

## CHAPTER 2 2007 BUDGET

### 2.1 OVERVIEW

The economy continues to improve, underpinned by solid global conditions and increased business and consumer confidence. Inflation is low, and expected to remain low. Interest rates have fallen and the exchange rate is expected to remain stable. The economy is expected to grow by around 3.7 per cent in 2006 and with solid domestic and external economic conditions as well as continued fiscal discipline, economic growth should continue to be strong in 2007.

**Table 16: Key Economic Assumptions 2005 – 2007**

	2005 Actual	2006 Revised	2007 Projection
Real GDP Growth	3.3*	3.7	4.5
Real Non-Mining GDP Growth	3.1*	4.1	4.2
Inflation (year average)	1.7	1.7	1.5
Oil Price (USD/Barrel)	53.4	65.0	65.0
Copper Price (USD/Pound)	1.67	2.99	2.49
Interest Rates (Treasury Bills)	4.5	5.0	6.0

Source: Department of Treasury and NSO

\* Treasury estimates

The 2007 Budget is set against this foundation and will advance the Government's economic growth strategy, providing detailed plans to enhance and promote a dynamic and competitive private sector in 2007 and beyond.

The sustained high prices on world markets for our main mineral commodities presents the Government with a significant opportunity to **invest in the future of our nation** with a total of K1,100 million expected to be available over the remainder of 2006 and 2007 on top of the ongoing Recurrent and Development Budgets.

The Medium Term Fiscal Strategy (MTFS) maps out an affordable and sustainable path of public spending, and the Medium Term Development Strategy 2005-2010 (MTDS), sets out the Government's medium-term development priorities. Consistent with the MTFS framework, the 2007 Budget targets a budget deficit of 0.2 per cent of GDP.

**Table 17: Budget Balance 2005 - 2007 (Kina Millions)**

	2005 Actual	2006 Revised	2007 Projection	Change
Total Revenue and Grants	5326.9	6161.8	5421.6	-740.2
Total Expenditure and Net Lending	5319.3	6161.8	5456.6	-705.2
Budget Balance	7.6	0.0	-35.0	-35.0
Per cent of GDP	0.0	0.0	-0.2	

Source: Department of Treasury

## 2.2 FISCAL STRATEGY

The 2007 Budget is set against a foundation of solid global and domestic economic conditions.

The 2007 Budget is this Government's fifth full-year budget, the final one of this term in Parliament. The political stability of the Government means that the 2007 Budget continues to be set within the same medium-term framework of the Medium Term Fiscal Strategy and the Medium Term Development Strategy.

Together, these broad strategies provide the strategic overview for the Budget. These strategies are translated into the guiding principles for the formulation and implementation of the 2007 Budget summarized in Box 1.

Specifically, the 2007 Budget will deliver a maximum budget deficit outturn in 2007 of K35.0 million or 0.2 per cent of GDP, consistent with achieving a sustained balanced budget over the medium term, as required by the recently enacted *Fiscal Responsibility Act 2006*.

The Government first announced this 2007 target in the 2004 Budget and its continued adherence to the target reflects well on its commitment to provide a stable planning environment for the private sector and its ongoing commitment to prudent public expenditure management.

The sustained high prices on world markets for our main mineral commodities (oil, copper and gold) presents the Government with a significant opportunity to **invest in the future of our nation** with a total of K1,100 million expected to be available over the remainder of 2006 and 2007 (K650 million in 2006; K450 million in 2007) on top of the ongoing Recurrent and Development Budgets.

This opportunity is also a significant responsibility. The Government has taken care to ensure this windfall does not result in unsustainable additions to ongoing spending and is not squandered on low quality spending.

The Government's allocation of these windfall gains provides the overall theme of the 2007 Budget: **"investing in the future of our nation"**.

The proposed 2007 Budget is based on the existing tax structure and does not propose any new taxes or tax increases. The scheduled tax reforms will continue as planned, including the phasing out of the mining levy and the second round of personal income tax cuts announced in the 2006 Budget.

The 2007 Budget proposes several revenue initiatives. The 2007 Budget revenue estimates have been prepared on the basis that these initiatives are implemented as recommended. Revenue measures in the 2007 Budget include:

- Tourism incentives,
- Reforms to forestry revenue sharing arrangements to provide fairer arrangements for landowners and developers; and
- Trial reduction in the excise on pre-mixed gasoline-oil ("Zoom").

While revenue is expected to remain strong in 2007, the current strength of revenue is not expected to be sustainable in the medium term. It follows that the main task for the expenditure side of the 2007 Budget is to ensure that temporary windfall gains are not built

into ongoing expenditure in an unsustainable manner, thereby maintaining consistency with the *Medium Term Fiscal Strategy*.

### **Box 1: Budget Guiding Principles**

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

Framework:

- Government will live within its means by producing a budget that is affordable and sustainable.
- Government will maintain the integrity of the tax system.
- Government will not raise the overall level of debt during its term.
- The budget will be in balance over the term of the Government
- 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 required to identify funding options and compensating savings with the department or agency.
- Government will work towards increasing the transparency of public finances by releasing timely budgetary information.

Through the maintenance of fiscal discipline over ongoing expenditure, we can ensure that the windfall gains are available to ***invest in the future of our nation*** through the:

- Rehabilitation of essential public infrastructure;
- Direct Investment in Economic Projects; and
- Repayment of Debt & other one-off obligations.

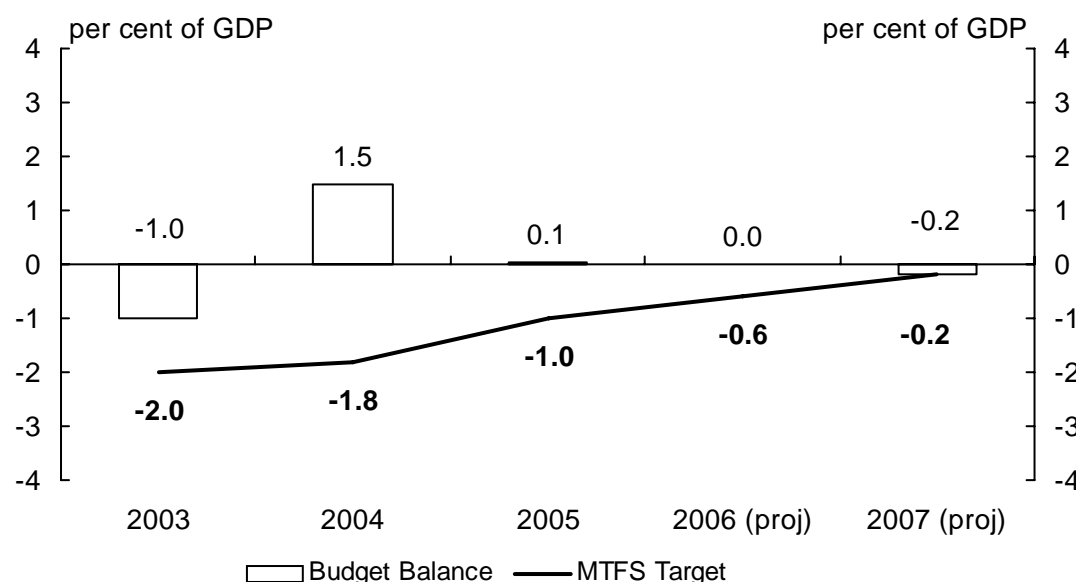
Consistent with this approach, a key focus of expenditure policy in 2007 is to increase the proportion of the Budget allocated to the seven priority areas identified in the *Medium Term Development Strategy* priorities. The 2007 Budget Strategy Paper set a target of achieving at least 52 per cent of total (GoPNG) Budget expenditure being allocated to MTDS priority

areas, with at least 84 per cent of (GoPNG) Development Budget expenditure being allocated to MTDS priorities in 2007.

The 2007 Development Budget has also placed a greater focus on ensuring that we provide a reasonable allocation of our own money into our key development priorities, rather than leave some key development tasks solely to donors. This allows us to send clear signals to donors and civil society that PNG's development should be driven according to the Government's policy framework and development strategy. It also reinforces our longer term objective of achieving self-reliance.

Another focus of expenditure policy in 2007 is to allocate resources to where they can be used most effectively. A key factor guiding expenditure decisions in the 2007 Budget is the quarterly budget reviews of expenditure, where agencies are required, among other things, to report on the results of their expenditure in the period. As a general rule, agencies that are using their money well should be provided more, and agencies that are not using their money well should be provided less (even if they are a MTDS priority).

**Figure 15: Actual Budget Balance and the MTFS Target**



Source: Department of Treasury

More generally, the 2007 Budget continues the broad strategy of promoting the development of a competitive and dynamic private sector by providing a supportive environment where the investment climate is stable, public services are delivered efficiently, cost structures are low, regulation is appropriate and financial incentives are set to reward productive effort.

## 2.3 REVENUE AND GRANTS

The 2007 Budget is based on the existing tax structure and does not propose any new taxes. It honours the Government's existing commitments on tax reduction which will continue as planned. These include the second round of personal income tax reductions and the phasing out of the mining levy.

The Government will also continue its commitment to improving the tax system, with reforms to forestry revenue sharing arrangements and a significant reduction in excise on "Zoom" in 2007.

In combination with this reform agenda, the focus of the Government's revenue efforts in 2007 will be on improving the level of compliance with the taxation laws, thereby ensuring that everyone pays their fair share of tax.

**Table 18: Revenue and Grants 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Tax Revenue	3744.0	4725.0	4129.9	-595.1
Non-tax Revenue	279.3	371.7	327.2	-44.5
Infrastructure Tax Credits	20.3	71.1	85.4	+14.3
Project Support Grants	1283.1	994.0	879.1	-114.9
<b>Total Revenue and Grants</b>	<b>5326.8</b>	<b>6161.8</b>	<b>5421.6</b>	<b>-740.2</b>

Source: Department of Treasury

Total Revenue and Grants are projected to be K5,421.6 million in 2007, a decrease of K740.2 million (or around 12 per cent) from the estimated level for 2006. This mainly reflects decreases in tax revenues from the minerals sector.

### 2.3.1 Tax Revenue

Tax revenue is projected to decrease by K595.1 million (or 12.6 per cent) to K4,129.9 million in 2007, compared with the K4,725.0 million estimated in 2006.

**Table 19: Tax Revenue 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Taxes on Income and Profits	2770.8	3644.1	3071.6	-572.5
Dom. Taxes on Goods & Services	657.3	760.1	758.0	-2.1
Taxes on International Trade	315.9	320.7	300.3	-20.4
<b>Tax Revenue</b>	<b>3744.0</b>	<b>4725.0</b>	<b>4129.9</b>	<b>-595.1</b>

Source: Department of Treasury

This reflects an expected K572.5 million (15.7 per cent) decrease in Taxes on Income and Profits along with a K20.4 million (or 6.4 per cent) decrease in Taxes on International Trade and a K2.1 million (or 0.3 per cent) decline in Domestic Taxes on Goods and Services.

**Table 20: Taxes on Income and Profits 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Personal Income Tax	841.0	878.6	890.3	+11.7
Company Tax	516.5	477.7	511.7	+34.0
Dividend Withholding Tax	154.7	176.3	168.1	-8.2
Mining and Petroleum Taxes	1076.8	1900.6	1292.8	-607.8
Interest Withholding Taxes	17.9	18.2	21.9	+3.7
Other Direct Tax	72.1	91.8	80.8	-11.0
Gaming Tax	91.9	101.0	106.0	+5.0
<b>Taxes on Income and Profits</b>	<b>2770.8</b>	<b>3644.1</b>	<b>3071.6</b>	<b>-572.5</b>

Source: Department of Treasury

Taxes on Income and Profits are expected to be K3,071.6 million in 2007, which is K572.5 million lower than the revised estimate of K3,644.1 million for 2006. The primary reason for this is an expected decline in tax revenues from the minerals sector in 2007.

Personal Income Tax receipts are expected to increase by K11.7 million (1.3 per cent) to K890.3 million in 2007 compared with the estimate of K878.6 million in 2006. The increase reflects the combined growth in employment and salaries which more than offsets the reduction in collections due to the second phase of the personal income tax reductions announced in the 2006 Budget.

Corporate Income Tax receipts are estimated to increase by K34.0 million (or 7.1 per cent) to K511.7 million in 2007, compared with K477.7 million estimated in 2006. The increase in corporate income tax reflects expected solid economic conditions resulting in continued improvements in corporate profitability.

Dividend Withholding Tax collections are expected to decrease by K8.2 million (4.7 per cent) to K168.7 million from the 2006 estimate of K176.3 million. The projected decrease largely reflects the lower dividend receipts from Ok Tedi assumed in 2007, as the world price for copper declines.

Mining and Petroleum Tax revenues are projected to fall by K607.8 million (32.0 per cent) to K1,292.8 million in 2007 against the 2006 estimate of K1,900.6 million. Major contributing factors to this projection include an assumed reduction in the international copper price and a moderate reduction in oil production.

Interest Withholding Tax receipts are projected to increase by K3.7 million (20.3 per cent) to K21.9 million in 2007 compared with K18.2 million estimated in 2006. The increase reflects the projected moderate rise in interest rates in 2007.

Other Direct Tax receipts are expected to decrease by K11.0 million (12.0 per cent) to K80.8 million from K91.8 million estimated in 2006. This decline is due to the receipt in early 2006 of stamp duty from a significant asset transfer.

Gaming Tax is projected to increase by K5.0 million (5.0 per cent) to K106.0 million in 2007 compared with K101.0 million estimated in 2006, reflecting continued growth in domestic demand.

**Table 21: Dom. Taxes on Goods & Services 2005–2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Excise	255.9	304.2	309.8	+5.6
GST	326.2	390.2	420.0	+29.8
Mining Levy	73.1	62.8	25.6	-37.2
Other Indirect	2.1	2.9	2.6	-0.3
<b>Domestic Taxes on Goods &amp; Services</b>	<b>657.3</b>	<b>760.1</b>	<b>758.0</b>	<b>-2.1</b>

Source: Department of Treasury

Domestic Taxes on Goods and Services are expected to decrease by K2.1 million (or 0.3 per cent) in 2007 to K758.0 million compared with K760.1 million estimated in 2006.

Domestic excise collections are expected to increase by K5.6 million (1.8 per cent) to K309.8 million in 2007 compared with the estimate of K304.2 million in 2006. The reflects continued stronger domestic demand being partially offset by the trial reduction in the excise on “Zoom”

The National Government’s share of Goods and Services Tax (GST) is expected to increase by K29.8 million (7.7 per cent) to K420.0 million in 2007 compared with the estimate of K390.2 million in 2006, in line with projected growth in economic activity.

Mining Levy collections are expected to decline by K37.2 million (59.2 per cent) to K25.6 million in 2007 compared with the 2006 estimate of K62.8 million. The decline reflects the continued phased reduction in the Mining Levy.

**Table 22: Taxes on International Trade 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Import Duty	101.1	89.5	96.9	+7.4
Export Duty	136.3	150.0	118.0	-32.0
Excise Duty on Imports	78.5	81.2	85.4	+4.2
<b>Taxes on International Trade</b>	<b>315.9</b>	<b>320.7</b>	<b>300.3</b>	<b>-20.4</b>

Source: Department of Treasury

Collections from Taxes on International Trade are expected to decrease by K20.4 million (or 6.4 per cent) in 2007 to K297.8 million compared with the 2006 estimate of K320.7 million.

Import Duty receipts are expected to increase by K7.4 million (8.3 per cent) to K96.9 million in 2007 compared to the 2006 estimate of K89.5 million, in line with the outlook for domestic demand.

Export Duty on logs is projected to decrease by K32.0 million (21.3 per cent) to K118.0 million in 2007 compared with the 2006 estimate of K150.0 million, reflecting the impact of the proposed reforms to forestry revenue sharing arrangements.

Excise Duty on Imports is projected to increase by K4.2 million (5.2 per cent) to K85.4 million in 2007 compared with an estimated K81.2 million in 2006, consistent with continued improved economic conditions.

### 2.3.2 Non-Tax Revenue

**Table 23: Non Tax Revenue 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Property Income	188.2	290.1	242.8	-47.3
Non-Mining Dividends	50.0	81.0	73.5	-7.5
Mining & Petroleum Dividends	138.2	209.1	169.3	-39.8
Interest and Fees from Lending	0.5	3.8	2.6	-1.2
Other Non Tax Revenue	90.7	77.8	81.8	+4.0
<b>Non Tax Revenue</b>	<b>279.3</b>	<b>371.7</b>	<b>327.2</b>	<b>-44.5</b>

Source: Department of Treasury

Non-Tax Revenue receipts are projected to decline by K44.5 million (or 12.0 per cent) in 2007 to K327.2 million compared with an estimated K371.7 million in 2006.

Property Income is projected to decline by K47.3 million (or 16.3 per cent) to K242.8 million in 2007 compared with the 2006 estimate of K290.1 million. The decline in property income is due largely to a projected reduced dividend from the State's 15 per cent interest in the Ok Tedi mine, reflecting an assumed reduction in the world price of copper.

The projection for non-mining dividends assumes the receipt of dividends in 2007 from the Bank of Papua New Guinea, National Fisheries Authority and the Independent Public Business Corporation. Mining and Petroleum dividends include an estimated dividend from the Mineral Resources Development Company (MRDC) in respect of the State's interest in the Moran joint venture.

Other Non-Tax Revenue, reflecting revenue from departments, is projected to increase by K4.0 million to K81.8 million in 2007 from the K77.8 million estimated for 2006. The increase in Other Non-Tax Revenue partly reflects the fact that the Government will continue to enhance effective monitoring and compliance to ensure improved collection in 2007.

### 2.3.3 Infrastructure Tax Credits

Infrastructure tax credits are expected to rise from K71.1 million in 2006 to K85.4 million in 2007, reflecting an assumed greater utilization of the tax credit system by mining and petroleum companies in 2007.

### 2.3.4 Grants

Project Support Grants for 2007 are expected to decrease by K114.9 million to K879.1 million from the estimated level of K994.0 million in 2006. The projected decrease largely reflects uncertainty over Papua New Guinea's share of donor funds for the region (particularly from the European Union, Japan and China).

**Table 24: Grants by Source (Kina Millions)**

	2005	2006	2007	Change
	Estimate	Estimate	Projection	
AusAID	1053.0	711.0	688.4	-22.6
JICA	110.4	50.6	26.8	-23.8
European Union (EU)	77.5	115.1	50.1	-65.0
New Zealand	23.2	36.5	36.2	-0.3
China		43.2	31.6	-11.6
United Nations (UN)			33.7	+33.7
Others	19.0	37.6	12.2	-25.4
<b>Total Project Grants</b>	<b>1283.1</b>	<b>994.0</b>	<b>879.1</b>	<b>-114.9</b>

Source: Department of National Planning and Monitoring

(a) Grants from China in 2005 and UN for 2005 & 2006 are included in Others

## 2.4 EXPENDITURE

Total Expenditure and Net Lending has been set at K5,456.6 million for 2007, which is K705.2 million or 11.4 per cent lower than the expected 2006 Budget outcome. This is consistent with the Government's 2007 Budget deficit target of 0.2 per cent of GDP (which is equivalent to K35.0 million).



**Table 25: Total Expenditure and Net Lending 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Recurrent Expenditure	3447.6	3824.6	3370.0	-454.6
Development Expenditure	1871.5	1687.2	1636.6	-50.6
Additional Priority Expenditure	0.0	650.0	450.0	-200.0
<b>Total Expenditure and Net Lending</b>	<b>5319.1</b>	<b>6161.8</b>	<b>5456.6</b>	<b>-705.2</b>

Source: Department of Treasury

### 2.4.1 Recurrent Expenditure

Total Recurrent Expenditure in 2007 is K3,370.0 million. This is K454.6 million or 11.9 per cent lower than the revised estimate for 2006. However, excluding the K682.5 million from the Supplementary Budget in 2006, Total Recurrent Expenditure increases by K227.9 million, or 7.3 per cent, in 2007. Total Recurrent Expenditure in 2007 is 61.8 per cent of Total Expenditure and Net Lending and 18.8 per cent of GDP.

**Table 26: Recurrent Expenditure: By Item: 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Personal Emoluments	1265.8	1404.2	1425.9	+21.7
Goods and Services	1245.1	1098.4	1250.5	+152.1
Gas Project Acquisition	400.0	0.0	0.0	0.0
Supplementary Budget	0.0	682.5	0.0	-682.5
Transfers to Statutory Institutions	206.3	211.2	221.6	+10.4
Interest Payments and Fees	332.8	432.2	475.9	+43.7
Net Lending to CSAs	-2.7	-4.0	-4.0	0.0
<b>Total Recurrent Expenditure</b>	<b>3447.6</b>	<b>3824.6</b>	<b>3370.0</b>	<b>-454.6</b>

Source: Department of Treasury

#### 2.4.1.1 Personal Emoluments

Personal emoluments is comprised of salary and allowances, wages, overtime, leave fares, superannuation contributions, superannuation payouts, and contract gratuities. Personal Emoluments for the National Departments and Provincial Governments, including teachers, are estimated to increase by K21.7 million or by 1.5 per cent to K1,425.9 million in 2007.

There are several factors behind the increase in personal emolument expenditure in 2007:

- Increase in school teacher numbers in line with population growth;
- Full year impact of new pay structure for police;
- Scheduled increase in the Government's superannuation contribution rate;
- General provision for moderate public service pay outcome;
- Payments of entitlements to Ministerial staff following the 2007 election;
- Increase in staffing for Department of Corrective Institutional Services; and
- Improving conditions and increase in staffing for Solicitor-General's office.

These factors more than offset savings from the retrenchment of unattached officers and the one-off clearance of leave fare arrears (particularly for Provincial Governments and Teachers) in 2006.

The Government has deferred consideration of the recommendations of the report of the Rightsizing Committee until after the 2007 Budget. Accordingly, the recommendations of the report have not been factored into the 2007 Budget estimates for personal emoluments.

**Table 27: Personal Emoluments 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
National Departments*	690.5	754.4	816.2	+61.8
Provincial Government	162.5	202.4	156.4	-46.0
Teachers	380.9	418.5	419.6	+1.1
Bougainville Government	31.9	28.9	33.7	+4.8
<b>Total Personal Emoluments</b>	<b>1,265.8</b>	<b>1,404.2</b>	<b>1,425.9</b>	<b>+21.7</b>

Source: Department of Treasury

\*Includes provisions for superannuation contributions and retirement payments.

A summary of the components of personal emoluments is provided in Table 28.

Salaries and Wages expenditure is estimated to be K1,163.1 million in 2007, which is K9.2 million or 0.8 per cent lower than the revised estimate for 2006.

The superannuation allocation in 2007 increases in line with the progressive shift to full funding of superannuation contributions for Government employees from 4.2 per cent of salary in 2006 to 6.3 per cent of salary in 2007.

Leave Fares expenditure decreases by K18.7 million in 2007, reflecting the one-off clearance of leave fare arrears in 2006.

**Table 28: Personal Emoluments: By Item 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Salaries and Wages	1,093.2	1,172.3	1,163.1	-9.2
<i>Salaries &amp; Allowances</i>	<i>1,018.9</i>	<i>1,082.8</i>	<i>1,096.3</i>	<i>+13.5</i>
<i>Wages</i>	<i>74.3</i>	<i>89.5</i>	<i>66.8</i>	<i>-22.7</i>
Superannuation	83.5	103.0	130.9	+27.9
Leave Fares	47.8	74.1	55.4	-18.7
Contract Gratuity	30.8	44.7	63.5	+18.8
Other*	10.5	10.0	13.0	+3.0
<b>Total Personal Emoluments</b>	<b>1,265.8</b>	<b>1,404.2</b>	<b>1,425.9</b>	<b>+21.7</b>

Source: Department of Treasury

\*Includes overtime and contract officer education benefits.

#### **2.4.1.2 Goods and Services**

Total Goods and Services expenditure in 2007 is K1,250.5 million. This is K152.1 million or 13.8 per cent higher than the revised estimate for 2006. The National Department, Provincial Governments and Bougainville Government's goods and services expenditures are

expected to increase by K121.2 million (12.2 per cent), K25.8 million (27.2 per cent) and K5.1 million (42.9 per cent) respectively.

**Table 29: Goods and Services 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
National Departments	1,142.6	991.7	1,112.9	+121.2
Provincial Governments	89.1	94.8	120.6	+25.8
Bougainville Government	13.4	11.9	17.0	+5.1
<b>Total Goods and Services</b>	<b>1,245.1</b>	<b>1,098.4</b>	<b>1,250.5</b>	<b>+152.1</b>

Source: Department of Treasury

#### 2.4.1.2.1 Goods and Services: National Departments

Total National Departments' Goods and Services provision is set at K1,112.9 million. This is K121.2 million or 12.2 per cent higher than the revised estimate for 2006.

**Table 30: National Dept. Goods & Services 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
General Goods and Services	904.0	823.0	948.4	+125.4
Education Subsidies	40.9	43.0	43.0	0.0
Other Goods and Services	197.7	125.7	121.6	-4.1
<i>Pre-March 2003 Arrears</i>	36.2	5.0	0.0	-5.0
<i>Structural Adjustment Program</i>	104.5	68.7	69.6	+0.9
<i>Court Orders</i>	57.0	52.0	52.0	0.0
<b>Total Goods and Services</b>	<b>1,142.6</b>	<b>991.7</b>	<b>1,112.9</b>	<b>+121.2</b>

Source: Department of Treasury

General Goods and Services expenditure by National Departments is estimated to be K948.4 million in 2007, an increase of K125.4 million or 15.2 per cent compared with the revised estimate for 2006. The net increase is mainly due to the allocation of K130.0 million for the conduct of the 2007 General Election.

Other goods and services expenditure in 2007 is estimated at K121.6 million. This is lower by K4.1 million compared with the revised estimate for 2006.

The Budget continues to face significant pressure from the awarding of significant damages against the State. The 2007 Budget continues to allocate K52.0 million for payment of court orders. Payments continue to be made in line with the established 'aged basis' process and the interest cost incurred for late payment. Steps to address the underlying causes of this pressure include improving conditions and increase in staffing for Solicitor-General's office and increased funding to the Department of Attorney-General's funding for engaging specialist assistance from private sector lawyers as required.

Substantial funding was provided in 2004 and 2005 to clear arrears incurred prior to the introduction in March 2003 of the *Authority to Pre-Commit* (APC) provisions of the *Public Finance (Management) Act*. There is no general provision for the Department of Finance to pay any remaining arrears in the 2007 Budget. Instead, funding requests for remaining outstanding amounts were considered at the Agency level.

In the Structural Adjustment Program funding is allocated for retrenchment programs and programs supporting the Government's expenditure control measures and structural reform agenda.

It is also instructive to examine the composition of general goods and services by item. The allocation of resources by item (that is, within programs and activities) in the 2007 Budget has been guided by where they can be used most effectively.

**Table 31: General Goods & Services: By Item 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Operational Materials & Supplies*	543.2	390.0	484.3	+94.3
Utilities	109.9	91.3	101.1	+9.8
Rental of Property	105.2	92.5	97.6	+5.1
Grants to Individuals & NPOs	51.8	69.6	61.1	-8.5
Transport and Fuel	25.5	29.0	34.4	+5.4
Travel and Subsistence	23.8	28.5	31.3	+2.8
Routine Maintenance	14.9	23.4	23.8	+0.4
Purchase of Vehicles	12.9	13.4	12.1	-1.2
Membership Fees/Contributions	7.3	13.3	9.9	-3.4
Other**	10.3	72.0	92.8	+20.8
<b>Total</b>	<b>904.8</b>	<b>823.0</b>	<b>948.4</b>	<b>+125.4</b>

Source: Department of Treasury

\* Includes Other Operational Expenses.

\*\* Other includes Office Furniture and Equipment, Training, Administrative Consultancy Fees.

The net increase (K125.4 million) in general goods and services in 2007 reflects increased funding to various expenditure programs.

An additional K9.8 million has been allocated to utilities in 2007 to ensure that funding needs are better provided for. This should reduce the further accumulation of arrears, and the attendant risks to the supply of essential services.

It has been recognized that various government agencies have incurred utility arrears due to increases in economic cost factors as well as administrative weakness in their ability to control consumption of utility services. In the latter, it is appropriate that all government departments and agencies should ensure that appropriate corrective measures are adopted and implemented to ensure that spending is within the budgetary allocations.

Travel and Subsistence has been increased by K2.8 million in 2007 to facilitate essential travels related to revenue generation activities and other activities that support the MTDS sectoral priority programmes.

Transport and Fuel increases by K5.4 million in 2007 to facilitate the delivery of essential services, and to reflect recent price increases for fuels.

#### **2.4.1.2.2 Goods and Services: Provincial Governments**

The Total Goods and Services allocation for Provincial Governments (excluding Bougainville) is K120.6 million in 2007, which is K25.8 million or 27.1 per cent higher than the amount provided in the 2006 Budget.

The increased allocations to Provincial and Local Level Governments is to support the important role they play in the delivery of essential services at the rural sector and also takes

into consideration the population growth rate and the projected rate of inflation. It also reflects a rebalancing of Provincial grants from personal emoluments to goods and services.

Unconditional Grants to Provincial Governments are expected to be K14.2 million in 2007, an increase of K2.4 million from the amount provided in 2006.

In 2004 a number of conditional function grants were introduced to direct funding to important development areas consistent with the direction under the Medium Term Development Strategy. The restrictions on the use of the National Government's Conditional Grants to Provincial Government are necessary to ensure that resources are directed to delivering essential services to the people according to the National Government's policy direction. For example, the Education Function Grant is provided solely for the supply of school rations and basic materials and equipment. Conditional Grants to Provincial Governments are expected to be K66.7 million in 2007, an increase of K7.6 million from the amount provided in 2006. A new functional grant, the Village Court function grant is provided in 2007 to recognize the important services provided by the Village Courts.

In addition, Grants for Local Level Government increase from K24.0 million in 2006 to K39.7 million in 2007, an increase of K15.7 million. This will significantly increase the capacity of Local Level Governments to implement the National Government's policy of providing essential services to people throughout the nation.

Allocations to individual provinces are based on the recommendations of the National Economic and Fiscal Commission (NEFC) and are aimed at, over time, allocating goods and services funding to Provinces on the basis of the cost of services in a given Province. While still consistent with the Organic Law, this process aims to shift allocation decisions away from the unsustainable formula-based approach of earlier years to a process where, over time, grants are provided to meet actual costs (taking into account the total fiscal resources available to the Province).

**Table 32: Provincial Goods & Services Grants 2005–2007 (Kina Millions)<sup>1</sup>**

	2005 Actual	2006 Estimate	2007 Projection	Change
Unconditional Grants	11.8	11.8	14.2	+2.4
<i>Administration/Block</i>	11.8	11.8	14.2	+2.4
Conditional Grants	55.5	59.1	66.7	+7.6
<i>Health Function</i>	11.8	12.5	13.4	+0.9
<i>Education Function</i>	19.8	21.2	21.6	+0.4
<i>Transport Maintenance</i>	12.7	13.0	15.3	+2.3
<i>Village Court Function</i>			2.2	+2.2
<i>Derivation</i>	11.2	12.4	14.2	+1.8
Other Grants for LLGs	21.8	24.0	39.7	+15.7
<i>Town &amp; Urban Services</i>	6.4	7.1	7.2	+0.1
<i>Rural LLG</i>	15.4	16.9	32.5	+15.6
<b>Total</b>	<b>89.1</b>	<b>94.9</b>	<b>120.6</b>	<b>+25.7</b>

Source: Department of Treasury, NEFC.

<sup>1</sup> This table excludes grants to the Autonomous Bougainville Government. These items are shown on a separate table in the following section.

### 2.4.1.3 Transfers to Autonomous Bougainville Government

In June 2005, the Autonomous Bougainville Government (ABG) was formed. Among other things, the relevant Organic law provides for new financial arrangements to be provided to Bougainville.

A total of K50.7 million in direct grants are provided to the ABG in the 2007 Recurrent Budget.

The Organic Law requires the National Government to pay a recurrent grant to Bougainville, covering the cost of the functions it has assumed. This grant is to cover both personal emoluments and goods and services. The Recurrent Grant to Bougainville in 2007 is K48.4 million, up K9.6 million over the amount provided in 2006. This reflects increases in both personal emoluments and goods and services.

The provision for personal emolument primarily reflects the effect of an approved restructure of the ABG along with updated data on teacher numbers in Bougainville. The allocation for goods and services was determined with reference to the NEFC's nationwide study on the costs of providing essential services in each Province, taking into account the ABG's estimated internal revenue.

The Organic Law also provides for a separate grant for the policing function in Bougainville. The Police Grant to Bougainville for goods and services is K2.1 million in 2007, an increase of K0.1 million over the amount provided in 2006, reflecting a continued commitment to assist the ABG in the process of managing and administering the policing function in Bougainville.

The Organic Law provides for a one-off establishment grant of K10.0 million. With the payments of K5.0 million in 2003, 2004 and 2005, the National Government's obligation to pay this grant was more than fully satisfied. Accordingly, no establishment grant has been provided to Bougainville in either 2006 or 2007.

**Table 33: Transfers to Bougainville 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Police Grant <sup>2</sup>	0.0	2.0	2.1	+0.1
Recurrent Grant <sup>2</sup>	40.3	38.8	48.4	+9.6
Conditional Grants	0.0	0.0	0.2	+0.2
Establishment Grant	5.0	0.0	0.0	0.0
<b>Total Recurrent Grant</b>	<b>45.3</b>	<b>40.8</b>	<b>50.7</b>	<b>+9.9</b>

Source: Department of Treasury

In addition, a conditional grant of K1.6 million is included under the Structural Adjustment Program above to assist in meeting the costs of restructuring the Bougainville public service. In terms of policing, a policing staffing grant of K1.7 million will be paid directly through the Police Budget.

### 2.4.1.4 Transfers to Statutory Authorities

The Statutory Authorities' funding will be increased by K10.4 million to K221.6 million compared with the 2006 Budget. The increase in funding reflects a moderate adjustment for projected inflation and increased funding to some priority agencies.

<sup>2</sup> Includes both personal emoluments (staffing grants, teachers salaries) and goods and services.

The Government's commitment to continued improvements in governance and accountability is reflected in increased allocations to the Auditor-General and Ombudsman Commission of 23 per cent and 17 per cent respectively.

The projected K1.5 million in collections from the Training Levy in 2007 has been specifically allocated to the National Training Council to support its development programs. Similarly, the allocation to the Legal Training Institute increases by around 29 per cent in 2007, a tangible reflection of the Government's commitment to the development of the legal profession in PNG.

The National Government's support for the National AIDS Council increases by K1.3 million or 32.0 per cent in 2007, to provide for significantly increased grants to community groups initiatives fighting this epidemic.

The National Agriculture Quarantine and Inspection Authority (NAQIA) plays a vital role in protecting Papua New Guinea from the ongoing risk of introduced diseases and pests (such as the cocoa pod borer and the coffee berry borer). An additional K1.2 million, or 77.0 per cent, has been provided to NAQIA in 2007 to support this critical role.

Funding for the PNG Sports Commission has been increased by around K1.5 million to allow for the Government's contribution to PNG's participation in the South Pacific Games.

**Table 34: Transfers to Statutory Authorities 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Tertiary Institutions	78.9	77.8	79.8	+2.0
<i>UPNG</i>	31.9	29.8	30.4	+0.6
<i>University of Technology</i>	27.3	28.6	29.0	+0.4
<i>University of Goroka</i>	10.3	10.4	11.1	+0.7
<i>University of Vudal</i>	5.6	5.7	5.8	+0.1
<i>Legal Training Institute</i>	0.7	0.8	1.0	+0.2
<i>PNG Maritime College</i>	2.3	2.5	2.5	0.0
PNG Forestry Authority	23.4	24.0	24.2	+0.2
Civil Aviation Authority	19.1	17.3	15.2	-2.1
National Broadcasting Commission	10.7	12.0	12.7	+0.7
Ombudsman Commission	9.0	9.4	11.0	+1.6
Office of Auditor-General	8.6	8.9	11.0	+2.1
Tourism Promotion Authority	8.9	8.1	8.2	+0.1
National AIDS Council	1.5	4.1	5.4	+1.3
National Training Council	0.7	0.7	2.2	+1.5
PNG Sports Commission	2.4	2.6	4.1	+1.5
Other *	43.5	46.3	47.8	+1.5
<b>Total Transfers to S.A.s</b>	<b>206.7</b>	<b>211.2</b>	<b>221.6</b>	<b>+10.4</b>

Source: Department of Treasury

\* Comprises NRI, NEFC, National Gaming Control Board, National Narcotics Bureau, Institute of Medical Research, National Youth Commission, IPA, SBDC, NISIT, ICDC, National Museum Authority, National Housing Commission, National Cultural Commission, CCI, FPDA, NARI, NAQIA, NRA, ICC, CLRC.

The Government's policy is for Statutory Authorities to become self-funding over time, allowing the Government to focus resources on core functions and MTDS priorities.

However, progress in implementing the reforms in this area proposed by the *Public Expenditure Rationalization and Review* (PERR) program has been slow.

### 2.4.1.5 Interest and Other Fees

Total interest and other fees payments are projected to be K475.9 million in 2007, an increase of K43.7 million from the revised estimate for 2006. The total payment comprises K358.8 million in domestic interest and fees outlays and K117.0 million in external interest and fees outlays.

**Table 35: Interest and Other Fees 2005 – 2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Domestic Interest Outlays	216.1	319.8	358.8	+39.0
<i>Treasury Bills</i>	84.7	90.0	100.3	+10.3
<i>Inscribed Stock*</i>	127.5	224.2	252.2	+28.0
<i>Other Domestic Debts</i>	3.9	2.6	3.3	+0.7
<i>Agency Fees</i>	0.0	3.0	3.0	0.0
External Interest Outlays	116.7	112.4	117.0	+4.6
<i>Interest</i>	111.7	99.2	105.3	+6.1
<i>Other Fees</i>	5.0	13.2	11.7	-1.5
<b>Total Interest and Other Fees</b>	<b>332.8</b>	<b>432.2</b>	<b>475.9</b>	<b>+43.7</b>

Source: Department of Treasury

\* Premiums on Inscribed Stock are treated as a negative interest outlay.

Domestic interest payments are forecast to rise by K39.0 million in 2007, from K319.8 million to K358.8 million. The increased payments reflect a moderate increase in Treasury Bill yields and the net replacement of external debt with domestic debt. In addition, interest outlays in 2006 and previous years were reduced by the receipt of premiums on the issuance of Inscribed Stock, which are accounted for as negative interest outlays.

External interest payments and other fees are projected to be K117.0 million in 2007, K4.6 million higher than the revised estimate for 2006, reflecting a moderate increase in world interest rates and the end of the grace period for several external loans.

### 2.4.2 Development Expenditure

The Development Budget for 2007 is K1,636.6 million, which is K50.4 million or 3.0 per cent lower than the revised estimate for 2006. This reflects a K114.9 million, or 11.6 per cent, decrease in donor funding, being only partially offset by a K64.3 million, or 9.3 per cent, increase in Government funding for the Development Budget.

The Government's total commitment – domestic funding, loans drawn down and infrastructure tax credit – to the Development Budget is K757.5 million in 2007, up K64.3 million from K693.2 million in 2006.

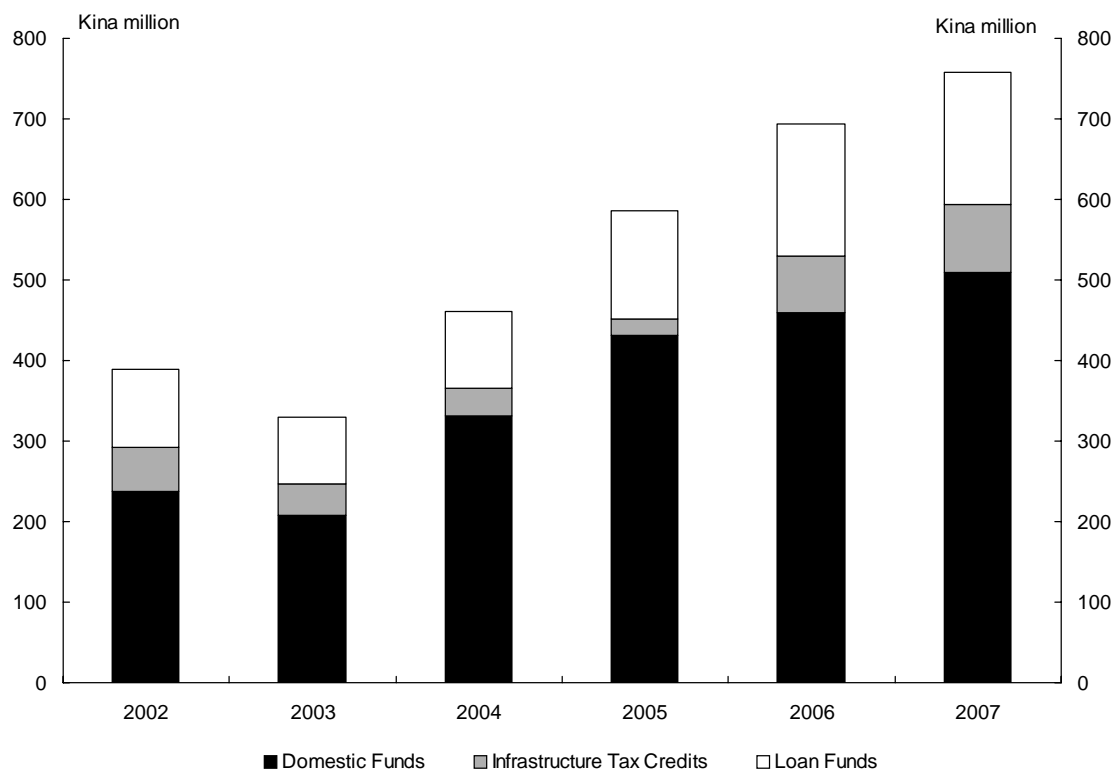


**Table 1: Development Expenditure: By Source 2005–2007 (Kina Millions)**

	2005 Actual	2006 Estimate	2007 Projection	Change
Government	588.4	693.2	757.5	+64.3
<i>Domestic Funding</i>	431.8	459.1	509.1	+50.0
<i>Infrastructure Tax Credit</i>	20.3	71.1	85.4	+14.3
<i>Loans</i>	136.3	163.0	163.0	0.0
<i>Concessional</i>	134.3	163.0	163.0	0.0
<i>Commercial</i>	2.0	0.0	0.0	0.0
Donor	1,283.1	994.0	879.1	-114.9
<i>Project Grants</i>	1,283.1	994.0	879.1	-114.9
<b>Total Development Expenditure</b>	<b>1,871.5</b>	<b>1,687.2</b>	<b>1,636.6</b>	<b>-50.6</b>

Source: Department of Treasury

The substantial increase in Government funding of the ongoing Development Budget in 2007 reflects the Government's commitment to increasing expenditure on MTDS priorities and meeting fixed commitments.

**Figure 16: Government Contribution to Development Budget**

Source: Department of Treasury

#### 2.4.1 Government Expenditure and the Medium Term Development Strategy

Consistent with its medium-term policy focus, the Government is committed to increasing the proportion of available resources being allocated to the seven priority areas identified in the Medium Term Development Strategy.

The 2006 Budget allocated 52 per cent of Budget allocations to the MTDS priority areas, with the remainder allocated to non-discretionary fixed commitments (such as interest outlays and court orders), general government administration and non-MTDS government services.

The effective implementation of the MTDS requires that the proportion of the Budget allocated to MTDS priority areas increase from 48 per cent in 2005 to 55 per cent in 2010.

A key objective of the 2007 Budget is to lift the proportion of the Budget allocated to MTDS priority areas.

- The target for 2007 is for **52 per cent** of total PNG expenditure to be allocation to MTDS priority areas.
- The target for 2007 is for **84 per cent** of total PNG development expenditure to be allocated to MTDS priority areas.

The 2007 Budget meets these targets, with 52.9 per cent of total PNG expenditure (44.9 per cent of the recurrent expenditure and 88.5 per cent of total PNG development expenditure) allocated to MTDS priorities.

**Table 37: Government Expenditure and MTDS 2006-2007 (Kina Millions)**

	2007 Recurrent	2007 Development <sup>3</sup>	2007 Total	Per cent
MTDS priorities	1511.7	670.1	2181.8	52.9
Fixed Commitments	737.0	0.0	737.0	17.9
General Govt. Admin.	788.3	64.1	852.5	20.7
Non-MTDS priority services	332.9	23.3	356.2	8.6
<b>Total Expenditure</b>	<b>3,370</b>	<b>757.5</b>	<b>4,127.5</b>	

Source: Department of Treasury

#### **2.4.3.1 MTDS priority spending**

The Government has attempted to align the recurrent budget with the MTDS priority expenditure programs which is exemplified in the funding allocations.

The Government's commitment to MTDS priority areas is reflected in the distribution of both recurrent and development expenditure.

<sup>3</sup> Government component only (domestic funds, loan draw downs and infrastructure tax credits).

**Table 38: Composition of MTDS priority spending: 2006-2007 (Kina Millions)**

	2007 Recurrent	2007 Development	2007 Total
Primary & Preventative Health	382.5	48.0	430.5
HIV/AIDS	5.6	12.5	18.2
Law and Justice	354.8	30.5	385.3
Transport Infr. Maint. & Rehab.	106.0	377.5	483.5
Income Earning Opportunities	125.0	59.8	184.7
Basic Education	491.6	26.9	518.5
Dev. oriented adult education	16.3	8.6	24.8
Other	30.0	106.3	136.3
<b>Total MTDS Expenditure</b>	<b>1511.7</b>	<b>670.1</b>	<b>2181.8</b>

Source: Department of Treasury

Of the K151.8 million in general grants in the development budget, including district support grants and special support grants, 70 per cent is estimated to be allocated to MTDS priority areas, with the remainder estimated to be allocated to general government administration.

#### 2.4.3.2 Fixed commitments

While the MTDS priority areas are the focal point for Government expenditure, there are some items that the Government also has to fund. These items are primarily reflected under recurrent expenditure and include items such as interest and other fees, court orders and public service superannuation obligations.

**Table 39: Composition of Fixed commitments 2007 (Kina Millions)**

	2007 Recurrent
Interest and other fees	475.9
Public Service Super	130.9
Retrenchment	53.6
Court orders	52.0
Workers Compensation	10.8
NASFUND Grant	5.9
IRC refunds	8.0
<b>Total Fixed commitments</b>	<b>737.0</b>

Source: Department of Treasury

The Development Budget also includes several items that are fixed in nature, including District Support Grants, Special Support Grants, Government commitments under MoAs and the Restoration & Development grant to the Autonomous Bougainville Government. In practice, expenditure under these items will be spent on either MTDS priorities, Government Administration or non-MTDS priorities.

#### 2.4.3.3 General Government Administration

Similarly, a significant amount of the Government's budget is set aside for general government administration. This includes the cost of Legislative Services (National Parliament), Executive and Representative services (including embassies), Fiscal, Financial & Planning Services, National & Provincial Government Co-ordination, Personnel Services, Rental of Government Buildings, Defence and Public Sector and Governance Reform.

**Table 40: Composition of Government Administration 2007 (Kina Millions)**

	2007 Recurrent	2007 Development <sup>4</sup>	2007 Total
Legislative Services	65.3	0.0	65.3
Executive & Representative Services	196.6	0.0	196.6
Fiscal, Fin & Planning Services	120.7	0.0	120.7
National/Prov. Govt Co-ord	10.1	0.0	10.1
Personnel Services	10.9	0.0	10.9
Government Buildings	71.3	0.0	71.3
Defence	91.2	0.0	91.2
Central Computer Services	11.8	0.0	11.8
PS & Governance Reform	0.0	16.1	16.1
Provincial & Regional Government	189.9	0.0	189.9
Other	20.5	48.0	68.5
<b>Total Government Administration</b>	<b>788.3</b>	<b>64.1</b>	<b>852.5</b>

Source: Department of Treasury

**2.4.3.4 Non-MTDS Government Services**

There are also some items that, while not among the seven priority areas identified by the MTDS, are provided with significant funding in the 2007 Budget. This includes, among other things, secondary and tertiary education, community development, broadcasting and publishing services, cultural services and sports.

**Table 41: Composition of Non-MTDS Services 2006-2007 (Kina Millions)**

	2007 Recurrent	2007 Development	2007 Total
Secondary Education	58.0	0.0	58.0
Tertiary Education	114.7	7.0	121.7
Other	160.2	16.3	176.5
<b>Total Non-MTDS Services</b>	<b>332.9</b>	<b>23.3</b>	<b>356.2</b>

Source: Department of Treasury

**2.4.4 Additional Priority Expenditure**

With sustained high prices on world markets for our main mineral commodities (oil, copper and gold), a further windfall of K1,100 million is expected to be available over the remainder of 2006 and 2007 on top of the normal Recurrent and Development Budgets.

It is proposed to use this windfall to repair the neglect of the past and invest in the future of the nation through the:

- Rehabilitation of essential public infrastructure;
- Direct Investment in Economic Projects; and
- Repayment of Debt & other one-off obligations.

<sup>4</sup> Government component only (domestic funds, loan draw downs and infrastructure tax credits).

To reduce the risk of this windfall being built into ongoing recurrent and development expenditure, its allocation is set out in separate Appropriation Bills for 2006 and 2007.

This approach is consistent with the International Monetary Fund's advice in its *World Economic Outlook* released last month that:

"The key policy message for countries that export commodities — particularly metals — is that they should not assume that high prices will be sustained. Current revenue windfalls should be saved or invested to support future growth in non-commodity sectors, rather than [be] used to increase spending in areas that will be difficult to reverse later."

While in practice, this windfall will be received over two years, with K650 million of additional priority expenditure in 2006 and the remainder (K450 million) in 2007, for analytical purposes it is preferable to think of it as a single windfall.

**Table 42: Use of 2006 & 2007 Windfall Gains (Kina Millions)**

		<b>Total</b>
<b>Rehabilitation of Essential Public Infrastructure</b>		<b>615</b>
<i>Rehabilitation of Education Infrastructure</i>	200	
<i>Rehabilitation of Transport Sector Infrastructure</i>	120	
<i>Rehabilitation of Health Sector Infrastructure</i>	110	
<i>Rehabilitation of Law &amp; Justice Sector Infrastructure</i>	75	
<i>District Finance Office Roll-out (10 new offices)</i>	30	
<i>Rehabilitation of NBC Infrastructure</i>	21	
<i>Rehabilitation of Bougainville Infrastructure</i>	20	
<i>Rehabilitation of Strategic District Markets</i>	20	
<i>Major Maintenance for National Parliament</i>	10	
<i>Feasibility Studies for EU Water Projects</i>	9	
<b>Direct Investment in Economic Projects</b>		<b>270</b>
<i>Equity Injection into State-owned enterprises</i>	130	
<i>Gas Project Equity</i>	100	
<i>Government Contribution to Major Agriculture Projects</i>	40	
<b>Repayment of Debt &amp; Other one-off obligations</b>		<b>215</b>
<i>Repayment of expensive debt</i>	100	
<i>Phasing of Elections</i>	30	
<i>Public Service Sign-on bonus</i>	25	
<i>Outstanding PBSS payments (teachers)</i>	20	
<i>Resettlement of Volcano Victims</i>	20	
<i>Parliament: Election-related one-off items</i>	20	
<b>Total</b>		<b>1,100</b>

Source: Department of Treasury

#### **2.4.4.1 Rehabilitation of Essential Public Infrastructure**

The majority of the windfall gain (K615 million) is allocated to the rehabilitation of essential public infrastructure that supports stronger economic and social development. The infrastructure targeted is driven by Medium Term Development Strategy priorities.

It will also be imperative to ensure that sufficient priority is given to ongoing maintenance in the future to ensure that we do not repeat the mistakes of the past. As part of the sector-wide approach to the allocation of this funding, the Departments of Treasury and National Planning and Monitoring will be working with agencies to develop mechanisms to ensure that adequate attention is paid to maintenance of essential public infrastructure in the future.

##### **2.4.4.1.1 Rehabilitation of Education Infrastructure**

Many essential educational facilities are in a poor condition, reflecting a legacy of neglect of essential maintenance and a failure to keep pace with technological developments. To this end, K200 million of the windfall gain has been allocated to the rehabilitation of education infrastructure.

This neglect is particularly evident in the nation's oldest universities, the University of Papua New Guinea and the University of Technology, making it very difficult for these institutions to retain their reputation for producing graduates of an internationally competitive standard. In order to address this neglect, K50 million has been allocated to restore facilities at these institutions to an acceptable standard.

National high schools were originally designed as nation-building institutions, which bring the best students from different parts of the country together in an environment of excellence. The validity of this concept is evident in the high proportion of current leaders in the public and private sector who have come through the National high school system.

Regrettably, the four oldest National high schools (Kerevat, Passam, Sogeri and Aiyura) are in a significant state of disrepair. Given that the upkeep of these schools is a National Government responsibility, and the role of these schools in building the nation, a total of K20 million has been allocated for the rehabilitation of facilities at these four National high schools (K5 million each).

The remaining K130 million provided for the rehabilitation of education infrastructure will be allocated between primary schools, provincial high schools and technical and vocational centres, utilizing a sector-wide approach for resource allocation.

##### **2.4.4.1.2 Rehabilitation of Transport Infrastructure**

The Medium Term Development Strategy and the National Transport Development Plan stress the importance of transport infrastructure to all sectors of the economy, particularly the agriculture sector. For this reason, this sector has been the focus of substantial additional funding in recent years, including a substantial share of the K682.5 million allocated in the 2006 Supplementary Budget.

Building on those continued allocations, K120 million of the windfall gain has been allocated for the rehabilitation of transport infrastructure. The distribution of this funding will be guided by the National Transport Development Plan, and will include allocations for the following:

- Highlands Highway Rehabilitation Project (K35 million)
- National Roads (K21 million)
- Provincial Roads (K20 million)

- District Feeder Roads (K20 million)
- Ports & Jetties (K14 million)
- Wewak Airport (K10 million)

#### **2.4.4.1.3 Rehabilitation of Health Infrastructure**

The 2006 Supplementary Budget allocated K70 million for the rehabilitation of health infrastructure, particularly for hospitals and medical equipment. However, this amount will not be enough to repair decades of underinvestment in the maintenance of these facilities. In addition, many districts in rural areas primary health care centres and aid posts have closed due to, among other reasons, the lack of the basic facilities required for primary and preventative health care.

To address these issues, an additional K110 million of the windfall gain has been allocated to the rehabilitation of health infrastructure, bringing the total including the 2006 Supplementary Budget to K180 million.

This is a very large investment, which is expected to result in a significant improvement in the nation's major health care facilities.

#### **2.4.4.1.4 Rehabilitation of Law & Justice Sector Infrastructure**

The Medium Term Development Strategy recognizes the importance of the law and justice sector to the economic and social development of the nation. There are many elements of an effective law and justice sector, including an efficient, honest and motivated police force, an impartial and accessible court system and a system of detention that serves as an effective deterrent, while respecting offenders' Constitutional rights and assisting in their rehabilitation and reintegration into the community.

The Police report noted that improved housing conditions is an important element to achieving an improved performance from police. On this basis, the 2006 Supplementary Budget allocated K25 million for the rehabilitation of police housing. An additional K25 million of the windfall gain has been allocated for this purpose, bringing the total including the 2006 Supplementary Budget to K50 million.

Properly functioning border and customs facilities are another aspect of an effective law and justice sector. The 2006 Supplementary Budget provided emergency funding of K1 million for urgent rehabilitation of border facilities at Wutung, near Vanimo. Further funding is required to make this border post fully operational. In addition, border facilities are proposed near the Ok Tedi mine and between Bougainville and the Solomon Islands. These posts would boost legitimate trade, reduce smuggling and assist quarantine efforts. K10 million of the windfall gain has been allocated for the rehabilitation of these border and customs facilities.

The remaining K40 million provided for the rehabilitation of law and justice sector infrastructure will be allocated utilizing a sector-wide approach for resource allocation, including rehabilitation of court houses, jails and police stations.

#### **2.4.4.1.5 District Finance Office Roll-out**

The District Finance Office roll-out program has reached 42 districts. The 2006 Supplementary Budget provided an additional K22 million to allow those district finance offices already opened to become fully functional. To support the continued roll-out of these offices at the district level, K30 million of the windfall gain is provided to meet the capital costs of establishing 10 new district finance offices in 2007 (that is, an initial capital cost of K3 million per office).

#### **2.4.4.1.6 Rehabilitation of Bougainville Infrastructure**

The crisis in Bougainville led to and followed the closure of the Panguna mine resulting in the neglect of infrastructure essential for the operation of Government services and the growth of the non-mining economy.

The National Government will be using K10 million of the windfall gain to assist Bougainville in the reconstruction of district facilities damaged and/or neglected during the crisis. An additional K10 million will be provided for the rehabilitation of key agricultural feeder roads, which should result in a significant increase in the production of cash crops, particularly cocoa.

This assistance is one-off in nature, and is separate from the ongoing restoration and development grant required to be paid to Bougainville from the Development Budget according to the relevant Organic Law.

#### **2.4.4.1.7 Rehabilitation of NBC Infrastructure**

The primary source of information for most of the people in Papua New Guinea is radio, specifically the National Broadcasting Commission (NBC). The National Government will be allocating K21 million for the rehabilitation of NBC infrastructure, with K19 million of this funding to be set aside for rehabilitation of Provincial radio stations (even though these are currently the responsibility of Provincial Governments).

#### **2.4.4.1.8 Strategic District Market Infrastructure**

With a relatively small proportion of the population engaged in formal employment, the Government is committed to developing and supporting the informal sector as a key source of income for people in both urban and rural areas. Consistent with this policy, K20 million of the windfall gain has been allocated for the rehabilitation of strategic district market infrastructure.

#### **2.4.4.1.9 Major Maintenance for National Parliament Haus**

National Parliament Haus is both an icon of the Independence of the nation and a centre of the operation of the National Government. Following years of neglect, the Government has been advised that K10 million is required in 2007 for major maintenance of National Parliament Haus. This amount is provided from the windfall gain, to avoid confusion with the one-line transfer provided to the National Parliament in the Recurrent Budget.

#### **2.4.4.1.10 Feasibility Studies for EU Water Supply Projects**

The European Union has allocated K90 million for rural town and village water supply projects, with the drawdown of these funds subject to the preparation of properly scoped projects. The windfall gain provides an amount of K100,000 per district to allow for the preparation of these studies on a timely basis.

#### **2.4.4.2 Direct Investment in Economic Projects**

The Budget framework principles in the *Fiscal Responsibility Act 2006* state that “the Government will limit its participation to core areas where there is a clear rationale for public intervention”.

In general, this principle means that the Government should focus on providing the environment needed for the private sector to flourish, rather than seek to invest directly in economic projects.



That said, the windfall gains are also applied to support K270 million in direct investment in economic projects considered to have a clear rationale for public intervention.

#### **2.4.4.2.1 Equity Injection into State-owned enterprises**

As with other areas of publicly-owned infrastructure, the assets of State-owned enterprises have deteriorated over recent decades, reflecting a lack of ongoing investment and maintenance.

While the major Government-owned utilities (PNG Power and Telikom) now have the plans and the financial capacity for major investment programs, additional Government support is required if these investment plans are to extend to rural districts. PNG Power and Telikom have been allocated K65 million and K35 million respectively of the windfall gain to assist them in extending their services to rural districts.

In addition, the national airline, Air Niugini, is in the process of expanding its fleet of F-100 aircraft. K30 million of the windfall gain has been provided to allow it to complete this program.

#### **2.4.4.2.2 Government Equity Investment in PNG Gas Project**

The Government remains committed to actively participating in the commercial development of PNG's significant gas reserves. In 2005, K400 million was set aside to purchase a substantial part of Papua New Guinea's equity stake in the PNG to Australia Gas Project. An additional K100 million of the windfall gain has been allocated for this purpose. This will further reduce the interest and costs associated with financing this equity stake and will give the Government greater flexibility in sourcing the remainder of its funding needs for the project.

#### **2.4.4.2.3 Government Contribution to Agriculture Impact Projects**

The Medium Term Development Strategy recognized the Agriculture sector as one of the key potential drivers of economic growth in PNG.

Many of the constraints facing the Agriculture industry are the same as those facing the rest of the private sector in PNG, including inadequate transport infrastructure, unreliable (or unavailable) and expensive utilities and relatively high levels of property crime. With this in mind, the Government's primary focus in assisting the Agriculture sector has been to improve the infrastructure in these and other areas used by the sector.

That said, the nature of the industry means that in some cases there is a case for direct government intervention in order to facilitate major agriculture impact projects. K40 million of the windfall gain has been allocated for this purpose, with the distribution of funds to be determined in accordance with the Government's National Agriculture Development Plan 2007-2012.

#### **2.4.4.3 Repayment of Debt & Other one-off obligations**

With our public debt still at a very high level, K215 million of the windfall is applied to the repayment of debt and meeting several one-off obligations faced by the Government.

##### **2.4.4.3.1 Repayment of Expensive Debt**

While PNG's public debt has fallen from its peak, it remains very high. While the majority of the windfall gain has been allocated to meeting public investment needs, K100 million has been allocated to the repayment of expensive debt, as a signal of the Government's continued commitment to fiscal responsibility.

#### **2.4.4.3.2 Phasing of Elections**

The Electoral Commission has the discretion on whether to hold Local Level Government (LLG) elections after the National elections. The Electoral Commissioner estimates that an additional K30 million will be required for this purpose in 2007. As this item is significant and not ongoing in nature, it has been provided for out of the windfall gain.

#### **2.4.4.3.3 Public Service Pay Deal Sign-on Bonus**

The National Government's current pay deal with the Public Employees' Association expires at the end of 2006. Negotiations on a new 3 year deal commencing in 2007 are an important priority for the Government. Given the importance of a moderate public sector pay outcome, based on productivity, and to continue the achievements of the Medium Term Fiscal Strategy and the maintenance of a low inflation environment, K25 million of the windfall gain has been set aside in 2006 as a one-off bonus, to be paid on the successful conclusion of the negotiations.

#### **2.4.4.3.4 Resettlement of Volcano Victims**

The recent eruption of the Tavurvur volcano in East New Britain has resulted in a large group of people being displaced. K20 million of the windfall gain has been set aside to meet the capital cost of resettling these people.

#### **2.4.4.3.5 Outstanding PBSS (Teachers)**

In discussions with representatives of teachers earlier this year, it became evident that over several years the National Government had not been meeting its obligations under the Performance Based Salary System (PBSS). The 2006 Supplementary Budget provided K40 million towards clearing this obligation. K20 million from the windfall gain is provided to complete the clearance of these underpayments.

#### **2.4.4.3.6 Parliament: Election Related One-off items**

The National Parliament has advised that K20 million will be required in 2007 to meet election-related items of a one-off nature. In particular, around K15 million is estimated to be required to cater for advances of allowances to members following the 2007 election. This amount is provided from the windfall gain, to avoid confusion with the one-line transfer provided to the National Parliament in the Recurrent Budget.

#### **2.4.4.4 Additional Priority Expenditure in 2007**

Although for analytical purposes it is preferable to think of it as a single windfall, this amount will be received (and therefore will be available for expenditure) over two years, with K650 million of additional priority expenditure in 2006 and the remainder (K450 million) in 2007.

To reduce the risk of this windfall being built into ongoing recurrent and development expenditure, its allocation is set out in separate Appropriation Bills for 2006 and 2007.

Given the limited time remaining in the year to implement the additional priority expenditure, items that could be implemented quickly (for example, involving the transfer of funds) were chosen for the 2006 Appropriation Bill, with the remaining items are included in the 2007 Appropriation Bill.

**Table 43: Additional Priority Expenditure in 2007 (Kina Millions)**

		<b>Total</b>
<b>Rehabilitation of Essential Public Infrastructure</b>		<b>395</b>
<i>Rehabilitation of Education Infrastructure</i>	200	
<i>Rehabilitation of Transport Sector Infrastructure</i>	44	
<i>Rehabilitation of Law &amp; Justice Sector Infrastructure</i>	50	
<i>District Finance Office Roll-out (10 new offices)</i>	30	
<i>Rehabilitation of NBC Infrastructure</i>	21	
<i>Rehabilitation of Bougainville Infrastructure</i>	20	
<i>Rehabilitation of Strategic District Markets</i>	20	
<i>Major Maintenance for National Parliament</i>	10	
<b>Direct Investment in Economic Projects</b>		<b>5</b>
<i>Government Contribution to Major Agriculture Projects</i>	5	
<b>Repayment of Debt &amp; Other one-off obligations</b>		<b>50</b>
<i>Phasing of Elections</i>	30	
<i>Parliament: Election-related one-off items</i>	20	
<b>Total</b>		<b>450</b>

Source: Department of Treasury

### 2.4.5 Consolidated Public Sector

This section seeks to identify the total size of the public resources available in 2007 at all levels of Government. This is not intended to imply that these funds are available to the National Government. Rather, it is intended to illustrate the various sources of public funds in PNG and where those resources are allocated.

Total public sector revenue (excluding grants) in PNG in 2007 is estimated to be K4,891.6 million or 27.3 per cent of GDP.

National Government revenue and Infrastructure Tax Credits are estimated to be K4,542.5 million or 25.4 per cent of GDP in 2007. Provincial and Regional Government revenue is estimated to be K349.1 million or 1.9 per cent of GDP in 2007. Information on internal revenue expected to be generated by statutory authorities in 2007 (excluding dividends paid to the National Government) is not available.

Total public sector expenditure in Papua New Guinea in 2007 is estimated to be K4,926.6 million or 27.5 per cent of GDP.

National Government recurrent expenditure, excluding transfers to other levels of Government, is estimated to be K2,405.0 million in 2007, or 14.1 per cent of GDP.

**Table 44: Consolidated Public Sector Revenue: 2007 (Kina Millions)**

	2007 Projected	Per cent of GDP
National Government	4542.5	25.4
<i>Tax Revenue</i>	4129.9	23.1
<i>Non-Tax Revenue</i>	327.2	1.8
<i>Infrastructure Tax Credits</i>	85.4	0.5
Provincial & Regional Governments	349.1	1.9
<i>GST (inland share)</i>	179.3	1.0
<i>Royalties</i>	91.6	0.5
<i>Own Source Revenue</i>	78.2	0.4
Statutory Authorities		
<i>Own Source Revenue</i>	*	*
<b>Total Public Sector Revenue</b>	<b>4891.6</b>	<b>27.3</b>

Source: Department of Treasury, NEFC

\* Not available

Provincial & Regional Government expenditure, including transfers from the National Government (including personal emoluments) and Provincial development projects, is estimated to be K1,256.2 million in 2007, or 7.4 per cent of GDP.

**Table 45: Consolidated Public Sector Expenditure: 2007 (Kina Millions)**

	2007 Projection	Per cent of GDP
National Government	2405.0	14.1
<i>Personal Emoluments</i>	816.2	4.8
<i>Goods &amp; Services</i>	1112.9	6.5
<i>Interest Payment &amp; Fees</i>	475.9	2.8
Provincial & Regional Govts	1200.9	6.7
<i>National Government Transfers</i>	747.3	4.2
<i>Other Expenditure</i>	349.1	2.0
<i>Development Projects</i>	104.5	0.6
District & Local Level Spending	221.1	1.2
<i>Infrastructure Tax Credits</i>	85.4	0.5
<i>Development Projects</i>	135.7	0.8
Statutory Authorities	217.6	1.2
<i>National Government Transfers</i>	221.6	1.3
<i>Other Expenditure</i>	*	
<i>Net Lending to CSAs</i>	-4.0	0.0
Other Development Projects	431.9	2.4
Additional Priority Expenditure	450.0	2.5
<b>Total Public Sector Expenditure</b>	<b>4926.6</b>	<b>27.5</b>

Source: Department of Treasury; \* Not available

Expenditure by Statutory Authorities<sup>5</sup> in 2007, including transfers from the National Government, is estimated to be K217.6 million in 2007, or 1.2 per cent of GDP.

In summary, while the vast majority of public sector revenue is generated by the National Government, much of this is actually spent at the provincial, district or local level.

Further, it is evident that statutory authorities control a substantial amount of public resources, highlighting the need for strong governance and effective oversight over these institutions.

More generally, this information illustrates that the reason for poor service delivery is not only that public resources are insufficient. In addition they are not being used as well as they could be.

## **2.5 FINANCING**

### **2.5.1 Overview**

The Government's total net financing requirement in 2007 – the Budget deficit – will be K35 million. This means total debt will increase by K35 million.

The net external financing will be an outflow of K83.7 million. The Government's net domestic financing – the Budget deficit and net external outflows – will be K118.7 million.

Consistent with the Medium Term Debt Strategy, the key elements of the Government's financing strategy in 2007 are:

- Reducing debt to sustainable levels.
- Reducing financial risks to prudent levels.
- Developing the Government Inscribed Stock, Bill and Loan Markets.

The Government's financing strategy is an important element of its overall strategy for achieving macroeconomic stability over the medium term. It is described in more detail in Chapter 8.

### **2.5.2 External Financing**

New external borrowing of K163.0 million will be undertaken in 2007, reflecting additional drawdowns on existing concessional loans.

The Government should continue to draw down on existing loans with international financial institutions, as long as the expenditures are consistent with government priorities and are within the Budget ceiling. No external commercial borrowing is required to fund the 2007 Budget.

This new borrowing will be more than offset by repayments (amortization) of existing loans of K246.7 million.

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<sup>5</sup> Excluding public business enterprises such as PNG Power, Eda Ranu and Telikom, but including IPBC, BPNG and National Fisheries Authority.

As a result, there will be a net external outflow of K83.7 million in 2007.

### **2.5.3 Domestic Financing**

The net domestic funding required in 2007 to fund the outflows in external financing and the Budget deficit will be K118.7 million, or around 0.7 per cent of GDP. This consists of K2,114.7 million in new borrowing and amortization of K1,996.0 million.

No receipts from asset sales have been factored into financing of the 2007 Budget.

The net funding required should be sourced domestically without an appreciable increase in interest rates (over and above what is already factored into the forecast for other reasons). 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 2007 the Government will continue with the Inscribed Stock program to lengthen the maturity of government debt and to reduce refinancing and interest rate risks. Together with the reduction in external debt, which reduces foreign exchange risk, this should considerably strengthen government's financial position.