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PUBLIC FINANCE AND ECONOMIC ACT 1998 -

- BUDGET POLICY STATEMENT: BUDGET 2001

Budget Policy Statement: Budget 2001

1 STATEMENT OF RESPONSIBILITY

The following Financial, Economic and Budget Policy Statement is made with reference to and in accordance with Sections 9, 10, 13, 14, 17, 18, 23 and 24 of the Public Finance and Economic Management Act 1998.

Section 9 requires the Government to:

- Specify its economic and financial policies; including those relating to key economic and fiscal variables; and

- State the discipline it will adhere to in economic and financial dealings.

Section 10 requires the Government to:

- State its **long-term objectives** for fiscal policy in terms of major economic and fiscal variables;

- Specify the main **strategic priorities** guiding the preparation of the budget;

- Indicate the **Government's intentions** (or **targets**) for fiscal and economic variables; and

- Provide an assurance that the long-term objectives outlined in the statement are:

- Consistent with the Principles of Responsible Fiscal Management laid down in Section 22 of the Public Finance and Economic Management Act; and

- Consistent with previous statements i.e. an assurance that policies have remained consistent over time, or justify their departure.

Pursuant to Section 10, the Government confirms that the fiscal policy objectives, strategic priorities and intentions are consistent with the Principles of Responsible Fiscal Management specified in Section 22 of the Public Finance and Economic Management Act of 1998 and that there is broad consistency with the previously published statement.

Honourable Mokin Stevens, MP	Jeffery Wilfred
	Director General
Minister of Finance & Economic Management	Ministry of Finance & Economic Management

2 ECONOMIC AND FINANCIAL POLICY

2.1 Government Vision and Philosophy

The vision underlying the Government's financial and economic reforms is of a fast, but sustainably growing economy where the rewards of growth are widely spread to ensure equitable distribution of income and wealth over time. The Government is committed to:

- A cohesive, well-governed and democratic nation with a sense of common destiny;
- A high level of economic prosperity;
- Empowerment of individuals, families and communities;
- A well-educated and trained workforce;
- Improving levels of health care;
- Infrastructure necessary for private sector growth;
- Reduced disparities between islands, men and women, rural areas and towns;
- Positive development of traditional values and customs; and
- Protection of the physical environment.

Achievement of this vision is dependent on increasing confidence in the country and on a subsequent resurgence of growth in the economy based on private sector led growth.

The Government's underlying philosophy will continue to see it working towards the achievement of:

- Stable government;
- Stable macro-economic environment;
- Good governance incorporating transparency and accountability;
- Sound and effective legal system;
- Human resources development;
- Sound micro-economic policies which increase productivity and enhance competitiveness;
- Private sector development; and
- Social equity and sustainability.

The Government recognises that it is the private sector that must take the lead in achieving higher growth. Sustainable growth can only be based on a dynamic private sector operating in increasingly competitive conditions. Sustainable growth also means that all sections of the community must have increased access to income earning opportunities. Providing ni-Vanuatu with the means to go into business is a critical component of the reform effort. Better education, training, business advice and access to credit are key elements of this strategy.

The Government's central role will be to provide the stable conditions necessary for private sector investment. This means reducing its direct participation in business to allow space for private initiatives. It also calls for an efficient public service governed by transparent rules and regulations. Predictable policies and a stable macro-economic environment are also critical pre-conditions for private sector investment.

The recent economic reforms have been wide-ranging and it will take several years to fully implement all the reforms. The Government is therefore committed to ensuring that financial and economic policies are maintained consistently over time and will persevere with reform policies for as long as it takes to achieve its development objectives.

2.2 Responsible Fiscal Management

The disciplines that Government will adhere to in its economic and financial dealings are based on the Principles of Responsible Fiscal Management which are laid down in the PFEM Act. These principles are:

1. Managing total State debt at prudent levels by ensuring that where such levels have been exceeded, the total overall expenditures of the State in each financial year are less than its total overall receipts in the same financial year;
2. Achieving and maintaining levels of State Net Worth that provide a buffer against factors that may impact adversely on the State's Net Worth in the future;
3. Managing prudently the fiscal risks facing the State; and
4. Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

3 BUDGET POLICIES

3.1 Strategic Priorities

3.1.1 Stable Government, Including a Macroeconomic Environment Conducive to Growth

- Maintenance of macro-economic stability through sound monetary, fiscal and exchange rate policies. This is a pre-condition for a sustainable balance of payments position and confidence in the Vatu to provide an economic environment for strong growth, with continuing low inflation.
- Continued strengthening of the public sector to ensure that it carries out its core roles effectively and efficiently.
- Further strengthening of the institutions of governance (such as Parliament, the Judiciary, the Police, the Public Prosecutor, the Ombudsman's Office and the Public Service), and clarification of the interface between politicians and public servants.
- The Government will continue to move out of business activities in order not to compete with the private sector.

3.1.2 Private Sector Development

- Encouragement of Ni-Vanuatu business development through improved access to credit, business training and advisory services.

- Continue to create a fairer and more efficient tax regime by creating incentives that encourage work, savings and investment.
- Continue to move towards greater openness to the global economy by encouraging foreign investment and promoting policies supporting internationally competitive exports.
- Prepare and implement a long-term Master Plan for transport infrastructure development.
- Formulate and implement sector policies and programmes especially in education and training to support private sector development.
- Capitalise on opportunities presented within the framework of the Melanesian Spearhead Group, Forum Secretariat and the World Trade Organization.
- Lower the cost structure of the economy by:
  - (i) encouraging stronger competition;
  - (ii) creating a regulatory framework for public utilities aimed at removing distortions in the economy;
  - (iii) pursuing more flexible wage structures that are internationally competitive in relation to productivity (including through the work of the new Remuneration Tribunal); and
  - (iv) pursuing an appropriate relationship between wage and exchange rate policies.
- Facilitate expansion of Vanuatu exports especially in agriculture, fisheries and tourism.
- Reform the land law system to minimize uncertainty about land tenure and facilitate investment and encourage better land use.
- Phased liberalisation of domestic industry, resulting in greater competition and thus reduction in the cost structure.

3.1.3 Education, Health and Social Equity

The Government recognizes that economic growth that benefits only a few people in the economy is not desirable and only leads to social injustice which may disrupt the process of development. Therefore, the Government emphasises that the benefits of growth must be distributed fairly and evenly.

Furthermore, it recognizes that improved education and health services are important preconditions for development. That is, a well-educated and healthy population is critical for the attainment of sustainable national development. The Government's policies here include:

- Further expansion of courses at INTV to cater for the country's technical skills needs.
- Restructuring and strengthening of the Health Ministry to ensure that it carries out its role effectively and efficiently.
- Gradually increasing the portion of the National Budget spent in the health and education sectors.
- Ensuring that the Education Master Plan is completed and implemented effectively and that education planning capacity is further strengthened. Also that

the Human Resources Development Plan is completed and implemented effectively.

3.1.4 Policy initiatives for 2001

Policy initiatives for 2001 are focused on achieving the three main objectives of government: stable government, private sector development and social equity and sustainability. These will involve the following:

- Further consolidation of fiscal responsibility by continuing the move started in 1999 towards a recurrent balanced budget following high and unsustainable deficits in earlier years;
- Introducing annual Ministry reports to improve accountability and transparency of Government operations;
- Improving the operation of the legal sector and judiciary by implementing a long term institutional strengthening project based on the Legal Sector Action Plan;
- Strengthening the independence and performance of all public employment bodies by reviewing the operations of the Teaching Service Commission and Public Service Commission (PSC) and pursuing an institutional strengthening project at PSC;
- Implementing decisions made by the Government's Remuneration Tribunal to review salaries and allowances for professional civil servants with a view to increasing market flexibility, though in the context of lowering wage costs in both public and private sectors of the economy, especially at unskilled levels;
- Lowering the cost structure of the economy by establishing regulatory regimes for utilities, transport and the Post Office;
- Organizing training for Ni-Vanuatu in business skills through further strengthening of the recently established Ni-Vanuatu Business Development Centre and developing and delivering business courses;
- Establishing a micro finance loan scheme to improve access to credit by Ni-Vanuatu;
- Developing and commencing the next phase of the CRP, including focus on outer islands development, improved service delivery and the environment;
- Holding impact-monitoring orientation courses for NGO's, Social Equity Task Force, D.G's and Ministers; and
- Establishing an Impact Monitoring System to assess the effect of the reforms on all sections of the society.

3.2 Long term Fiscal Objectives

3.2.1 Fiscal Framework

In regard to the collection of revenue and expenditure of Government funds, the Government will:

- Comply with responsible spending levels reflecting a more focussed role for Government;

- Achieve a balanced recurrent budget in 2001 and surpluses over the medium-term to allow for contingencies such as debt repayments and unforeseen circumstances such as natural disasters;
- Ensure that all new borrowings finance high return developmental projects and not recurrent activities and are consistent with the Government's debt management policy; and
- Allocate expenditures consistent in a way with clear and realistic service targets of Government institutions that reflect Government priorities.

The successful implementation of fiscal stabilization measures during fiscal year 2000 is encouraging and will help maintain the momentum of the economic restructuring in terms of:

- Consolidating the gains emanating from implementation of programme budgeting;
- Ongoing improvements in compliance and collection of tax and non-tax revenues;
- Strengthening the capacity of the public service; and
- Maintenance of tight controls over recurrent expenditures until cash position improves.

3.2.2 Revenue Objectives

The breadth and robustness of the Government's revenue base, along with the ability of Government agencies to administer the collection of these taxes, are key factors in assisting the Government to meet its various objectives. A sound and wide revenue base accompanied by a high degree of voluntary compliance will enhance the Government's ability to encourage and promote private sector driven growth and to meet its social policy targets.

As part of the implementation of the CRP, a Revenue Strategy Committee has been established with the objective of reviewing the current revenue base in order to propose options to widen the revenue base. This is in line with the CRP document, endorsed by the 1997 Summit, which proposed that revenue should, in the long term, rise from its present level of around 22 to 23 per cent of GDP, to 27 per cent of GDP.

3.2.3 Expenditure Objectives

The Government has, from 2000 presented an integrated recurrent and development budget. The integrated budget incorporates all expenditures funded from domestic and external sources including aid funds.

The Government's long-term objectives are for expenditure levels to be consistent with:

- Accumulating and maintaining cash reserves consistent with the cash flow needs of government operations and sufficient as shock absorbers against shocks resulting from unexpected natural disasters or sudden changes in external conditions;
- Gradually increasing its development expenditures (to around 25% of total expenditures), which are consistent with the Government national development goals and debt management policy;

- Providing priority expenditure allocations to education, health and infrastructure, while de-emphasising central agency and administrative expenditures; and
- Maintaining a prudent level of debt.

In order to build up cash reserves the Government will have to ensure that total expenditure is kept in line with domestic revenue. This policy objective will be achieved in the 2001 Budget which aims for a balanced recurrent budget. Recurrent budget surpluses are targeted over the medium term.

Increased developmental expenditure is important for the maintenance of existing infrastructure and the building of new infrastructure. It is critical that only quality investments are accepted for funding. The funding sources chosen for such investments will be determined within the framework of the Government's Deficit and Financing Objectives.

3.2.4 Deficit and Financing Objectives

Government's long term objective for the overall budget deficit is to ensure that borrowing is limited to financing development expenditures. Furthermore, deficits will only be budgeted after loans to finance the deficit have been arranged. In addition, any borrowings for development expenditures must be based on sound analysis of the projects to be financed and where the demonstrated rates of return of such projects are well in excess of the cost of borrowing.

Government will not undertake net new borrowing to finance recurrent expenditure.

Borrowing for development projects will be the exception rather than the rule. On average, 95% of development projects are funded by cash grants and aid-in-kind. Projects financed through aid-in-kind are not, at present, featured in the government's budgeted expenditure.

The first priority for financing development projects is cash grants and aid-in-kind. If grant funding (including aid-in-kind) are not sufficient to fund approved development expenditures then borrowing will be considered.

Two sources of borrowing are available for financing development projects – domestic and overseas. When borrowing from overseas, government will only consider concessional borrowing. This will normally mean borrowing from multilateral agencies such as the World Bank or ADB.

The choice of borrowing from the domestic market or from overseas, depends on the costs and risks of each choice. In general, domestic borrowing is to be preferred over external borrowing. This is because domestic borrowing is made in Vatu and so there is no exchange risk involved. However, domestic borrowing is done on a commercial basis with the interest cost determined by the local financial market. Concessional loans from overseas may sometimes therefore be less costly, and, if the exchange risk is judged to be small, and liquidity in the domestic capital market relatively tight such loans could be incurred to avoid crowding out domestic private investors.

If borrowing for a development project is necessary, Government will make the decision on whether to borrow domestically or from overseas on a case-by-case basis based on the costs and risks of each source at that time.

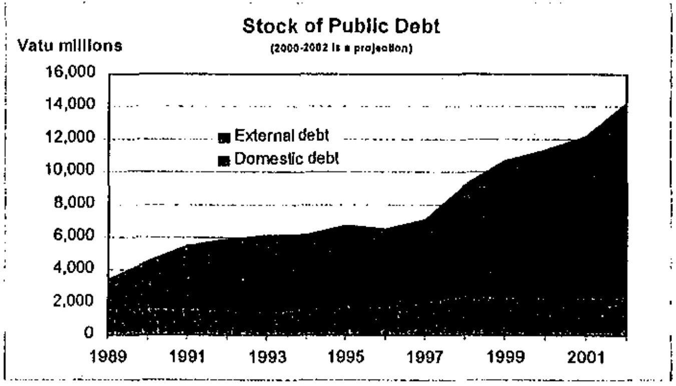
Government's effort to develop the local capital market, a major objective of financial sector reform under the reform programme, is an important determining factor in future decisions on balancing domestic and external borrowings for development financing.

Limits to borrowing

But there must be limits on the amount of borrowing government undertakes. Extra borrowing builds up the amount of debt in the country. This debt must be serviced and must be repaid. The PFEM Act requires that government must be prudent in its approach to debt. A prudent level of debt is defined as a level of debt that results over an extended period of time in:

- annual debt service costs (domestic and foreign interest, charges and external principal repayments) of no more than 8% of domestic revenue, and
- a total stock of external public debt of no more 40% of GDP.

In 2000 total debt service costs as described above are projected at 5.7% of domestic revenue. By 2002 this will have risen slightly to 6.5% as the payment of recently procured external debt begins to take effect. Nevertheless, the Government debt servicing expenditure is still within prudent limits to 2002. Maintaining prudent levels will depend heavily on running low and responsible budget deficits and on maintaining a sound financing strategy over the coming years.



During the period 1997 to 1998 there was a build up in levels of **domestic debt** in large part related to financing the Provident Fund crisis. In the short-term, the aim is to stabilise domestic debt levels by running zero to negative net domestic financing outcomes. In the longer term, reductions in domestic debt levels will be pursued as the recurrent budget moves into surplus.

The stock of **external debt** has risen rapidly in recent years and in 2000 stands at Vatu 8.9 billion, or 30.2% of GDP. This compares with a stock of external debt of only Vatu 2.8 billion, or 15.6% of GDP, in 1990. By 2002 external debt will be Vatu 11.8 billion, or 36.1% of GDP, based on current projections in the Half Year Economic and Fiscal Update. Clearly such a continued increase in external debt is unsustainable and limits need to be placed on the size of external debt.

Government considers it prudent to limit external debt over the medium term to an average of 40% of GDP. This limit would allow new borrowings to finance priority development projects but would ensure that the growth of external debt is stabilised at a level which is manageable. This would keep Vanuatu just below the average external debt to GDP ratio for all developing countries.

3.3 Economic and Fiscal Targets

The national economic and financial management performance of the Government will be measured against the following targets:

- Economic growth (real) averaging at least 4.0% per annum over the next three years providing for an improvement in income per capita and higher employment growth. This implies that average rate of economic growth, (as measured by changes in real Gross Domestic Product), will exceed that of population growth during that period.
- Inflation (CPI) averaging no more than 3% over a three-year cycle.
- Competitive real effective exchange rates will be maintained.
- Annual surpluses in the Government's recurrent budget will be achieved thereby allowing government savings to accumulate and for part of the Government's investment programme to be financed from internal resources.
- Overall budget deficit to average no more than 2 per cent of GDP over the coming three year period.
- Net domestic financing of the deficit to be negative or at worst zero over a three year cycle.
- Ratio of External Public Debt to GDP, to be maintained in the medium term at 40% or less.
- Percentage shares of the following components of the national expenditure budget to be adjusted in the following directions over the next three years:

	Average of 1998 to 2000 budgets	*Medium Term Target*
Recurrent Expenditure	***79.4***	***75.0***
Development Expenditure	***20.6***	***25.0***
Wages and Salaries (As % of Recurrent)	***55.0***	***50.0***
Recurrent expenditures of Central Government Administrative/Economic Ministries (MFEM-excluding debt service, Prime Ministers, PSC, Trade and Business Development (As % of Recurrent)	19.6	12.0
Total Expenditures (Recurrent plus Development), Ministry of Education, Youth and Sport (As % of Total Expenditure)	21.7	26.0
Total Expenditures (Recurrent plus Development)Ministry of Health (As % of Total Expenditures)	11.4	14.0

- Domestic Revenue (tax revenue and other domestic receipts excluding grants) at around 25% of GDP over the medium term with a long-term objective of 27% of GDP.

- Achieve consistent annual improvements in the relative placing of Vanuatu in the World Human Development Index Table.

3.4 Expenditure priorities for the 2001 budget

The 2001 Budget will be consistent with the economic and financial performance targets above. The Government's main expenditure priorities continue to be in the key sectors of education, health and infrastructure as shown below:

- Education – between the years 1998 and 1999 the education sector's budget increased marginally from 25% to 26% of the overall budget respectively. Their share of expenditure for 2000 is forecast to be 26% of the overall budget expenditure. This is planned to remain the same in 2001 to 26% in line with the medium term target of 26%.
- Health - between the years 1998 and 1999 the health sector's budget was 12% of the overall budget respectively. Health's share of expenditure for 2000 is forecast to be 13% of the overall budget expenditure. This is planned to remain the same in 2001 to 13% thus moving towards the medium target of 14%.
- Infrastructure – share of expenditure for 2000 was 11% of the overall budget expenditure. It is also budgeted to be 11% of total expenditure and net lending in 2001. However, this excludes donor-funded expenditure.
- The Government will be targeting its recurrent expenditure on servicing the rural areas, which comprised 80% of the total population.