funds because of the absence of secure title. As well, individual landowners have little incentive to improve the land if the resulting benefits accrue to a large number of people who did not contribute to the improvement effort. Mobilizing customary land for large-scale economic projects is also viewed as costly, time-consuming and is characterized by ongoing uncertainty. As such, the Government is investigating ways to bring about culturally sensitive land reform, including through the strengthening and streamlining of the lease-lease-back system that has proved to be successful in the agriculture industry.

Under the 1995 Organic Law on Provincial and Local Level Governments, service delivery was to be improved through the transfer of significant responsibilities and funds to the lower level governments, especially local level governments. However, the outcome has been that in the years since the passage of the Organic Law, service delivery has deteriorated. Service delivery systems are dysfunctional and there remains widespread confusion over the functional (who does what) and financial (who pays for what) responsibilities of the various levels. Institutional capacity to deliver services is generally poor, and in many local level government areas, is grossly inadequate.

In order to address these issues, the Government is committed to reviewing the current system of provincial and local level government. In line with this, a review into inter-governmental financing is currently being carried out by the National Economic and Fiscal Commission. The issue of integration between the three levels of government is also being addressed directly in the 2005 Development Budget through projects such as the District Roads Improvement Program (DRIP), which requires contributions from all levels of government to road improvement projects, and the Provincial Performance Improvement Initiative.

In order to achieve the *MTDS* objectives as well as to overcome the challenges outlined above, the *MTDS* 2005-2010 identifies seven expenditure priorities. These are:

- Rehabilitation and maintenance of transport infrastructure;
- Basic education;
- Primary and preventive health care;
- HIV/AIDS prevention;
- Development oriented adult education;
- Law and justice; and
- Generation of income-earning opportunities.

These expenditure priorities, whilst each being important in their own right, are also mutually reinforcing. For example, once income-earning opportunities have been identified, they will not be taken up unless people can be sure that they will be able to get the goods that they have grown to market. Thus, there must be useable roads. Equally, if people cannot ensure that they will not lose their produce or money to criminals, then they will have little incentive to enter into productive activity. Thus there is a crucial role for law and justice.

The focus in the *MTDS* on the generation of income-earning opportunities, in order to involve ordinary Papua New Guineans in economic growth and the development process, is not limited to the agriculture sector. Rather, the Government also aims to create the requisite supporting environment that will lead to the establishment of a viable down-stream processing and manufacturing sector.

The *MTDS* devotes considerable attention to the issue of implementation, in order to ensure that service delivery improves as a result of the strategy, with a consequential impact on development.

A key approach that will be adopted in order to implement the *MTDS* is that of forming strategic alliances in the development process, and ensuring that these are used effectively to achieve the objectives of the *MTDS*. These strategic alliances include integrating the three tiers of government and forming a partnership with the private sector, international development partners and other stakeholders in the development process, such as non-governmental and community-based organizations.

The National Charter Program will form the basis of the implementation strategies. The Charter places an emphasis on the improvement of basic services, through the shared financial participation of lower level governments and the National Government. The Government will use this concept to design a number of programs that will allow for more effective coordination of activities and better use of scarce resources. An example of one such program is the DRIP, which has been created to better integrate programs in the transport infrastructure sector. Under the DRIP program, National Government funds will not be provided until Members of Parliament and provincial governments have contributed to the project.

#### **5.4 THE 2005 DEVELOPMENT BUDGET: APPROACH AND KEY INITIATIVES**

The 2005 Development Budget will be driven by the *MTDS*. As such, the Public Investment Program and donor funded projects have been reviewed to ensure that they are in line with the *MTDS* priorities. Those that are not, have not been funded in the 2005 Development Budget.

The first priority of the 2005 Development Budget is the rehabilitation and maintenance of transport infrastructure. Roads have been consistently identified as one of the main obstacles to development in Papua New Guinea, and as such, this must be reflected in the 2005 Development Budget. The Development Budget will include counterpart funding for large development partner projects, including the ADB five Highlands Provinces project, the World Bank Road Maintenance Programme and AusAID Key Roads for Growth. In addition, significant government and development partner funds will be directed to the District Roads Improvement Programme, as outlined above. The Government will also support transport infrastructure through infrastructure tax credits.

Generating income-earning opportunities and nurturing growth is another key initiative in the 2005 Development Budget. It should be noted that the role of government in this case is only to provide the supporting environment that will allow the private sector to flourish. Thus government programs will focus on the provision of rural credit, extension and marketing services and support for the informal sector. The Development Budget includes large projects funded jointly with development partners, such as the Nucleus Agro-Enterprises Project and the Employment Orientated Skills Development Project. In addition, in 2005 the Government will be funding a new program, the Provincial Economic Impact Program, aimed at identifying key opportunities for economic growth in the provinces.

Overall, for the 2005 Development Budget, K1.88 billion has been allocated, an increase of 38.2 per cent on the 2004 appropriation. This large increase is in part due to the police component of the Enhanced Cooperation Programme as agreed between the Governments of Australia and Papua New Guinea, which has been included in the Development Budget for the first time in 2005. There has also been a 22 per cent increase in the amount of Government funds in the Development Budget compared with the 2004 appropriation. In addition to the K281.0 million of Government funds in the 2005 Development Budget a further K110.9 will be provided in the form of infrastructure tax credit. The infrastructure tax credit will be used to help the Government meet its counterpart requirements, in order to ensure that projects are advanced in a timely manner. The funds will be spent primarily on the Highlands Highway with K50 million going to this purpose. A large part of the remainder (K27.2 million) will be spent on infrastructure projects in the Southern Highlands province.

**Table 23: 2005 Development Budget, Listing of Key 'Impact Programmes'**

<b>Impact Category and Program</b>	<b>Kina Millions</b>
Transport Infrastructure Rehabilitation and Maintenance	
• Highlands highway maintenance and rehabilitation	108.1
• Infrastructure tax credit highlands highway	50.0
• Other roads and bridges maintenance and rehabilitation	199.2
• District Road Improvement Programme	20.0
• Airport Maintenance and Upgrading	14.5
• Maritime infrastructure development	38.0
Export Promotion and Income Earning Opportunities	
• Provincial Economic Impact Programme	10.0
• PNG Gas to Queensland Support	2.0
• Petroleum Industrial Park	0.7
• Marine Industrial Park	0.6
• Agro Industry Development	8.0
• Agricultural Research	9.6
• Tourism Awareness	2.0
Public Sector Reform and Governance	
• Provincial Services Cadetship	0.3
• Enhanced Cooperation Program	502.7
Access to Basic Education and Health	
• Human resource development (phase 2)	17.4
• Health sector improvement program	20.1
• Funding for National AIDS Council	10.5

SOURCE: Department of National Planning and Rural Development



## CHAPTER 6. SECTORAL POLICIES

### 6.1 OVERVIEW

The *MTDS* is the Government's overall medium-term planning framework. The new *MTDS* 2005-2010 has been developed following a comprehensive consultation process, which sought the views of international development partners, the private sector and civil society. As a result of this extensive review, the new *MTDS* more closely reflects the development priorities of Government and is likely to have a greater impact on development than its predecessor.

The *MTDS* document provides the overarching development and expenditure framework for Papua New Guinea. The *MTDS* is complemented by the longer-term National Poverty Reduction Strategy (NPRS). The NPRS will be closely integrated with the new *MTDS*. Given that the period of implementation of the NPRS is longer than that of the *MTDS*, it is envisaged that this strategy will be the anchor to carry forward the development goals through successive governments, resulting in policy continuity.

The Government's broad development strategy is also underpinned by its support for environmental sustainability. It is a party to international conventions to uphold environmental standards and to prevent environmental degradation. Accordingly, the Government is preparing a National Sustainable Development Strategy in recognition of its concerns and obligations, in order to ensure that the country's development program is carried out in an ecologically sustainable manner.

Integrated with these overarching strategies, Papua New Guinea has a series of sectoral plans, which detail the programs and approaches that are to be adopted in the respective sectors in order to achieve the Government's development priorities.

### 6.2 TRANSPORT INFRASTRUCTURE

In order to promote export-driven economic growth, as well as to facilitate improved access to services in order to alleviate poverty, effective and efficient transport infrastructure is essential.

The critical nature of the transport sector for development in Papua New Guinea is reflected by the fact that rehabilitation and maintenance of transport infrastructure is recognized as one of the seven expenditure priorities in the *MTDS* 2005-2010. The focus in the *MTDS* is upon maintaining existing infrastructure, in particular the Highlands Highway.

The overall policy framework for the transport sector is found in the National Transport Infrastructure Development Plan 2001-2010. A number of other sectoral plans and strategies also note the pivotal importance of well-maintained transport infrastructure for development in Papua New Guinea.

The main thrust of the current transport infrastructure program is to enable rural development through service delivery and expansion in the agriculture sector. This is compatible with the Government's major policy directive, the export driven economic growth strategy. Growth in the agriculture sector will not be attained without a supportive policy environment. Access to markets, as well as market information and credit will be provided in order to create an environment conducive to increased production.

Rehabilitation of the Highlands Highway remains an immediate priority of the Government. Two major on-going loans have received significant funding in the 2005 Budget. The ADB Road Rehabilitation (five Highlands provinces) program loan will be used to rehabilitate the Western Highlands sections of the Highlands Highway together with high priority feeder and other highlands provinces roads. The program has received K20 million of Government funds in the 2005 Budget, alongside K50 million in concessional loan funds from the ADB. The World Bank Road Maintenance Program Loan which was effected in 2002, will be used to rehabilitate both national and provincial roads in six provinces including Manus, West New Britain, East New Britain, Central, Oro and Morobe. The Government has allocated K10 million to this project in 2005 alongside a concessional loan of K26.5 million from the World Bank.

In total, road maintenance receives K89.9 million of Government funds in the 2005 Development Budget, alongside K146.4 million donor grant funding and K91.1 million in loan financing. Thus, there will be a total of K327.4 million spent on road maintenance in 2005. In addition to this financing, a number of road projects will be funded in 2005 using infrastructure tax credit. In total K110.9 million of tax credit is included in the 2005 Budget although not all of this will be allocated to expenditure on roads.

In addition to the ongoing projects described above, in 2005 the Government will be funding the District Roads Improvement Program (DRIP). The DRIP is based on the principles of the National Charter Program. Its primary aim is to improve access to services in the districts, by creating a more coordinated approach to the maintenance of roads. The DRIP will ensure that government funds have the greatest possible impact on road maintenance by requiring that lower level governments and Members of Parliament contribute to road maintenance projects in their area. Once funds from these two sources have been secured, the Government will provide matching funds. International development partners will also contribute to the DRIP. It is hoped that by integrating the three levels of government, as well as by providing one overarching umbrella for the coordination of all road maintenance projects, the DRIP will ensure that money spent on road maintenance has the greatest possible impact.

Although the Government's focus in 2005 will be on road transport, it also recognizes that many Papua New Guineans rely on water transport in order to gain access to markets and services. As such, the Development Budget 2005 includes the ongoing ADB Maritime Navigational Aids and Community Water Transport Projects. Total Development Budget expenditure on water transport in 2005 will be K38.0 million.

### **6.3 LAW AND JUSTICE**

Papua New Guinea's law and order problems continue to be a hindrance to the economic development of the nation.

The law and justice sector agencies are now using an effective integrated system to address law and order issues in line with the Papua New Guinea Law and Justice Sector Resource Plan. The sector-wide approach aims to improve sector coordination, to distribute resources equally, and to unify efforts in addressing crime.

The National Coordinating Mechanism (NCM), which commenced in 2003, has endorsed a Sector Strategy for reforming law and justice. The key objectives are:

- The prevention and control of criminal and other activities that threaten peace and good order;

- To improve access to, and the reliability of, civil, criminal and other dispute resolution processes;
- To improve integrity in leadership and good governance at all levels; and
- To develop reliable and effective rehabilitation processes.

The Law and Justice Sector Working Group (LJSWG), made up of the technical taskforce of the NCM, identified activities that need to be undertaken to support the objectives and strategies which formed the basic structure of the sector plan. The LJSWG linked the law and justice reform agenda to the overarching economic, social and community objectives of the sector plan.

There are ten high-level priorities identified for the purposes of planning in the sector and at the agency level. These include maintaining security over the nation's major urban centers and highways, with the National Capital District and Highlands Highway as the first to be addressed. Consistent with the Government's priority for rural development, the project will support comprehensive interventions in selected rural areas, through locally devised and managed prevention agencies.

A large share of expenditure will be appropriated for the on-going operations and maintenance costs of the key agencies, such as the Departments of Police, Justice and Attorney General, the Courts and Correctional Services. Given the movement towards a sector wide approach, this expenditure all falls under the Law and Justice Sector Program. The long-term strategy for the Government in the sector is to maintain the capacity of the system to arrest and process offenders effectively.

The law and justice sector agencies, with the help of the Ombudsman Commission and Auditor General, have resolved to establish the National Anti-Corruption Alliance (NACA) to co-ordinate their investigative activities. This arrangement will allow the agencies to jointly investigate corruption cases utilizing a collaborative effort with their expertise and legislative powers.

In 2005, the ongoing activities in the law and justice sector will be enhanced by the police element of the Enhanced Cooperation Program (ECP). This will see a significant increase (approximately K390 million) in spending on policing, as reflected by members of the Australian police force working alongside the Royal Papua New Guinea Constabulary.

## **6.4 EDUCATION**

In 1990/1991 the Government instigated an Educational Sector Review. The result of this review was the fundamental restructuring of the education system, away from the six years of primary, four years of lower secondary and two years of upper secondary model, to a model of nine years of basic (three years of elementary and six years of primary) education and four years of secondary education.

Broadly stated, the aims of the reform policy were to:

- increase access and participation at all levels of education;
- support the 'Education for All' goal of Universal Primary Education; and
- revise the education curriculum to be more relevant to village life and allow students to pursue a range of post Grade 8 pathways through the introduction of vernacular education and focus on life skills in the curriculum.

Implementation of the reforms did not begin until the mid 1990s. Although the initial implementation period was planned to be ten years, there is still a large part of the country that operates under the pre-reform system. Indeed, in 2004 more than 50 per cent of school children were still in the pre-reform system.

The general enrolment rate, which increased from 66.3 per cent in 1990 to 77.4 per cent in 2000, shows that there has been some improvement in access to school over the reform period. However, this improvement is much smaller than had been envisaged. Nonetheless, it is expected that as more elementary schools open, the enrolment rate will increase.

Further improvement in access to education lies very much at the heart of government policy. The *MTDS* 2005-2010 includes basic education as one of its seven expenditure priorities. This means that over the medium-term, government expenditure on basic education will be supported.

The National Education Plan 2004-2014, which is currently being developed by the Department of Education, continues to place emphasis on accessibility to basic education, aiming to expand the system so that there is a place for all children aged six in elementary school. The plan includes strategies to improve the retention rate over the period of the plan.

There will also be a focus on vocational education, the importance of which is recognized in the context of the majority of school leavers needing practical skills that can be of use in village life. As such, the National Education Plan 2004-2014 will include major shifts in policy concerning vocational education.

## **6.5 HEALTH**

The health sector is governed by the National Health Plan 2001-2010, which aims to guide programs and activities to improve rural health. This year the emphasis for the sector remains primary and preventative health care as highlighted by the *MTDS*, with priority being on services in the rural areas, delivered through aid posts and health centers equipped with appropriately trained staff, effective supervision, regular community outreach and mobile clinics or patrols, and sufficient supplies of drugs and materials.

A result of the Health Sector Reform, the Health Sector Improvement Program (HSIP), provides a new direction for the Government and development partners, creating a more coherent system through the sector-wide approach. This approach rationalizes the number of projects and priorities in the sector, releasing more funds for sector-wide activities. In the past, the expansion of the health sector was restricted since there were many projects that were donor funded without proper coordination by both the Government and its development partners.

Using the Medium Term Expenditure Framework (MTEF), the Department of Health has improved expenditure planning in the sector through effective resource costing and allocation. The MTEF allocates sufficient resources over the medium term to the health sector priorities as identified by the Health Plan.

To address Papua New Guinea's declining health indicators, assistance to the health sector over the medium term will increase in real terms. The expenditure framework will now shift resources to direct service delivery in order to have a more rationalized and efficient system, achieving the objectives of the National Health Plan.

HIV/AIDS is now a generalized epidemic in Papua New Guinea, and there is increasing urgency to curb the current rate of infection. HIV/AIDS has very serious implications for the social welfare of the people as well as the wellbeing of the economy. Its causes and impacts are not limited to the health sector alone. Therefore, a multi-sectoral approach is being used to tackle the epidemic. A collaborative effort by central government departments, civil society, non-governmental organizations, community-based organizations and churches is a major initiative of the ongoing response to the HIV/AIDS epidemic.

The principal agency responsible for coordinating the national response to HIV/AIDS is the National AIDS Council (NAC), which has a comprehensive national framework of action. The ultimate aim is to significantly reduce the infection rate of the disease. This is addressed through the National HIV/AIDS Support Project and the NAC awareness and control activities.

In light of the findings of the review of the first Medium Term Plan (1998-2002), the approach of the National Strategic Plan for HIV/AIDS 2004-2008 is multi-sectoral. It provides a broad framework for every organization within government and the non-government sector to respond to the epidemic according to its own capacity and resources. The overall goal of the National Strategic Plan is "to reduce the HIV/AIDS prevalence rate in the general population to below 1 per cent, and by at least 1 per cent by 2008, to improve care for those infected, and to minimize the social and economic impacts of the epidemic on individuals, families and communities". The focus of the plan is on leadership, partnership and coordination, prevention and education and monitoring and evaluation to ensure that progress of activities is noted and results are used to further improve future programs and activities.

Development expenditure for the NAC is budgeted at K10.5 million in 2005.

## **6.6 AGRICULTURE**

Over the period of the last *MTDS*, there was negative or modest growth of export volumes of the major agricultural export commodities with the exception of palm oil for which export volume in 2002 was 23 per cent higher than in 1997. During this period, agricultural exports accounted for an average of 20 per cent of Papua New Guinea's total export value, declining from 25 per cent in 1997 to 14 per cent in 2002.

The Government acknowledges that major constraints impede positive growth in the sector. These include a collapsing road network, serious law and order problems, ongoing land tenure constraints, a lack of access to credit markets and lack of extension services.

Notwithstanding the above, the oil palm industry is a success story with impressive real growth of over 10 per cent per annum since 1980. The growth in the domestic oil palm industry owes much to the successful application of the nucleus enterprise model of agricultural development. This model successfully integrates plantation operation with a localized network of smallholders.

The prospects for the oil palm industry remain favorable with higher world prices for palm oil attributed to a decline in world production levels, and the competitive edge of the domestic palm oil industry due to the depreciated Kina. In 2003, with the opening of the Kumbango Oil Palm Refinery, the domestic industry moved beyond the production of crude oils to pursue opportunities in refined products.

The current *MTDS* (2005-2010) recognizes that to achieve the desired increase in economic growth, agricultural initiatives must strategically target high impact areas. As such, the strategies pursued will include focusing on areas of competitive advantage, allocating scarce development funds to high impact projects, forming strategic alliances with relevant stakeholders, encouraging private sector participation and empowering the rural populace to drive the export-driven growth strategy of the Government.

The Government appreciates that agricultural development requires a multi-sectoral approach including an improvement in rural infrastructure and delivery of basic services in order to bring about increased productivity and sustained growth in the sector. The most critical issue in moving agriculture forward is improving farmers' accessibility to markets and services. As such, the maintenance of transport infrastructure is crucial, as is spending on rural education and health facilities, which will have a positive effect on productivity. As well, easily accessible market information and resource centers are necessary to improve the efficiency and effectiveness of farmers.

The Government's efforts to ensure cost-effective use of scarce resources includes the adoption of existing models of agricultural development with proven records of success. The Nucleus Agro-enterprises Project, jointly funded by the Asian Development Bank and the Government of Papua New Guinea, is designed to mobilize land for agriculture estate development in order to increase income-earning opportunities for rural Papua New Guineans. In 2005 the project will receive a total of K8 million in funding. Customary land, which accounts for 97 per cent of all land in Papua New Guinea, can be mobilized in partnership with village out-growers. There is potential to adopt the oil palm nucleus enterprises model in relation to a range of activities including food crops, coffee, cocoa, cashew nuts, and spices.

The National Agricultural Development Plan, which is currently in the process of development, will contain specific strategic interventions in the sector. However, the National Agricultural Development Strategy recognizes the role of the private sector in the development, processing and marketing of agricultural products. The Government will facilitate the involvement of the private sector by fostering an environment conducive to private sector investment and activity. Major policy initiatives, including the 'Green Revolution' package are a significant feature of this strategy.

Agriculture extension, financial services, marketing information and advice and micro-credit are priorities under the 2005-2010 *MTDS*. Agriculture research will focus on improving smallholder production systems and basic staples, as well as research into new and existing export crops.

The Department of Agriculture and Livestock recognizes that the extension system has become fragmented and ineffective. To address this issue the proposed focus will be to develop a non-government operated National Extension System. The approach will be based on the Smallholder Support Services Pilot Project being trialed in the Eastern Highlands and Morobe provinces. In line with this approach, there is a general shift in the provision of extension services away from Government agencies and towards non-government organizations and innovative and trained farmers. The Government's role in this system would be to support and develop community-based extension service providers, and to implement schemes in the most equitable and cost effective way.

In order for government investment in agricultural research to achieve the desired economic and social returns, greater co-ordination and integration between research and extension services will be promoted. In addition, closer co-ordination between universities, private research agencies and commodity-based research institutes will allow for research findings to be shared. Sub-national governments are in the frontline of delivering extension services and are empowered through the Organic Law to set up agricultural services. Hence one of the research and development challenges is to improve coordination with the provinces and districts.

The Government is reviewing a set of policy options in the area of rural credit. Facilitating credit supply to rural areas will need to address the role of the Rural Development Bank, the operating requirements and standards of medium-scale operators, and the underlying causes that prevent the commercial sector from lending to the agriculture sector. A number of Government programs will continue to provide credit in 2005. The ADB supported Microfinance and Employment Project will assist the training of Microfinance Institutions to improve the performance of credit providers.

The Commodity Boards will continue to play a pivotal role in implementing Government policies related to respective agricultural commodities while undertaking their mandated functions such as industry regulation, provision of research and extension services, market research and export promotion.

The challenge for the Government remains to significantly improve the performance of the agriculture sector in order to improve the overall rate of economic growth. As well, economic growth must translate into material benefits in the form of higher standard of living for the majority of Papua New Guineans living in the rural areas.

## **6.7 FORESTRY**

The Government recognizes that sustainable management and conservation of forest resources is of paramount importance, since forestry resources play a key role in the livelihood of the rural population and in economic development. Consequently, the forestry industry is faced with the challenge of finding a balance between the objectives of economic development and forest conservation as well as accommodating the shift in market preference towards sustainable forestry practices and away from current industry practice of log harvesting.

The World Bank funded Forestry and Conservation Loan approved in December 2001 aims to improve sustainable resources management, increase landowner participation in forest management and conservation, improve forest management practices, streamline planning, monitoring and enforcement capacity of Papua New Guinea National Forest Authority (PNGNFA) and strengthen the environmental monitoring by the Department of Environment and Conservation. As a result of the slow progress with meeting requirements related to the projects, the disbursement of further funds was suspended in August 2003. The Government continues to be fully committed to bringing the forestry sector into compliance with the project requirements.

The timber industry in Papua New Guinea is at present log export oriented with only a few companies currently involved in processing and exporting sawn timber, veneer, plywood, wood chips, furnish and other products. There is a shift in government policy to encourage industrial development in both the National Forest Policy and the National Forest Plan. Consistent with the National Forest Policy, the timber industry has increased its investment in processing and exporting value added products.

The capacity of the PNGNFA and the National Forest Service to manage and undertake operations in the sector will continue to be enhanced by the Government in 2005.

## **6.8 FISHERIES**

Marine products continue to contribute significantly to the economy of the country.

The Government will continue to strengthen the fisheries sector in 2005. The development of the sector will continue to be focused on the improvement of fishing infrastructure, market access, training and better access to credit facilities.

The National Fisheries Authority as a lead agency of the sector will continue to promote private sector development in the industry and safeguard the nation's natural marine resources as stipulated in the 1998 Fisheries Management Act. Under this arrangement, the Authority will continue to raise the revenue to carry out its activities through the imposition of licenses, access fees and the retention of penalty payments as a result of industry offences.

The Asian Development Bank (ADB) will continue to assist the sector in 2005 through the Coastal Waters Fisheries Management and Development Project. This project aims to strengthen the capability of sub-national governments and fisheries stakeholders to participate in management decision-making affecting the sector. In addition, it will also develop infrastructure necessary for commercial and small-scale fishing activities. The loan was declared effective in August 2003 and together with the institutional strengthening programs to be implemented, the infrastructure component, which commenced in 2004, will continue in 2005. This includes the tuna wharf and small boat jetty in Lae, a jetty and shore facility in Alotau and a wharf in Daru. In total, the project has been appropriated K5.7 million in the 2005 Development Budget.

AusAID assistance through the National Fisheries College Strengthening Project appropriated K0.8 million in 2005 to upgrade the National Fisheries College (NFC) in 2005 in order to create a more effective training body with the capacity to develop and deliver appropriate and cost effective competency-based training.

The European Union's (EU's) support through the Rural Coastal Fisheries Development Project in 2005 will continue to sustain and improve the welfare of rural coastal communities in Papua New Guinea by increasing rural family incomes through greater participation in the sustainable harvesting and improved marketing of marine resources. The major activities to be undertaken in 2005 under this project will include construction of fish markets in Port Moresby, Daru, Buka and Kavieng and the construction of fishing boats. The two Credit facilities will be fully operational in the seven-targeted Maritime Provinces. The training under this project will be provided for all seven provinces during the year. The project has been appropriated a total of K3 million in 2005.

A number of new projects to commence in 2005 include maritime boundaries delimitation and an industrial park in Madang. These projects will see improvement in the fisheries surveillance capability, further development of on-shore based facilities that will enhance the domestication policy and the Government's export driven growth strategy, and improvement and capacity building within the fisheries sector.

The NFA will continue to provide the fisheries smallholder credit facility in 2005. The program will provide access to affordable micro-finance to small-scale fishing activities in the regions not covered by the existing EU and ADB supported projects.



## **6.9 PETROLEUM AND ENERGY**

Crude oil production declined in 2004 but exploration activities, and prices, increased in 2004.

Government initiatives in this sector aim to increase exploration and production through maintaining the incentives that were introduced in the 2002 Supplementary Budget to encourage exploration and development activities. In addition to these measures, during 2005 the Government will help to create an environment conducive to investment in the sector, by focusing on improving transport infrastructure, addressing law and order and land ownership issues, and encouraging the development of local support industries to reduce high exploration costs.

Also essential to the growth of the sector is the development of PNG's large natural gas resources. The Government is committed to securing market agreements and handling benefit sharing arrangements with landowners in order to facilitate development in this area, such as the PNG-Australia Gas project, for which Front End Engineering and Design (FEED) has recently commenced.

The FEED program is expected to take 12-18 months and will advance the project to the point where an investment decision can be made whether to allow the project to proceed to construction. FEED will determine the final design of the project, while continued intense gas marketing activities are designed to confirm sufficient firm sales to support the project.

During this period, the Government will take the necessary actions to acquire an equity interest in the project, while at the same time ensuring that community and landowners are provided for in a balanced and sustainable manner.

Landowner issues still remain the dominant challenge to the operation of gas and oil projects in Papua New Guinea and the Government will continue to balance the development of the sector with greater participation of the landowners through the enforcement and implementation of the provisions in the Oil and Gas Act 1998.

## **6.10 MINING**

Mining products are PNG's main commodity exports. The sector remains a significant contributor to the economy, accounting for an estimated 11.9 per cent of nominal GDP in 2003.

Although the volumes of mining products had been decreasing over recent years, gold export volumes increased between 2002 and 2003. Moreover, the depreciating Kina and improved international commodity prices helped to increase export earnings in Kina terms, with the exception of silver, for which export value declined between 2001 and 2002 before, this recovering in 2003.

Apart from its direct economic contribution to Papua New Guinea, the sector is also an important provider of basic services including through the Tax Credit Scheme, which has assisted the Government in providing employment opportunities in the provinces. In 2005 it is predicted that the Tax Credit Scheme will contribute K110.9 million to spending in infrastructure in Papua New Guinea.

Production from most of the mines is declining, with Misima Mine being the first large scale open cut mine to cease full operations in early 2004 after 15 years of mining. Others such as Ok Tedi and Porgera are now phasing down production, targeting eventual closure in 2010 and 2012 respectively. Nonetheless, Papua New Guinea is a promising country for gold and copper extraction, with reserves of nickel, cobalt and chrome having been identified, but yet to be exploited. The commercial development of these opportunities is of critical importance in order to sustain national mineral output. Furthermore, the diversification of mineral production will help to reduce the country's exposure to variability in commodity prices.

In the longer term, it is anticipated that an expansion at Lihir, and the modest new gold developments at Kainantu and Hidden Valley, will help to offset the impact of the phase-down of current projects in the coming years.

The Government is committed to improving the conditions for foreign and national investment in the sector, including the enforcement of existing regulations, the provision of supporting infrastructure and the maintenance of an attractive taxation regime for prospecting and development activities.

It is envisaged that continuous implementation of infrastructure and maintenance programs and the emphasis on law and order and governance will complement investment activities in the sector. In line with this, the fiscal incentives initiated during the 2003 Budget will be maintained during 2005, with the mining levy being phased out as planned. The positive effect of these structural reforms and fiscal incentives was evident as the number of mineral exploration licenses issued increased significantly from 5 in 2002 to 15 in 2003. It is expected that 25 new licenses will be issued in 2004.

## **6.11 TOURISM**

The Tourism Promotion Authority (TPA) was established under the 1993 Tourism Promotion Authority Act to foster development of the tourism industry in the country. Specifically, the TPA is required to maximize the economic benefits of the industry to Papua New Guineans, while at the same time protecting society, culture and the environment of the country from harmful exploitation.

The tourism industry is relatively under-developed although it has considerable potential for expansion. The poor performance to date is due to lack of proper organization and the low priority given to tourism development by past governments. Other factors, such as poor infrastructure, high costs and law and order problems continue to impede progress. This Government has recognized the significance and potential of the tourism sector as one of the export oriented growth industries, which can contribute to broadening the country's economic base.

According to the TPA, tourist arrivals increased sharply in the latter half of the 1990s. The increase realized during this period was due to more business travelers and holiday makers, attributed to a favorable macroeconomic environment. However, in the succeeding period, 2000 – 2003, the number of tourist arrivals fell. This was attributed to an increase in law and order problems.

Over time, increased funding of infrastructure, and efforts to improve law and order, should also underpin growth in tourism.

## CHAPTER 7. MEDIUM TERM OUTLOOK

### 7.1 OVERVIEW

In 2005, Papua New Guinea's economy is expected to build on the momentum of the last two years, to grow at 2.9 per cent, with the non-mining sector growing at 2.8 per cent.

This will be three successive years of economic growth between 2.5 and 3 per cent, a significant improvement from the first part of the decade.

The International Monetary Fund (IMF) expects global economic growth to decline in 2005 from the very strong outcome in 2004, but it is still expected to grow above its long run average. Reflecting this, in 2005 prices of key commodities are expected to decline somewhat, but to remain at historically high levels.

Inflation is expected to remain low, with a forecast outcome in 2005 of around 4.2 percent. Employment and wages growth are also expected to remain positive but moderate, reflecting the need for a sound investment climate and sustained reform to make inroads into unemployment.

**Table 24: Principal Economic Forecasts for 2005**

	2003 Actual	2004 Projection	2005 Projection
Real GDP <sup>(a)</sup>	2.8	2.6	2.9
Real Non-Mining GDP <sup>(a)</sup>	1.7	2.8	2.8
Inflation (TTY)	8.5	3.7	4.2
Treasury Bill rate (%)	18.3	9.0	9.0
World Economic Growth	3.9	5.0	4.3
Oil Price (US\$)	27.2	37.3	35.0

Sources: National Statistical Office, Treasury Department, and IMF.  
(a) Real GDP and Non-mining GDP for 2003 are Treasury estimates.

In the medium term, with continued macroeconomic and political stability and sustained reform, growth in the non-mining sector is projected to progressively increase with output growing at 3.5 per cent per annum by 2009. Improvement is expected across all sectors, particularly agriculture, forestry and fisheries.

Although activity in the mining and petroleum sector is expected to remain volatile, the pick up in exploration activity suggest it will continue to make a significant contribution to economic growth in the future.

With global economic growth expected to return to its long-run average over the medium term, prices of key commodities are expected to return to levels in line with longer-term historical trends.

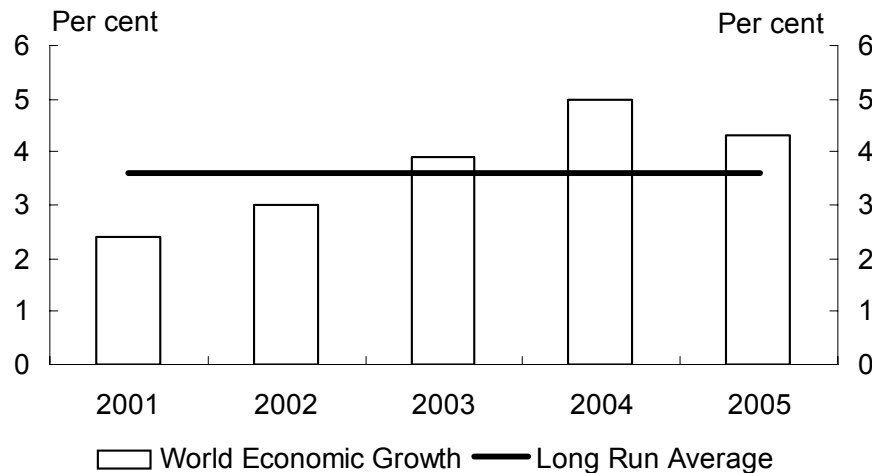
### 7.2 WORLD ECONOMIC OUTLOOK

#### 7.2.1 Overview

Growth in the world economy is now firmly established with most regions growing strongly. In 2004, global GDP growth is now projected to average 5.0 per cent. This is the highest growth rate for nearly three decades.

This increase in global growth has been underpinned by an extended period of accommodative macroeconomic policies, rising corporate profitability, wealth effects from equity markets and house prices, rising employment, and exceptionally rapid expansion in emerging markets, particularly China.

**Figure 12: World economic growth (%)**



Source: IMF *World Economic Outlook*, September 2004.

Looking forward, however, global growth is expected to moderate from the second quarter of 2004 as these positive factors are offset by the ongoing withdrawal of fiscal and monetary stimulus and the impact of higher oil prices. Although global growth is projected to ease to 4.3 per cent in 2005, this is still significantly above the historical trend.

**Table 25: IMF World Economic Outlook 2004-2005\***

	2002 Actual	2003 Actual	2004 Projection	2005 Projection
World Output %	3.0	3.9	5.0	4.3
Major industrial countries %	1.6	2.1	3.6	2.9
Newly industrialised Asian countries %	5.0	3.0	5.5	4.0
Developing countries %	4.8	6.1	6.6	5.9
World trade volume %	3.3	5.1	8.8	7.2
Commodity prices				
Oil (US\$) %	2.5	15.8	28.9	-
Non-fuel (US\$) %	0.6	7.1	16.8	-3.9
Consumer prices				
Advanced economies %	1.5	1.8	2.1	2.1
Developing countries %	6.0	6.1	6.0	5.5
Six-month LIBOR (interest %)				
On US dollar deposits %	1.9	1.2	1.6	3.4
On Japanese yen deposits %	0.1	0.1	0.1	0.3
On euro deposits %	3.3	2.3	2.2	2.8

\*Annual percentage change, apart from LIBOR rates

Source: International Monetary Fund, *World Economic Outlook*, September 2004.

The risks to the near-term world economic outlook are balanced. There are downside risks around sustained higher oil prices and the impact of terrorism. On the policy side, interest rates will need to rise further as the recovery proceeds, although the pace and timing may vary considerably across countries, depending on their relative cyclical positions.

However, the key challenge is to take advantage of the upturn to make progress in addressing fundamental medium-term imbalances. These include difficult fiscal positions, growth-restraining structural weakness, financial and corporate vulnerabilities and continuing global current account imbalances. While progress is being made, it is generally limited.

According to the IMF, the major industrial countries are anticipated to continue to grow very strongly in 2004, before moderating in 2005. For the newly industrialized Asian economies, growth is forecast to be nearly double this year before slowing down in 2005.

#### **7.2.1.1 Australia**

The **Australian** economy is expected to record solid economic growth and low inflation in 2004, against a background of strong world growth. In 2004, the Australian economy is forecast to grow by 3.6 per cent up from 3.0 per cent in 2003. This reflects buoyant domestic demand, solid global demand, and the easing of the effects of drought.

Economic growth in 2005 is forecast to slow to 3.4 per cent, as domestic demand returns to more sustainable levels and net exports improve. However, the short-term outlook is subject to considerable uncertainty. If external demand is weaker than expected and the Australian dollar remains at current levels, the expected recovery in net exports may not occur.

#### **7.2.1.2 Japan and Asia**

Growth in **Japan** was uneven in the first part of 2004, but forward-looking indicators generally suggest that underlying private domestic demand and external demand remained robust in the second half of the year. Against this background, GDP growth is now projected to have increased to 4.4 per cent in 2004, but it is anticipated to fall back to 2.3 per cent in 2005. Growth prospects depend heavily on ongoing strength in other parts of Asia, supportive policy settings and on continued progress in reducing financial vulnerabilities in the corporate and banking sectors.

Growth in emerging **Asia** has continued to exceed expectations, despite the impact of higher oil prices on many countries. The strong growth is underpinned by the global recovery, very strong growth in China, recovery in the global information technology sector, and generally supportive macroeconomic policies, including highly competitive exchange rates.

Prospects for the region depend heavily on the profile of growth in China over the coming year. Looking forward, on the assumption of a soft landing in China, the regional outlook is for continued solid but slowing growth. Given the strong first half, regional GDP growth is projected to average 7.6 per cent in 2004. Growth should be a little moderate to 6.9 per cent in 2005.

#### **7.2.1.3 United States**

In the **United States**, the economic expansion remained generally strong early this year, but growth moderated in the latter part of the year. This has been due to a slow down in personal consumption, apparently reflecting a combination of higher oil prices, weaker than expected employment growth and a sharp fall on spending on durable goods. Business investment has remained healthy, reflecting firms' healthy balance sheets, strong profitability and modest improvement in external demand.

Growth is projected to slow to 3.5 per cent in 2005, although this is still above average. Given the recent rise in oil prices and declines in some forward-looking indicators, downside risks and uncertainties have increased in recent months. On the positive side, business confidence and indicators of investment spending remain healthy and labor productivity should continue to grow strongly.

On the downside, however, the soft patch in consumption could persist for longer than assumed, and weaker labor market conditions and higher oil prices could slow consumption growth.

#### 7.2.1.4 Euro Area

The recovery in the **Euro area** has finally gained momentum, with GDP growth projected to rise to 2.2 per cent in 2004. However, the upturn remains moderate and has so far been heavily dependent on external demand, and while industrial production and business confidence are gradually improving, consumer confidence and retail sales continue to lag.

Looking forward, the recovery is projected to be increasingly supported by domestic demand, as private consumption is boosted by rising disposable incomes, and investment picks up as corporate balance sheet restructuring continues. Nonetheless, with GDP growth in the remainder of 2004 and 2005 expected to exceed potential only modestly, the output gap will remain substantial, and area-wide unemployment will decline only marginally. Overall, the risks appear tilted to the downside.

#### 7.2.1.5 Commodity Prices and Inflation

Most commodity prices increased in 2004, including a sharp and sustained increase in the price of oil.

The main developments in oil markets during 2004 have been the rise in crude oil prices to record nominal highs, and higher price volatility. This is despite OPEC's decision to increase official quotas.

The sharp increase is due to unexpected decline in US inventories and geo-political instability or unrest in key producer countries including Iraq, Nigeria, Russia and Venezuela. Looking ahead, futures markets suggest that oil prices will remain relatively high for the remainder of 2004 and 2005. However, it is possible that oil prices could fall sharply in early 2005, once inventories are replenished and tensions in key producer nations ease.

Gold and copper prices have been very high so far in 2004, and are expected to remain at high levels in 2005.

**Table 26: Principal Commodity Price Forecasts for 2005**

	2003 Actual	2004 Estimate	2005 Projection
Gold (US\$ per oz)	363	395	400
Copper (US\$ per lb)	0.81	1.23	1.04
Oil Price (US\$)	27.2	37.3	35.0

Sources: IMF and Treasury Department

Non-fuel commodity prices have generally experienced relatively modest gains so far in 2004. The slower increases coincided with attempts by China, a larger consumer of non-energy commodities, to cool the pace of its economic expansion, and moves by the Federal Reserve to raise U.S. interest rates. Looking forward, non-energy commodity prices should be supported at reasonable levels by a robust global economy.

After falling to unusually low levels in mid-2003, inflation across the world has turned up, underpinned by strong growth and higher oil prices. Headline inflation has inevitably increased with higher oil prices. But in a number of countries including the United States, core inflation has also picked up.

Consumer price inflation in advanced countries is projected to remain moderate, reflecting continued excess capacity and weak labor markets in some countries, solid productivity growth and limited producer power in the face of strong domestic and global competition. Inflation in other emerging market and developing countries is also now in single digits in every major region.

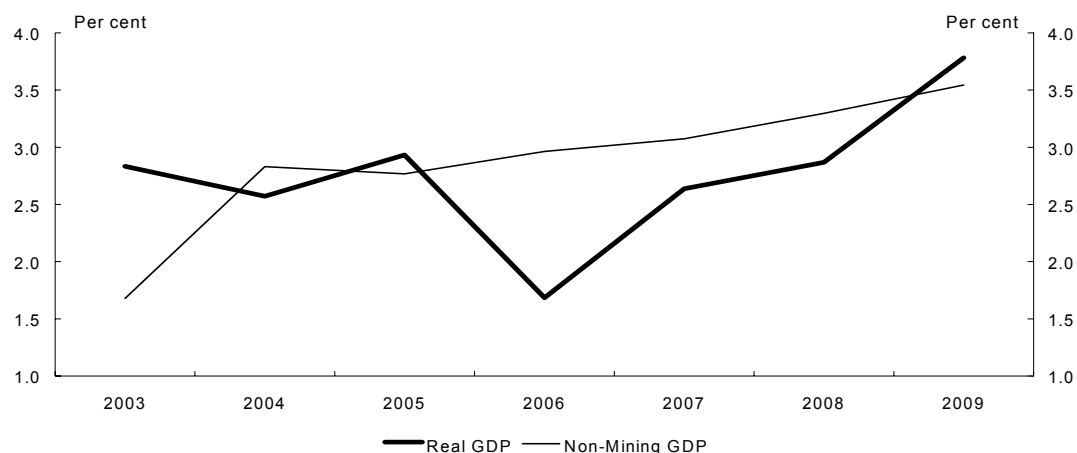
## 7.3 GROSS DOMESTIC PRODUCT

### 7.3.1 Overview

The outlook for Papua New Guinea in 2005 is for continued economic growth building on the momentum of the last two years. GDP is forecast to grow by 2.9 per cent. This would represent three successive years of economic growth between 2.5 and 3 per cent, a significant improvement from the first part of the decade.

Growth is expected to be broadly based in 2005. Production in most key sectors of the economy, including mining and petroleum, is expected to increase in 2005. The non-mining sector is forecast to grow at 2.8 per cent, the same rate as in 2004.

**Figure 13: Economic growth**



Source: Department of Treasury.

Inflation is expected to remain low, at around 4.2 per cent through the year. Low inflation should be underpinned by sound fiscal and monetary policies, continued stability of the exchange rate and moderate wage increases. Wages should increase moderately, with public sector wages growth reflecting the pending wage agreement between Government and the public sector unions.

Employment growth is expected to be moderate, consistent with steady growth in the economy.

In the medium term, with continued macroeconomic and political stability and sustained reform, growth in the non-mining sector is projected to progressively accelerate, to be growing at 3.5 per cent per annum by 2009. Improvement is expected across all sectors, particularly through growth in agricultural trade. Mining and petroleum sector production is expected to decline from 2006, although recent high levels of exploration activity and the decision to proceed to Front End Engineering Design (FEED) with the PNG-Australia Gas pipeline should see a recovery in production in later years.

With global economic growth expected to return to long run average growth over the medium term, prices of key commodities are expected to return to levels in line with longer-term historical trends.

### **7.3.2 Agriculture, Forestry and Fisheries**

The agriculture, forestry and fisheries sector is projected to grow at 3.0 per cent in 2005, the same rate as in 2004.

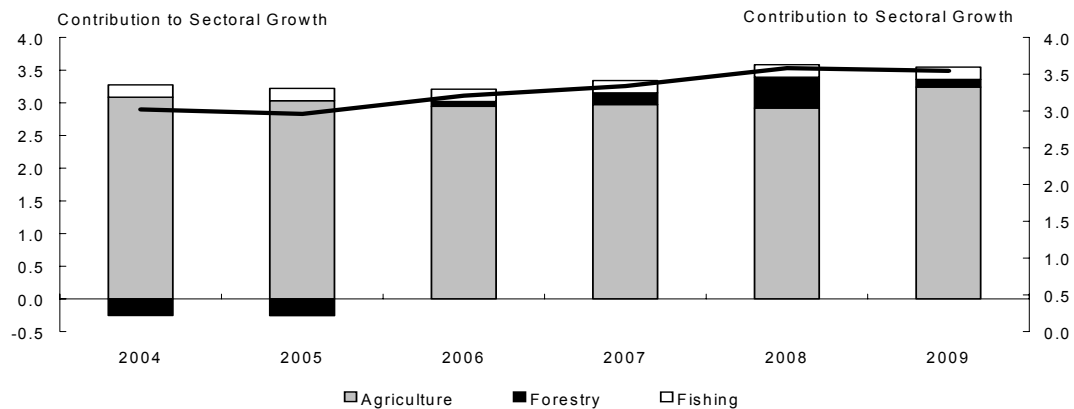
Agriculture production is forecast to grow by 3.3 per cent in 2005 underpinned by 3.8 per cent growth in real value added from agriculture exports. Fisheries production is expected to continue to grow at a solid rate of 3.2 per cent in 2005, reflecting continued investment. On the other hand, the logging industry expects production to fall in 2005, with industry projections of log exports down 11.0 per cent in 2005.

Over the medium term, agricultural production is expected to be a leading contributor to the increase in non-mining GDP growth. This increased production is expected to be supported by the Government's 'Export Driven Economic Growth Strategy'. By improving access to markets (domestic and foreign), removing unnecessary impediments to business and generally by creating a conducive environment for investment (including through macroeconomic stability and improved law and order) the Government is supporting agricultural production.

By 2009, real growth in the agriculture, forestry and fisheries sector is expected to have reached 3.5 per cent, led by sustained growth in agricultural exports and supported by accelerating growth in production for domestic consumption.

Prices in Kina terms of agricultural commodities excluding coffee, tea and logs are forecast to fall in 2005. In US dollar terms, prices of agricultural commodities are forecast to be weaker, reflecting increased global agricultural production. Over the forecast period, prices of most agricultural commodities are projected to gradually improve. Price projections for 2005 to 2009 are set out in Table 3 in Appendix 3.



**Figure 14: Agriculture, forestry & fisheries sector output**

Source: Department of Treasury.

### 7.3.3 Mining and Petroleum

Growth of 3.2 per cent is projected for the mining sector in 2005, reflecting increased gold production from the major mines and the commencement of production at two new smaller mines, and slightly higher copper production.

Gold production is anticipated to rise to 73.6 tonnes in 2005 from 71.8 tonnes in 2004. This is due to forecast production increases from all existing mines, except Misima, and the commencement of production at the Kainantu and Simberi mines. Copper production at Ok Tedi is also forecast to increase to 229.8 tonnes in 2005, up from 226.9 tonnes in 2004.

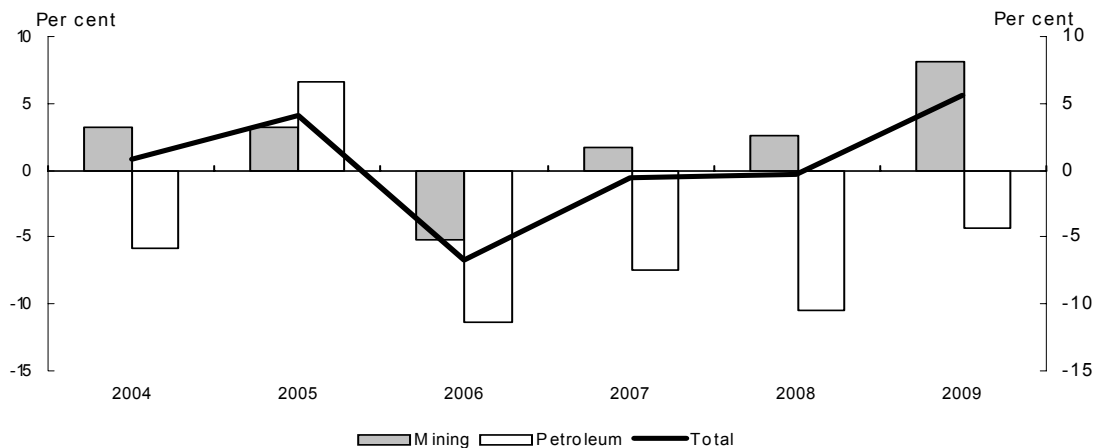
Over the medium term, mining and quarrying production is forecast to grow by around 2.0 per cent per year. This reflects the addition of some new mines and limited expansion of existing mines, offsetting reduced production from others (in particular, the Porgera mine) as reserves are depleted.

That said, reflecting the volatile nature of the industry, the mining sector's contribution to economic growth is expected to fluctuate significantly from year to year.

In the petroleum sector, strong growth of 6.7 per cent is expected in 2005 following a 5.8 per cent contraction in 2004, as the benefit of investment in 2004 in existing fields temporarily offsets continued natural declines in production.

Crude oil production is forecast to rise to 17.7 million barrels in 2005 from 16.6 million barrels in 2004. This expected improvement reflects production increases in the Moran oil field, following investment to accelerate production and increase aggregate recoverable reserves. This offsets continued natural declines from the Kutubu and Gobe fields, as the fields mature.

Over the medium-term, oil production is forecast to contract quite sharply from 17.7 million barrels in 2005 to around 12.5 million barrels by 2009, a decline of 29.7 per cent. This outcome reflects natural depletion of reserve levels from the country's existing oil fields. Production from any new discoveries is not likely to begin before the end of the projection period.

**Figure 15: Mining and petroleum sector output**

Source: Department of Treasury.

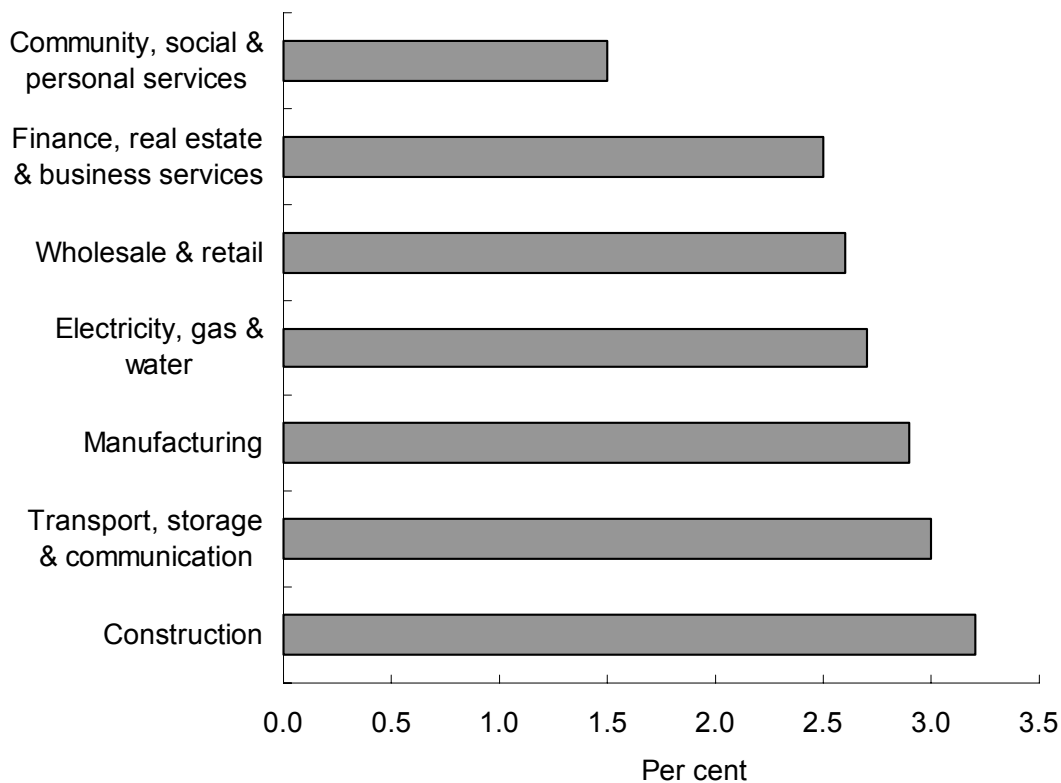
In terms of prices, the gold price is anticipated to be slightly higher in 2005. In contrast, the copper price is expected to be lower, reflecting slower world growth and increased global supply. Over the forecast period, the US dollar price for gold is assumed to remain around US\$400 per ounce. The copper price is projected to progressively return to closer to its historical trend over the medium term, reflecting the assumed return of global growth to trend. Price estimates for 2005 to 2009 are set out in Table A3.3 in Appendix 3.

The US dollar crude oil price is forecast to be lower at US\$35.0 per barrel in 2005. Over the medium term, the oil price is assumed to progressively return to the mid point of the OPEC range. This would be consistent with global growth returning to trend and supply increasing from increased global oil investment in response to higher prices.

### 7.3.4 Other Sectors

All sectors of the economy are expected to contribute to economic growth in 2005, in line with the general improvement in business conditions from sustained macroeconomic and political stability and the Government's reform agenda, including the removal of impediments to business.

The construction and transport, storage & communication sectors are expected to lead economic growth in 2005.

**Figure 16: Sectoral Growth in Non-commodity sectors in 2005**

Source: Department of Treasury.

The construction sector is expected to grow by 3.2 per cent in 2005, reflecting increased public expenditure on the maintenance and construction of roads and continued improvement in the conditions for private sector investment.

The transport, storage and communication sector is expected to grow by 3.0 per cent in 2005, reflecting increased capacity in the transport sector (as roads improve) and the expected increase in agricultural trade (internal and external) from greater access to markets.

Positive, but more moderate, growth in the range of 1.5 to 2.9 per cent is expected in the remaining sectors of the economy. Growth in these sectors, such as real estate & business services, is expected to be underpinned by the strong growth in leading sectors of the economy stimulating domestic demand.

This pattern of growth is expected to continue in the medium term, with growth in leading sectors such as construction and transport, storage and communications accelerating to 4.0 per cent by 2009, while overall non-mining GDP is projected to be growing at 3.5 per cent by 2009. However, this outlook depends on continued improvements in macroeconomic and political stability, infrastructure, law and order and the legal and financial institutions in the economy.

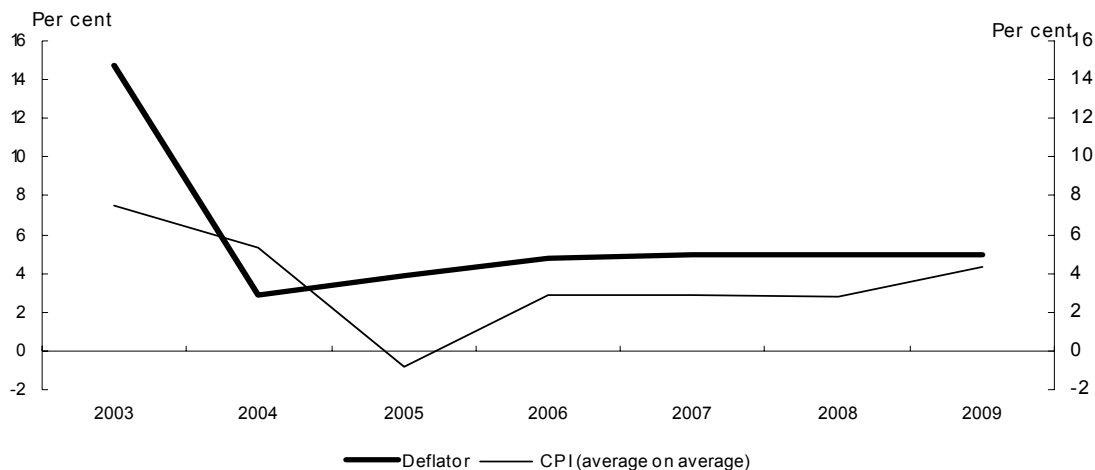
## **7.4 PRICES**

Annual average inflation as measured by Consumer Price Index (CPI) is projected to be 4.2 per cent in 2005. Although a little higher than in 2004, this is still a very positive outlook compared with previous years.

Over the forecast period, annual average inflation is projected to be around 5 per cent. This positive outlook reflects forecast stability in the exchange rate, in response to greater macroeconomic stability and continuing responsible approaches to monetary, fiscal and wages policies over the medium term.

The GDP deflator is forecast to rise by 2.5 per cent in 2005, down from a 3.3 per cent increase in 2004. Thereafter, it is projected to be around 5 per cent over the forecast period.

**Figure 17: Changes in CPI and GDP deflator**



Sources: Department of Treasury, NSO.

## 7.5 EMPLOYMENT AND WAGES

This Government's efforts over the last two years to stabilize and reform the economy through prudent implementation of sound fiscal and monetary policies, and the focused implementation of structural reforms, should support employment growth over the forecast period. These policies will allow private sector decision-making to take place in a more stable and transparent environment, with less government intervention.

Growth in employment is forecast to improve in 2004, consistent with improvements in the agriculture, fisheries and forestry, manufacturing, construction, electricity, gas and water, wholesale and retail, transport, storage and communication and finance, real estate and business services sectors.

Nonetheless, stronger growth in the non-mining sector of the economy should provide the basis for increased employment opportunities in 2005 and over the forecast period.

Wages growth is anticipated to be moderate in 2005 and over the medium-term. The 2005 Budget assumes moderate growth in the Government wage bill in 2004 and over the forecast period.

## 7.6 BALANCE OF PAYMENTS

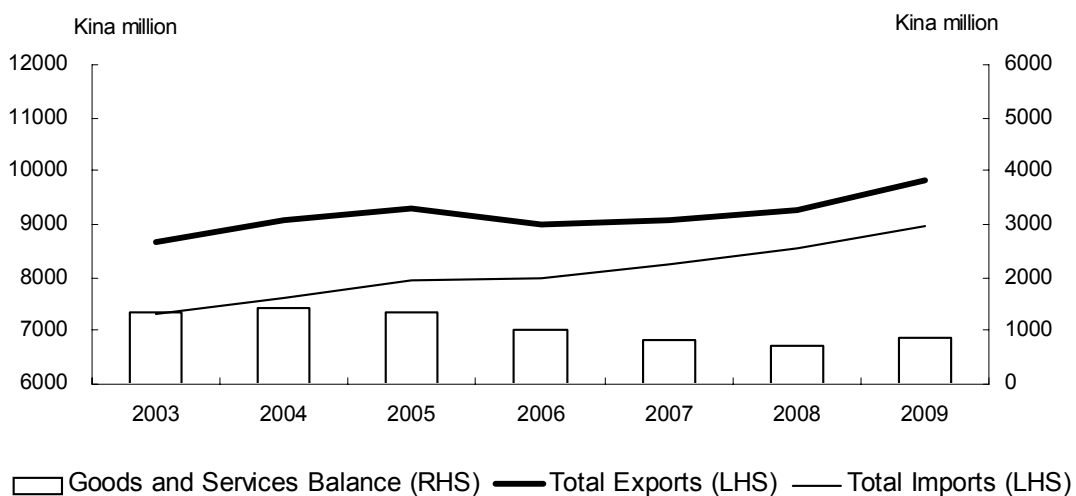
The balance of payments position is likely to remain healthy in the medium term, with a narrowing in the surplus reflecting expectations of solid export growth, but increased import growth in line with the strengthening of the economy.

**Figure 18: Current Account Balance**

Source: BPNG for 2003, Department of Treasury for 2004 to 2009

### 7.6.1 Balance of Trade in Goods and Services

The balance of trade in goods and services is expected to be a surplus of K1356.5 million in 2005, down from the K1439.1 million surplus expected in 2004. Over the medium term, the balance of trade in goods and services is expected to decline further as exports remain relatively stable in nominal terms while imports rise.

**Figure 19: Balance of Trade in Goods and Services**

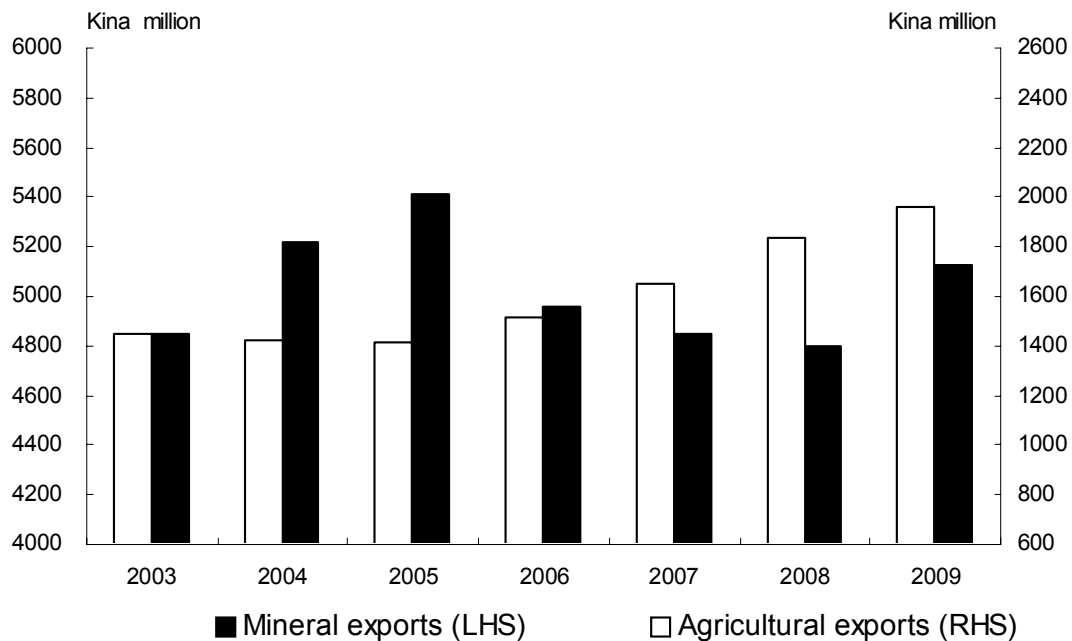
Source: BPNG for 2003, Department of Treasury for 2004 to 2009

### 7.6.2 Goods Balance

The Goods Balance is projected to increase in 2005, recording a surplus of K3886.1 million compared with K3849.2 million in 2004, as merchandise exports increase by slightly more than merchandise imports. Over the medium-term, the Goods Balance is expected to fall.

Exports of goods are expected to remain relatively stagnant over the medium term as growth in most export categories is offset by a sharp reduction in mining and petroleum exports. As oil and copper prices ease, and petroleum exports fall from 2006 onwards, mining and petroleum exports are expected to fall. By contrast, agricultural exports are expected to perform strongly over this period, rising from K1414 million in 2005 to K1959 million in 2009. This reflects the expected success of the Government's initiatives under its 'Export Driven Growth Strategy'.

**Figure 20: Commodity Exports**



Source: BPNG for 2003, Department of Treasury for 2004 to 2009

Imports of goods are expected to grow solidly over the forecast period reflecting strong growth in domestic demand and improving conditions for business investment.

### 7.6.3 Services Balance

The services deficit is projected to increase from K2409.9 million in 2004 to K2529.5 million in 2005 and subsequently continue to widen in line with expected growth in service imports as domestic demand strengthens.

### 7.6.4 Income Balance

The Income Balance is expected to decline from a deficit of K1812.2 million in 2004 to a deficit of K1899.3 million in 2005.

Income credits are likely to rise to K64.9 million in 2005, before increasing further over the forecast period. Income debits are expected to increase strongly to K1964.1 million in 2005 and subsequently projected to increase over the medium term. The short-term outlook reflects higher payments for dividends and interest on foreign loans by the government and mineral companies, which is expected to more than offset relatively higher compensation of employees and lower income receipts.

### **7.6.5 Transfers Balance**

The Transfers Balance is expected to increase steadily to K911.5 million in 2005, up from K877.5 million in 2004, and thereafter projected to rise gradually. The improved short-term outlook reflects higher superannuation and tax payments.

### **7.6.6 Current Account Balance**

The Current Account Balance is expected to record a surplus of K368.9 million in 2005, down from a surplus of K504.6 million in 2004. Over the medium-term, the Current Account Balance is expected to narrow.

As a percentage of GDP, the Current Account Balance is expected to be around 3.7 per cent in 2004, before falling to 2.5 per cent in 2005 and thereafter decline significantly to an average deficit of 0.8 per cent from 2006 to 2009. The downward movement of current account surpluses over the medium term is attributed to lower prices for crude oil and copper and lower production in the petroleum sector from 2006, and stronger imports as domestic demand picks up in line with the strengthening economy.

## **7.7 MONETARY POLICY**

Monetary policy is the independent responsibility of the Bank of Papua New Guinea. Monetary policy has been eased substantially in 2004 in line with the prudent fiscal policies of the Government and the sharp fall in inflation.

Monetary policy should continue to remain accommodative while the inflation outlook remains relatively subdued. The Government will support this through a continuation of prudent fiscal policy, sound macroeconomic management and ongoing reforms to increase productivity.

## **7.8 MEDIUM TERM FISCAL OUTLOOK**

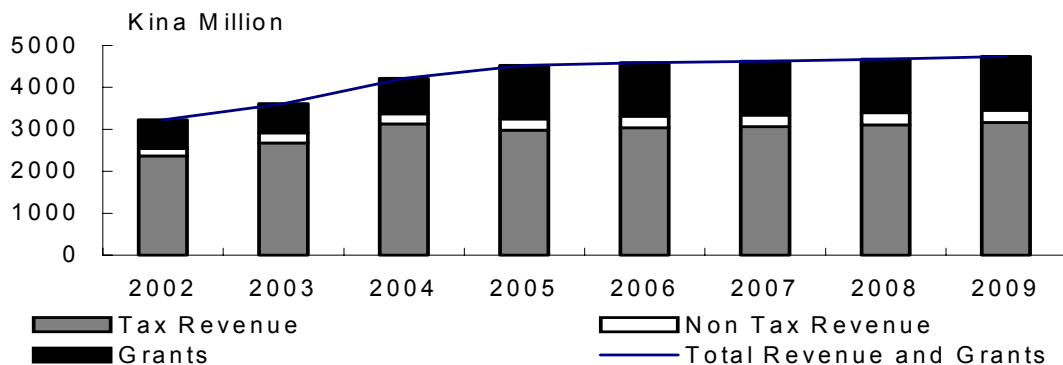
### **7.8.1 Overview**

The Medium Term Fiscal Outlook has been prepared in the context of conservative and achievable estimates for economic growth.

Real GDP growth is projected to increase from 2.9 per cent in 2005 to 3.8 per cent in 2009, with some volatility in the contribution from the mining and petroleum sector. Real non-mining GDP is projected to grow from 2.8 per cent in 2005 to 3.5 per cent in 2009.

### **7.8.2 Revenue and Grants**

Total Revenue and Grants are projected to increase moderately over the medium term. As a proportion of GDP, Total Revenue and Grants are projected to fall from 32.0 per cent in 2005 to 26.6 per cent in 2009.

**Figure 21: Total Revenue and Grants: 2002-2009**

Sources: Department of Treasury, Department of National Planning and Rural Development.

### 7.8.3 Tax Revenue

Tax Revenue is projected to increase from K2984.9 million in 2005 to K3168.5 million in 2009, an average annual increase of 1.2 per cent. As a proportion of GDP, Tax Revenue is projected to fall from 20.6 per cent in 2005 to 17.4 per cent in 2009. The main factor behind this subdued performance is the projected decline in revenue from the mining and petroleum sectors.

Mining and Petroleum Taxes are projected to fall from K487.3 million in 2005 to K283.1 million in 2009. This reflects the combined effect of natural declines in petroleum production and the projected return of the international price for oil and copper to closer to historical averages. Further, the Mining Levy is scheduled to be phased out over the period, after raising an estimated K86.3 million in 2005.

In addition, subdued mining profits growth points to stagnant dividend withholding tax, while import duty is projected to remain relatively flat, reflecting the high proportion of projects granted duty exemptions.

That said, solid economic growth in the non-mining sector is expected to see substantial growth in taxes on personal and company incomes, value added and excise.

Looking ahead, there are limited options available to the Government to expand the Tax Revenue base. The Government is focusing on improving compliance with existing tax laws, to ensure everyone pays their fair share, rather than seeking to introduce new taxes or increase existing taxes.

### 7.8.4 Non-Tax Revenue

Non-Tax Revenue is projected to increase from K260.8 million in 2005 to K290.6 million in 2009, an average annual increase of 2.7 per cent. As a proportion of GDP, Non-Tax Revenue is projected to fall from 1.8 per cent in 2005 to 1.6 per cent in 2009.

The expected slow growth in non-tax revenue mainly reflects the moderate increase of other non-tax revenue (i.e. revenue raised from fees and charges by departments and agencies). In the estimates, asset sales have been fully treated as financing items, rather than revenue, and the operating costs of the IPBC are no longer appropriated in the Budget.



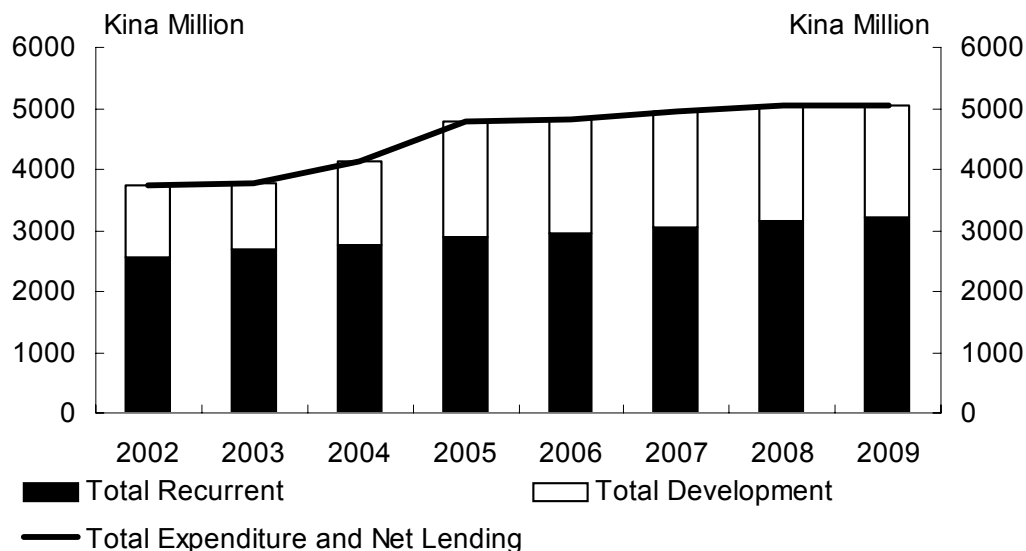
### 7.8.5 Grants

As Grants are provided at the discretion of donors, they are not able to be forecast on any economic criteria. Instead, a technical assumption is made that Grants are constant over the medium term. As Grants are denominated in foreign currencies, any movements in the Kina against the currencies of donor countries will determine the Kina value of Grants received.

### 7.8.6 Expenditure and Net Lending

Total Expenditure and Net Lending is projected to increase from K4777.4 million in 2005 to K4801.7 million in 2009, an average annual rate of 0.1 per cent over the medium term. As a proportion of GDP total Expenditure and Net Lending falls significantly from 33.0 per cent in 2005 to 26.3 per cent in 2009. Expenditure reduction is necessary to meet responsible deficit targets in the light of low revenue growth estimates.

**Figure 22: Total Expenditure & Net Lending, 2002-2009**



Sources: Departments of Treasury, National Planning and Rural Development.

Total recurrent expenditure is expected to increase at an average annual growth of 2.7 per cent, while the total development budget is projected to decline at an annual average of 0.6 per cent over the medium term. However, to achieve these projected levels, yet-to-be-identified fiscal adjustment measures averaging K200 million a year will need to be effected over the years 2006-2009. It is the objective of the Government, under the auspices of the PERR, to identify and implement these changes.

### 7.8.7 Recurrent Expenditure

In the absence of adjustment measures, total Recurrent Expenditure is expected to increase from K2889.1 million in 2005 to K3216.7 million in 2009, an average annual growth rate of 2.2 per cent. As a proportion of GDP, total Recurrent Expenditure is projected to decline from 19.9 per cent in 2005 to 17.6 per cent of GDP in 2009.

National Department expenditures are projected to increase by an average annual growth rate of 4.0 per cent, while Provincial transfers are projected to grow by an average annual growth rate of 1.4 per cent over the forecast period. Interest outlays are projected to increase by 1.0 per cent over the medium term.

Total Government salaries and wages expenditure is projected to increase by an average annual growth rate of 4.5 per cent over the medium term. The expected growth in National Department salaries and wages expenditure includes provisions for superannuation contributions, retirement payments and future pay rise for both National and Provincial Government employees, including school teachers, but also assumes continuing freeze on new recruitment and strict treatment of casual employees. The medium term growth for provincial salaries and wages expenditure, on the other hand, assumes net savings from the right sizing exercise of the public service and assumes a 2.7 per cent increase in teacher numbers in line with population growth over the medium term.

Goods and Services Expenditure by National Departments is projected to increase by an average annual growth rate of 5.0 per cent over the medium term.

Education subsidy funding is projected to increase to take into account the projected population growth rate over the medium term.

Pre 1<sup>st</sup> March arrears payments are expected to be cleared in 2005.

Structural adjustment payments record an average of around K64.1 million up to 2008 (taking into consideration rightsizing cost of both National and Provincial Departments).

Transfers to Statutory Institutions are projected to remain constant over the medium term, with agencies becoming increasingly self-funded and looking to cost savings and productivity gains to fund additional expenditures.

Interest payments and fees on existing debt are projected to increase by 1.0 per cent over the medium term.

#### **7.8.8 Development Budget**

As a proportion of GDP, the Development Budget is expected to decline from 13.0 per cent of GDP in 2005 to 10.1 per cent of GDP in 2009. This reflects the technical assumption that grants are held constant at current levels. Under the *MTDS*, expenditures will be more carefully targeted to promote growth and development.

#### **7.8.9 Financing**

On the expenditure side, identified fiscal adjustment measures averaging K200 million a year will be made over the years 2006-2009. It is the objective of the Government, under the auspices of the PERR, to identify and implement these changes and make deeper structural reforms to expenditure.

On the revenue side, the Government will look into improving tax administration, so revenue flows are improved through increased compliance.

#### **7.8.10 Public Debt**

Reducing Government indebtedness is a central objective of the Government's *Medium Term Fiscal Strategy*. Fiscal consolidation, coupled with economic growth, is projected to yield successive declines in the debt-to GDP ratio, from current levels of 55 per cent of GDP in 2004 to 45 per cent of GDP in 2009.

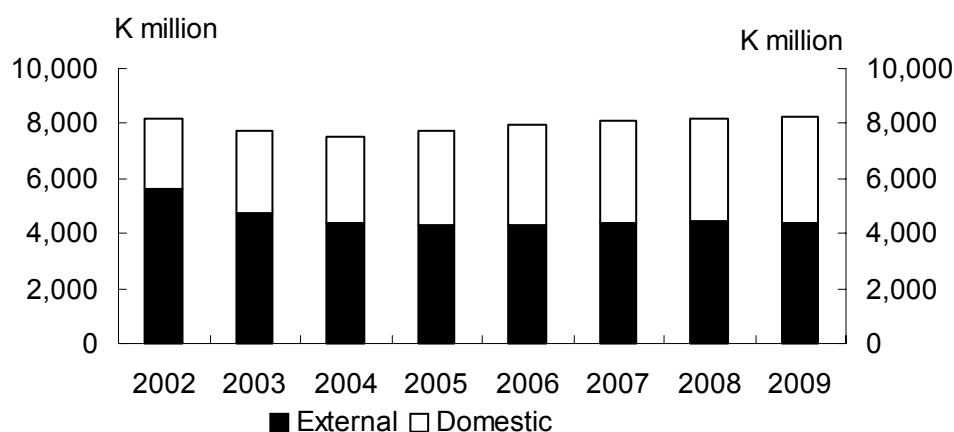
## 7.9 MEDIUM TERM DEBT STRATEGY

### 7.9.1 Overview

In line with the Medium Term Fiscal Framework, the overall Medium Term Debt Framework is aimed at reducing the current level of Government debt from 55 per cent of GDP in 2004 to 45 per cent of GDP by the year 2009. The strategy is formulated on the objective of minimizing debt service costs while containing the Government's exposure to risk and having a sustainable level of debt in the medium to long term. It will also ensure the development and maintenance of a well functioning market for domestic government securities.

Part of the strategy is to reduce the percentage share of external or foreign currency debt from the current level of 59 per cent of total Government debt to a target range of 40 per cent to 45 per cent over the medium-term and increase domestic or local currency debt from the current level of 41 per cent of total Government debt to a target range of 55 per cent to 60 per cent over the medium term. The current level of Government debt is around K7.5 billion (K4.4 billion external and K3.1 billion domestic). The actual Government debt levels for 2002 and 2003 together with projected debt levels for 2004 to 2009, classified by domestic and external debt, are shown in Figure 23.

**Figure 23: Total Government Debt: 2002-2009**



Source: Department of Treasury.

## 7.10 DOMESTIC DEBT STRATEGY

The domestic debt strategy for the medium term is aimed at:

- (i) lengthening the maturity of domestic debt to reduce rollover/refinancing risk;
- (ii) restructuring the debt instrument composition to have it consistent with internationally acceptable structures;
- (iii) ensuring a smooth maturity profile;
- (iv) developing and maintaining a well functioning market for domestic government securities; and
- (v) providing the financial institutions and investors with a pre-announced schedule of Inscribed Stock tenders for the financial year, to be announced at the time of the Budget.

### 7.10.1 Domestic Debt Composition

The strategy will progressively restructure domestic debt over the period 2005 to 2009 in order to meet the proposed structure set out in Table 27.

**Table 27: Composition of Domestic Debt by Instrument**

Instrument Type	Current Structure	Proposed Structure
Treasury Bills	84%	25%-40%
Inscribed Stocks	14%	60%-75%
Other Domestic Debt	2%	Less than 1%

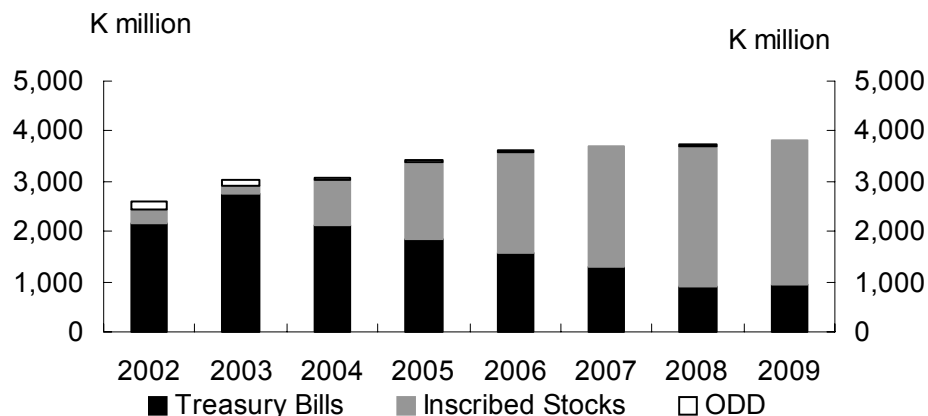
Source: Department of Treasury.

In order to implement the proposed domestic debt composition in Table 27, the following initiatives are planned:

- (i) Development over the medium-term of 4-6 “benchmark” Inscribed Stocks of up to K500 million and progressively extending maturities out to 10 years, which is intended to develop the market for Government securities in order to create greater liquidity and promote secondary market trading.
- (ii) Use of “debt switching” from Treasury Bills into Inscribed Stocks of around K500 million per year for the next 4 years, in order to accelerate the build up of Inscribed Stocks and lengthening of maturities, thereby reducing rollover/refinancing risk to the Government.
- (iii) Review of the existing Treasury Bills tender program, covering the objective and structure of the program; timing, structure and size of the regular weekly tenders of Treasury Bills; and maturities including the scope to introduce 364-day Treasury Bills.
- (iv) The scope to introduce a retail debt instrument for small investors (i.e. a savings bond) will be examined.

The effect of the strategy on the composition of domestic debt over the period 2002 to 2009 is shown in Figure 24.

**Figure 24: Composition of Domestic Debt: 2002-2009**



Source: Department of Treasury.

### 7.10.2 Domestic Debt Maturity Profile

The strategy will ensure that debt issued does not lead to excessive maturities in any one fiscal year and thereby ensure a smooth maturity profile. For example, the strategy will set an upper limit of around K500 million for Inscribed Stocks maturing in any fiscal year. This rebalancing will take several years to achieve due to the large volume of Treasury Bills outstanding and the early stages of development of a profile of Inscribed Stocks across multiple maturities.

## 7.11 EXTERNAL DEBT STRATEGY

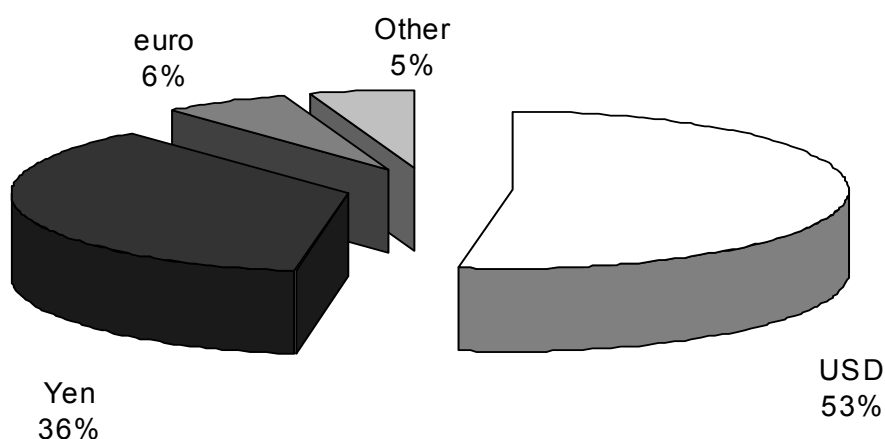
The external debt strategy for the medium term is aimed at:

- (i) restructuring external debt in order to have the currency composition more closely aligned with the country's Foreign Exchange Reserves, thereby reducing the foreign exchange risk;
- (ii) establishing a benchmark for determining the concessionality of new loans contracted from bilateral and multilateral sources; and
- (iii) ensuring a smooth maturity profile.

### 7.11.1 Currency Composition of External Debt

The strategy for determining the currency composition of external debt is based on international practices using a government asset-liability management approach. While the foreign exchange reserves are managed by the BPNG, the restructuring of external debt will reduce the overall risk to the Government through hedging the total foreign currency exposure. The current composition of external debt is shown in Figure 25.

**Figure 25: Currency Composition of External Debt**



Source: Department of Treasury.

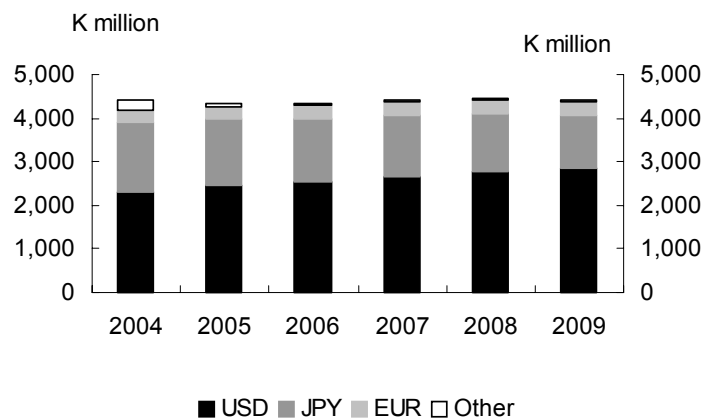
**Table 28: Currency Composition of External Debt**

Currency	Current	Proposed Range
USD	52.4%	50%-55%
JPY	36.4%	10%-15%
AUD	4.1%	10%-15%
EUR	6.0%	15%-20%
Others	1.0%	0%-5%

Source: Department of Treasury.

The effect of the strategy on the composition of external debt over the period 2004 to 2009 is shown in Figure 26.

**Figure 26: Currency Profile of External Debt: 2004-2009**



Source: Department of Treasury.

In order to achieve the proposed currency composition, the strategy will involve:

- (i) Switching K40 million per year for the next 5 years using Asian Development Bank (ADB) single-currency pooled loans denominated in Japanese yen to euro and Australian dollars.
- (ii) Switching K20 million per year for next 5 years using ADB LIBOR-based loans and World Bank (IBRD) Single Currency/Fixed Spread loans denominated in US dollars to euro and Australian dollars.
- (iii) Repatriating K50 million per year for the next 5 years through pre-payment of IBRD multi-currency pooled loans or maturing external debt to be financed from the Inscribed Stock tender program.
- (iv) Ensuring the all new borrowing of foreign currency or external loans are consistent within the proposed range in Table 28.

#### 7.11.2 Interest Rate Composition

The setting of the fixed/variable interest rate for external debt is based on international practices. The proposed interest rate composition for fixed rate and variable rate external debt will be 65 per cent to 75 per cent and 25 per cent to 35 per cent respectively. Currently, external debt interest rate composition falls within these ranges.

**Table 29: Interest Rate Composition**

Interest Rate Range	Current Composition	Proposed Interest Rate
Fixed	70%	65%-75%
Variable	30%	25%-35%

Source: Department of Treasury.

The proposed range will be used to manage interest rate risk and reduce volatility that might lead to increased budget debt service cost and uncertainty in interest rate forecasts. The determination of the interest rate on new borrowing/loan contraction will be consistent with the proposed range in Table 29.

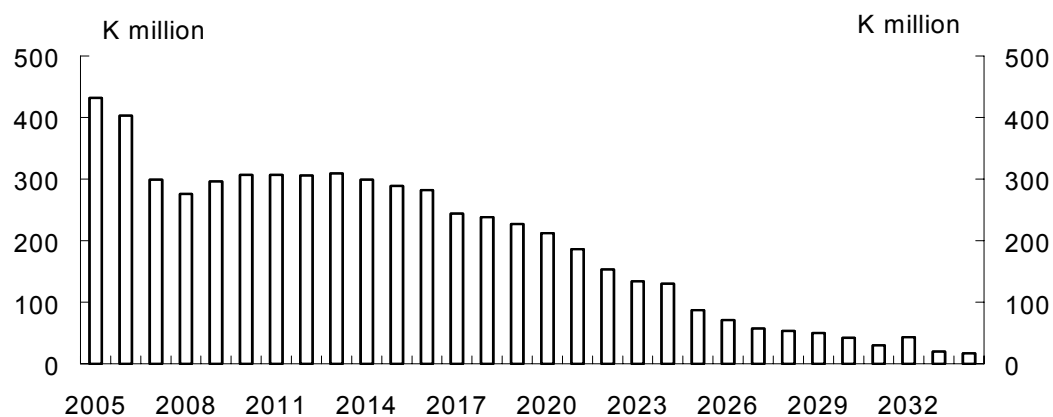
### 7.11.3 Concessional Borrowing Criteria for New Loans

In order to secure concessional funding from multilateral and bilateral sources, the condition to which concessional of a loan is determined should be based on the grant element of a loan rather than creditor source. In line with international debt management practice and as recommended by IMF and World Bank, the grant element of 35 per cent or more on a new loan will be used to classify a concessional loan. This will minimize borrowing of non-concessional loans under bilateral and multilateral sources.

### 7.11.4 External Debt Maturity Profile

The strategy will ensure that debt issued does not lead to excessive maturities in any one fiscal year and thereby ensure a smooth maturity profile. The existing maturity profile meets this criterion due to the long-dated debt issued through multilateral and bilateral sources. The maturity profile of external debt as at the end of 2004 is set out in Figure 27.

**Figure 27: Maturity Profile of External Debt**



Source: Department of Treasury.

The strategy set out above will be monitored, reviewed and updated annually to factor in developments on debt and related issues relevant to Papua New Guinea and international debt management practices.

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## **APPENDIX 1: REVENUE TABLES**

Table A1.1: Summary of Infrastructure Tax Credit Scheme (Kina Millions).

Table A1.2: Incentives Under the Income Tax Act Resulting in Permanent Loss of Revenue (Kina).

Table A1.3: Incentives Under the Income Tax Act Involved in Deferral of Income Tax Payment (Kina)

Table A1.4: Exemptions from Indirect Taxes (Kina)



**Table A1.1: Summary of Infrastructure Tax Credit Scheme (Kina Millions).**

	Actual 2000	Actual 2001	Actual 2002	Actual 2003	Est. 2004	Proj. 2005
Total Mining & Petroleum Taxes Paid	451.5	306.8	277.3	462.6	659.4	455.6
Mining & Petroleum Taxes Paid by Companies involved in ITC	451.0	306.8	277.3	462.6	659.4	455.6
Total ITC Claimed & Allowed	59.9	47.3	48.9	39.1	60.6	110.9
Expenditure Incurred on Approved ITC Projects	42.7	62.7	55.2	40.0	60.6	110.9
Tax Credit Claimed as Percentage of Taxes Paid by Companies Subject to ITC	13.3	15.4	17.6	8.5	15.0	19.0
Excess Credits Carried Forward (from prior years)	92.2	91.5	80.1	na	na	na

## Notes:

1. Total tax expenditure projection of K110.9 million is expected to be incurred on approved ITC Project in 2005. Detailed information on this expenditure is not yet available.
2. Tax Credit expenditures for 2004 are based on company tax returns assessed by 30 October 2004.
3. ITC is abbreviated for Infrastructure Tax Credit.
4. na: not available.

Source: Department of National Planning and Internal Revenue Commission.

**Table A1.2: Incentives Under the Income Tax Act Resulting in Permanent Loss of Revenue (Kina Millions).**

Section	Description	2000 Number	Amount	2001 Number	Amount	2002 Number	Amount	2003 Number	Amount	Grand Total Amount
35	Exempt Interest	16	1,087,858	7	1,558,466	3	579,936	-	-	3,226,260
35A	Fishing Operations	-	-	2	254,810	-	-	-	-	254,810
45B	Export Sales Exemptions	2	965,368	1	54,000	5	1,473,536	1	130,670	2,623,574
45I	Rural Development	2	634,028	1	990,263			1	1,000	1,625,291
45N	Bougainville Incentive	4	1,135,212	3	712,589	3	190,699	2	264,299	2,302,799
46AA	Rabaul Incentive	74	36,630,600	4	2,453,436	-	-	-	-	39,084,036
69A	Gifts to Sporting Bodies	12	114,872	7	62,867	3	6,500	-	-	184,239
69C	Gifts Law, Order and Justice	8	30,814	2	1,700	-	-	1	250	32,764
69E	Gifts to Charities	10	62,219	10	57,399	5	28,596	1	13,688	161,902
69I	Gifts National Day Celebrations	6	24,750	3	4,500	1	85,051	-	-	114,301
69J	Gifts PNGSC 2000 Olympics	4	322,834	-	-	-	-	-	-	322,834
70A	Deduction Education Expenses	49	842,604	35	717,557	22	382,103	14	212,323	2,154,587
72A	Double Deduction - Training	48	5,537,802	37	2,893,865	25	1,293,089	11	1,193,589	10,918,345
72C	Export Market Development	5	1,060,237	2	955,360	3	906,892	2	30,869	2,953,358
97A	Primary Production Development Expenditure	3	10,068,356	1	210,360	2	221,894	-	-	10,500,610
CH 119	Pioneer Industries	1	696,707	1	1,936,551	2	2,884,803	-	-	5,518,061
		<b>244</b>	<b>59,214,261</b>	<b>116</b>	<b>12,863,723</b>	<b>74</b>	<b>8,053,099</b>	<b>33</b>	<b>1,846,688</b>	<b>81,977,771</b>

Note: Number means the number of taxpayers claiming the concessions.  
A dash means no exemptions were recorded.

Source: Internal Revenue Commission

**Table A1.3: Incentives Under the Income Tax Act Involved in Deferral of Income Tax Payment (Kina Millions)**

Section	Description	2000 Number	Amount	2001 Number	Amount	2002 Number	Amount	2003 Number	Amount	Grand Total Amount
68A	Solar Heating	1	177,264	-	-	1	13,705	-	-	190,969
73(3)	Depreciation 20% loading	4	23,093	6	9,567,893	4	1,601,269	-	-	11,192,255
73(6)	Depreciation - non oil fired plant	-	-	2	4,319,557	1	313,828	1	37,434	4,670,819
73(7)	Depreciation Industrial Plant	13	13,661,946	11	5,375,300	5	3,606,512	2	3,133,312	25,777,070
73(9)	Depreciation Primary Production	5	6,696,704	4	44,461,548	2	729,000	2	11,621,628	63,508,880
<b>Total</b>		<b>23</b>	<b>20,559,007</b>	<b>23</b>	<b>63,724,298</b>	<b>13</b>	<b>6,264,314</b>	<b>5</b>	<b>14,792,374</b>	<b>105,339,993</b>

Note: Number means number of taxpayers claiming the concessions.

A dash means no exemptions were recorded.

Source: Internal Revenue Commission.

**Table A1.4: Exemptions from Indirect Taxes (Kina Millions)**

<b>Description</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>Total Amount</b>
Import Duty	-	1,000,125	456,952	16,323,928	8,703,718	26,484,723
Import Excise	-	-	59,323	3,911,295	3,884,920	7,855,538
Value Added Tax	-	2,065,969	1,834,964	92,296,695	51,587,159	147,784,788
<b>Total</b>	<b>2,724,291</b>	<b>3,066,094</b>	<b>2,351,240</b>	<b>112,531,918</b>	<b>64,175,798</b>	<b>120,673,543</b>

- Notes: 1. Break down of tax amounts in 2000 is not possible due to non-availability of data.  
2. It is believed that the above data does not capture all concessions and the total value of tax lost is greater.  
3. A dash means no exemptions were recorded.  
4. The 2004 figures are only for months up to 30 September.

Source: Internal Revenue Commission.

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## **APPENDIX 2: GRANTS AND TRANSFERS TO PROVINCES**

Table A2.1: National Governments Grants to Provincial and Local Level Governments (Kina Thousands)

Table A2.2: Grants, Transfers and other resources of the Provinces (Kina Thousands)

**Table A2.1: National Governments Grants to Provincial and Local Level Governments (Kina Thousands)**

	Staffing grants for Provincial Governments (1)	Conditional Grants for Provincial Governments				Unconditional Grants for Provincial Governments	Staffing grants for LLGs	Other grants for LLGs		Development Grants for Provincial Governments (2)	
	Teachers and public servants (including and leave fares)	Health Function Grant	Education Function Grant	Transport Infrastructure Maintenance Function Grant	Derivation Grant	Block Grant	LLG Secretariat	Town & Urban Services Grant	Rural LLG grant	SSG and PIP projects	Members' Non- Discretionary Funds
Western Prov	25,539.0	431.6	680.6	784.7	972.8	282.9	461.1	244.2	656.7	1,600.0	1,000.0
Gulf	14,547.1	474.6	479.1	118.8	554.0	357.5	361.0	51.3	453.2	1,500.0	750.0
Central	27,894.2	462.3	1,005.2	184.2	178.9	550.6	388.0	191.1	662.0	2,000.0	1,250.0
NCD	79.0	-	-	-	-	-	-	2,546.6	-	-	1,000.0
Milne Bay	26,756.1	292.2	1,024.3	508.3	566.6	608.3	-	99.1	703.6	300.0	1,250.0
Oro	15,583.5	241.5	672.1	315.1	721.5	370.9	294.7	199.0	429.6	-	750.0
Southern Highlands	39,624.9	2,250.0	1,687.5	1,125.0	34.6	1,194.2	1,200.5	314.9	1,777.8	3,700.0	2,250.0
Enga	27,111.8	786.8	843.1	899.3	82.9	843.1	538.4	42.2	999.5	1,200.0	1,500.0
Western Highlands	33,912.3	989.7	1,107.6	2,250.3	1,330.1	647.4	473.2	279.3	1,401.3	-	2,000.0
Simbu	28,322.4	545.8	1,282.8	383.7	112.9	737.4	568.1	92.9	851.9	-	1,750.0
Eastern Highlands	36,186.3	902.5	1,886.5	902.5	667.9	1,230.5	326.5	263.6	1,386.1	200.0	2,250.0
Morobe	46,691.8	629.7	2,399.7	1,637.0	275.5	1,555.4	1,354.4	944.7	1,565.4	1,200.0	2,500.0
Madang	30,040.5	768.9	1,640.5	768.9	420.1	1,059.5	478.4	286.0	1,190.7	-	1,750.0
East Sepik	31,050.0	945.6	1,436.4	764.6	174.9	905.2	580.2	203.0	1,175.1	3,500.0	1,750.0
Sandaun	21,897.5	273.6	775.5	638.3	301.7	562.5	551.2	98.0	668.2	500.0	1,250.0
Manus	11,447.8	372.3	341.6	111.6	73.1	43.4	325.4	58.9	130.5	-	500.0
New Ireland	19,478.7	224.9	787.2	200.2	513.1	163.1	474.5	113.0	380.1	1,100.0	750.0
East New Britain	30,995.1	825.2	1,152.9	449.9	1,666.6	120.2	570.8	238.9	692.4	3,300.0	1,250.0
West New Britain	23,903.7	584.7	1,076.5	394.6	2,514.1	113.6	377.0	142.1	616.3	-	750.0
Bougainville	24,966.5	-	-	-	610.3	11,935.4	-	367.5	484.4	1,000.0	1,000.0
<b>TOTALS</b>	516,028.2	12,001.9	20,279.1	12,437.0	11,771.6	23,281.1	9,323.4	6,776.2	16,224.8	21,100.0	27,250.0

(1) Village Courts officials' allowances

(2) Development Grants data excludes: Least Developed District Grants

**Table A2.2: Grants, Transfers and other resources of the Provinces (Kina Thousands)**

	Grants to Provincial Governments	Mining & Petroleum		Tax Credit	
		GST (1)	Royalties (2)	Own Source Revenues (3)	Scheme Expenditures (4)
Western Province	31,292	2,004	28,319	2,706	24,371
Gulf	18,781	510	-	1,471	14,934
Central	33,525	924	465	4,061	-
NCD	3,626	71,036	-	19,665	-
Milne Bay	31,306	2,066	-	670	-
Oro	18,655	1,355	-	210	-
Southern Highlands	51,866	1,420	16,936	8,380	22,083
Enga	33,267	3,175	17,160	3,959	11,500
Western Highlands	42,237	9,368	-	2,645	2,500
Simbu	33,135	1,032	-	251	1,692
Eastern Highlands	44,226	5,713	140	1,155	1,000
Morobe	56,889	26,864	-	4,234	1,000
Madang	36,448	8,563	-	1,552	1,000
East Sepik	40,527	2,698	-	424	-
Sandaun	26,199	1,128	-	1,838	200
Manus	12,890	1,034	-	366	-
New Ireland	23,217	3,784	10,000	739	-
East New Britain	39,760	9,240	-	1,796	-
West New Britain	29,337	4,356	-	2,071	5,783
Bougainville	39,512	571	-	252	-
<b>TOTALS</b>	<b>646,695</b>	<b>156,840</b>	<b>73,021</b>	<b>58,447</b>	<b>86,063</b>
Memorandum item					
<i>Tax Credit Scheme unallocated estimates</i>					<i>24,837</i>

(1) Distribution is for each province to receive 60% of estimated net inland GST collections from that province, or the 2003 distribution (whichever is the high). Special distribution arrangements apply for Bougainville (Autonomy Arrangements), whereby it receives 30% of net inland GST collections in the province. Estimates from the IRC.

(2) NEFC estimates, using mining and petroleum production and price forecasts from Treasury.

(3) NEFC estimates, which include dividends from equity shares of mining and petroleum resource projects.

(4) Expenditure under the Tax Credit Scheme. Estimates in the memorandum item have not yet been allocated to a particular province. Data from the DNPI.

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## **APPENDIX 3: ECONOMIC AND FISCAL DATA TABLES**

Table A3.1: Gross Domestic Product by Economic Activity at Current and Constant Prices

Table A3.2: Contributions to Growth in Real Gross Domestic Product

Table A3.3: Prices of Main Export Commodities

Table A3.4: Production of Main Export Commodities

Table A3.5: Value of Main Export Commodities

Table A3.6: Summary of Balance of Payments

Table A3.7: Employment Classified by Industry

Table A3.8: Central Government Revenue and Grants

Table A3.9: Central Government Expenditure and Net Lending

Table A3.10: Central Government Financing

Table A3.11: Monetary Aggregates

Table A3.12: Public Debt

Table A3.13: Major Assumptions Underlying the Budget



**Table A3.1: Gross Domestic Product by Economic Activity at Current and Constant Prices**

	2002 Actual	2003 Est.	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
Agriculture, Forestry and Fishing								
nominal	4428.0	5026.9	5291.0	5616.3	6065.9	6558.5	7099.9	7684.8
deflator	158.8	174.2	178.0	183.5	192.0	200.9	210.0	219.5
real	2788.8	2885.8	2972.9	3061.0	3159.2	3264.7	3381.6	3501.6
rate of real growth	-4.1	3.5	3.0	3.0	3.2	3.3	3.6	3.5
Oil and Gas Extraction								
nominal	1096.7	1179.7	1306.3	1336.8	1127.7	1003.6	860.1	782.4
deflator	402.3	426.9	501.9	481.6	458.1	440.4	421.5	400.9
real	272.6	276.4	260.3	277.6	246.2	227.9	204.1	195.1
rate of real growth	-36.1	1.4	-5.8	6.7	-11.3	-7.4	-10.5	-4.4
Mining and Quarrying								
nominal	1252.1	1537.7	1609.7	1698.9	1626.4	1686.9	1767.7	1975.5
deflator	186.9	199.6	202.4	207.0	209.0	213.2	217.8	225.1
real	669.9	770.3	795.5	820.8	778.3	791.1	811.5	877.7
rate of real growth	-3.5	15.0	3.3	3.2	-5.2	1.7	2.6	8.2
Manufacturing								
nominal	729.3	766.1	811.1	859.7	920.0	985.5	1060.8	1147.4
deflator	130.2	135.4	139.5	143.7	149.4	155.4	161.6	168.1
real	560.0	565.6	581.4	598.3	615.6	634.1	656.3	682.6
rate of real growth	-5.8	1.0	2.8	2.9	2.9	3.0	3.5	4.0
Electricity, gas and water								
nominal	193.8	217.1	229.3	238.0	246.3	255.0	263.9	287.0
deflator	181.6	201.5	207.6	209.8	211.4	212.9	213.9	224.8
real	106.7	107.8	110.5	113.4	116.5	119.8	123.4	127.7
rate of real growth	-0.4	1.0	2.5	2.7	2.7	2.8	3.0	3.5
Construction								
nominal	995.7	1068.5	1158.7	1236.3	1315.5	1399.7	1489.8	1735.1
deflator	123.7	130.1	136.7	141.4	145.8	149.9	154.1	172.6
real	805.0	821.1	847.4	874.5	902.5	934.1	966.8	1005.4
rate of real growth	34.0	2.0	3.2	3.2	3.2	3.5	3.5	4.0
Wholesale and retail trade								
nominal	745.5	801.7	863.6	930.4	1003.3	1083.0	1171.2	1272.8
deflator	141.9	151.8	159.4	167.4	175.7	184.5	193.7	203.4
real	525.5	528.1	541.9	555.9	571.0	586.9	604.6	625.7
rate of real growth	22.7	0.5	2.6	2.6	2.7	2.8	3.0	3.5
Transport, storage and communication								
nominal	179.9	190.8	206.3	218.9	236.7	256.0	278.2	303.8
deflator	130.5	137.0	143.8	148.1	155.6	163.3	171.5	180.1
real	137.9	139.3	143.5	147.8	152.2	156.8	162.2	168.7
rate of real growth	-34.2	1.0	3.0	3.0	3.0	3.0	3.5	4.0
Finance, real estate and business services								
nominal	407.0	423.0	455.3	481.6	507.4	534.7	563.4	623.7
deflator	125.5	128.5	135.0	139.3	143.2	147.2	151.3	162.6
real	324.2	329.1	337.3	345.7	354.4	363.2	372.3	383.5
rate of real growth	-5.5	1.5	2.5	2.5	2.5	2.5	2.5	3.0
Community, social and personal services								
nominal	1351.8	1354.3	1398.8	1460.4	1618.6	1712.3	1817.3	1956.7
deflator	115.2	116.6	118.6	122.0	132.3	137.0	141.8	148.2
real	1173.7	1162.0	1179.4	1197.1	1223.4	1250.3	1281.6	1320.0
rate of real growth	2.9	-1.0	1.5	1.5	2.2	2.2	2.5	3.0
<b>TOTAL GDP*</b>								
nominal	<b>11766.6</b>	<b>12947.5</b>	<b>13727.4</b>	<b>14490.7</b>	<b>15097.6</b>	<b>15921.7</b>	<b>16836.1</b>	<b>18250.7</b>
rate of nominal growth	<b>14.9</b>	<b>10.0</b>	<b>6.0</b>	<b>5.6</b>	<b>4.2</b>	<b>5.5</b>	<b>5.7</b>	<b>8.4</b>
deflator	<b>153.6</b>	<b>164.4</b>	<b>169.9</b>	<b>174.2</b>	<b>178.5</b>	<b>183.4</b>	<b>188.5</b>	<b>196.9</b>
real	<b>7660.9</b>	<b>7877.9</b>	<b>8080.5</b>	<b>8317.5</b>	<b>8457.6</b>	<b>8680.7</b>	<b>8929.7</b>	<b>9267.5</b>
rate of real growth	<b>-1.0</b>	<b>2.8</b>	<b>2.6</b>	<b>2.9</b>	<b>1.7</b>	<b>2.6</b>	<b>2.9</b>	<b>3.8</b>
Total non-mining GDP								
nominal	9417.8	10230.1	10811.5	11454.9	12343.5	13231.2	14208.4	15492.9
rate of nominal growth	<b>17.8</b>	<b>8.6</b>	<b>5.7</b>	<b>6.0</b>	<b>7.8</b>	<b>7.2</b>	<b>7.4</b>	<b>9.0</b>
deflator	140.2	149.8	153.9	158.7	166.1	172.7	179.5	189.1
real	6718.4	6831.2	7024.7	7219.1	7433.1	7661.6	7914.1	8194.6
rate of real growth	<b>1.5</b>	<b>1.7</b>	<b>2.8</b>	<b>2.8</b>	<b>3.0</b>	<b>3.1</b>	<b>3.3</b>	<b>3.5</b>

\*Sum of industries less imputed bank service charge, plus import duties, less subsidies.

Source: Actuals from National Statistical Office. Projections from Dept. of Treasury

**Table A3.2: Contributions to Growth in Real Gross Domestic Product**

	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
	<b>Actual</b>	<b>Est</b>	<b>Proj</b>	<b>Proj</b>	<b>Proj</b>	<b>Proj</b>	<b>Proj</b>	<b>Proj</b>
Agriculture, Forestry and Fishing	-1.6	1.3	1.1	1.1	1.2	1.2	1.3	1.3
Oil and Gas Extraction	-2.0	0.0	-0.2	0.2	-0.4	-0.2	-0.3	-0.1
Mining and Quarrying	-0.3	1.3	0.3	0.3	-0.5	0.2	0.2	0.7
Manufacturing	-0.4	0.1	0.2	0.2	0.2	0.2	0.3	0.3
Electricity, gas and water	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Construction	2.6	0.2	0.3	0.3	0.3	0.4	0.4	0.4
Wholesale and retail trade	1.3	0.0	0.2	0.2	0.2	0.2	0.2	0.2
Transport, storage and communication	-0.9	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Finance, real estate and business services	-0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Community, social and personal services	0.4	-0.2	0.2	0.2	0.3	0.3	0.4	0.4
<b>TOTAL GDP</b>	<b>-1.0</b>	<b>2.8</b>	<b>2.6</b>	<b>2.9</b>	<b>1.7</b>	<b>2.6</b>	<b>2.9</b>	<b>3.8</b>
Total Non-mining GDP	1.5	1.7	2.8	2.8	3.0	3.1	3.3	3.5

\*Sum of industries less imputed bank service charge, plus import duties, less subsidies.

Source: Actuals from NSO. Projections from Dept. of Treasury

**Table A3.3: Prices of Main Export Commodities**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
<b>AGRICULTURE</b>								
Copra	677	776	1014	929	919	909	898	885
Cocoa	6484	6395	4933	4923	5393	5560	5678	5790
Coffee	4384	4339	4510	4606	4781	5097	5425	5689
Palm Oil	1204	1289	1322	1220	1233	1245	1259	1270
Rubber	2316	2929	3350	3136	2628	2572	2574	2508
Tea	3373	2833	2553	2689	2740	2920	3036	3136
Copra Oil	1181	1413	1845	1690	1673	1654	1635	1610
Logs (K/m <sup>3</sup> )	199	183	176	187	201	216	226	236
<b>MINERALS</b>								
Gold (US\$/oz)	311	363	395	400	400	400	400	400
Copper (US\$/lb)	0.71	0.81	1.23	1.04	0.91	0.86	0.88	0.90
Oil (Kutubu Crude: US\$/barrel)	24.0	27.4	37.3	35.0	32.5	30.5	28.5	26.5

**Source:** Actuals from BPNG. Projections from IMF and Dept. of Treasury.

**Table A3.4: Production of Main Export Commodities**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
<b>AGRICULTURE</b>								
Copra	15.8	8.4	8.5	8.7	8.8	8.9	9.0	9.2
Cocoa	34.9	40.3	41.5	42.8	44.0	45.4	46.7	48.4
Coffee	63.1	68.8	70.5	72.3	74.1	75.9	78.2	80.6
Palm Oil	323.9	326.9	339.8	358.0	371.2	386.6	397.3	414.6
Rubber	3.8	4.2	4.3	4.5	4.6	4.7	4.9	5.0
Tea	5.2	6.6	6.8	7.0	7.2	7.4	7.7	7.9
Copra Oil	28.2	47.7	50.2	52.9	55.7	58.6	61.8	65.0
Logs	1834.0	2016.0	1822.7	1620.9	1675.3	1816.3	2211.3	2308.4
<b>MINERAL</b>								
Gold (tonnes)	59.1	68.4	71.8	73.6	68.8	69.6	70.9	78.5
Copper	170.1	230.6	226.9	229.8	263.2	253.4	271.8	271.8
Oil (million barrels)	17.4	17.6	16.6	17.7	15.7	14.5	13.0	12.5

**Source:** Actuals from BPNG. Projections from Dept. of Treasury.

**Table A3.5: Value of Main Export Commodities**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
<b>AGRICULTURE</b>								
Copra	10.7	6.5	8.6	8.0	8.1	8.1	8.1	8.1
Cocoa	226.3	257.7	204.8	210.5	237.5	252.2	265.3	280.0
Coffee	276.6	298.5	318.0	332.9	354.3	387.0	424.4	458.3
Palm Oil	389.9	421.3	449.2	436.7	457.5	481.4	500.0	526.4
Rubber	8.8	12.3	14.5	14.0	12.1	12.2	12.5	12.6
Tea	17.5	18.7	17.4	18.8	19.8	21.7	23.2	24.7
Copra Oil	33.3	67.4	92.7	89.4	93.2	97.0	100.9	104.7
Logs	365.5	369.6	321.1	303.4	336.8	391.5	499.2	544.6
<b>MINERAL</b>								
Gold	2296.7	2842.9	2961.9	3139.5	3004.6	3115.4	3248.9	3681.3
Copper	101.1	156.7	214.0	188.0	191.8	179.6	202.6	209.9
Silver	28.8	35.3	31.9	23.8	23.4	6.4	24.3	28.1
Oil	1687.3	1814.9	2009.6	2056.6	1735.0	1544.0	1323.2	1203.7

**Source:** Actuals from BPNG. Projections from Dept. of Treasury.

**Table A3.6: Summary of Balance of Payments**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
<b>CURRENT ACCOUNT BALANCE</b>	<b>-502</b>	<b>496</b>	<b>505</b>	<b>369</b>	<b>72</b>	<b>-121</b>	<b>-269</b>	<b>-234</b>
<b>Balance of Trade in Goods and Services</b>	<b>180</b>	<b>1348</b>	<b>1439</b>	<b>1357</b>	<b>1004</b>	<b>830</b>	<b>723</b>	<b>857</b>
<i>Goods Balance</i>	<i>2190</i>	<i>3611</i>	<i>3849</i>	<i>3886</i>	<i>3528</i>	<i>3449</i>	<i>3470</i>	<i>3795</i>
Credit (Exports)	6387	7842	8184	8362	8014	8037	8173	8623
Debit (Imports)	-4231	-4231	-4335	-4476	-4486	-4588	-4703	-4828
<i>Services Balance</i>	<i>-2010</i>	<i>-2263</i>	<i>-2410</i>	<i>-2530</i>	<i>-2524</i>	<i>-2619</i>	<i>-2747</i>	<i>-2937</i>
Services Credit	630	829	879	928	973	1032	1099	1197
Services Debit	-2640	-3091	-3289	-3457	-3497	-3650	-3846	-4135
<b>Income Balance</b>	<b>-787</b>	<b>-1699</b>	<b>-1812</b>	<b>-1899</b>	<b>-1870</b>	<b>-1929</b>	<b>-2014</b>	<b>-2169</b>
Income Credit	106	58	62	65	66	69	72	79
Income Debit	-894	-1757	-1874	-1964	-1936	-1998	-2087	-2248
<b>Transfers Balance</b>	<b>106</b>	<b>847</b>	<b>877</b>	<b>912</b>	<b>938</b>	<b>978</b>	<b>1023</b>	<b>1078</b>
Transfers Credit	334	1137	1188	1235	1237	1278	1330	1410
Transfers Debit	229	-289	-311	-323	-300	-300	-307	-332
<b>CAPITAL AND FINANCIAL ACCOUNT<sup>(a)</sup></b>	<b>559</b>	<b>536</b>	<b>-505</b>	<b>-369</b>	<b>-72</b>	<b>121</b>	<b>269</b>	<b>234</b>
NET ERRORS AND OMISSIONS	-57	40	0	0	0	0	0	0
Current account balance as percentage of Gross Domestic Product (GDP)	-4.3	3.8	3.7	2.5	0.5	-0.8	-1.6	-1.3

**Source:** Actuals from BPNG. Projections from Dept. of Treasury.

(a) Capital and Financial Account includes changes in reserves.

**Table A3.7: Employment Classified by Industry**

	1996 Annual	1997 Annual	1998 Annual	1999 Annual	2000 Annual	2001 Annual	2002 Annual	2003 Annual	2004 Mar Q
Retail	94.8	104.3	112.1	99.9	102.8	100.6	99.5	99.6	98.1
Wholesale	82.1	82.7	82.8	114.7	115.0	102.7	97.1	113.9	103.9
Manufacturing	114.7	119.1	123.9	103.1	108.8	99.5	102.2	108.5	109.4
Building and Construction	89.4	85.8	74.1	130.8	128.0	92.9	90.5	101.6	95.5
Transportation	96.5	99.0	95.2	109.4	102.2	99.4	106.3	107.0	106.0
Agriculture, Forestry, Fisheries	90.8	83.3	75.7	99.2	103.8	102.2	104.1	117.9	116.9
Financial and Business	116.1	127.3	139.0	116.0	106.2	100.5	102.9	107.3	104.8
<b>TOTAL NON-MINING</b>	<b>100.5</b>	<b>100.3</b>	<b>98.0</b>	<b>104.9</b>	<b>106.5</b>	<b>100.6</b>	<b>102.2</b>	<b>109.9</b>	<b>108.4</b>
Mining	116.2	121.7	135.9	94.5	103.4	96.9	98.8	97.6	110.4

Source: BPNG .

**Table A3.8: Central Government Revenue and Grants**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
<b>TAX REVENUE</b>	<b>2369.9</b>	<b>2677.9</b>	<b>3129.9</b>	<b>2984.9</b>	<b>3038.7</b>	<b>3062.5</b>	<b>3110.0</b>	<b>3168.5</b>
TAX ON INCOME AND PROFITS	1491.1	1786.6	2139.4	2072.0	2103.7	2123.4	2166.4	2219.2
Personal Income Tax	694.3	758.4	827.0	865.5	922.7	968.8	1017.2	1068.1
Company tax	310.9	334.5	380.0	394.8	421.3	449.5	480.0	513.6
DWT	62.1	117.2	130.0	124.3	120.8	114.3	114.6	114.6
Mining and Petroleum Taxes	258.9	396.5	603.0	487.3	431.7	373.4	326.3	283.1
Interest withholding tax	21.9	41.4	31.8	30.7	30.8	31.2	31.5	31.8
Other Direct	69.0	55.3	77.5	74.1	76.4	81.2	86.4	92.1
Gaming Tax	73.9	83.3	90.0	95.3	100.0	105.1	110.3	115.8
DOM. TAXES ON GOODS AND SERVICES	575.7	596.0	613.5	621.4	637.3	629.9	610.2	610.2
Excise	178.8	174.7	190.4	202.2	215.8	230.2	245.9	245.9
VAT	289.6	311.8	317.0	332.4	352.1	357.5	363.7	363.7
Mining Levy	105.9	101.8	105.6	86.3	69.0	41.5	0.0	0.0
Other Indirect	1.4	7.8	0.5	0.5	0.5	0.6	0.6	0.6
TAXES ON INTERNATIONAL TRADE	303.2	295.3	377.0	291.5	297.6	309.2	333.3	339.0
Import Duty	79.5	73.7	145.5	74.6	72.9	74.0	76.9	76.9
Export Duty	106.7	111.8	94.2	76.6	79.2	85.9	104.5	109.1
Excise Duty on Imports	117.0	109.8	137.3	140.2	145.5	149.3	151.9	153.0
<b>NON TAX REVENUE</b>	<b>169.9</b>	<b>239.2</b>	<b>243.5</b>	<b>260.8</b>	<b>271.7</b>	<b>278.1</b>	<b>283.6</b>	<b>290.6</b>
PROPERTY INCOME	74.4	159.7	161.0	183.0	183.5	187.0	189.5	193.5
Dividends	64.0	85.7	61.0	83.0	83.5	87.0	89.5	93.5
Mining and Petroleum Dividends	10.4	74.0	100.0	100.0	100.0	100.0	100.0	100.0
Other*								
INTEREST AND FEES FROM LENDING	1.3	4.3	5.0	5.0	5.0	5.0	5.0	5.0
OTHER NON TAX REVENUE	72.2	75.2	77.6	72.9	83.3	86.1	89.1	92.2
ASSET SALES	22.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>TOTAL REVENUE</b>	<b>2539.8</b>	<b>2917.13</b>	<b>3373.4</b>	<b>3245.7</b>	<b>3310.4</b>	<b>3340.6</b>	<b>3393.5</b>	<b>3459.1</b>
% of GDP	21.6%	22.5%	24.6%	22.4%	21.9%	21.0%	20.2%	19.0%
<b>INFRASTRUCTURE TAX CREDITS</b>	<b>55.2</b>	<b>40.0</b>	<b>60.6</b>	<b>110.9</b>	<b>110.9</b>	<b>110.9</b>	<b>110.9</b>	<b>110.9</b>
<b>GRANTS</b>	<b>691.4</b>	<b>693.0</b>	<b>849.7</b>	<b>1283.1</b>	<b>1283.1</b>	<b>1283.1</b>	<b>1283.1</b>	<b>1283.1</b>
Budgetary Support	20.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project Support Grants	670.5	693.0	849.7	1283.1	1283.1	1283.1	1283.1	1283.1
<b>TOTAL REVENUE AND GRANTS</b>	<b>3286.4</b>	<b>3650.1</b>	<b>4283.7</b>	<b>4639.7</b>	<b>4704.4</b>	<b>4734.6</b>	<b>4787.5</b>	<b>4853.1</b>
% of GDP	27.9%	28.2%	31.2%	32.0%	31.2%	29.7%	28.4%	26.6%
<b>PRINCIPAL RECEIPTS FROM LENDING</b>	<b>4.8</b>	<b>9.6</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>
<b>GROSS BORROWING</b>	<b>1011.4</b>	<b>813.7</b>	<b>1438.9</b>	<b>1149.6</b>	<b>1294.8</b>	<b>1317.4</b>	<b>1284.8</b>	<b>758.6</b>
<b>ASSET SALES</b>	<b>201.0</b>	<b>40.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>TOTAL RECEIPTS</b>	<b>4503.7</b>	<b>4513.4</b>	<b>5726.6</b>	<b>5793.3</b>	<b>6003.2</b>	<b>6056.0</b>	<b>6076.3</b>	<b>5615.7</b>
% of GDP	44.0%	38.4%	44.2%	42.2%	41.4%	40.1%	38.2%	33.4%

Source: Department of Treasury.



**Table A3.9: Central Government Expenditure and Net Lending**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
<b>RECURRENT BUDGET</b>								
NATIONAL DEPARTMENTS	1357.1	1192.4	1555.4	1586.6	1613.2	1706.9	1782.8	1852.1
Salaries and Wages <sup>(a)</sup>	574.3	618.0	671.1	769.3	795.0	858.7	896.2	990.9
Goods and Other Services	568.1	514.1	729.3	675.6	709.4	744.8	782.1	821.2
Education Funding	134.7	29.9	40.0	41.1	42.2	43.3	44.5	40.0
Pre-March 2003 Arrears Payments	12.0	20.6	33.1	35.0	0.0	0.0	0.0	0.0
Structural Adjustment Payments	68.0	9.7	81.9	65.6	66.7	60.0	60.0	0.0
PROVINCIAL DEPARTMENTS	587.9	594.6	607.6	628.1	635.0	642.5	650.3	663.4
Salaries and Wages	485.0	504.2	514.9	525.3	529.7	534.6	539.9	550.2
Staffing Grants	160.4	165.2	166.9	171.0	165.9	160.9	156.1	156.1
Teachers' Salaries	324.6	339.0	348.0	354.3	363.9	373.7	383.8	394.1
Goods and Other Services	48.6	61.4	62.1	67.4	68.9	70.5	72.2	73.9
Administration / Block Grants	38.0	41.6	21.3	23.3	23.9	24.6	25.4	26.0
Health Function Grant	0.0	0.0	11.0	12.0	12.0	12.1	12.1	12.2
Education Subsidies / Function Grant	0.0	11.0	17.6	20.3	20.8	21.4	22.0	22.6
Derivation Grants	10.6	8.8	12.2	11.8	12.1	12.4	12.8	13.1
Conditional Grants	54.3	29.1	30.6	35.4	36.4	37.4	38.3	39.3
Provincial Infr / Transp Maint Grants	24.4	15.3	9.9	12.4	12.8	13.1	13.5	13.8
Local & Village Services / Rural LLG	26.6	8.9	14.6	16.2	16.7	17.1	17.6	18.0
Town and Urban Services	3.3	4.9	6.1	6.8	7.0	7.1	7.2	7.4
TRANSFERS TO STAT. INS.	164.9	178.4	187.6	197.9	197.9	197.9	197.9	197.9
INTEREST PAYMENTS AND FEES	436.4	739.6	416.7	480.5	493.0	501.3	504.5	500.0
Domestic	248.0	578.8	285.0	347.1	359.6	367.9	371.1	366.6
External	188.4	160.8	131.7	133.4	133.4	133.4	133.4	133.4
NET LENDING TO CSAs	-4.8	-9.6	-4.0	-4.0	-4.0	-4.0	-4.0	-4.0
<b>TOTAL RECURRENT</b>	<b>2541.5</b>	<b>2695.5</b>	<b>2763.3</b>	<b>2889.1</b>	<b>2935.2</b>	<b>3044.6</b>	<b>3131.5</b>	<b>3209.4</b>
% of GDP	21.6%	20.8%	20.1%	19.9%	19.4%	19.1%	18.6%	17.6%
<b>DEVELOPMENT BUDGET</b>								
DOMESTIC FUNDS	236.8	207.3	292.0	281.0	281.0	284.0	287.0	290.0
PROJECT GRANTS	670.5	693.0	849.7	1283.1	1283.1	1283.1	1283.1	1283.1
INFRASTRUCTURE TAX CREDITS	55.2	40.0	60.6	110.9	110.9	110.9	110.9	110.9
CONCESSIONAL LOANS	97.5	82.8	136.6	198.7	203.1	233.4	236.0	161.4
COMMERCIAL LOANS	135.0	55.9	26.9	14.6	0.0	0.0	0.0	0.0
<b>TOTAL DEVELOPMENT (PIP)</b>	<b>1195.0</b>	<b>1079.0</b>	<b>1365.8</b>	<b>1888.3</b>	<b>1878.1</b>	<b>1911.4</b>	<b>1917.0</b>	<b>1845.4</b>
% of GDP	10.2%	8.3%	9.9%	13.0%	12.4%	12.0%	11.4%	10.1%
<b>REQUIRED ADJUSTMENT MEASURES</b>					<b>-23.5</b>	<b>-194.0</b>	<b>-319.0</b>	<b>-260.4</b>
% of GDP					-0.2%	-1.2%	-1.9%	-1.4%
<b>TOTAL EXPENDITURE AND NET LENDING</b>	<b>3736.5</b>	<b>3774.5</b>	<b>4129.1</b>	<b>4777.4</b>	<b>4789.8</b>	<b>4762.0</b>	<b>4729.5</b>	<b>4794.4</b>
% of GDP	31.8%	29.2%	30.1%	33.0%	31.7%	29.9%	28.1%	26.3%
<b>AMORTISATION</b>	<b>764.0</b>	<b>729.4</b>	<b>1593.5</b>	<b>1011.9</b>	<b>1203.1</b>	<b>1283.3</b>	<b>1335.9</b>	<b>810.0</b>
Domestic	404.9	283.7	1161.1	608.4	903.8	1007.0	1039.8	503.2
External	359.1	445.6	432.4	403.5	299.3	276.3	296.1	306.8
<b>LOAN REPAYMENTS</b>	<b>4.8</b>	<b>9.6</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>
<b>TOTAL PAYMENTS</b>	<b>4505.3</b>	<b>4513.4</b>	<b>5726.6</b>	<b>5793.4</b>	<b>5996.9</b>	<b>6049.3</b>	<b>6069.4</b>	<b>5608.4</b>
% of GDP	41.0%	36.6%	42.5%	40.9%	39.6%	37.9%	35.9%	43.8%

Source: Department of Treasury.

(a) National Departments salary and wages includes provisions for superannuation contributions, retirement payments and future pay rises for both national and provincial government employees, including school teachers.

**Table A3.10: Central Government Financing**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
TOTAL REVENUE AND GRANTS	3231.2	3650.1	4283.7	4639.7	4704.4	4734.6	4787.5	4853.1
TOTAL EXPENDITURE AND NET LENDING	3681.3	3774.5	4129.1	4777.4	4789.8	4762.0	4729.5	4794.4
<b>DEFICIT (-) / SURPLUS (+)</b>	<b>-450.0</b>	<b>-124.3</b>	<b>154.6</b>	<b>-137.7</b>	<b>-85.4</b>	<b>-27.5</b>	<b>58.0</b>	<b>58.7</b>
% of GDP	-3.8%	-1.0%	1.1%	-1.0%	-0.6%	-0.2%	0.3%	0.3%
<b>NET EXTERNAL FINANCING</b>	<b>-126.6</b>	<b>-307.0</b>	<b>-155.9</b>	<b>-190.2</b>	<b>-96.2</b>	<b>-42.9</b>	<b>-60.1</b>	<b>-145.4</b>
CONCESSIONAL FINANCING	-177.9	-136.5	-83.0	-19.1	-78.3	-25.0	-42.2	-127.5
New Borrowing	97.5	82.8	136.6	198.7	203.1	233.4	236.0	161.4
Less Amortisation	-275.4	-219.3	-219.6	-217.8	-281.4	-258.4	-278.2	-288.9
COMMERCIAL FINANCING	51.3	11.3	0.3	-5.8	-17.9	-17.9	-17.9	-17.9
New Borrowing	135.0	55.9	26.9	14.6	0.0	0.0	0.0	0.0
Less Amortisation	-83.7	-44.6	-26.6	-20.4	-17.9	-17.9	-17.9	-17.9
EXTERNAL EXTRAORDINARY FINANCING	0.0	-181.8	-73.2	-165.4	0.0	0.0	0.0	0.0
New Borrowing	0.0	0.0	113.0	0.0	0.0	0.0	0.0	0.0
Less Amortisation	0.0	-181.8	-186.2	-165.4	0.0	0.0	0.0	0.0
<b>NET DOMESTIC FINANCING</b>	<b>576.6</b>	<b>431.3</b>	<b>1.3</b>	<b>327.9</b>	<b>187.9</b>	<b>77.0</b>	<b>9.0</b>	<b>94.0</b>
DOMESTIC MARKET BORROWING	300.7	361.5	169.3	327.9	197.9	87.0	19.0	104.0
New Borrowing	705.5	645.2	1330.4	936.3	1101.7	1094.0	1058.8	607.2
Less Amortisation	-404.8	-283.7	-1161.1	-608.4	-903.8	-1007.0	-1039.8	-503.2
MRSF NET DRAWDOWN								
TEMPORARY ADVANCE	74.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
End period balance	74.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
less: Beginning period balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
ASSET SALES FINANCING	201.0	40.0	0.0	0.0	0.0	0.0	0.0	0.0
OTHER DOMESTIC FINANCING		29.8	-168.0	0.0	-10.0	-10.0	-10.0	-10.0
Change in check float		44.0	-65.0	0.0	-10.0	-10.0	-10.0	-10.0
End period stock		165.0	100.0	100.0	90.0	80.0	70.0	60.0
less: Beginning period stock		-121.0	-165.0	-100.0	-100.0	-90.0	-80.0	-70.0
POSF financing (a)		0.0	-63.0	0.0	0.0	0.0	0.0	80.0
BPNG financing		0.0	-40.0	0.0	0.0	0.0	0.0	0.0
Change in suspense account		-14.2	0.0	0.0	0.0	0.0	0.0	0.0
<b>NET FINANCING</b>	<b>450.0</b>	<b>124.3</b>	<b>-154.6</b>	<b>137.7</b>	<b>91.7</b>	<b>34.1</b>	<b>-51.1</b>	<b>-51.4</b>
<i>MEMO:</i>								
FINANCING REQUIREMENT	<b>576.6</b>	<b>431.3</b>	<b>1.3</b>	<b>327.9</b>	<b>181.6</b>	<b>70.4</b>	<b>2.1</b>	<b>86.7</b>
% of GDP	5.2	3.5	0.0	2.3	1.2	0.4	0.0	0.5
NET DOMESTIC FINANCING BEFORE ASSET SALES	375.6	391.3	1.3	327.9	187.9	77.0	9.0	94.0
GROSS BORROWING	1012.9	813.7	1438.9	1149.6	1294.8	1317.4	1284.8	758.6
Domestic	780.4	675.0	1162.4	936.3	1091.7	1084.0	1048.8	597.2
External	232.5	138.7	276.5	213.3	203.1	233.4	236.0	161.4
Concessional	97.5	82.8	136.6	198.7	203.1	233.4	236.0	161.4
Commercial	135.0	55.9	26.9	14.6	0.0	0.0	0.0	0.0
Extraordinary	0.0	0.0	113.0	0.0	0.0	0.0	0.0	0.0
GROSS AMORTIZATION	763.9	729.4	1593.5	1011.9	1203.1	1283.3	1335.9	810.0
Domestic	404.8	283.7	1161.1	608.4	903.8	1007.0	1039.8	503.2
External	359.1	445.6	432.4	403.5	299.3	276.3	296.1	306.8
Concessional	275.4	219.3	219.6	217.8	281.4	258.4	278.2	288.9
Commercial	83.7	44.6	26.6	20.4	17.9	17.9	17.9	17.9
Extraordinary	0.0	181.8	186.2	165.4	0.0	0.0	0.0	0.0

Source: Department of Treasury.

Note: 2005 includes the issuance of K457 million in Inscribed stocks to replace Treasury bills.

(a) In 2004 the Government provide a Bond issue of K63 million to the POSF in consideration of the obligation owed by the Government for accumulated superannuation contribution to the POSF scheme. This Budget recognises as an imputed cash flow that portion of the Bond which reflects the actual 2004 amount due and payable by the Government to the POSF.

**Table A3.11: Monetary Aggregates**

	1996 Actual	1997 Actual	1998 Actual	1999 Actual	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 July
Domestic Credit	1891.3	2320.4	2716.3	2824.8	2471.8	2367.0	2850.3	2620.1	2588.5
% Change	6.5%	22.7%	17.1%	4.0%	-12.5%	-4.2%	20.4%	-8.1%	-1.2%
Net Credit to Government	684.9	840.1	969.3	1077.4	933.4	696.9	1256.5	1123.0	1146.3
% Change	19.2%	22.7%	15.4%	11.2%	-13.4%	-25.3%	80.3%	-10.6%	2.1%
Credit to Private Sector	780.4	1063.9	1372.2	1516.8	1562.1	1543.2	1445.4	1382.7	1354.1
% Change	0.4%	36.3%	29.0%	10.5%	3.0%	-1.2%	-6.3%	-4.3%	-2.1%
Money Supply	2736.8	3101.1	3212.3	3500.3	3888.6	3904.6	4269.7	4233.3	4463.3
% Change	32.3%	13.3%	3.6%	9.0%	11.1%	0.4%	9.4%	-0.9%	5.4%
Money Velocity (M3*) (average)	2.5	2.3	2.4	2.5	2.5	2.6	2.8	3.1	3.1

Source: BPNG

**Table A3.12: Public Debt**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
Domestic	2,588.3	3,022.9	3,089.2	3,417.1	3,615.0	3,702.0	3,721.0	3,825.0
Treasury Bills***	2,169.1	2,755.3	2,112.5	1,834.8	1,586.5	1,280.5	889.3	946.5
Inscribed Stock	283.8	174.7	930.8	1,553.5	2,015.2	2,413.7	2,828.5	2,878.5
Other Domestic debt**	135.4	92.9	45.9	28.8	13.3	7.8	3.2	0.0
<i>Domestic debt as % GDP</i>	22.0%	23.3%	22.5%	23.6%	23.9%	23.3%	22.1%	21.0%
External	5,594.6	4,709.1	4,411.2	4,326.8	4,334.5	4,395.5	4,441.0	4,402.2
International Agencies	5,464.1	4,547.8	4,248.6	4,166.1	4,187.8	4,263.3	4,323.4	4,299.7
Commercial Loans	107.4	135.9	137.0	134.5	119.9	104.8	89.5	73.7
Other Loans	23.1	25.4	25.6	26.2	26.8	27.4	28.1	28.8
<i>External debt as % GDP</i>	47.5%	36.4%	32.1%	29.9%	28.7%	27.6%	26.4%	24.1%
<b>Total Public Debt Outstanding</b>	<b>8,182.9</b>	<b>7,732.0</b>	<b>7,500.4</b>	<b>7,743.9</b>	<b>7,949.5</b>	<b>8,097.5</b>	<b>8,162.0</b>	<b>8,227.2</b>
<i>As % GDP</i>	69.5%	59.7%	54.6%	53.4%	52.7%	50.9%	48.5%	45.1%

Source: BPNG and Department of Treasury.

\*\*Includes Temporary Advance Facility

Note: Based on existing borrowings to cover financing gaps 2005 to 2009.

**Table A3.13: Major Assumptions Underlying the Budget**

	2002 Actual	2003 Actual	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
<b>Inflation</b>								
Average on Average (%)	11.8	14.7	2.9	3.8	4.8	4.9	5.0	4.9
Dec on Dec (%)	14.8	8.5	3.7	4.2	4.9	5.0	5.0	4.9
<b>Exchange rate</b>								
Real Exchange Rate Index (2004 = 100)	75	96	100	100	100	100	100	100
<b>Interest rate</b>								
T/Bills (average for the year)	13.3	18.3	9.0	9.0	9.0	9.0	9.0	9.0
<b>Mineral Prices</b>								
Gold (US\$/oz)	311	363	395	400	400	400	400	400
Copper (US\$/lb)	0.71	0.81	1.23	1.04	0.91	0.86	0.88	0.90
Oil (Kutubu Crude: US\$/barrel)	24.0	27.4	37.3	35.0	32.5	30.5	28.5	26.5

Source: Department of Treasury.