2005

BUDGET SPEECH

DELIVERED BY

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On The Occasion Of The
Presentation Of The 2005 National Budget To Parliament

Tuesday 16th November, 2004

Speech

2005 Budget
"Building the Economy Through Sustained Reform"

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

16th November 2004

1. INTRODUCTION

Mr. Speaker, I move that the Bill now be read a second time.

It is a great honour and a great responsibility to present to the House the Somare Government's third full-year Budget.

Honourable Members, since coming to power in August 2002 the Government has acted firmly to restore fiscal discipline and improve economic conditions.

The country and our people are now beginning to see positive results from our responsible financial and economic management. The economy and the state of our finances are today in far better shape than when I stood here before you two years ago.

Building on this platform, the 2005 Budget is the cornerstone of the Government's economic and financial management plan for next year and into the medium term.

The central theme that I will keep returning to is the Government's plan of building the economy through sustained reform, through achieving:

- A Stable Investment Climate.
- An Efficient, Effective and Affordable Public Sector; and
- A Competitive and Dynamic Private Sector.

The Government has a clear vision of where we want to see Papua New Guinea go over the next five to ten years.

Our short-term policies are framed in a medium-term context and are thus strategically directed towards the economic and social development of our nation over time.

We want to grow the economy, to create jobs, to generate income and to provide services for all our people. We will achieve this through good economic management and sustained reform.

We will not take the easy way and put up taxes to get more money, while leaving everyone worse off. This Budget contains no new taxes and no increases in existing tax rates.

We will not promise what we cannot deliver.

Instead, we will follow the same principles of prudent expenditure management and prioritization that have worked so well over the past two years.

Mr. Speaker, with that introduction I would now like to review the state of the economy and the Budget in 2004, before going on to outline the main themes and initiatives in the 2005 Budget.

2. STATE OF THE ECONOMY

Mr. Speaker,

The Papua New Guinea economy has improved significantly since 2002. In 2002, the economy was in its third year of deep crisis.

There was little investment taking place, companies were closing, down-sizing and moving their head offices off-shore. Economic activity had contracted. Employment was stagnant. Inflation was trending upwards, eating away at people's income. The standard of living was falling.

The Kina had fallen against the US dollar and the Australian dollar. The country's balance of payments was vulnerable. A large deficit was in prospect. Exports were falling. Capital outflows were increasing and foreign exchange reserves were under pressure. A large fiscal deficit was also in prospect.

On taking office, the Somare Government set to work to put the economy on track and lay the foundations for a return to fiscal responsibility through a mixture of macroeconomic policies and structural reforms. The supplementary Budget in August 2002 and the 2003 and 2004 Budgets set about to improve government finances and turn around the economy.

Today, I can say confidently that we have succeeded in turning around the economy and improving government's budgetary position. The economy and the state of our finances are in far better shape now than in 2002.

Mr. Speaker,

The Papua New Guinea economy started to grow in 2003 and economic activity has continued to pick up in 2004. Investment has increased, businesses are making profits and employment has risen.

The economy is expected to grow by 2.6 per cent in 2004; non-mining and petroleum GDP is expected to grow by 2.8 per cent in 2004.

Inflation is at historical low levels, down to under 2 per cent after being in double digits not too long ago.

Interest rates have fallen sharply, reflecting prudent fiscal management. Treasury Bill rates have fallen from as high as 20 per cent around the middle of 2003 to around 5 per cent. The Bank of Papua New Guinea's Kina Facility Rate has come down from 14 per cent at the start of the year to 7 per cent today.

Commercial interest rates have also declined, helping ordinary borrowers and reducing the cost of funds for investors.

Our external position is very solid in 2004 with the current account recording a surplus of around 3 per cent of GDP in the first two quarters of 2004. This reflects high international prices for oil, metals and agricultural commodities as well as increased domestic production in the agriculture sector, the mining sector and fisheries sector.

Our gross international reserves have reached record levels of more than US$600 million or over K1900 million. These reserves make us less vulnerable to shocks and will help the central bank cushion potentially destablising movements in the exchange rate.

The Kina remains stable against the United States and the Australian dollars in 2004. The most important factor in the stability of the Kina in 2004 has been the maintenance of sound expenditure control by the Government. That said, the Kina has also been supported by higher prices of key commodity exports and the continued recovery of agricultural exports. It also reflects increasing confidence about Papua New Guinea's growth prospects.

On the fiscal front, fiscal responsibility has been restored with a considerable improvement in the government's budgetary position. The deficit in 2003 was less than 1.0 per cent of GDP and this good outturn has continued in 2004. For 2004, the budget balance is expected to be a surplus of 1.1 per cent of GDP.

This will be the first time in many years that Government has been able to pay off some of its debt. Debt as a percentage of GDP will fall to 55 per cent by the end of 2004, down from 70 per cent at the end of 2002.

Of course this good fiscal outcome has been partly due to higher revenues because of high commodity prices, particularly oil and copper prices. At the same time, however, it reflects strong fiscal discipline by this Government, which has seen expenditure kept tightly under control.

Let me now turn to directly discuss the state of the Budget in 2004.

3. 2004 FISCAL OUTCOMES

Mr. Speaker,

Managing the Government's expenditure, revenue and financing in 2004 continued to be as challenging as in the previous two years.

The 2004 Budget balance is likely to be a surplus. This outcome reflects three factors:

(i) disciplined expenditure management;

(ii) the reduction in interest payments; and

(iii) strong revenue growth in line with high commodity prices and stronger economic growth.

Mr. Speaker,

Total expenditure and net lending was managed tightly throughout 2004 with most expenditure remaining within the 2004 Budget forecasts.

Prudent fiscal management reduced pressure on interest rates, which reduced government interest payments by well over K200 million. This freed up money to pay some of our outstanding obligations and to spend on priority areas. We have been able to fund increased redundancy payments, additional payments for court orders and arrears, and some other high-priority spending including on the Highlands Highway.

The additional spending made possible by the fall in interest payments is a tangible benefit of Government's sound fiscal management.

This shows that good economic management can benefit the ordinary person.

Total expenditure and net lending remained within the appropriation levels set by Parliament.

Mr. Speaker,

Total Revenue and Grants, received by the Government in 2004 turned out to be significantly higher than the initial 2004 Budget estimate. The windfall in revenue primarily reflects the temporary surge in the international prices of oil, gold and copper resulting in significantly higher-than-expected mining and

petroleum taxes. It is also further evidence of the strength of the domestic economy.

In line with the requirements of the Public Finance (Management) Act, this revenue windfall has been largely used to reduce government debt.

The Government has also decided to spend K100 million of this windfall in 2004 on meeting outstanding obligations in the form of arrears, court orders and POSF obligations.

Overall, total Revenue and Grants is now estimated to be substantially higher than estimated in the 2004 Budget.

Given the developments in expenditure and revenue, the 2004 Budget balance is now expected to be a small surplus of K154.6 million, which is 1.1 per cent of GDP, instead of the initial 2004 Budget forecast of a deficit of 1.5 per cent of GDP.

4. CHALLENGES FOR THE 2005 BUDGET

Mr. Speaker,

I wish to stress that, despite the favourable outcome in 2004, there is still a lot of hard work to be done, particularly in the area of adjustment and prioritization of public expenditure.

- Debt levels are still too high and interest payments continue to take up too large a share of recurrent expenditure.

- Public expenditures are still too high and do not line up well with the agreed fiscal priorities as established in the Medium Term Development Strategy and other supporting strategies.

- There continues to be excessive expenditure on salaries and wages, which is crowding out spending on goods and services and infrastructure.
- Financing of the budget remains fragile with large external payments scheduled to be made in coming years.

These are challenges that we have started to address over the past two years and continue to do so in the 2005 Budget. Clearly there is still much work to do.

5. 2005 ECONOMIC OUTLOOK

Mr. Speaker,

Honourable Members, looking ahead, the stable macroeconomic management and sustained reforms being undertaken by this Government should see the economy continue to grow solidly in 2005.

The economy is forecast to grow by 2.9 per cent in 2005; the non-mining part of the economy is forecast to grow by 2.8 per cent. This will be three successive years of economic growth between 2½ and 3 per cent, a significant improvement from the first part of the decade.

Inflation is expected to remain low, underpinned by exchange rate stability. Interest rates are also expected to remain low.

External conditions should continue to be solid. Although prices for some of our key commodities are likely to fall from their current very high levels, they are expected to remain well above their historical trend levels in 2005.

Of course, as always there are risks to the outlook.

Political stability is critical to the ongoing stability and health of the economy.

More generally, there is a risk that, if oil prices remain above $US50 per barrel for an extended period, global economic conditions will weaken significantly.

6. THE 2005 BUDGET STRATEGY

Mr. Speaker,

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 outlines the Government's plan to **grow the economy through sustained reform**, through achieving:

- A Stable Investment Climate.
- An Efficient, Effective and Affordable Public Sector; and
- A Competitive and Dynamic Private Sector.

The 2005 Budget 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 Reform and Rationalisation* process.

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

Specifically, the 2005 Budget:

- Delivers a Budget deficit in 2005 of around 1 per cent of GDP, as part of the ongoing fiscal adjustment strategy of moving to a balanced budget over the medium term.
- Has no new taxes and no increases in existing taxes.
- Increases the state contribution to POSF in line with the transition to a fully-funded superannuation scheme.
- Initiates a program of expenditure adjustment that will see relatively less spending on 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 (including 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 finance management, particularly with respect to expenditure controls.

6.1 REVENUE MEASURES

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

Rather, the focus of the Government's revenue collection efforts will be on improving compliance with the tax laws, thereby ensuring everyone pays their fair share of tax.

In this Budget, the Government fulfils its promise to discontinue the 2 per cent temporary import levy in 2005. The Budget also includes the commitment to the continued phased reduction in the mining levy.

The Government will also be continuing the significant tax incentives for the agricultural sector outlined in the 2004 Budget.

This policy continuity is an important benefit of political stability, and will further enhance investor confidence.

The Government will build on this record through the expansion and extension of current proposals.

In particular, the infrastructure tax credit for agricultural activities will be increased from 0.75 per cent to 1 per cent, to provide increased support for agricultural road maintenance.

Further, the Highlands Highway supplementary tax credit will be renewed for a further three years to support road maintenance, providing better transport infrastructure to facilitate the distribution and marketing of rural products.

Finally, in 2005 there will be a review of the forestry revenue system to ensure that forestry taxation arrangements are cohesive and effective.

6.2 EXPENDITURE PRIORITIES

Mr. Speaker, the 2005 Budget will see additional funds allocated to priority areas.

It will also see the continued implementation of the *Public Expenditure Rationalisation and Review (PERR)*, in conjunction with a World Bank-led group of donors.

More money is provided for law and order, including police, education, health and transport infrastructure maintenance.

Provision has also been made for a salary increase for public servants. This has been a long-outstanding issue and substantial progress has been made. Government has worked very hard with the union to provide a fair salary increase for government employees, but also one which is affordable and sustainable. I am hopeful we will be able to announce an agreed settlement in coming weeks.

Funding has been provided to pay off the remaining pre-2003 arrears. A substantial amount of this debt was paid off in 2004. Further funding has been provided to pay outstanding court orders.

More money has been provided to the provinces, with higher funding for provincial wages and salaries, goods and services, and conditional grants. The National Economic and Fiscal Commission (NEFC) will continue to develop proposals for more substantial improvements to the system of intergovernmental fiscal relations.

The Development Budget will see a substantial increase in funding, partly due to the funding of the police component of the Enhanced Cooperation Program (ECP) and partly because of the increase in domestic funds provided by the Government. The Development Budget spending will increase by K522.5 million to K1,888 million in 2005.

Donor grants are projected to increase by around K433 million. Most of this increase reflects the deployment of Australian Federal police under the Government's Enhanced Cooperation Programme

The Government's total direct contribution to the Development Budget, including money provided through infrastructure tax credits, will be K392 million in 2005, a substantial increase on the allocation provided in recent years.

One of the key priorities of the Development Budget is the rehabilitation and maintenance of transport infrastructure. The Development Budget includes counterpart funding for large development projects, including the ADB five Highlands Provinces project, the World Bank Road Maintenance Programme and the AusAID Key Roads for Growth. In addition, substantial government funds will go to the District Roads Improvement Programme.

More money is provided for law and justice. The ECP program should support an improvement in law and order and boost the capacity of the PNG police force to tackle crime.

More funds have been provided for health and more funds allocated to tackle the looming HIV/AIDS threat. HIV/AIDS is a critical development issue which can have major economic and social costs if left unaddressed. Development expenditure for the National AIDS Council is budgeted at K10.5 million in 2005.

Funding has also been provided in the 2005 Budget to provide for initial costs associated with the PNG-Australia Gas project, for which front end engineering and design has recently commenced. This is potentially a very large project which will bring substantial benefits to Papua New Guinea. The progress in this venture reflects the Government's efforts to build the economy and the increasing confidence in Papua New Guinea's growth prospects.

6.3 ECONOMIC GROWTH THROUGH SUSTAINED REFORM

Mr. Speaker,

Stronger economic growth in Papua New Guinea will only come about by good management of the economy and sustained reform.

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

A stable investment climate requires several things: a stable political environment, a stable macroeconomic environment and a stable policy environment. The 2005 Budget continues with 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.

Government will manage its existing debt obligations consistent with its recently introduced Medium Term Debt Management Strategy.

The domestic debt strategy aims to lengthen the maturity of debt to minimize rollover and interest cost risks, while the external debt strategy aims to rearrange the composition of the external and domestic debt ratio, to around 40:60 in the medium term, and to restructure the currency composition of external debt in order to minimize foreign exchange risk exposure.

Accordingly, during 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 also introduce a debt-switching program to complement 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.

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

An Efficient, Effective and Affordable Public Sector

An efficient, effective and affordable public sector requires an affordable and prioritised resource allocation, efficient service delivery mechanisms, and sufficient 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 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 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.

Governance reforms will continue 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 seek to improve accountability, compliance, and leadership, improve fiscal management, and improve service delivery.

The Government will continue to fund and strengthen the oversight agencies.

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.

This reform is being supported by the revitalization of the Public Service Commission. A further strengthening of the Commission will continue 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.

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 pursue strengthening government procurement practices including through a review of all trust accounts.

A competitive and dynamic private sector

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.

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

Government has been working with the business community, through the Impediments to Business and Investment Committee (IBIC) and the Consultative Implementation Monitoring Committee to find solutions to a range of issues that have been identified as impediments to business and initiatives flowing from that process are included in the 2005 Budget.

The Government has agreed to streamline the PNG immigration and work permit system. These initiatives include the removal of requirements for localization plans, and extension of long-term work permit periods from 3 years to 10 years, and a new permanent residency category for long-term residents, particularly for skilled employees and business people.

Government has also agreed to the implementation of APEC Business Travel to facilitate travel within the APEC region by business people.

The Bank of Papua New Guinea is currently reviewing PNG's foreign exchange controls and is expected to 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.

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.

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, through the Independent Public Business Corporation (IPBC), is continuing in its program for rehabilitating and, where appropriate, partially or fully privatising public enterprises and other State assets.

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.

An independent review of aspects of the Telikom sale process has been completed and a decision on the proposed sale is expected shortly.

Good progress has also continued to be made 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. Post PNG and Air Niugini, for example, are now realising solid profit growth.

Support for Agriculture

The 2005 Budget provides continued support for agriculture.

Substantial increases in road maintenance expenditure is provided in the Budget. This should make it easier to get crops to the markets. Substantial additional spending will occur on law and order, helping to provide increased security.

The Government will continue to explore and support microfinancing programs in 2005. The Rural Development Bank will be rehabilitated to support agricultural lending.

There are, in addition, new and continuing tax incentives to help promote income earning opportunities in rural areas.

These 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.

In addition, as stated earlier, 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 credit for agricultural activities will be increased from 0.75 per cent to 1 per cent, to provide increased support for agricultural road maintenance. A review of the forestry revenue system is also proposed for 2005 to ensure that forestry taxation arrangements are cohesive and effective.

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

7. CONCLUDING REMARKS

In conclusion, let me reiterate the key messages from the 2005 Budget.

The 2005 Budget is a plan for the future. We have stabilized a difficult position and have begun to move forward. It is a long road ahead. We have problems we must confront, but also have significant potential.

The 2005 Budget is fiscally responsible. It is focused on the priorities of the nation. Spending is being shifted to high priority areas. There are no new taxes or tax increases.

The 2005 Budget establishes a framework for stronger economic growth in Papua New Guinea by building on the reforms of the past two years. It is pro-growth and pro-development. The 2005 Budget will deliver a better future for Papua New Guineans.

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