

CHAPTER 9. MEDIUM TERM FISCAL STRATEGY

9.1 OVERVIEW

The Department of Treasury has produced a draft of a new Medium Term Fiscal Strategy (MTFS) for 2008-2012, and used it as a framework for the strategy of the 2008 Budget. It is currently consulting stakeholders inside and outside the Government, including PNG's development partners, on the draft Strategy. When that is done, the Minister for Treasury and Finance is likely to ask NEC to consider and agree to the new MTFS, and to approve its publication. This chapter contains a summary of the draft Strategy.

9.2 RATIONALE

The rationale of this strategy is:

- firstly to provide a stable framework for the Government to use its fiscal resources to serve the National Goals in the Constitution and the objectives of the Medium Term Development Strategy (MTDS);
- secondly to develop further the strategy followed in 2002-2007 for handling varying amounts of additional revenue from PNG's commodity exports; and
- thirdly to contribute to partnership between the Government and the private sector by making it clear that the Government will conduct public-sector investments and borrowing within a sound fiscal framework.

9.3 BACKGROUND

The first Medium Term Fiscal Strategy (MTFS), for 2002-2007, was directed towards arresting a decline in economic performance in PNG, and it played a key role in turning around both Government finances and the overall economy.

However, the first MTFS has been overtaken by events. From 2005 to 2007, PNG has enjoyed an extraordinary surge in revenues resulting from the commodity price boom. In this situation, the goal of balanced budgets contained in the first MTFS is less than what is needed for prudent fiscal management.

9.4 MINERAL REVENUE-HOW MUCH IS RELIABLE?

Mineral revenues, from mining and petroleum tax (MPT) and associated dividends, are expected to continue at unusually high levels in 2007 and 2008, then decline in line with production and price movements. Total mineral revenue over the period 2008-2012 is currently forecast at just under K7 billion.

But commodity prices are highly volatile and no one can confidently predict which way they will move. This is the biggest risk in basing plans for ongoing spending on revenue derived from high commodity prices. The Government would have to make difficult decisions to reduce expenditure if prices were to drop suddenly. Other risks to mineral revenue include natural disasters and landowner disputes which could disrupt production.

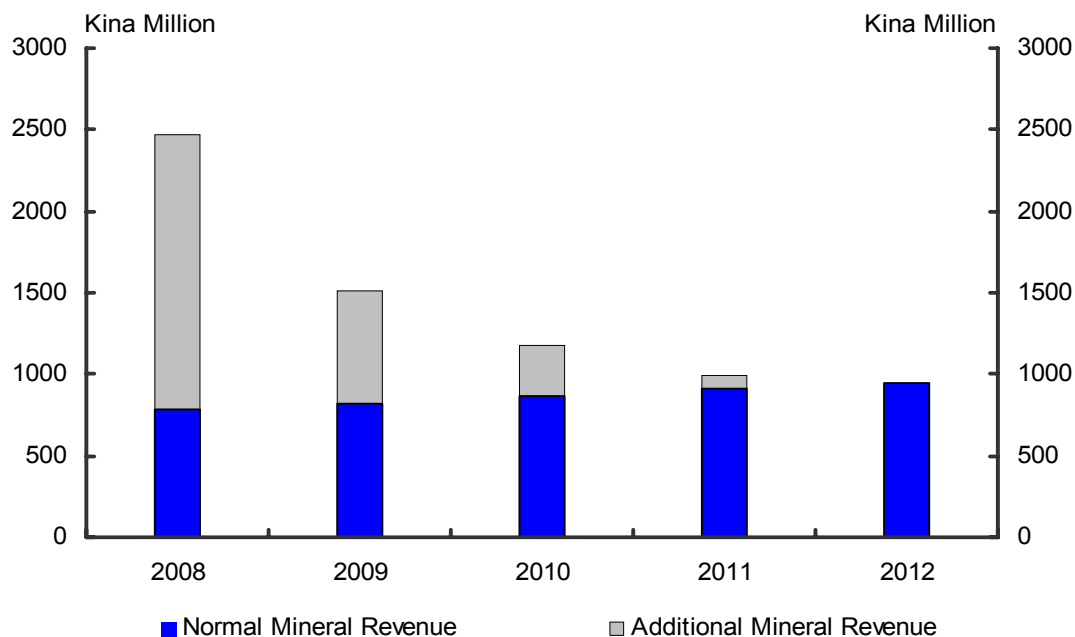
In formulating the new MTFS, a key step is defining how much of the expected mineral revenue can be regarded as normal — that is, expected even in the absence of a commodity boom, and reliable as a source of funds for ongoing spending. This normal component of mineral revenue can prudently be included in the amount allocated for spending in the recurrent and development budgets.

The rule in this strategy is that **only the component of expected mineral revenue equal to 4 per cent of GDP will be used to fund ongoing spending**. The remainder of mineral revenue is to be regarded as additional revenue, to be allocated in ways which can be adjusted, with a minimum of disruption, when the amounts received vary from their forecasts and fluctuate from year to year.

The 4 per cent rule will be reviewed after two years, or earlier if developments such as production shortfalls or changes in price outlook mean that an overall Budget deficit occurs or becomes likely. In those circumstances, spending plans would be cut, or a temporary Budget deficit would be necessary, or both.

Figure 30 shows the current forecasts for each year of the MTFS period 2008-2012 of mineral revenue, with its normal and additional components.

Figure 30: Normal and additional mineral revenue, 2008 - 2012 (Kina Millions)



Source: Department of Treasury

9.5 ALLOCATION OF ADDITIONAL MINERAL REVENUE

There are four key principles which apply to the choice of ways in which mineral revenue above the 4 per cent of GDP threshold will be allocated.

Benefits for future generations — because mineral revenue is derived from once-only extraction and sale of PNG's non-renewable resources, it should be used also for investments that will benefit future generations.

- Some of the best investments for future generations are the basic services and infrastructure which are defined as priorities for spending in the MTDS.

Flexibility — uses of additional mineral revenue should be of kinds which will not be disrupted if the amount of revenue received varies from the forecast during the year for which plans are being made. Repayment of public debt is the most obvious use of this kind, and it is already the standing use for additional revenue received too late in the year to be the basis for additional appropriations.

Consideration of impacts on domestic and import demand — uses of additional mineral revenue should be chosen so that they do not make overall demand by the Government for non-government goods and services within PNG fluctuate through time by large amounts. This may mean that some uses of large amounts will need to be phased over several years. Uses which involve mainly demand for imports into PNG will not add much to demand, but their effect on PNG's external position will need to be considered.

Basis for comparison — investment projects which are potential uses for additional mineral revenue should be –

- compared with each other in terms of their expected net benefits, adjusted for the risks which attach to the receipt of benefits; and
- compared with other possible uses of funds in the context of formulating annual budgets, so that Ministers can make the best informed decisions about how to allocate scarce funds.

Applying the four principles stated just above to PNG's likely situation in the period from 2008 to 2012 suggests that there are two preferred areas for allocating additional revenue, and that each year's budget will involve a carefully balanced choice between them:

- additional public investments, and
- repayment of public debt.

9.6 ADDITIONAL PUBLIC INVESTMENTS

Public Investments seem to many people the most attractive option for use of additional revenue. But in order for public money to be well spent, the Government must carefully assess in every case of a prospective investment –

- **implementation capacity** — whether the project can be implemented effectively, in addition to everything else to which the Government is committed, within the constraint of available capacity in the public service and in relevant areas of the private sector; and
- **net benefit threshold** — whether the expected margin of benefits over costs, with all the associated risks factored into the assessment, represents a better proposition than the assured benefit of reducing public debt and thereby saving on interest cost.

Very large prospective investments, such as State equity stakes in gas commercialization or other resource development projects, involve some added factors –

- assessing investments may be a complex task for which specialist advisers need to be contracted;
- Investments may need to be funded from more than one year's additional revenue; and
- the concentration of risks in the State's financial outlook may represent a constraint on the size of the investment that can prudently be made, in addition to the constraints on available budget and debt funding.

9.7 REPAYMENT OF PUBLIC DEBT

This is the other option for use of additional revenue. In mid-2007 PNG had K6,541 million of public debt, with K2,992 million in domestic debt and the equivalent of K3,459 million in external debt. The advantages of repaying public debt are as follows:

- It would have an immediate positive effect on the spending side of the Budget, freeing resources every year from debt servicing which could be used for service delivery, maintenance of public infrastructure, or new investments;
- Debt repayment strengthens the Government's financial position or "balance sheet", which increases investors' confidence and helps to lower interest rates. This reduces the borrowing costs of all PNG households and businesses; and
- Debt repayment also reduces the interest rate risks and foreign exchange rate risks for the Budget — if interest rates rise, or the currency depreciates, the impact on interest expenses will be smaller. This provides the greatest flexibility for future Budgets, including for further financing of State investments when necessary.

Apart from public debt, there are **other State liabilities** which it would be helpful in much the same way to repay or reduce. The State's liability to Nambawan Super Ltd (formerly POSF), in respect of public servants for whom the employer contributions to superannuation are as yet unpaid, is the largest one.

The **choice each year** between additional public investments and repayment of public debt should be made through –

- rigorous evaluation of prospective public investments;
- allocation to them of appropriate amounts in a regular or supplementary budget process; and
- allocation of the remainder to repayment of public debt.

Such a process could result in any combination of additional public investments and repayment of public debt depending on what feedback the Government is getting from implementation efforts. It will also depend on the state of the economy, especially if there are inflationary pressures.

But as a guideline or starting-point for the budgeting process, this strategy contains a 60:40 guideline — **60 per cent additional public investments and 40 per cent repayment of public debt.**

An important reason for devoting a substantial proportion of additional revenue during the period 2008-2012 to repayment of public debt, even if there are worthwhile public investments which could be effectively implemented, is the prospect that after this period PNG may face more difficult times, which will make greater demands on budgets and the State's balance sheet. This is because –

- a number of major **resource projects** are due to be wound down within the next decade, significantly reducing mineral revenues;
- the epidemic of **HIV-AIDS** is growing and is likely to cause large and mounting costs; and
- **climate change** is likely to affect both PNG's propensity to natural disasters, and the climatic conditions for PNG's agricultural industries including fisheries.

It will therefore be prudent to aim at ending the MTFS period with stronger State finances than at present.

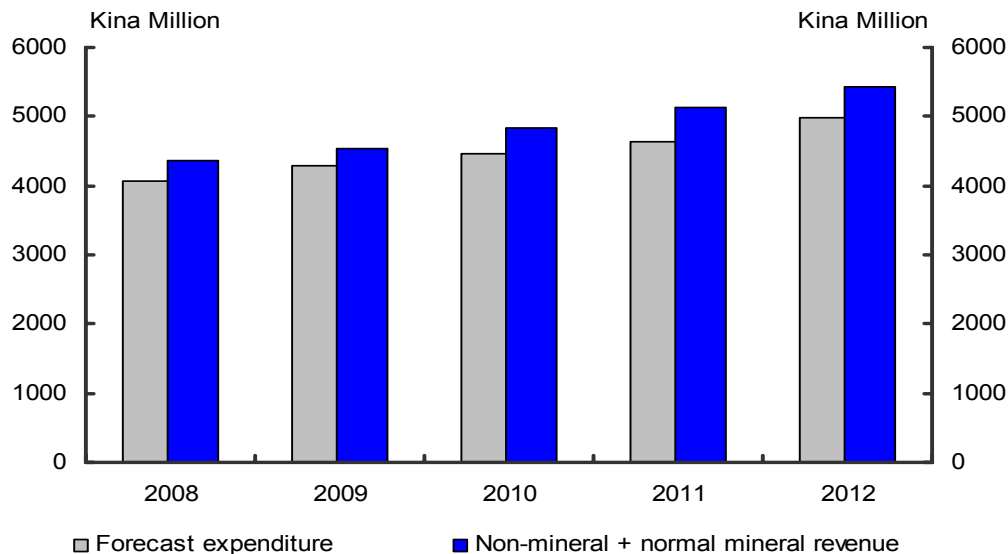
9.8 IMPLICATIONS FOR ONGOING EXPENDITURE

The main implications of this proposed strategy for ongoing spending are –

- that the amounts of ongoing spending will be fairly stable from year to year; and
- that if forecast expenditure is less than the sum of normal mineral revenue and non-mineral revenue – what can be called total normal revenue – then expenditure could be increased up to that sum, while staying within a prudent fiscal framework.

Before Ministers made decisions on the 2008 Budget, the Department of Treasury forecasted that with no changes in relevant Government policies, ongoing spending would remain less than total normal revenue in the MTFS period. This is shown in Figure 31.

Figure 31: Forecast expenditure compared with total normal revenue, 2008 - 2012
(Kina Millions)



Source: Department of Treasury

Therefore under this strategy there is scope for policy decisions, such as those in the 2008 Budget, which would increase ongoing spending to levels corresponding to total normal revenue.

At the same time, it will be crucial for the success of this fiscal strategy that ongoing spending be kept each year within the limit of total normal revenue. This is vital in order to ensure that ongoing spending can be sustained.

9.9 IMPLICATIONS FOR BUDGET AND PUBLIC DEBT

The overall (or “headline”) balance in each year’s Budget will depend on –

- whether ongoing spending is kept within its limit of total normal revenue; and
- how additional mineral revenue is allocated between public investments and debt repayment — since public investments are recorded in the Budget as “above the line” spending, while debt repayment is not.

If the proposed 60:40 guideline were applied in allocating additional mineral revenue, the pattern of balances would be a declining series of surpluses in 2008-2011 and a deficit in 2012.

The counterpart of that series of overall balances would be a series of reductions in public debt in 2008-2010, by amounts equal to the 40 per cent components of additional mineral revenue, and a small increase in 2012.

On the basis of current forecasts of GDP growth, this would mean over the MTFS period a substantial further reduction in the ratio of public debt to GDP, to about 25 per cent at the end of the period.

Bringing the public debt to GDP ratio down to the 25 per cent level would represent a major fiscal achievement. It would make it more likely that according to the measure used by the International Monetary Fund (IMF), PNG's public debt would be assessed as sustainable. This lower public debt level would also be a positive factor in the rating agencies' ratings of PNG's sovereign debt. These kinds of international recognition for a lower debt level would, in turn, contribute to business and investor confidence in PNG.

9.10 FUNDING OF INVESTMENT PROJECTS

Funding for investment projects can come both from the Budget and from additional State borrowing.

9.10.1 Budget funding

The five-year total of additional mineral revenue represents the limit on what will be available from the Budget for funding of investment projects.

- If additional mineral revenue is received as currently forecast, and allocated by the 60:40 guideline, this would provide K1,649 million for public investments.
- Alternatively, if the 60:40 guideline were over-ridden, all K2,749 million could be used for public investments.

9.10.2 State borrowing

The scope for State borrowing to supplement funds from the Budget, while keeping to a prudent debt strategy, is not great. This is because prudent use of State borrowing would not allow the overall level of public debt to rise again, past its level at the start of the Government's current term in August 2007.

The *Fiscal Responsibility Act 2006* contains principles of sound fiscal management. One is that the Government will not raise the overall level of public debt during its term.

- This principle would be applied if a period of net repayment of debt, while additional mineral revenue was being received in large amounts, was followed by some net borrowing in later years – provided the net borrowing did not raise the level of public debt past its level at the start of the Government's term.

9.10.3 Project borrowing

The limit on funding of investment projects from the Budget and from additional State borrowing does not apply to:

- investment projects by State-owned enterprises (SOEs) which the SOEs fund by themselves; and

- investment projects with funding arrangements fully independent of the State.

For example, if projects can be designed as public-private partnerships, so that private investors supply the funding needed beyond what SOEs can fund through their own operations, their direct effects would be outside this strategy.

However, if project funding arrangements involve contingent liabilities for the State, or could reduce the value of State assets including ownership interests in SOEs, they would have actual or potential effects on the State's creditworthiness and ability to borrow when necessary.

Therefore, when investment projects involve SOEs or are sponsored by the State, the indirect effects of funding arrangements for those projects need to be carefully identified, and the Government's direction of such arrangements needs to be integrated with implementation of this MTFS.

9.11 MAINTAINING THE TAX BASE

A major challenge for the Government in pursuing this strategy is to maintain the integrity of the tax base.

The tax system is severely compromised when concessions are provided to specific projects or taxpayers.

- The use of project agreements to create special tax arrangements for individual projects has encouraged a wide range of investors to seek a growing list of tax concessions, even when forms of tax relief are already provided by the tax law for investors in the type of business involved.
- Project agreements containing project-specific tax concessions have created an uneven playing field on which businesses have to operate.
- Often the concessions sought are difficult to cost, but in many cases they could deprive the Government of significant amounts of revenue.

To enhance the integrity of the tax system, concessions provided to projects should be confined to those available for the relevant industry in the existing tax law.

- This would ensure equitable treatment of projects in each sector, and transparency in tax policy.
- The assurance of equitable treatment for all investors would encourage further investment in the economy.