

## **CHAPTER 9. MEDIUM TERM FISCAL STRATEGY**

### **9.1 OVERVIEW**

The new Medium Term Fiscal Strategy (MTFS) for 2008-2012, was endorsed by the Government in mid 2008. The strategy was put together after thorough consultation with stakeholders inside and outside the Government, including PNG's development partners.

The MTFS is used as the main guiding framework for the 2009 Budget. This chapter contains a summary of the Strategy.

### **9.2 RATIONALE**

The rationale of this strategy is:

- 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);
- to develop further the strategy followed in 2002-2007 for handling varying, volatile and highly uncertain amounts of additional revenue from PNG's commodity exports; and
- 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 new MTFS includes –

- a rule for how much of the expected mineral revenue is reliable enough to fund ongoing spending;
- principles for allocating any additional mineral revenue, whenever it is received, to the best uses for improving PNG's long-term future;
- principles concerning how quickly additional mineral revenues should be spent in order to avoid destabilizing swings in Government expenditures; and
- an approach to funding major State investment projects, and flexibility for dealing with changing circumstances, such as a different outlook for commodity prices, during the next five years.

### **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.

Commodity prices are highly volatile and no one can confidently predict which way they will move. While there is a possibility of mineral revenue coming in much stronger than projected – as has been the case over recent years – there is also a possibility that prices could fall sharply, and revenue could come in much lower than projected. The recent decline in commodity prices is an example of this.

In formulating the new MTFS, a key step has been to define 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 combined with non-mineral revenue and allocated for spending in the recurrent and development budgets. This should provide for sustainable growth in ongoing Government expenditure that is broadly linked to economic growth and that does not have to be slashed if commodity prices return to long-term values.

Therefore, the rule in this strategy is that **mineral revenue equal to 4% of GDP will be included in funding of ongoing spending**. The remainder of mineral revenue is to be regarded as additional revenue, to be allocated in ways which can be adjusted, with minimal disruption, when the amounts received vary from their forecasts and fluctuate from year to year.

The 4% 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, ongoing spending plans would be cut, or a temporary Budget deficit would be necessary, or both.

## 9.5 IMPLICATIONS FOR ONGOING EXPENDITURE

Ongoing spending is constituted by the recurrent and development budgets (in this context the part of development spending funded by the Government's resources including borrowing, but excluding the part of development spending funded by grants from development partners). The main implications of the strategy for ongoing spending are –

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

In 2009 revenue is expected to decline significantly due to lower commodity prices and the natural decline of oil production as reserves are run down. However, ongoing spending for 2009 has not changed substantially from the 2009 Budget Strategy. This is because non-mineral revenue growth is still strong. According to the MTFS, ongoing expenditure is kept in line with normal revenue - revenues that can be expected in the absence of a commodity price boom.

It is a crucial part 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.

## 9.6 PRINCIPLES FOR ALLOCATION OF ADDITIONAL REVENUE

There are four key principles which apply to the choice of ways in which mineral revenue above the 4% of GDP threshold — referred to here as additional mineral revenue — 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 for investments, preferably in line with the MTDS priorities, that will benefit future generations as well as this one.

This is the principle of fairness, as stated in the Constitution's National Goals: *"safeguard the national wealth, resources and environment in the interests of not only the present generations but also future generations"*.

Unless this principle is followed, future generations will be left poorer when PNG's mineral resources are used up.

**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.

**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 Government 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:

- adding to the funds held in trust for additional public investments over the medium term; and
- repayment of public debt.

## 9.7 PREFERRED AREAS FOR ALLOCATION OF ADDITIONAL REVENUE

### Additional Public Investments

In order for public money to be well spent, every prospective investment must be carefully assessed:

- **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.

These assessments represent hard tests.

The average cost of interest on domestic public debt can be regarded as a threshold rate, which must be exceeded by the risk-weighted expected net benefit from an investment project in order to justify allocating additional revenue to that project.

**Very large prospective investments**, such as State equity stakes in gas commercialization or other resource development projects, should be assessed in the way just described if they are candidates for funding from State revenue or borrowing. But their size introduces some added factors –

- assessing them may be a complex task for which specialist advisers are needed;
- they may need funding from more than one year's additional revenue; and
- the concentration of risks in the State's financial outlook associated with them 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.

**Pre-funding** of spending which is ongoing in its nature, such as rehabilitation and maintenance of public infrastructure, can be regarded as part of this category. This has been one of the main uses to which “windfall” revenue was allocated in supplementary budgets in 2006, 2007 and 2008.

### **Repayment of public debt**

This is the other option for use of additional revenue. The advantages of repaying public debt are as follows.

- It would have an immediate positive effect on the spending side of the Budget, continuing every year, as resources are freed from debt servicing.
- Debt repayment strengthens the Government's financial position or “balance sheet”, which increases investors' confidence and helps to lower interest rates. This reduces borrowing costs for PNG households and businesses.
- 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.
- In a higher inflationary environment, the repayment of debt does not directly add to demand pressures like additional Government spending.

Apart from public debt, there are **other State liabilities** which should be similarly repaid or reduced. 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. But there are two necessary conditions for including the reduction of these liabilities in uses of additional revenue –

- different State liabilities have associated with them different types of risks, related to trends in the economy or to other more specific factors, and these risks should be assessed in comparing the benefit of reducing the liability to Nambawan or other liabilities with the benefit of repaying public debt; and
- it would be harmful to the public interest to reduce the disincentives for fraudulent or unnecessary acceptance of claims, and that could be the effect of specially paying out such liabilities as court orders and payment arrears.

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. It will depend on what feedback the Government is getting from implementation efforts. It will also depend on the state of the economy, especially if demand is already growing strongly and there are inflationary pressures which additional public investments would worsen.

A starting-point for the budgeting process, this strategy contains a 70:30 guideline — **70% to pre-fund future additional public investments and 30% repayment of public debt.** The reason for this guideline is the desirability of ending the MTFS period with a lower level of public debt, and correspondingly stronger State finances.

## **9.8 IMPLICATION FOR OVERALL BUDGET BALANCE & PUBLIC DEBT**

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

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

The overall balance in each year's Budget *will not* be affected by the amount drawn down from the trust accounts for actual public investment expenditure, as for budgetary purposes, the expenditure is recorded once the funds are transferred to trust.<sup>3</sup>

---

<sup>3</sup> This differs from the IMF definition of the Budget balance, which records the expenditure only once it has been drawn down from the trust account and actually spent.

Nonetheless, it is important to consider the expected rate of drawdown while framing the Budget, in order to contain inflationary and other demand pressures.

## 9.9 DEMAND MANAGEMENT

A major consideration for fiscal policy is the impact that Government spending has on aggregate demand in the economy. Too much Government spending over a given period of time can cause excess demand, resulting in sharply higher inflation and interest rates, a surge in imports and crowding out of private sector investment. This has been a major problem for PNG on numerous occasions in the past.

A rapid drawdown of funds held in trust could contribute to higher inflation, which is why the MTFS limits actual government expenditure from additional mineral revenue to a maximum of 4 per cent of GDP per annum. In order to adhere to this rule, the Government will improve efforts to closely monitor and control spending from trust funds.

## 9.10 PREPARING FOR LONG-TERM CHALLENGES

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 may not be contained for some time. It is likely to cause large and mounting costs, not only for people directly affected by illness and deaths but also for the public health system, for many types of private businesses, and for the State as an employer; and
- further in the future but already in sight is the prospect of having to adapt to **climate change** — affecting 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.

## 9.11 FUNDING OF INVESTMENT PROJECTS

Funding for investment projects can come both from the Budget and from additional State borrowing. However, 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 70:30 guideline could be over-ridden and the forecast additional mineral revenue in 2009-2012 could be used for public investments.

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.

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.

## **9.12 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.