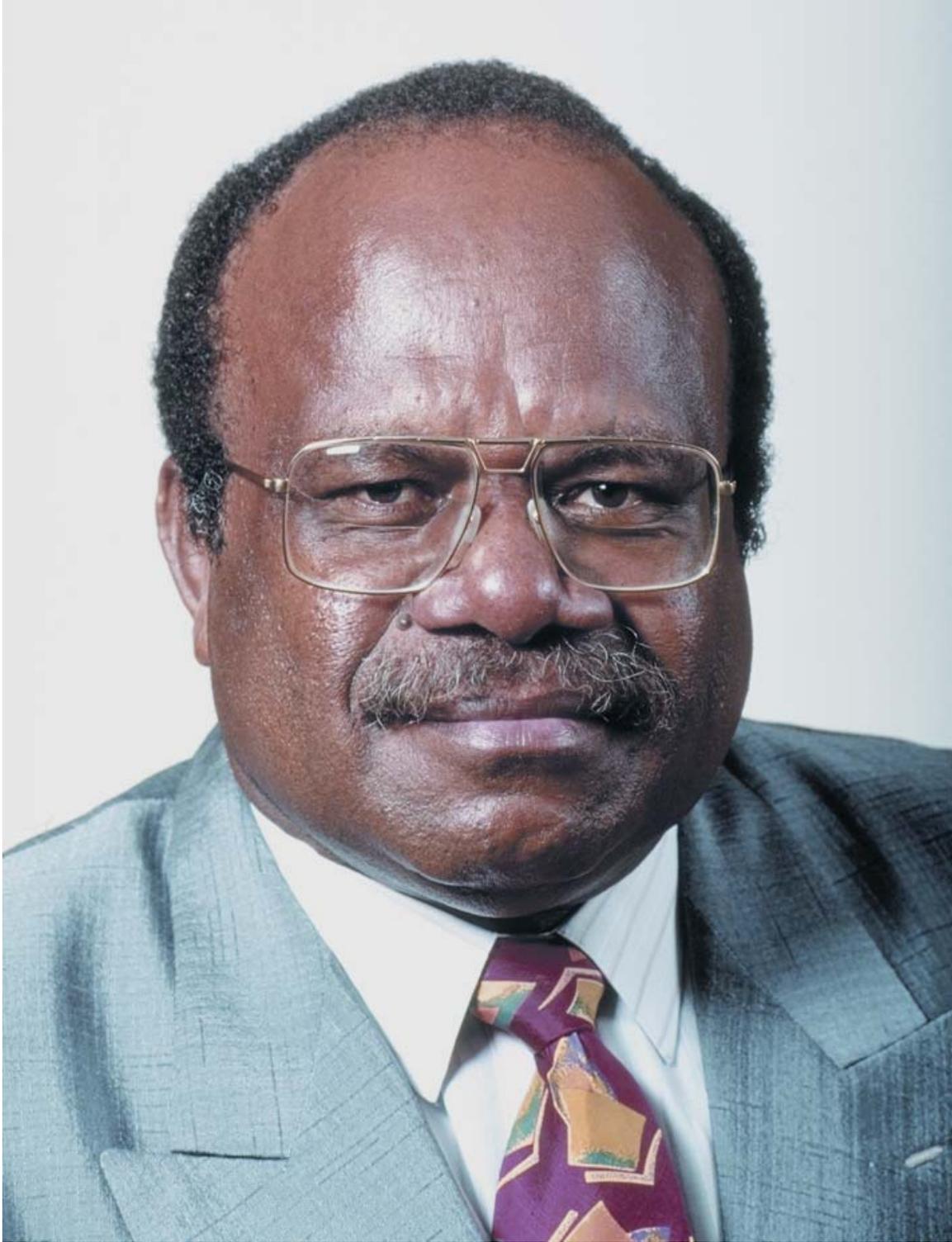




Budget Strategy Paper - 2008

**Presented by the
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Government of Papua New Guinea

Budget Strategy Paper - 2008

A. Background

This Budget Strategy Paper (BSP) will help guide preparation of the 2008 Budget. This is an important component of the Government's approach for improving the preparation of budgets and the management of public finances in Papua New Guinea (PNG). This document has been made available to the public, consistent with the Government's approach of improving public transparency and accountability.

B. Purpose

The BSP has several purposes:

1. To establish the *broad principles* that will guide the 2008 budgetary processes.
2. To set out the *broad fiscal parameters for the 2008 budget year* and indicate the key Government strategies and policies for the management and reform of revenues and expenditures.
3. To provide a *framework for the preparation of departmental ceilings for budget estimates and for developing detailed budget policies*.
4. To assist understanding of the *fiscal situation and the Government's proposed budget strategies* amongst government officials, the business sector and the general public.

The fiscal data and targets included in the BSP are *indicative* only. They are not binding on Government and may be adjusted if and when circumstances change during budget preparation. The macroeconomic and fiscal forecasts will be updated closer to Budget to reflect any changes in economic and financial conditions.

C. 2008 Budget Strategy

The 2008 Budget will continue to build on the strong foundation of the Government's prudent fiscal management and economic growth strategy, and to enhance and promote a dynamic and competitive private sector. It will also continue the use of windfall gains associated with high commodity prices to improve PNG's future welfare, in ways that do not pose any considerable threat to fiscal sustainability in the medium term.

It is clear that the medium term poses a budgetary challenge because, if numbers of employees remain near their present levels, expenditure on personnel emoluments for Government employees is set to increase by more than the probable increase in revenue. This calls for renewed consideration of ways, such as those recommended in the Rightsizing Report of 2005, to make the public service more affordable while maintaining or improving its effectiveness in service delivery and other core functions.

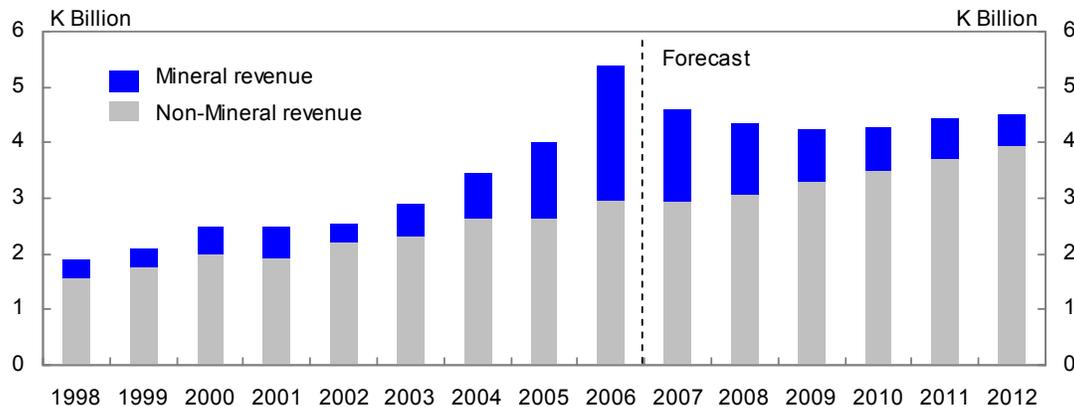
In the near term, this budgeting challenge requires the strategy for the 2008 Budget to include –

- keeping the windfall part of revenue out of the ongoing streams of expenditure which are most difficult to reduce in future years, and
- maintaining discipline in the ceilings on recurrent expenditure and domestically funded development expenditure.

Provided the spending limits in the 2007 Budget are observed, and there are no substantial losses of production this year because of civil disturbances during the election period or for other reasons, the 2008 Budget is expected to be framed in favourable economic and fiscal conditions. The economy is forecast to grow by around 4½ per cent in 2008, underpinned by solid macroeconomic conditions and the stimulatory effects of high commodity prices.

Commodity prices are projected to keep easing down from the record levels of 2006, but to remain high in 2008 relative to historical levels and the levels forecast for the medium term. This will provide a windfall component of revenue of about K230 million (Chart 1).

Chart 1: Total Revenues – Mineral and Non-Mineral



Inflation and interest rates are expected to remain at low levels in 2008, and the exchange rate is expected to remain relatively stable.

As Chart 1 shows, 2008 is expected to be the fourth year of windfall revenues resulting from high commodity prices. To date, these windfall revenues have been managed prudently, according to the principles outlined in the Medium Term Fiscal Strategy (MTFS).

Because the windfall revenues are expected to be only temporary, one key objective has been to prevent them being factored into ongoing expenditure. This avoids the need in the future, when commodity prices fall from the current high levels, to make difficult cuts in ongoing expenditure or else borrow to fund Budget deficits.

Another key objective has been to ensure that the windfall revenues are used for the long-term benefit of PNG. Because of this objective, they have so far been allocated in three ways –

- to fund essential one-off expenditures, such as arrears payments, backlogs in the Performance Based Salary System, and claims;
- for investments, such as State equity in the gas project and public infrastructure rehabilitation; and
- for the repayment of high cost debt.

In forming the 2006 Supplementary Budgets and the 2007 Budget, the Government allocated a total of about K0.9 billion in windfall revenue for investments in rehabilitating and

improving public infrastructure. There are major tasks still ahead in implementing these large additions to the public investment program. The pace at which the additional investments can be undertaken effectively is limited by the implementation capacities of both the public and private sectors. Attempting to implement over-rapidly all of these investments would contain the danger of sparking inflationary pressures.

Therefore in forming the 2008 Budget strategy, the Government recognises that given these capacity constraints, there will probably be little if any need to add in 2008 to the funds already allocated for expenditure on high-priority public investments — with the exception of the agriculture sector, and perhaps also of gas commercialisation.

A number of decisions have been made in March 2007 by the National Executive Council adjusting spending priorities for the 2008 Budget, including the enlargement of education subsidies, a commitment to spending under the National Agricultural Development Plan and additional public investment in the East Sepik. These decisions will be incorporated in the 2008 Budget, but in order to do so within the terms of the MTFs, offsetting savings need to be identified.

One of the major uncertainties in framing the 2008 Budget Strategy is the Government's desire to fund State equity in a suitable PNG based gas commercialization project. It can be confidently expected that such a project will soon take shape, as long as the Government continues to provide a favourable policy framework and active support. However, key variables such as the appropriate amount of State equity, and the manner and timing of funding within the project financing plan, cannot yet be reliably estimated.

In this situation, debt repayment represents the most responsible and beneficial use for windfall revenues in 2008. Using the 2008 windfall revenues for debt repayment would have a number of benefits:

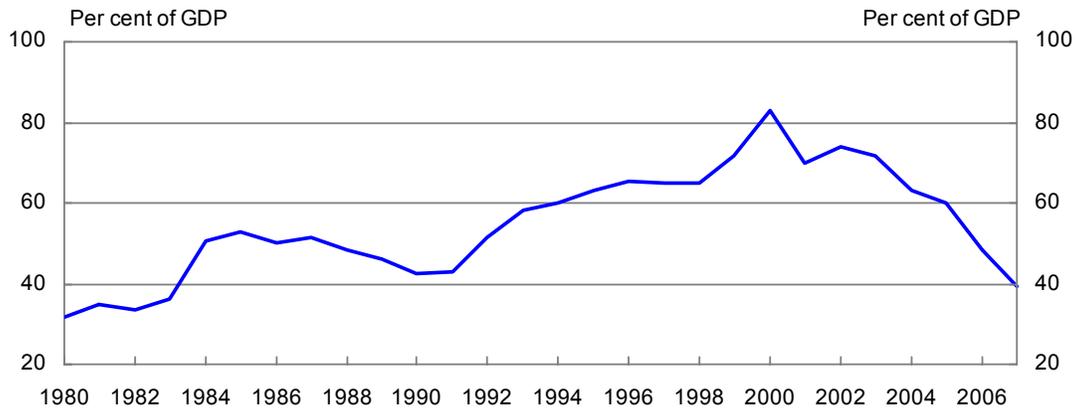
- It would have an immediate positive effect on the spending side of the Budget, continuing every year, as resources are freed from debt servicing. These funds could be used for service delivery, new investments, or maintenance of the infrastructure on which spending has increased during the past two years.
- Compared with ear-marking funds and setting them aside, even in interest-earning accounts, debt repayment saves money through lower debt servicing costs.
- Debt repayment strengthens the Government's balance sheet, which increases investors' confidence and helps to lower interest rates. This reduces the borrowing costs of all PNG households and businesses.
- Debt repayment reduces the interest and foreign exchange rate risks to the Budget, in that if interest rates rise, or the currency depreciates, the impact on interest expenses will be smaller.
- Debt repayment provides the greatest flexibility for future Budgets, and for further financing of State equity in gas commercialisation.

It should be stressed that this Budget strategy is not one of planning a series of Budget surpluses over the long term. Rather, this is a strategy for the particular circumstances of 2008, while –

- windfall revenues continue,
- the priority expenditures already well funded are being implemented, and
- the State financing needs associated with gas commercialisation are being determined.

The 2008 Budget Strategy is to have a budget surplus of K229 million in 2008 – exceeding the existing MTFS target of budget balance. This will be the sixth and final year of the current MTFS, and the fourth in which its budget-balance targets have been exceeded. This performance during the term of the present Government has brought about a remarkable improvement in the country’s fiscal and debt position.

Chart 2: Public Debt as a percentage of GDP



By meeting – and exceeding – the MTFS targets, macroeconomic stability has improved; public debt has fallen below 40 per cent of GDP for the first time since 1982 (Chart 2); inflation and interest rates have fallen; and both domestic and international investor confidence in PNG has improved. By holding to or exceeding the MTFS targets, the Government has put the PNG economy in the strongest position to be able to ride out possible shocks in the future.

Box 1: Fiscal Principles in the Fiscal Responsibility Act 2006

- 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
- Budget expenditures will be consistent with agreed national and sectoral priorities.
- Government will limit its ownership role and direct participation in service delivery 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.

Reviewing and reprioritizing recurrent and development expenditure is an important part of the Budget strategy. The overall level of spending should be kept at or near current levels, because this is the maximum that can be funded on a sustainable basis in the medium term, when commodity prices and windfall revenues are likely to fall from their current high levels.

Other spending options to be assessed during preparation of the Budget include increased spending on supervision of the priority expenditures on public infrastructure, and on maintenance of rehabilitated infrastructure. In addition, the Budget process will assess the

scope for savings on administrative overheads, low-priority functions, duplication and what could be better achieved by the private sector.

C.2 Complementary Policies

The 2008 Budget strategy will operate in combination with other policies designed to promote private sector development and growth. With national elections approaching in mid-2007, the Government's policy is to continue with the reform measures introduced in the 2006 and 2007 Budgets. The Government remains focused on removing impediments to businesses, creating a favourable business environment through economic stability and an efficient and effective public sector, and introducing competition to key sectors.

Significant progress has been made over the last few years in removing impediments to business, including improved opportunities for the private sector, opening the economy to potential markets and investment, developing public infrastructure, and supporting rural activities. However, a lot more needs to be done.

An efficient, effective and affordable public sector is one of the pillars in the Government's growth strategy. Poor service delivery by the public sector is an impediment to business and the welfare of the public, and agencies need to be administered more efficiently and use resources for the delivery of services to the public. It was noted above that the size and expected growth of the public sector payroll is the most obvious problem for the Budget over the medium term. Many agencies have too many staff on the payroll and too few other resources to do their job properly.

The Government's approach to public sector reform includes reviewing the resourcing of agencies to ensure they have enough funding for priority functions, but focus less on non-priority areas. The principles in the 2005 Rightsizing Report have been accepted by the Government, which remains committed to improving financial management and efficiency in public sector institutions. Consideration of the recommendations in the Rightsizing Report for restructuring Government agencies has been postponed until after the 2007 national elections. If those recommendations are adopted by the incoming Government, they will be included in the 2008 Budget process.

The Government will keep reviewing the performance of utility providers, and look at options for increasing private sector involvement in the provision of utilities. In order to enhance service delivery, the Government has embarked on introducing competition in key economic sectors such as tourism, international aviation and telecommunications, and is reviewing regulation and competition in wholesale and retail trading and in the provision of fire and general insurance.

Other structural reforms being undertaken while the 2008 Budget is prepared are the implementation of recommendations of the task force on land tenure systems, increasing the coverage of superannuation, and reviewing the system of import tariffs in terms of their benefits for protected manufacturing and wider economic costs. After the national election it will be for the incoming Government to decide whether to continue these reforms, and whether to introduce others with the 2008 Budget.

In summary, whichever option is chosen for use of 2008 windfall revenue, the strategy of the 2008 Budget will be to -

- enable the large allocations of funds for rehabilitating public infrastructure and other priority expenditures in 2006 and 2007 to be implemented well and without overheating the economy;
- deliver a budget surplus in 2008 that can be used for the repayment of public debt;

- not impose any new taxes or tax increases;
- continue the reallocation of spending to the high priority areas of the MTDS; and
- keep improving budget strategy and processes, and public financial management.

D. Economic Developments and Outlook

The economic outlook remains robust.

2006 Economic Update

The PNG economy is continuing to reap the benefits of the Government's sound and consistent macroeconomic policy framework and historically high prices for major commodities.

In 2006, Real Gross Domestic Product (GDP) grew by an estimated 2.6 per cent, down from 3.4 per cent in 2005. However, this reduction in the rate of growth was largely due to contractions in the minerals sector. Non-mining GDP is estimated to have grown by 3.8 per cent, up from 3.1 per cent in 2005, largely as a result of strong growth in the construction, manufacturing and business services sectors.

The oil and gas extraction sector is estimated to have declined slightly due to an oil-spill that resulted in a one month shut down in operations at the Kumul terminal. In the absence of this shut-down, the oil and gas sector would have grown by around 5 per cent. The mining and quarrying sector also declined in real terms in 2006.

Despite the decline in the volume of mineral production, the sharp increase of commodity prices to record highs in 2006 saw the value of mineral production increase significantly, resulting in a large trade surplus of 18 per cent of GDP. This provided a substantial stimulus to the rest of the economy, with particular impacts on the building and construction, and business services sectors, which have benefited from both higher mining exploration and investment activity, as well as increased public infrastructure expenditure.

It also saw international reserves increase to record levels, standing at around US\$1.5 billion at the end of 2006 – more than sufficient to perform the role of appropriately smoothing any short-term exchange rate volatility.

The agriculture, forestry and fisheries sector grew only moderately in 2006, due to heavy rains in 2005 which, combined with it being an "off-year" season (coffee crops operate on a biannual season), resulted in sharply lower coffee production. Copra production also declined as operations were disrupted due to the volcanic eruptions in late 2006. Offsetting these factors were high log production and continued growth in the palm oil industry.

Employment grew by a strong 4.6 per cent through the year to September 2006, with particular strength in the Wholesale/Retail trade and Finance, Real estate and business service sectors. This is in line with strong non-mining GDP growth.

The inflation outcome for 2006 was 2.9 per cent in year average terms compared to 1.7 per cent in 2005. With inflation being low, interest rates have also remained low.

2007 Outlook

Economic growth is expected to increase to 5½ per cent in 2007, up from 2.6 per cent in 2006, with non-mining GDP expected to grow by 5¼ per cent in the year. This forecast acceleration in growth is largely due to a rebound in the mineral and agriculture sectors from weaker performances in 2006.

While commodity prices are expected to fall from the record levels of 2006, they are expected to remain high compared to historical levels, and continue to be a major source of stimulus to the economy. As a result of high commodity prices, the value of PNG's exports is expected to remain at an elevated level, resulting in another large trade surplus.

The gold, oil, and agriculture sectors are expected to drive real GDP growth in 2007. Increased gold production should result in strong growth in the mining and quarrying sector. The return of the Oil and Gas extraction sector to normal levels of production after the unexpected shut down in 2006 will also boost growth.

The agriculture sector is expected to contribute strongly to growth in 2007, driven by a return to normal production levels of copra, copra oil and coffee, after 2006 production was disrupted by poor weather and volcanic activity. Growth will also be supported by the expected expansion in the palm oil industry.

PNG has been subjected to changes in major economic anticipated stimuli with the cancellation of the gas pipeline project. While this will reduce anticipated activity in 2007 and 2008, this will be largely offset by the increased public infrastructure spending coming out of the Additional Priority Expenditure announced in the 2007 Budget. This spending will have a particular impact on the building and construction sector, which is expected to continue growing strongly in 2007.

Annual inflation in 2007 is expected to be 4.3 per cent. This is up from 1.5 per cent expected in the 2007 Budget and reflects the higher year average outcome from the 2006 CPI and the volatility in betel nut prices. Nevertheless, inflation is expected to remain at relatively low levels in 2007, attributable to prudent fiscal and monetary management and a stable exchange rate.

2008 Outlook

The outlook for 2008 is for continued solid economic conditions with expected economic growth of 4¼ per cent, after an increase of 5½ per cent in 2007. Non-mining GDP is forecast to grow by 4 per cent.

Economic growth should be supported by strong growth in mining production, as existing mines are expected to increase production, reflecting both recent investments ramping up production and continued higher production from high grade ore bodies in 2008. This is expected to offset the contraction in the petroleum sector due to natural declines in production from existing fields.

Continued investment in the exploration and mineral sector is expected to support higher growth in the construction sector in 2008. The sector will also be supported by the elevated levels of public infrastructure investment associated with the Additional Priority Expenditure announced in the 2007 Budget.

Continued growth in the agriculture sector is expected to be driven largely through increased palm oil and cocoa production, reflecting an expansion in palm oil mills and increased cocoa planting in Bougainville.

Inflation is expected to continue to remain low in 2008, with forecast year average growth of around 2.9 per cent, slightly lower than the inflation rate expected in 2007. Both the inflation rate and the exchange rate are expected to remain reasonably stable in the out years.

Risks

The major risk to the Budget forecasts relate to the outlook for global economic conditions and movements in commodity prices. It is extremely difficult to forecast commodity prices, and it is possible that commodity prices could fall from their current high levels faster than forecast. Indeed, the events of early 2007, where commodity prices have been volatile and have fallen sharply should serve as a warning. On the other hand, it is also possible that commodity prices could remain at their elevated levels for longer than expected, or even increase further.

The economic outlook for 2008 assumes no significant disruptions to major mining and petroleum projects – existing and prospective. Nevertheless, there will always be some risk of supply disruptions, as illustrated in 2006 when an oil spill affected oil production, and low rainfall in the Western Province prevented Ok Tedi from exporting copper at full capacity. There would be significant fiscal implications arising from any sustained disruption to resource flows.

The agriculture sector faces ongoing risk from introduced diseases and pests. Particular risks in 2007 include the potential for an outbreak of bird (avian) flu and the spread of the cocoa pod borer.

More generally, the economic outlook assumes that fiscal discipline is maintained, with the Government continuing to meet its MTFs targets. If the Government fails to meet MTFs targets, investor and consumer confidence would be affected and the economy would suffer as a consequence.

Table 1: Economic Forecasts

	2005	2006	2007	2008	2009	2010	2011	2012
Economic Growth								
GDP	3.4	2.6	5.4	4.3	4.0	4.5	3.8	2.5
Non-mining GDP	3.1	3.8	5.2	4.0	4.3	3.8	3.7	3.7
Inflation								
Year average (%)	1.7	2.9	4.3	2.9	2.9	2.9	2.9	2.9
Interest rate								
T/Bills	4.5	5.0	6.0	6.0	6.0	6.0	6.0	6.0
3 year I/S		6.0	6.0	6.0	6.0	6.0	6.0	6.0
Mineral Prices								
Gold (US\$/oz)	445	604	600	550	500	450	450	450
Copper (US\$/lb)	1.67	3.05	2.72	1.84	1.43	1.22	1.14	1.06
Oil (Kutubu: US\$/barrel)	53.4	64.3	54.0	57.0	57.5	57.8	58.0	58.3

2009 to 2012

Looking further ahead, economic growth is expected to remain robust over the next few years but tail off towards the end of the projection period. Growth in the non-mining part of the economy is expected to progressively increase, in line with the positive outcomes expected from government investments and policies, as well as expansion in the agricultural sector.

From 2008 the petroleum sector will begin detracting from economic growth due to natural production declines in existing fields. However, this will be largely offset by a ramp up of gold production coming from a number of new projects, as well as the start of production

from the Ramu Nickel mine in 2010. After this, in the absence of any new major projects, economic growth is expected to slow, as the natural decline in oil fields begins to dominate growth in other sectors.

E. Fiscal Developments and Outlook

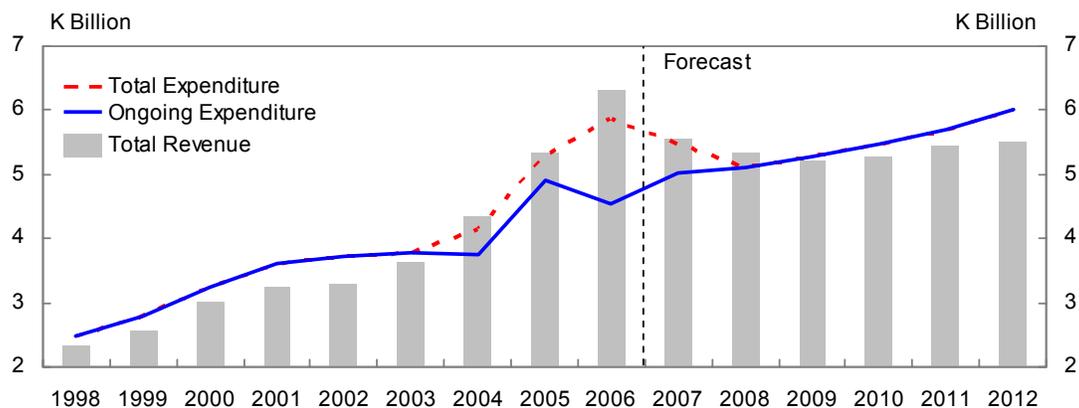
The 2007 Budget projected a budget deficit of K35 million or 0.2 per cent of GDP in 2007. However, the fiscal position has strengthened slightly since the Budget, with stronger collections of non-mineral revenues offsetting a fall in the price of oil below the Budget forecast. A surplus of K84.4 million or 0.5 per cent of GDP in 2007 is now expected.

The 2008 Budget surplus is projected to be K229.1 million, or 1.3 per cent of GDP, in line with windfall revenues coming from high commodity prices. Revenues are expected to increase slightly, with the fall in mining and petroleum taxes offset by growth in most other tax revenues. Expenditure is forecast to fall, as the windfall gains are used for debt repayment. However, apart from the Priority Expenditures in 2007, expenditure will actually increase slightly.

Medium Term Fiscal Outlook

Total revenue is expected to decline from the peak in 2006. The principal reasons for this expected decline are the fall in mining and petroleum tax revenue over the medium term as commodity prices ease from historically high levels, natural declines in production for existing projects experience, and new projects take time to move into profitable operations or for tax exemptions to expire.

Chart 2: Medium Term Expenditure and Revenue Projections



Expenditure is projected to fall from the current elevated levels in 2006. However, excluding extraordinary spending allocations (such as the 2005 purchase of Gas equity, the 2006 Supplementary Budget, and the 2006 and 2007 Additional Priority Expenditures), ongoing expenditure is expected to rise significantly over the medium term. This is due to large increases in personal emoluments, as well as smaller increases in goods and services and development expenditure.

The increase in personal emoluments is driven by two factors: increased funding provisions for superannuation; and public servant pay increases. The increase in superannuation provisions is due to better accounting of the decision to increase the Government's funding of superannuation from 75 per cent to 100 per cent in 2009. By fully funding superannuation, the Government will no longer be building up unfunded liabilities. This will have a significantly positive effect on the Government's balance sheet and the fiscal position over the longer-term, however it will mean that recorded expenditures will rise.

The second factor increasing personal emoluments is public sector wage increases, which come in two forms. The majority of public servants receive performance-based increment

advancement each year – and in periods of relatively low inflation this increment increase provides a real wage increase. In addition, there is an expectation of a base pay increase, and the Government is currently negotiating with the Public Employees Association on this matter.

The combination of these two factors means that, with staffing levels holding steady, personal emoluments' share of total recurrent expenditure are forecast to increase from an average of 40 per cent over the past 5 years, to more than 50 per cent by 2012. Clearly, this path is not sustainable, and highlights the need to reduce the size of the public sector, in line with the Rightsizing Report, as well as to contain wage increases to affordable outcomes.

With Government revenues temporarily elevated, and unexpected Budget surpluses over the past few years, it is easy for the importance of expenditure control to move into the background. However, with projected Budget deficits in the out-years, the need to prevent current high revenues from being factored into ongoing expenditure takes on great importance. It also highlights the continuing need to consolidate Government expenditure into a long-term sustainable position, in order to prevent large, unnecessary and painful adjustments later.

F. Fiscal Parameters for the 2008 Budget

The fiscal parameters for the 2008 Budget are based on current forecasts of revenues and expenditures.

- Total Revenue and Grants are expected to be K5,325.6 million.
- Total Expenditure and Net Lending is expected to be K5,096.5 million.
 - Total recurrent expenditure is forecast at K3,448.0 million.
 - Total development expenditure is forecast to be K1,648.5 million.
- A Budget surplus of K229.1 million, in line with the windfall gains from high commodity prices.

F.1 Revenues

The economy is expected to continue its positive performances in 2008. In line with this, revenues from most major taxes are anticipated to remain high. Offsetting this is a forecast decline in mining and petroleum tax receipts, which are expected to fall in line with lower commodity prices. In addition the GST concession in tourism will reduce revenue collection when the incentive is taken up in 2008.

As in 2006 and 2007, there are no new taxes and no increases in existing taxes are proposed at this stage for 2008. The mining levy phase down is scheduled for 2008 and the second phase of 2006 income tax reduction was implemented in 2007.

The 2007 Budget announced a permanent reduction in the level of log export taxes to enable the industry to pay the new Log Export Development Levy. This levy will be used to fund projects in log exporting provinces.

As also announced in the 2007 Budget, there was a change in the structure of log export tax, from a progressive scale based on log export price per cubic metre to a flat rate of 28.5 per cent so that the same rate of tax applies across the price range. This change was designed to be revenue neutral in 2007 after taking into account the reduction in the tax levels to accommodate the Log Export Development Levy.

GST concessions in tourism will also have a slight reduction impact on revenue as the incentives are introduced in 2007.

No provision is made in 2008 for proceeds from asset sales.

Based on initial indications of donor support in 2006, project support grants are expected to rise moderately in 2008.

The major risk on the revenue side relates to the outlook for global economic conditions and movements in commodity prices. If oil and other commodity prices fall substantially, which is possible in the current environment, revenues will be less than the current forecast.

Other potential risks to the revenue forecasts within the domestic economy include: supply disruptions through landowner disputes; weather related problems at major projects (Ok Tedi, Porgera, Oil fields); and loss of fiscal discipline resulting in negative investor and consumer confidence thereby reducing tax revenue.

F.2. Expenditures

The key policy document guiding the Government's funding allocation decisions is the MTDS. The MTDS provides an overarching development strategy that the Government has determined should be used to guide expenditure decisions as outlined in the annual Budget.

The MTDS identifies expenditure priorities in the period from 2005 to 2010 as:

- Primary and Preventive Health;
- HIV/AIDS Prevention;
- Basic Education;
- Development Oriented Adult Education;
- Transport Rehabilitation and Maintenance;
- Promotion of Income Earning Opportunities; and
- Law and Justice.

The 2007 Budget allocated 52.9 per cent of total Budget allocations and 88.5 per cent of Development Budget allocations to MTDS priority areas – exceeding the MTDS target of 52 per cent. The remainder was allocated to non-discretionary fixed costs (such as interest outlays and court orders); general government administration; general grants and non-MTDS government services.

The effective implementation of the MTDS requires that the proportion of the Budget allocated to MTDS priority areas continues to increase, year on year. Furthermore, the Government has pledged that total MTDS Budget allocations should increase from 48 per cent in 2005 to 55 per cent in 2010.

To meet this goal, a key objective of the 2008 Budget will be for Government to allocate at least 53 per cent of total Budget allocations and at least 88.5 per cent of Development Budget allocations to MTDS priorities.

Recurrent Expenditures

Recurrent expenditures are forecast to increase by 62.9 million in the proposed 2008 Budget ceilings.

2008 Personal emolument expenditure ceilings for Departments and Agencies were determined by each program using the appropriation for personal emoluments contained in the 2007 Budget as the starting point. The ceilings are then reduced to take account of the impact of the retrenchment of unattached officers in 2006 and any other one-off items.

The impacts of year-by-year incremental adjustments to salaries in the public service are then included as a general provision. There is also a general provision for a moderate pay outcome in 2007, which is then brought forward into 2008. This general provision will not be

allocated to agencies until the outcome of the public service pay negotiations has been finalised.

In addition, the number of school teachers is assumed to grow in line with population growth of 2.7 per cent.

Goods and services expenditure ceilings for Departments and Agencies were determined by each program using the appropriation for goods and services contained in the 2007 Budget as the starting point. The ceilings are then reduced to take account of one-off expenditures in 2006 and then indexation for general price increases is applied. The major one-off expenditure in 2007 related to the election.

Goods and services expenditure ceilings for Provinces are made up of funding for function and block grants, town services grants, rural local-level government grants, and the derivation grant. These interim financing arrangements, and the minimum levels for each of these grants, have been applied since the 2004 Budget. These interim arrangements were implemented through an NEC Decision and were gazetted in 2004. While they received unanimous support in the first vote to have them legislated into law, a subsequent vote was required, but did not take place. Nevertheless, provincial administrations have worked collaboratively with the Department of Treasury and the National Economic and Fiscal Commission (NEFC) and have accepted that these grants be supported.

For the 2008 Budget, proposed amendments to the *Organic Law on Provincial Governments and Local-level Governments* were intended to result in the implementation of a new intergovernmental financing system for provincial and local-level government. The overarching policy objective underlying these proposed amendments is to move towards the distribution of funding based on needs, where each provincial government will have a similar financial capacity to deliver its service delivery functions and responsibilities. The proposed amendments received unanimous Parliamentary support at the first vote of the proposal in mid 2006.

Unfortunately, these proposed amendments have not yet been considered by Parliament for a second time, and it will now not be possible to fully implement the new intergovernmental financing system in the 2008 Budget. As a result, it is proposed to make the 2008 Budget a transition year for the implementation of the new intergovernmental financing system, while maintaining the interim financing arrangements and funding levels introduced in the 2004 Budget.

In this transition year, the amounts provided to provincial governments through function and block grants in the 2007 Budget and the entitlement to the derivation grant, will be maintained in the 2008 Budget. However, additional funding that remains available for funding the goods and services expenditure ceilings will be allocated to provincial governments on the basis of their fiscal needs (with the funding to be allocated to block and function grants). This approach is consistent with the proposed new system of intergovernmental financing that received unanimous Parliamentary support at the first vote.

In regard to funding for local-level governments, NEFC will also advise Treasury a suggested breakdown of funding between provinces. In the 2008 Budget, there will also need to be some rebalancing between rural and urban local level government funding, including between provinces, based on an adjustment to the reallocation of funding from the *LLG Secretariat Grant* which was previously provided to ensure that urban LLGs receive a more balanced and appropriate level of funding to enable them to undertake the functions they have responsibility for. As with the 2007 Budget process, there will continue to be a higher level of goods and services funding for rural LLGs (than was provided in the 2006 Budget) to enable them to provide improved service delivery to the rural people they service.

Goods and services expenditure ceilings for the 2008 Budget will be advised to Treasury by the NEFC, which will also assess the fiscal needs of provincial governments on the basis of a 'costs minus revenues' formula. In order to assist provincial governments constructing their own budgets, a Budget circular will also be provided to provincial administrations on the purposes of grants at the same time as advising national government agencies of their goods and services expenditure ceilings. Further information may also be provided to assist all agencies in the allocation of funding between the health, education, transport infrastructure maintenance and village court function grants, and the block grant.

Consistent with previous years arrangements, the 2008 Budget for the Autonomous Bougainville Government (ABG) will be the subject of negotiations between the National Government and ABG.

Interest payments will remain relatively high in 2008 because of the large amount of outstanding Government debt. However, they are well below the peak in 2003, due to lower interest rates, as well as significantly reduced Government debt levels, coming off the back of Budget surpluses in 2004, 2005 and 2006. Domestic interest payments are forecast to increase slightly in 2008, in line with the continued shift to longer term debt, which, while coming at a slightly higher cost, provides greater stability than short-term debt.

With a projected Budget surplus in 2008, the Government will continue to pay off debt, reducing interest costs into the future, and putting downward pressure on interest rates.

A major risk on the expenditure side is unaffordable pay outcomes for public servants. Should this occur, funding for service delivery (i.e. goods and services) would need to be cut or taxes (such as GST) would need to rise in order to avoid damaging the economy through a budget blowout. Another major risk to the Budget relates to spending promises made from incoming government during the election campaign.

Development Expenditures

A key objective of the 2008 Budget will be to at least maintain the proportion of the Budget allocated to MTDS priority areas. The majority of this expenditure is sourced from the Development Budget.

The Development Budget is made up of 4 funding components: direct government financing; the tax credit scheme; concessional loans; and grants. In 2008, development expenditure is expected to increase to K1,648.5 million, a rise of K16.5 million on 2007. This is due to increases in donor grants and direct Government financing.

In 2008, the Government's contribution to the Development Budget is expected to increase to K516.7 million. However, more than half of the Government's contribution is already committed (Table 2).

Table 2: Fixed Commitments in the Development Budget (K million)

	2007	2008	Change
District Support Grant (including Members' Non Discretionary Funds)	54.5	54.5	0
Ongoing MoA obligations	41.5	41.0	-0.5
Ongoing Special Support Grant obligations	42.8	45.0	2.2
Project Grants to Bougainville	13.0	14.0	1.0
Counterpart Funding for Donor Projects	73.3	70.0	-3.3
Total	225.1	224.5	-0.6

These commitment estimates are subject to change except for District Support Grants. Special Support Grants are particularly hard to predict given their correlation with commodity prices.

With the budget moving into surplus, the need for external loans to finance development projects has also declined. The ceiling for the drawdown of concessional loans reflects this in 2008, falling to K150 million. Based on initial indications of donor support in 2007, project support grants are expected to rise moderately in 2007.

Overall, the net effect is that total development expenditure in 2007 is expected to increase moderately from the level provided in the 2006 Budget.

Prioritising Development Expenditure

Building on the approach taken in the 2007 Budget, the Government will continue to pursue its Expenditure Sequencing and Matching Funds Strategy to translate the MTDS into an efficient set of expenditure choices.

These two Strategies are applied to Government's expenditure decisions through the Medium Term Resource Framework (MTRF). The MTRF is the expenditure-planning tool that enables Government to direct future donor and Government expenditure to fill existing funding gaps. The MTRF will be used to generate indicative sector ceilings to guide Government's development expenditure over the seven expenditure priority areas.

Performance Management of the Development Budget

To establish a performance framework, the Government has chosen a sample of key performance indicators that reflect MTDS implementation in each focal sector. These indicators have been determined through collaboration and consultation between relevant Government agencies and wider stakeholders. It is envisaged that performance against these indicators will be used to influence discrete budgetary decisions when the various Government committees presiding over Budget formulation sit to deliberate over the 2008 Budget.

G. Financing

The Government's total net financing requirement in 2008 – equal to the Budget surplus – is forecast to be minus K229.1 million. This means that, everything else being equal, total debt will fall in 2008, bringing total public debt to K6,485.5 million, or 36 per cent of GDP – the lowest since 1981.

Despite the overall debt repayment, the Government will continue to engage with international financial institutions for limited external borrowing on concessional terms, as long as the expenditures are consistent with government priorities and are within the Budget ceiling. No commercial borrowing is required.

During 2008 the Government will continue with the inscribed stock program to lengthen the maturity structure of government debt and to reduce rollover and interest rate risk. Together with the reduction in external debt, which reduces foreign exchange risk, this should considerably strengthen the Government's financial position and help to insulate the Budget from short term economic shocks.

H. Conclusion

The above set of policies has the specific endorsement and approval of the Cabinet and will guide and direct central agencies and departments in preparation of the 2008 Budget.