Pacific Economic Monitor

BUDGET ANALYSIS

December 2014

www.adb.org/pacmonitor

The *Monitor* provides an update of developments in Pacific economies and explores topical policy issues.

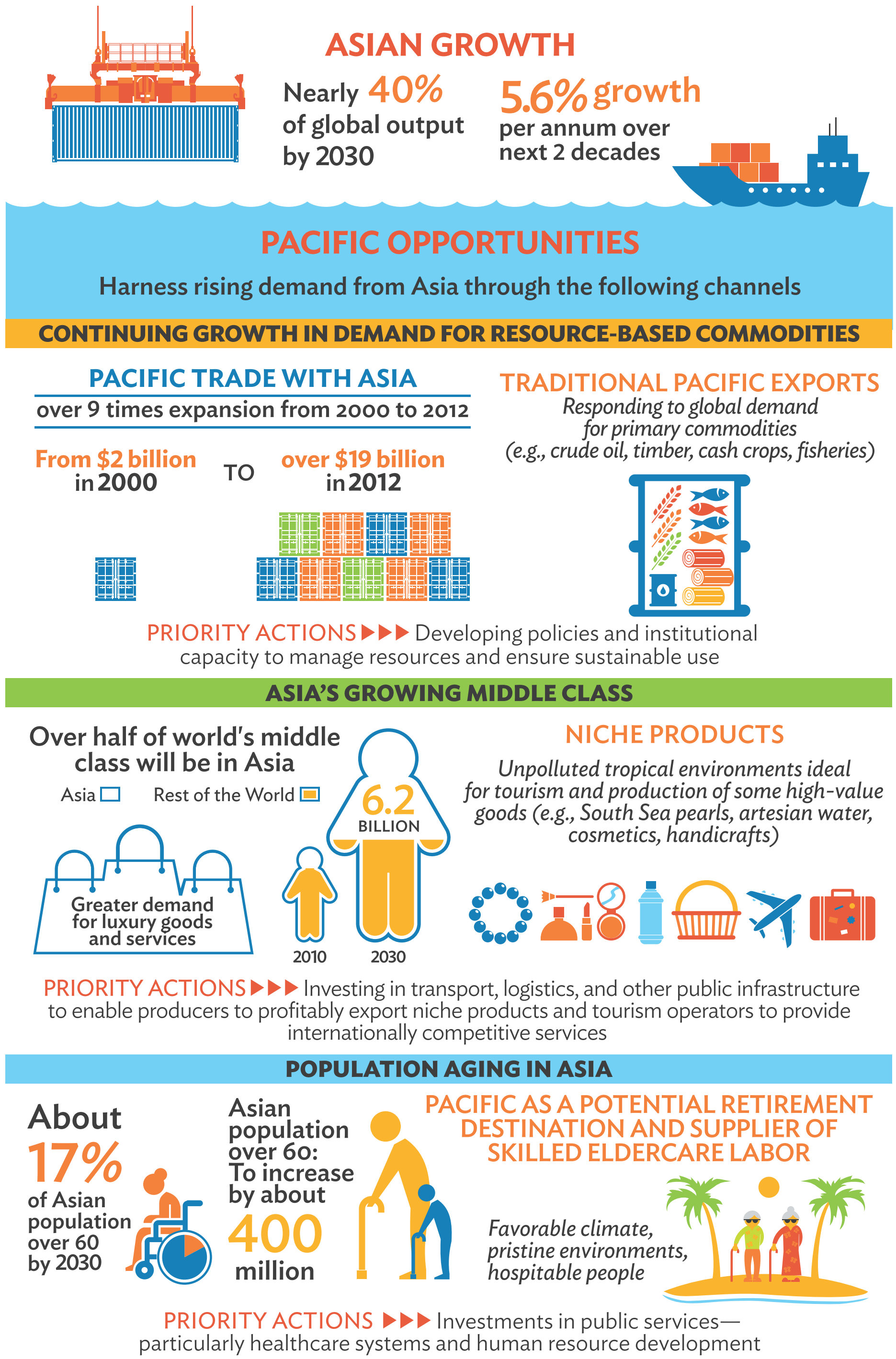
Contents

Highlights

- **Robust revenue collections in smaller Pacific economies.** Rising rates under a regional vessel day scheme continue to support strong fishing license revenues in Kiribati, the Republic of the Marshall Islands, the Federated States of Micronesia, Nauru, and Tuvalu. Increased economic activity and improved compliance are also pushing tax revenue collections higher in Fiji, Palau, Tonga, and Vanuatu.

- **Limited 2015 expenditure growth planned in larger economies.** High revenues have underpinned expanding budget allocations in large resource-rich economies, but low implementation rates limit the development gains. For 2015, Papua New Guinea plans fiscal consolidation to reduce its deficit, while Timor-Leste is budgeting a minimal increase in total expenditure to bring budgeted and actual expenditures closer.

- **Seizing new opportunities.** This issue's policy briefs consider longer-run opportunities and challenges facing Pacific economies from changing external conditions. Efforts to utilize scarce public resources more effectively in developing the infrastructure and institutional capacity needed to harness emerging opportunities are explored—focusing on efforts to improve fiscal planning and management.



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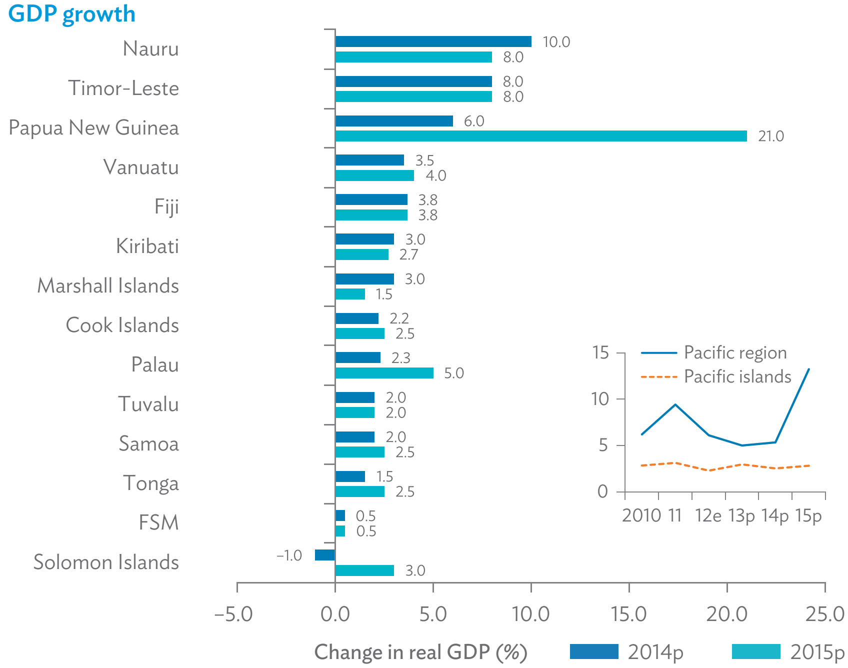
Abbreviations

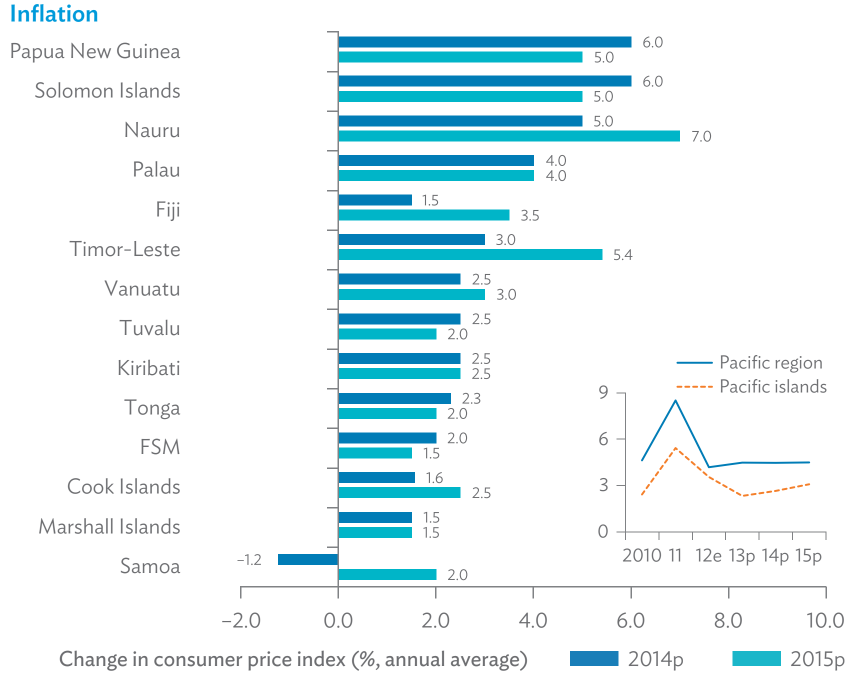
$	US dollar, unless otherwise stated
A$	Australian dollar
ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
DMC	developing member country
FMM	fiscal management model
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
lhs	left-hand scale
LNG	liquefied natural gas
m.a.	moving average
PEM TA	Pacific Economic Management Technical Assistance project
PFTAC	Pacific Financial Technical Assistance Centre
NZ$	New Zealand dollar
PNG	Papua New Guinea
PPP	public–private partnership
PRC	People's Republic of China
RPC	Regional Processing Centre
rhs	right-hand scale
RMI	Republic of the Marshall Islands
SOE	state-owned enterprise
US	United States
y-o-y	year-on-year

Asian Development Bank projections

GDP growth



Inflation



e = estimate, FSM = Federated States of Micronesia, GDP = gross domestic product, p = projection.
Note: Projections are as of November 2014 and refer to fiscal years. Regional averages of gross domestic product (GDP) growth and inflation are computed using weights derived from levels of gross national income in current US dollars following the World Bank Atlas method. Averages for the Pacific islands exclude Papua New Guinea and Timor-Leste. Timor-Leste's GDP is exclusive of the offshore petroleum industry.
Source: ADB estimates.

Notes

This *Monitor* uses year-on-year (y-o-y) percentage changes to reduce the impact of seasonality, and 3-month moving averages (m.a.) to reduce the impact of volatility in monthly data.

Fiscal years end on 30 June for the Cook Islands, Nauru, Samoa, and Tonga; 30 September in the Marshall Islands, the Federated States of Micronesia, and Palau; and 31 December elsewhere.

International and regional developments

Global growth outlook softens

- A weakening global economy could dampen near-term growth prospects in the Pacific, but the outlook for the region's major economic partners remains relatively robust. Major economies grew more weakly than expected in the first three quarters of the year, and global output is now expected to grow by 3.0% in 2014 (from an initial 3.5%) according to the average projections of the Economist Intelligence Unit, the International Monetary Fund (IMF), and the Organisation for Economic Co-operation and Development. Economic growth is projected to accelerate to 3.6% in 2015, but conflicts in the Middle East and Ukraine, as well as the threat of Ebola, raise risks that threaten the global growth outlook.

- Recovery in the eurozone has faltered and growth is now seen at 0.8% in 2014, down from an earlier average projection of 1.2%. Weak demand continues with consumer confidence showing signs of deterioration. In September, the European Central Bank unexpectedly reduced its policy interest rate and launched an asset-purchase program to stimulate growth. Conversely, the United States (US) officially ended its Quantitative Easing bond-buying program in October, as economic momentum continues, with growth projected at 2.2% in 2014 and 3.1% in 2015. In Japan, the economy entered recession in the third quarter due to stronger than anticipated impact of higher consumption taxes. Growth for 2014 is seen at 1.1% from a previous forecast of 1.4%.

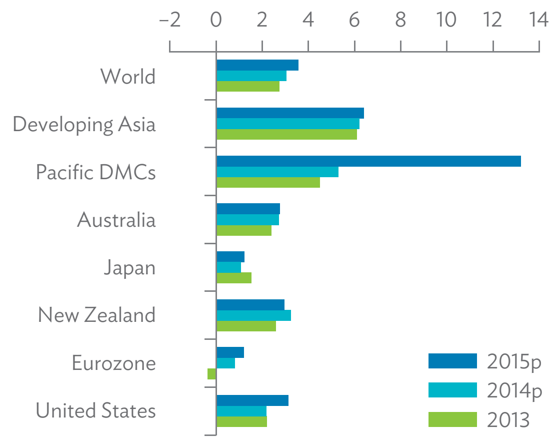
- Developing Asia is still expected to grow by 6.2% in 2014 before slightly accelerating to 6.4% in 2015, according to the *Asian Development Outlook 2014 Update*. Growth in the People's Republic of China (PRC) is seen to remain relatively flat—from 7.5% in 2014 to 7.4% in 2015. In contrast, growth in India is expected to accelerate from 5.5% in 2014 to 6.3% in 2015 on the back of renewed business and consumer confidence following the outcome of the general elections in April and May.

- GDP growth in Australia is expected to increase from 2.4% in 2013 to around 2.7% in 2014 and 2.8% in 2015. Growth was mainly driven by higher net exports, as higher volumes of mineral exports countered the effects of lower prices for key commodity exports. Higher private consumption and investment further boosted growth. With the government aiming to reduce the fiscal deficit from an equivalent of 2.8% of GDP in FY2014 (ended 30 June) to 1.6% in FY2015 and targeting a surplus by FY2018, public spending provides little stimulus for growth. Despite the fairly positive growth outlook, unemployment rose to 6.1% in September 2014, its highest rate since 2003.

- In New Zealand, GDP growth is seen to rise from 2.6% in 2013 to 3.2% in 2014, before moderating slightly to 3.0% in 2015. Growth is anchored on rising exports, strong consumer confidence, and stable housing and construction investment. There are no anticipated major changes in fiscal policy as the current government has been reelected to a third consecutive term in September. From a deficit equivalent to 1.1% of GDP in FY2014 (ended 30 June), fiscal surplus is expected at 0.2% of GDP in FY2015 and is projected to rise to 1.1% in FY2018.

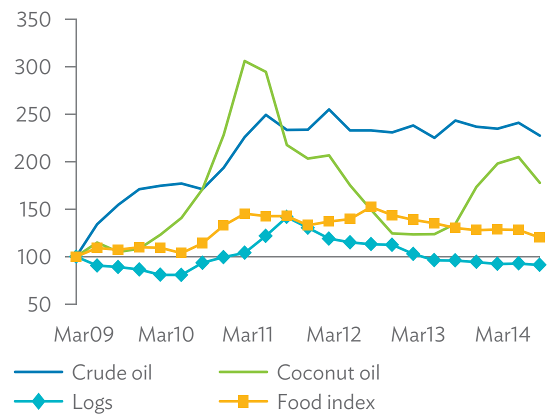
- The average price of crude oil fell to $86 per barrel in October from $108 in June, while food prices fell by 6.7% over the first 3 quarters of 2014 (y-o-y). The IMF projects continuing declines in international food (–7.9%) and fuel (–3.3%) prices through 2015.

GDP growth
(%, annual)



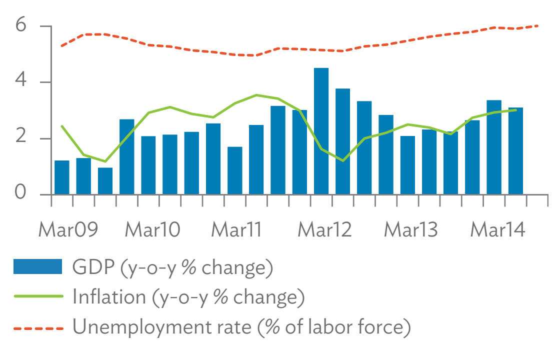
DMC = developing member country, GDP = gross domestic product, p = projection.
Note: Developing Asia and Pacific DMCs based on ADB definition. 2013 figures are based on ADB estimates for developing Asia, Pacific DMCs, and the world.
Sources: ADB. 2014. *Asian Development Outlook 2014 Update*. Manila; CEIC; Economist Intelligence Unit; International Monetary Fund; Organisation for Economic Co-operation and Development.

Commodity prices
(March 2009 = 100, quarterly)



Source: World Bank Commodity Price Data (Pink Sheets).

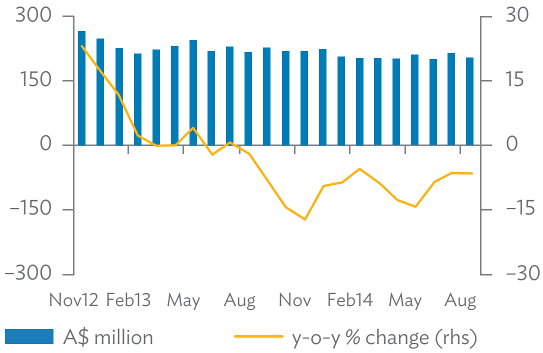
Australia economic indicators
(quarterly)



Sources: Australian Bureau of Statistics and CEIC.

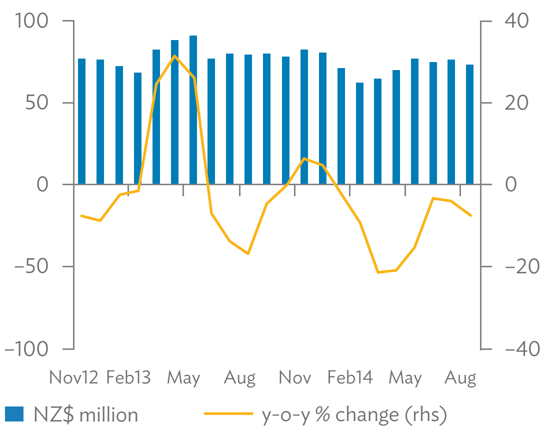
International and regional developments

Nonfuel exports from Australia to the Pacific (3-month m.a.)



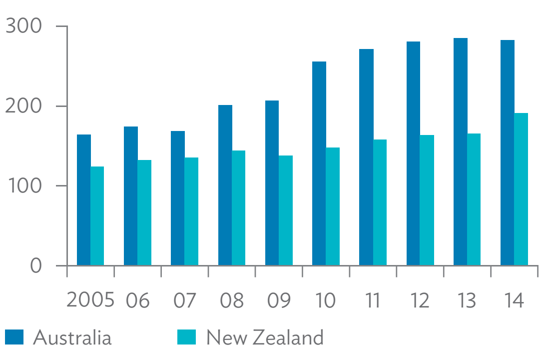
A$ = Australian dollar, m.a. = moving average, rhs = right-hand scale, y-o-y = year-on-year.
Source: Australian Bureau of Statistics.

Nonfuel exports from New Zealand to the Pacific (3-month m.a.)



m.a. = moving average, NZ$ = New Zealand dollar, rhs = right-hand scale, y-o-y = year-on-year.
Source: Statistics New Zealand.

Tourist departures to Pacific destinations ('000, January–August totals)



Sources: Australian Bureau of Statistics and Statistics New Zealand.

Lead authors: Prince Cruz, Christopher Edmonds, Rommel Rabanal, and Cara Tinio.

Import bills down on international price declines and completion of infrastructure projects

- The value of Pacific nonfuel imports from New Zealand fell by 40% (y-o-y) between January and August 2014. Decreased imports of vegetables and iron and steel in Fiji; iron and steel, and machinery in Papua New Guinea (PNG); and wood and machinery in Samoa led the decline. Lower international prices and the completion of PNG's liquefied natural gas project both contributed to the falling import bill. PNG's nonfuel imports from Australia—mainly machinery and transport equipment—also fell during the first 8 months of 2014, driving a 25.1% drop (y-o-y) in the value of Pacific nonfuel imports from Australia.

- The value of regional exports to New Zealand also decreased by 6.6% (y-o-y) during the period January–August 2014. Lower processed food and clothing export earnings from Fiji and, to a lesser extent, phosphate export earnings from Nauru, led this decline. In contrast, the value of Pacific exports to Australia increased by 26.7% (y-o-y) during the same period as PNG exported higher volumes of crude oil.

- As a result of these developments, the region's trade deficit with New Zealand narrowed by 12.0% (y-o-y) to NZ$509.7 million. The Pacific also realized a trade surplus with Australia of A$1.0 billion during the first 8 months of 2014, compared with a A$74.7 million deficit incurred over the same period a year ago.

Divergent departure trends from major Pacific tourist source markets

- After a strong start to 2014, departures from Australia to South Pacific destinations have fallen, while those from New Zealand continue to increase at a rapid pace. This divergence has emerged despite simultaneous appreciations of the Australian and New Zealand currencies.

- Australian tourism to the South Pacific fell by 0.8% over the first 8 months of 2014 compared with the same period last year. It appears that a strengthening Australian dollar may have spurred diversion of outbound overseas tourism from the Pacific to more distant and expensive destinations, as departures to non-Pacific destinations have continued to grow robustly. Departures from Australia to Fiji and Vanuatu—the top two Pacific destinations for Australian tourists—declined slightly, while arrivals to Tonga recorded minimal growth. Australian tourism to the Cook Islands and Samoa, however, maintained relatively solid expansion over the same period.

- In contrast, New Zealand tourism to the Pacific has built upon its strong performance from early 2014. Departures from New Zealand to South Pacific destinations rose by 15.4% from January to August 2014 (y-o-y)—outpacing growth in tourism to non-Pacific destinations. Fiji, Samoa, Tonga, and Vanuatu, all recorded double-digit growth in the number of visitors from New Zealand. The Cook Islands—the largest Pacific market for New Zealand tourists—sustained strong growth in the first 8 months of 2014 compared with the same period last year.

- Tourism flows from Asia to Pacific destinations have also been increasing in 2014. In particular, rising visitor arrivals from the PRC are boosting tourism performance in the Cook Islands, Fiji, and, especially, Palau.

Cook Islands

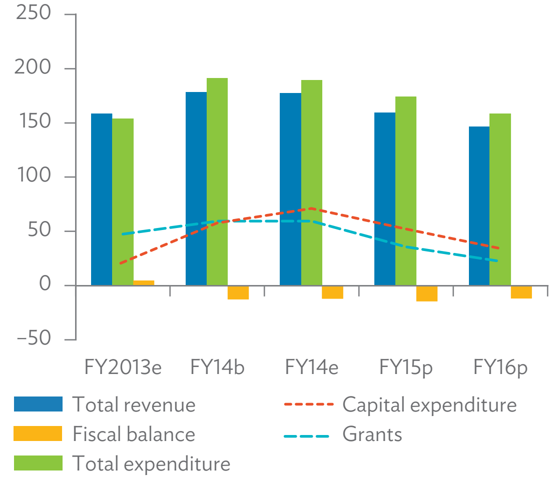
- The FY2014 (ended 30 June) fiscal deficit is estimated at NZ$5.1 million (equivalent to 1.2% of GDP)—more than three times the NZ$1.6 million target. This was driven by a 32.6% (y-o-y) increase in total expenditures on the back of a 6.0% rise in welfare payments and 31.0% growth in outer islands operating costs. Capital expenditure rose by 15.0% (y-o-y), while payments to Air New Zealand and the petroleum company under government guarantees fell by 12.0% and 14.0% (y-o-y), respectively. Total revenues in FY2014 were 6.1% higher than in FY2013 due to increased collections from departure taxes and import levies on alcohol and tobacco. Value-added tax collections also grew by 5.3% (y-o-y).

- Due to the dissolution of the Parliament in April prior to the elections, the FY2015 budget was delayed. In November, the government passed a NZ$123.2 million budget, with education, health, and infrastructure as priority sectors.

- Visitor arrivals grew by 1.6% (y-o-y) in FY2014 driven by increased arrivals from Australia (2.9%), the US (5.8%), and Asia (34.3%). Arrivals from the main market of New Zealand grew by only 0.5%.

- The July election saw the Cook Islands Party win 12 seats, the Democratic Party 9 seats, and the One Cook Island Party 2 seats. The results of a by-election for the remaining seat (representing the outer island of Mitiaro), which will likely determine the next government, is on hold pending court action.

Fiscal balance
(NZ$ million, annual)



FY = fiscal year, lhs = left-hand scale, rhs = right-hand scale.
Sources: Cook Islands Budget Policy Statement and 2013/2014; Cook Islands Government Budget Estimates 2013/14; and Cook Islands Half Year Economic and Fiscal Update 2014/2015.

Lead authors: Malie Lototele and Robin Boumphrey.

Fiji

Budget performance 2014

- The budget deficit is projected to expand to the equivalent of 2.0% of GDP in 2014. This follows a revised 2013 deficit estimate equivalent to only 0.5% of GDP—the lowest in the past 5 years.

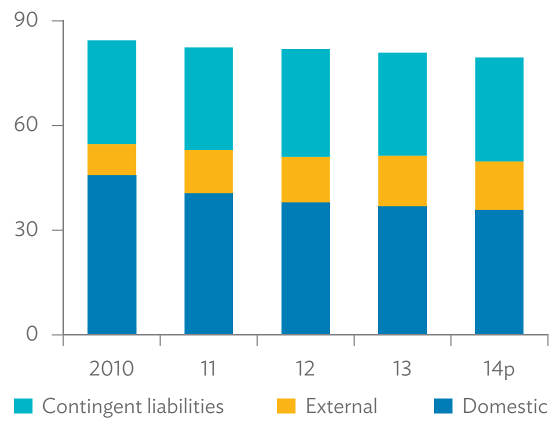
- Improvements in the health of the economy pushed total tax revenue up 17.3% (y-o-y) at the end of September, and nearly 7.0% above the target for the period. Higher consumer spending and greater tax compliance contributed to increased collections of value-added tax and of income tax. Customs duties were also 4.2% above revenue projections, largely due to an increase in vehicle imports.

- Public debt, excluding contingent liabilities, is projected at about $2.0 billion, or the equivalent of 49.7% of GDP, compared with 51.4% at the end of 2013. Nominal domestic debt rose slightly to $1.5 billion (from $1.0 billion at the end of 2013) with increased issuances of bonds and treasury bills. Substantial contingent liabilities, however, pushed the total debt burden closer to the equivalent of 80% of GDP.

Budget 2015

- The 2015 budget, passed in late November, plans for a further ramping up of road funding to $332 million, and more than doubles allocations for the water utility to provide free services. Free education, which was introduced at the primary and secondary levels last year, will be extended to preschool.

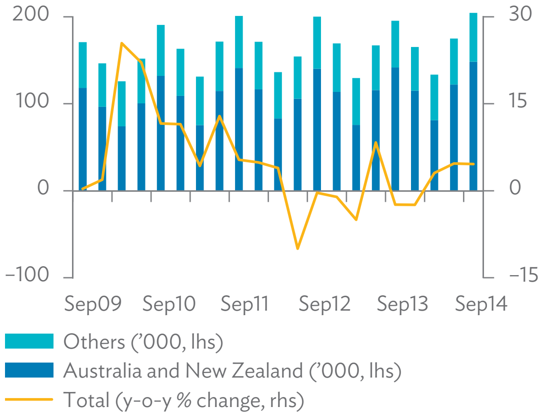
Public debt
(% of GDP, annual)



Note: For 2014, the estimate of contingent liabilities is as of June.
Source: Fiji Ministry of Finance.

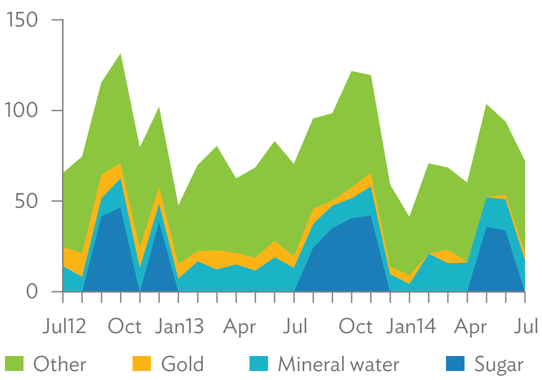
Fiji

Visitor arrivals, by source country ('000, quarterly)



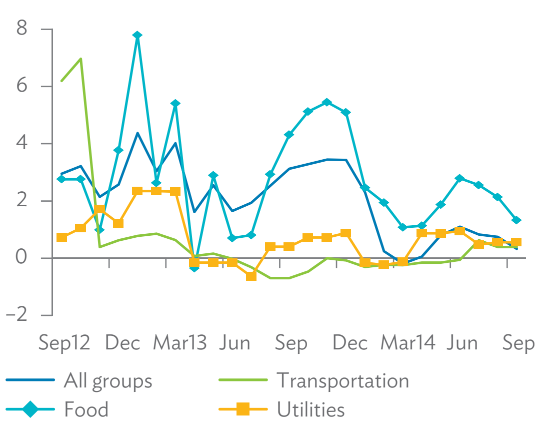
lhs = left-hand scale, rhs = right-hand scale, y-o-y = year-on-year.
Source: Fiji Bureau of Statistics.

Merchandise exports (F$'000, monthly)



F$ = Fiji dollar.
Source: Fiji Bureau of Statistics.

Consumer price index, by commodity group (y-o-y % change, monthly)



Source: Fiji Bureau of Statistics.

Lead author: Caroline Currie.

Health services delivery will also be strengthened by building a new hospital, hiring more doctors and nurses, and providing free medicines to low-income households.

- The planned increase in government expenditures is expected to be only partially covered by higher revenues, including from the introduction of new duties and excises for tobacco, alcohol, and softdrinks. The budget deficit is therefore projected to expand to the equivalent of 2.5% of GDP in 2015.

Recent developments

- The lead up to the elections and their successful conduct has seen investor confidence improve. According to the Reserve Bank of Fiji, private sector investment is expected to reach 15% of GDP in 2014, up from 13% in 2013. Growth is seen to be broad-based, led by construction, manufacturing, and financial and insurance services.

- Visitor arrivals reached about 380,000 over the first 9 months of 2014, a 4.2% increase compared with the same period last year. Tourist numbers from the main markets of Australia and New Zealand posted growth of 3.6% and 12.6% (y-o-y), respectively. Arrivals from emerging markets such as the PRC, which recorded a 13.4% y-o-y increase to nearly 16,000, provided a further boost. Tourism earnings for 2014 are forecast to reach $1.0 billion, which is 5.6% higher than in 2013.

- Fiji's merchandise trade deficit (excluding aircraft) widened as of the end of August as both exports and imports increased by 13% over the period. Exports are forecast to reach $1.1 billion in 2014 ($1.0 billion in 2013), and imports $2.5 billion ($2.2 billion in 2013). Mineral water exports increased by 15.3% (y-o-y), and sugar exports were recorded in May and June, a couple of months earlier than in recent years. Earnings from gold exports, however, fell sharply by 66% (y-o-y) as production fell by 64% (y-o-y). Foreign reserves declined from the equivalent of 4.8 months of imports in January 2014 to 4.6 months in October 2014. Inward remittances of $139.1 million (up by 14.3% as of September) and trade in services (tourism and air transport) continue to support Fiji's external position.

- Inflation remains low at an average of 0.7% (y-o-y) through the first 3 quarters of 2014. Food prices eased in the third quarter, while transport and utilities costs remained stable. Price pressures may increase during the final quarter of the year due to the possible effects of dry weather conditions on agricultural output and domestic food supply, as well as a potential increase in post-election economic activity.

Key issues

- The government's plans to extend its social protection network in the 2015 budget will leave limited fiscal space to maneuver. Substantial progress must be made in the government's public enterprise reform program—particularly after weak results in 2014—to help contain the fiscal deficit and debt level.

- Elevated levels of public investment and increased private consumption have pushed growth higher in recent years. Ongoing increases in public investment must translate into higher private investment and productivity to maintain high growth and make it more inclusive. This will require strong macroeconomic fundamentals, and steady progress with reforms designed to create a more business-friendly environment.

Kiribati

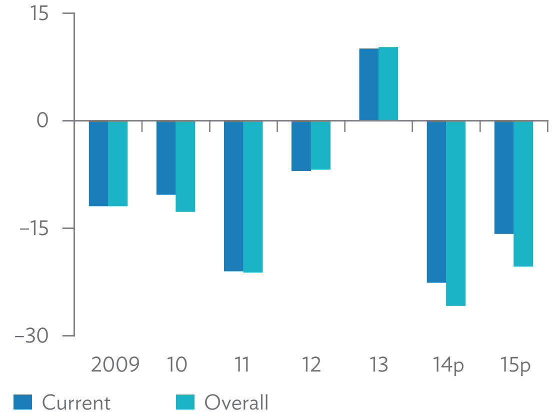
- The 2014 budget deficit is expected to reach the equivalent of 19.3% of GDP, to be funded through drawdowns from the Revenue Equalization Reserve Fund. According to the IMF, the budget deficit needs to be reduced to 5%–6% of GDP in order to achieve the government's informal target to restore the fund to its 1996 real per capita value.

- The government has fully repaid an $8.9 million loan from ANZ Bank for state-owned enterprise (SOE) activities. Under the government's public finance program, any new debt will be restricted to concessional loans from ADB; Taipei,China; and the European Investment Bank. In line with the SOE Reform Roadmap, work to privatize two SOEs is well advanced.

- Under a recently concluded agreement between the US and the Pacific Islands Forum Fisheries Agency, Kiribati will allocate 300 fishing days to US vessels. It will also implement arrangements that promote greater on-shore activity and achieve broader economic benefits for the country.

- Fishing license revenues from January to July 2014 reached A$43.8 million, exceeding full-year budget expectations. The government forecasts that, due to the El Niño effect and an increase in the vessel day scheme price from $6,000 in 2014 to $8,000, fishing license revenues in 2015 will be around A$75 million. However, the planned closing of the Phoenix Islands Protected Area to commercial fishing in January 2015, and overfishing of big-eye tuna, could have a negative impact on fisheries revenues.

Fiscal balance
(% of GDP, annual)



p = projection.
Source: International Monetary Fund. 2014. *Kiribati: 2014 Article IV Consultation—Staff Report.* May. Washington, DC.

Lead authors: Malie Lototele and Marinella Gamboa.

Marshall Islands

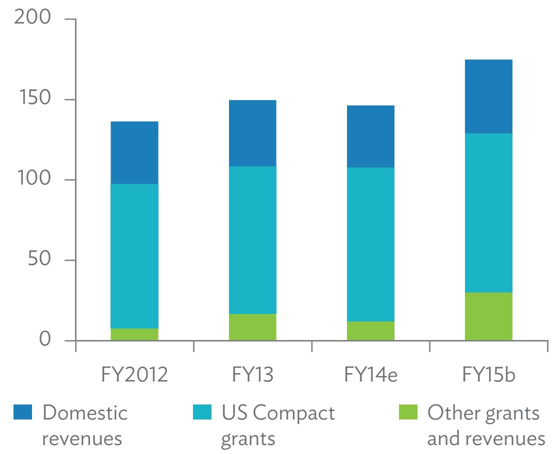
- Total revenues including grants in FY2014 (ended 30 September) are estimated at $146.2 million, roughly the same as forecast in the budget. The FY2015 budget projects a 19.5% increase in revenues. Higher fishing license fees and improved tax collection, as well as grants from ADB, the European Union, and the World Bank, are expected to boost total revenues. The recently concluded agreement between the US and the Pacific Islands Forum Fisheries Agency, which is expected to significantly raise the average vessel day fee, should provide a further boost to revenues.

- Grants under the Republic of the Marshall Islands' (RMI) compact agreement with the US will increase due to inflation adjustments to Compact Trust Fund (CTF) payments, along with rising rents from the Kwajelein airbase. These will outweigh decrements in other grant categories.

- The FY2015 budget targets a 3.0% cut in recurrent expenditures and subsidies to state-owned enterprises (SOEs), in line with the recently endorsed Decrement Management Plan. The plan seeks to prepare the economy for fiscal self-reliance when compact grants expire in 2023. The budget earmarks $2 million from domestic revenues and grants for deposit into the CTF, and allocates funding for infrastructure and other capital improvements.

- The Decrement Management Plan is required by the Joint Economic Management and Financial Accountability Committee (JEMFAC)—which oversees the RMI's compact agreement—for the release and use of funds. Along with the JEMFAC's sector-specific accountability measures (e.g., compliance with accreditation requirements, water and sanitation standards, and SOE performance benchmarks), the plan is expected to help the RMI adjust to a shrinking grant envelope under the compact agreement.

Sources of revenue and financing
($ million, annual)

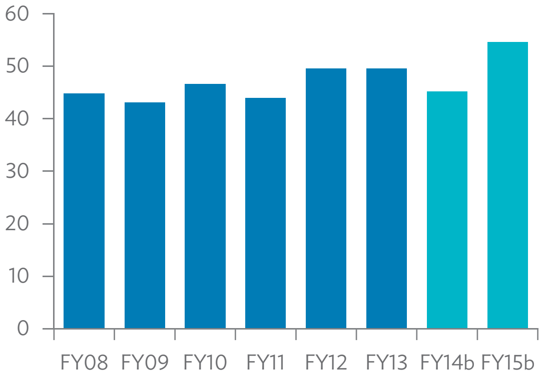


b = budget, e = estimate, FY = fiscal year.
Sources: Republic of the Marshall Islands budget documents, various years; and Nitijela of the Marshall Islands Appropriations Committee Report on the FY2015 Budget.

Lead author: Cara Tinio.

Micronesia, Federated States of

National government expenditures ($ million, annual)



b = budget, FSM = Federated States of Micronesia, FY = fiscal year.
Sources: FSM FY2013 Statistical Compendium, Graduate School USA, Pacific Islands Training Initiative; and FSM national budget documents.

Lead author: Prince Cruz.

- Domestic revenues for FY2014 (ended 30 September) were estimated to be 20.0% higher than budget projections, largely due to increased revenues from fishing licenses. However, expenditures rose to 31.4% above the original budget with the passage of several supplemental budgets. In a number of cases, Congress overrode the President's veto on increased spending.

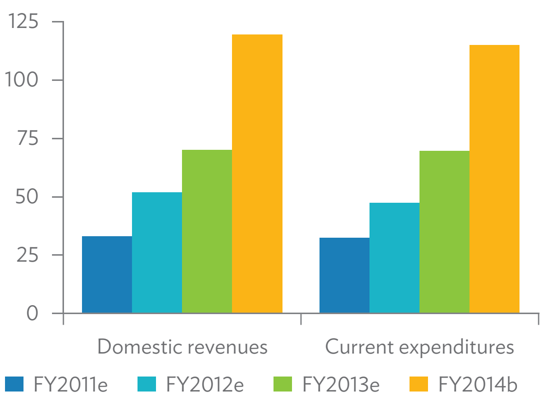
- The FY2015 budget appropriates $54.5 million, 8.1% lower than the previous year's expenditures. Revenues are budgeted at $66.9 million. Fishing license fees were initially projected at $36.0 million but collections as of October were already at $46.9 million.

- The value of imports from the US fell by 19.2% (y-o-y) in FY2014 due to a 43.0% drop in nonfood imports. A 23.9% increase in food and beverage imports was not enough to offset the decline in nonfood imports, mostly of machinery, transport equipment, and manufactured goods.

- The FY2015 budget includes an allotment of $10 million for the Federated States of Micronesia Trust Fund. The trust fund is in preparation to replace grants under the current compact agreement with the US, which expires in FY2023. The President welcomed the initial contribution to the trust fund but highlighted the need for Congress to adopt the comprehensive package of reforms contained in the 2023 Action Plan, including establishment of a new investment development fund.

Nauru

Domestic revenues and expenses (% of GDP, annual)



b = budget, e = estimate, FY = fiscal year.
Source: Republic of Nauru budget documents.

Lead author: Milovan Lucich.

- The economy has grown rapidly in the past 2 years, driven mainly by the reopening of the Australian Regional Processing Centre for asylum seekers, and most recently by substantial payments to Nauruan landowners from final liquidation of the Nauru Phosphate Royalties Trust. Solid growth in revenues from fishing licenses and phosphate exports have also boosted growth.

- Following 65% growth in domestic revenue in FY2014 (ended 30 June), the government expects this to plateau at A$104 million in FY2015. Overall, a surplus of A$0.4 million is expected in FY2015.

- The government is holding discussions with development partners to establish a new Nauru Trust Fund. The FY2015 budget sets aside a contribution of A$5 million to the fund. This follows an earlier set aside of A$5 million for the fund in FY2014, including an ADB commitment of $2 million.

- In early September, the Supreme Court of New South Wales issued a garnishee order against the Government of Nauru, freezing all the government's bank accounts held in Australia and severely hampering public sector operations. The case stems from 1986, when the Republic of Nauru Finance Corporation (NFC) issued a series of government-guaranteed bonds worth 9 billion yen. When these bonds matured in 1994, NFC and the Government of Nauru defaulted on payments, resulting in a series of lawsuits that culminated in the garnishee order. The same court overturned the order in early October, ruling that the government's funds had sovereign immunity. The New South Wales Court of Appeal dismissed a subsequent petition for reconsideration.

Palau

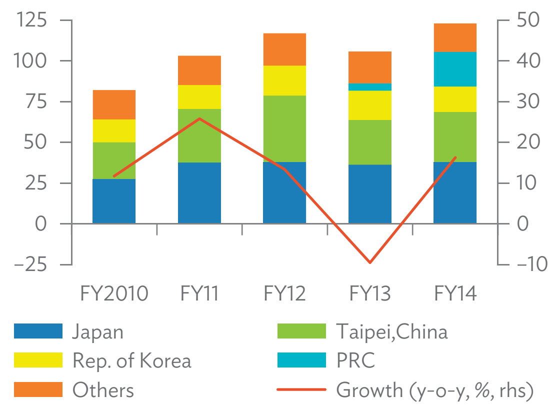
- In FY2014 (ended 30 September), government revenues including grants rose by 5.7% (y-o-y), while expenditure declined by 4.3% (y-o-y), leading to an operating surplus equivalent to 8.0% of GDP. Tax revenues rose by 4.4% (y-o-y) mainly due to higher collections from gross revenue taxes, hotel room taxes, and tobacco taxes. The decline in expenditures was mainly due to lower purchases of goods and services.

- The FY2015 budget appropriates $75.9 million, up by 11.3% (y-o-y), supported by higher tax collections from rising tourism. Although the second phase of the tobacco tax hike (from $3.50 per pack in 2014 to $5.00 in 2015) should further boost revenues, government expenditures for wages and salaries, and purchases of goods and services, are expected to increase steadily. The fiscal surplus will be used to retire old debt.

- Visitor arrivals rose by 16.2% (y-o-y) in FY2014 mainly on the back of increased arrivals from the PRC; Japan; and Taipei,China. In the last quarter of FY2014, the PRC became the largest tourist group, narrowly edging out Japan, and arrivals from the PRC are likely to increase further as a second airline started offering chartered flights from Hong Kong, China in September.

- The overall fiscal balance is projected to decline from the equivalent of 1.0% of GDP in FY2014 to 0.1% in FY2015 and 0.5% in FY2017. This highlights the need for further tax reforms, including a shift to a more efficient value-added tax system, from the current system based on gross revenue taxes.

Visitor arrivals
('000, annual)



PRC = People's Republic of China, FY = fiscal year, rhs = right-hand scale, y-o-y = year-on-year.
Note: Data from 2010 to 2012 based on usual residence, from 2013 onwards based on nationality. The PRC includes Hong Kong, China based on Palau Visitors Authority classification.
Sources: Palau Visitors Authority and Office of Planning and Statistics.

Lead author: Prince Cruz.

Papua New Guinea

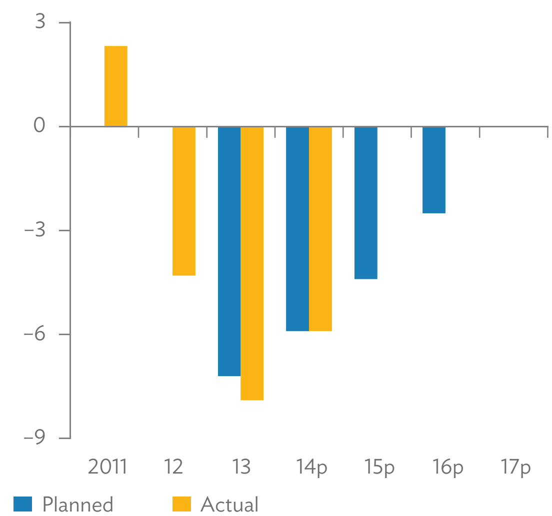
Budget performance 2014

- 2014 was a mixed year for fiscal management. The government remains on target to achieve its planned budget deficit equivalent to 5.9% of GDP. Total expenditure and net lending is expected to grow by 21%, reaching 15.1 billion kina (K) by the end of 2014 against an original target of K15.0 billion. The *Mid-Year Economic and Fiscal Outlook* had previously highlighted the potential for K879 million in unbudgeted expenditure items to result in a much larger deficit outcome. However, additional expenditure is now offset by the inclusion of K1.1 billion in unplanned savings from a reallocation of idle project trust fund balances back into the central government's consolidated account.

- On the revenue side, mining and petroleum taxes were 32% below expectations, pushed down by lower than expected commodity prices. Goods and services taxes also underperformed by K685 million, or 36% below target. A further K600 million in planned asset sales did not materialize, and dividends from state-owned enterprises were lower than expected. On the upside, revenue collection was aided by stronger than expected company and personal income taxes which were 2% and 8% above target, respectively. A further boost of K416 million was added from liquefied natural gas (LNG) dividends due to the early commencement of LNG exports in mid-2014.

- After a decade of commendable fiscal discipline which brought public debt down from a high of 72% of GDP in 2002 to 22% of GDP in 2011, expansionary fiscal policy has seen a rebound in public debt up to 35.5% of GDP by end of 2014. This level of debt slightly exceeds the government's own Medium Term Debt Strategy (2013–2017) ceiling of 35% of GDP, which had already been revised upward from the original ceiling of 30% in 2013.

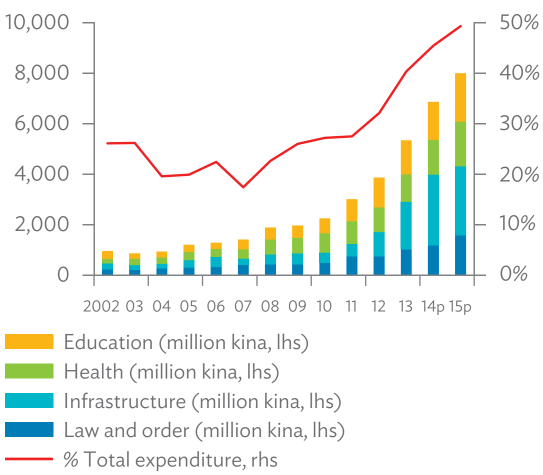
Fiscal balance—planned vs. actual
(% of GDP, annual)



GDP = gross domestic product, p = projection.
Sources: National budget documents (various years); ADB calculations.

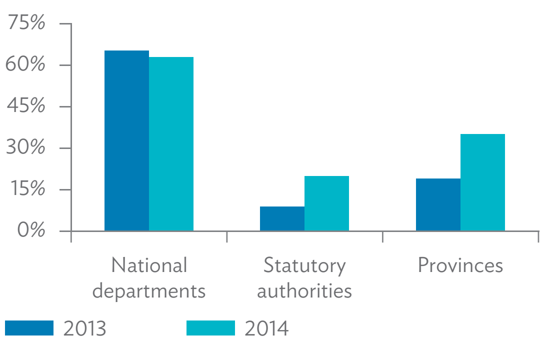
Papua New Guinea

Budget priorities (annual)



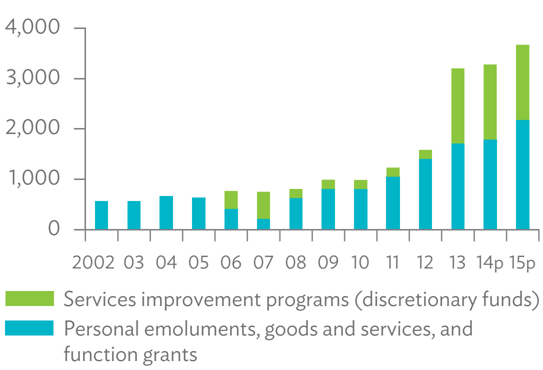
lhs = left-hand scale, p = projection, rhs = right-hand scale.
Sources: National budget documents (various years); ADB calculations.

Final quarter expenditure required to meet full year budget targets (% of total)



Sources: National budget documents (2015); Department of Treasury Quarterly 2014 Funding Release Reports; ADB calculations.

Subnational government funding (million kina)



p = projection.
Sources: National budget documents (various years); ADB calculations.

- High government spending is exerting pressure on the economy, increasing imports and demand for scarce foreign exchange, and pushing inflation to 5.5% at the end of 2014. High spending has also begun to impact on domestic interest rates with government's borrowing costs for longer-term inscribed stock now reaching up to 14%.

Budget 2015

- The 2015 budget targets a much-needed fiscal consolidation. The budget deficit is planned at 4.4% of GDP in 2015, and aims for a return to budget balance by 2017. Achieving this target will however require a 6.0% decline in nominal expenditure in both 2016 and 2017. In 2015, expenditure will grow by 7.0%, underpinned by 130.0% growth in mining and petroleum taxes (to an estimated K1.8 billion), as a result of payments associated with LNG exports. Personal, company, and sales taxes are expected to remain more stable, as the early benefits of enhanced compliance measures fade and growth in non-mineral sectors of the economy remains weak.

- Expenditure priorities in the 2015 budget remain broadly aligned with those established in 2013, focusing on additional funding for infrastructure, education, health, and law and order. The proportion of the budget allocated to these sectors has now increased from 20% in 2007 to 50% in 2015. Another major feature of the 2015 budget is increased funding for provincial, district and local governments. Since 2010 the share of funding directed to subnational governments has increased from 12% to 22% of the budget. Steady growth in provincial function grants have contributed to this outcome. However, the major driver has been a rapid growth in discretionary member funds. In 2015, the District Services Improvement Program will remain at K10 million per member, following an increase from K1 million prior to 2013. Adding to this in 2015 is a further K5 million per district for local health and education investment while the Provincial Services Improvement Program will remain at K5 million per province.

Key issues

- Transport infrastructure remains a major focus of government spending. The 2015 budget appropriates approximately K1.5 billion for the sector. This is slightly less than in 2014 but still more than three times the 2011 allocation, and a tenfold increase since 2003. The sector is expected to account for 10% of expenditure in 2015, compared with 4% in 2011. Transport infrastructure is vital to enhancing connectivity to markets and access to essential social services. However, higher funding has amplified existing shortfalls in institutional and technical capacity of agencies tasked with designing, implementing, and maintaining such infrastructure.

- In 2014, the total capital budget is expected to be underspent by a relatively modest 6.7%. However, this masks significant differences across expenditure categories, and a tendency for project funds to be pushed out before the end of the fiscal year. For example, by the end of October 2014, the Department of Works and Implementation—responsible for approximately 90% of the government's land transport program—had disbursed just 47% of its original budget appropriation. With similar challenges faced by a number of national government departments, they need to disburse more than 60% of original capital project funding in the final quarter of the year if planned 2015 expenditures are to be achieved.

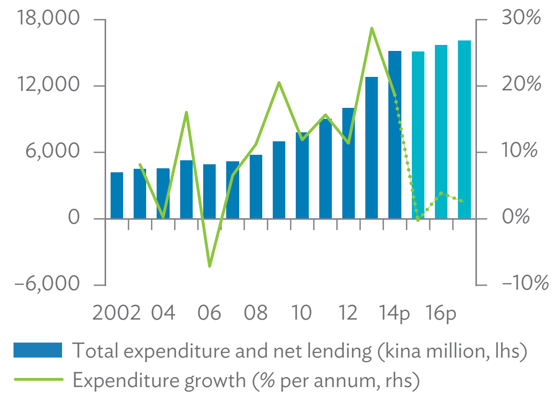
Papua New Guinea

- Capacity shortfalls are often identified as the underlying reasons for slow implementation, but there are a number of other important factors. Sector agencies highlight a frequent disconnect between their sector budget submissions and the approved budget, often forcing project staff to hurriedly design and implement unfamiliar projects. A lack of feasibility and design work before projects are financed has led to unrealistic cost estimates, tendering delays, and difficulties in attracting private sector construction capacity. Further, increased funding is being given to provincial and district governments, which often lack the expertise and administrative systems to plan, procure, and maintain infrastructure assets.

- In addition, funding new capital projects has been prioritized over recurrent operations. Between 2009 and 2014, recurrent budget allocations fell from 60% of total allocations to 51%. This has limited sector agencies' ability to expand human resources in response to growing investment demands, and jeopardized the sustainability of investments by underfunding routine maintenance. Again, the trend is particularly evident in transport: recurrent spending comprised just 11% of Department of Works and Implementation expenditure in 2014, down from 33% in 2011.

- The moderate funding growth for transport outlined in the 2015 budget provides an important opportunity for sector agencies to 'catch up' with their investment backlog, and focus on building the technical and institutional capacity required to deliver cost effective and sustainable infrastructure. During this period, central agencies will also need to focus on improving infrastructure budget coordination and planning, aided by plans to further integrate the recurrent and capital budgets, and moving towards a 5-year forward spending estimates approach for all new projects.

Government expenditure (annual)



lhs = left-hand scale, p = projection, rhs = right-hand scale.
Sources: National budget documents (various years); ADB calculations.

Lead author: Aaron Batten.

Samoa

Budget performance FY2014

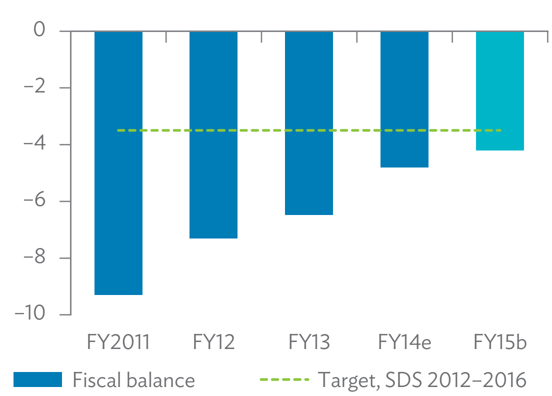
- Higher development expenditure associated with post-cyclone reconstruction and rehabilitation, and preparations for the Small Island Developing States conference held in Apia last September pushed total expenditure to 35.2% of GDP in FY2014 (ended 30 June) from 30.6% of GDP in FY2013. Total revenue, including budget support from development partners, similarly increased from 26.7% of GDP in FY2013 to 29.9% of GDP in FY2014.

- The fiscal deficit increased from the equivalent of 3.9% of GDP in FY2013 to 5.3% of GDP in FY2014. Consequently, the debt-to-GDP ratio rose to 54.5% in FY2014 from 50.9% in FY2013.

Budget FY2015

- The fiscal deficit is budgeted at 1.2% of GDP in FY2015. Current expenditure is seen to decline to 26.2% of GDP in FY2015 from 28.4% of GDP in FY2014. A small increase in total expenditure is expected, however, with preparations for the Commonwealth Youth Games, which will be held in Samoa in September 2015. Non-tax revenue and external grants are projected to be higher.

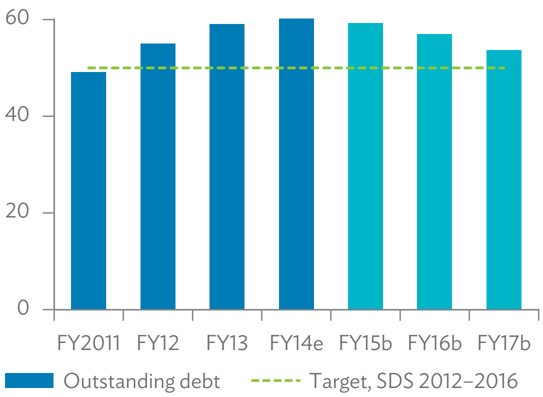
Fiscal balance (% of GDP, annual)



b = budget, e = estimate, FY = fiscal year, SDS = Strategy for the Development of Samoa.
Source: Samoa Ministry of Finance. 2014. *Fiscal Strategy Statement Budget 2014/2015*. May. Apia.

Samoa

Official external debt
(% of GDP, annual)



b = budget, e = estimate, FY = fiscal year, GDP = gross domestic product, SDS = Strategy for the Development of Samoa.
Source: Samoa Ministry of Finance. 2014. *Fiscal Strategy Statement Budget 2014/2015.* May. Apia.

Lead author: Shiu Raj Singh.

Recent developments

- The current account deficit in FY2014 was 8.0% of GDP, up from 6.7% in FY2013, reflecting reduced export earnings, export processing receipts, and remittances. Although arrivals from New Zealand declined, arrivals from other major sources increased, and overall tourism earnings rose by 2.4% in FY2014. In FY2013, remittances stood at the equivalent of 26.6% of GDP, but declined to 23.9% in FY2014. Total remittances fell by 6.6% (y-o-y) in FY2014, driven by lower receipts from Australia and the US.

- Agricultural production had been in decline for a number of years but has recovered in recent quarters. This recovery has contributed to lower prices for domestic agricultural produce. The government is also implementing measures to stimulate agribusiness exports.

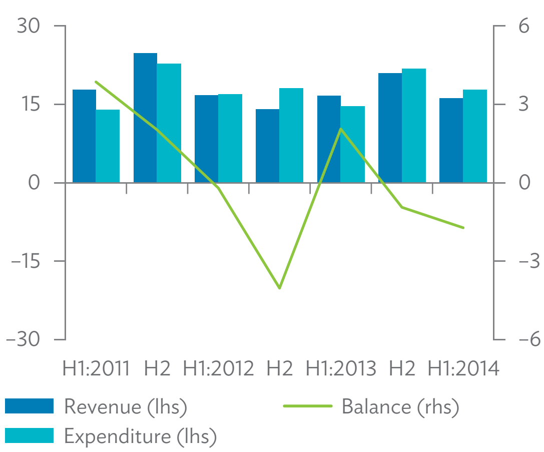
- Deflation deepened to 1.2% in FY2014 from 0.2% in the previous year as international commodity prices and domestic food prices fell, while the tala exchange rate held steady. These declines more than offset the effects of a 3.0% public sector wage increase, and higher prices of housing, alcohol, and transport.

Key issue

- In the past 5 years, natural disasters have required diversion of resources to relief and reconstruction. This has contributed to low and volatile economic growth, as well as higher debt. Continuing investments in climate change adaptation and mitigation measures have the potential to reduce the impacts of shocks over the long term, but will be constrained by the country's rising debt burden.

Solomon Islands

Fiscal position
(% of GDP, semiannual)



GDP = gross domestic product, H = half, lhs = left-hand scale, rhs = right-hand scale.
Source: Central Bank of Solomon Islands Monetary Policy Statement September 2014.

Budget performance 2014

- A fiscal deficit equivalent to 1.7% of GDP was recorded over the first half of 2014, as disruptions caused by the April flooding held revenue collections well below budget projections. In particular, business losses—most notably the closure of the Gold Ridge mine—translated to weak collections of company and withholding taxes. Although total government spending was also under budget, non-payroll recurrent expenditures exceeded budgeted levels due to spending related to post-flood response and recovery efforts.

- Over the first half of 2014, public debt (excluding contingent liabilities) declined to the equivalent of 10% of GDP, continuing recent progress in reducing the country's debt burden. Steady repayments reduced external and domestic debt stocks to the equivalent of 8% and 2% of GDP, respectively, and debt sustainability indicators remain well within threshold levels.

Budget 2015

- Solomon Islands uses the calendar year as its fiscal year and plans to pass its 2015 budget by the end of December. In recent years, budget approval has typically been delayed until the first quarter of the budget year—raising

Solomon Islands

challenges to the full implementation of the annual expenditure plan. Elections are scheduled for November, and it is anticipated that no single party will secure a majority of seats in Parliament. Depending on how long it will take to form a coalition government, it is likely that there would be a very narrow window for budget approval this year. With a balanced budget forecast and the government committed to limiting borrowing to only concessionally financed development projects, fiscal space will likely be limited in 2015.

Recent developments

- Log exports recovered strongly in the aftermath of the April flooding, which caused a brief disruption due to damaged infrastructure links. Overall, log exports were 7% (y-o-y) higher in the first 8 months of 2014. In contrast, gold production is likely to remain suspended for some time. With the international price of gold remaining relatively stable at close to $1,300 per ounce, this resulted in forgone export revenues over the second and third quarters of 2014. The government is currently negotiating with the mine operator to transfer its lease and the management of operations.

- Inflation has moderated after supply disruptions triggered price spikes in April and May. Prices for locally produced fruits and vegetables have largely returned to pre-flood levels. Inflation eased to 5.8% in July (y-o-y), driven by moderating costs of alcohol, tobacco, housing, and utilities.

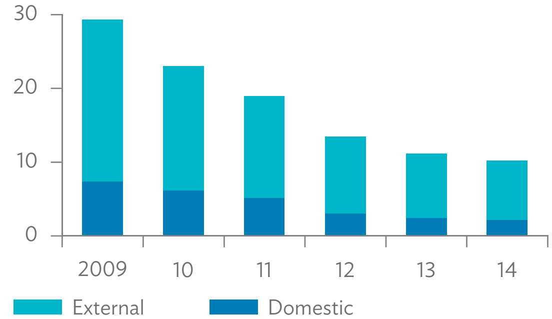
Key issues

- Constituency development funds were reduced in the 2014 budget and made subject to audit and other reforms, but it appears that some of the money saved is now being paid to politicians in a different, even less accountable form. Termination payments for exiting members of Parliament have been increased to $53,980 (SI$400,000) per member, more than four times the previous payment of $13,400.

- Solomon Islands now faces a more constrained budgetary environment than in recent years. There is an urgent need to reduce growth in government spending and improve its quality in order to deliver services to a rapidly growing population more effectively. Between 2004 and 2011, average annual government expenditure grew by more than 20%, fueled by strong growth in logging output and associated government revenue collections. Since 2012, spending growth has moderated to 5%–10% per annum as logging output leveled off and revenue growth slowed. The revenue outlook appears less promising with the decline in logging stocks and because the medium-term future of gold mining is now in doubt.

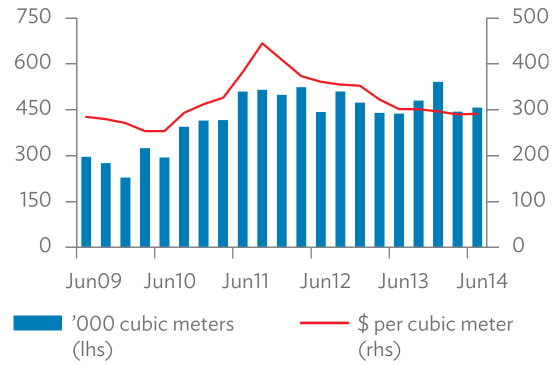
- The Disaster Management Office estimates unmet financing needs from the April flooding at $24 million. Along with a $21 million revenue shortfall, this implies a flood-induced financing gap equivalent to 4% of GDP. This will have to be met largely through reprioritization of other government expenditures. Development partner assistance for flood recovery and reconstruction total some $25 million, partly through realignment of existing commitments. Overall grant support from development partners is expected to continue to fall over the next year as the Regional Assistance Mission to Solomon Islands winds down. The World Bank estimates that grant support from development partners will decline from approximately 30.0% of GDP in 2010 to 16.6% of GDP in 2015, even with additional grant support for flood recovery.

Public debt
(% of GDP, annual)



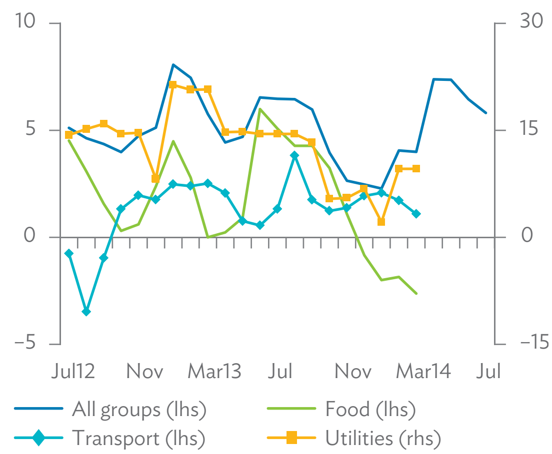
GDP = gross domestic product.
Note: For 2014, data is for the period from January to June.
Source: Central Bank of Solomon Islands.

Log exports and prices
(quarterly)



lhs = left-hand scale, rhs = right-hand scale.
Sources: Central Bank of Solomon Islands and World Bank Commodity Price Data (Pink Sheets).

Consumer price index, by commodity groups
(y-o-y % change, monthly)

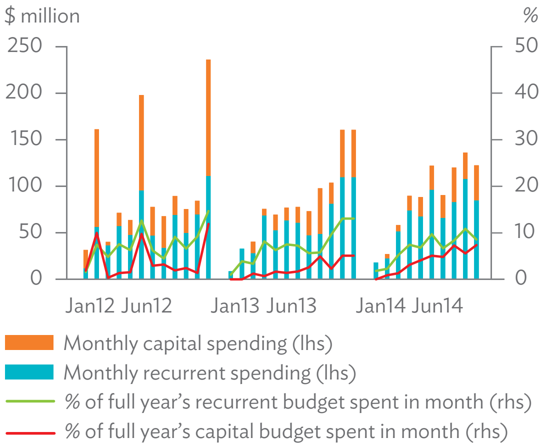


lhs = left-hand scale, rhs = right-hand scale, y-o-y = year-on-year.
Source: Central Bank of Solomon Islands.

Lead author: Milovan Lucich.

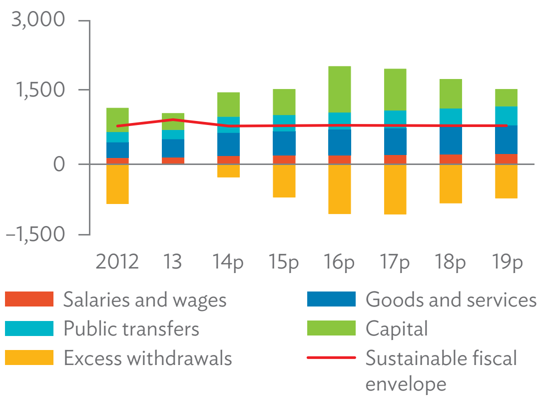
Timor-Leste

Capital and recurrent expenditure (monthly)



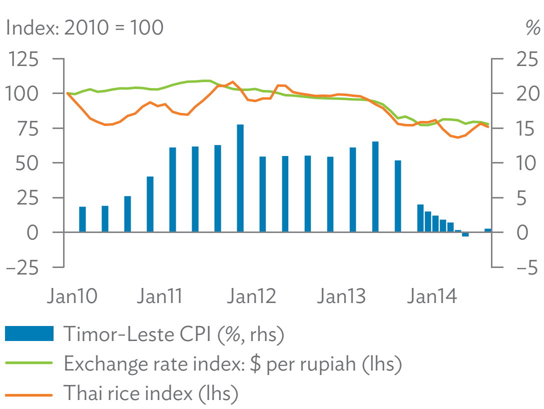
lhs = left-hand scale, rhs = right-hand scale.
Source: Government of Timor-Leste Transparency Portal. www.transparency.gov.tl

Government expenditure, by category ($ million, annual)



Source: Government of Timor-Leste Transparency Portal. www.transparency.gov.tl

Consumer price index (monthly)



CPI = consumer price index, lhs = left-hand scale, rhs = right-hand scale.
Sources: Statistics Timor-Leste and World Bank.

Budget performance 2014

- Budget execution has improved in all categories of government expenditure, with 58.9% of the budget spent in the first 10 months of 2014 compared with only 39.9% during the same period last year. Timely execution has been encouraged by a new measure that requires the government to prepare a rectification budget in the third quarter if it expects final budget execution to be below 80%. The 2014 budget also aimed to improve the quality of public spending by limiting single-source procurement to 10% of agency budgets. However, the extent of compliance across government agencies is unclear.

- Offshore petroleum revenue collections surpassed the 2014 budget target of $1.4 billion in September, and further receipts are due in the fourth quarter. In contrast, domestic revenues have been below projections for most of the year, but larger collections are expected in the fourth quarter.

Budget 2015

- A draft of the 2015 budget was submitted to Parliament for review and debate in October. This budget plans for total spending of $1.7 billion, over 90% of which is to be funded from domestic and petroleum revenues. This is very close to the 2014 budgeted spending but is significantly above the Ministry of Finance's targeted fiscal envelope of $1.3 billion—the government's threshold for long-term fiscal sustainability. With total spending stabilizing, growth stimulus from rising spending in recent years is likely to fade in 2015.

- Execution of budgeted expenditure would require a withdrawal of $1.3 billion from the Petroleum Fund—more than double the "estimated sustainable income" (the amount that can be withdrawn yearly without depleting the long-term balance). The draft budget also projects further spending increases from 2016 to 2019 to support rising capital and recurrent expenditure.

- More than a third of budgeted recurrent spending is allocated to public transfers, which include various social benefits, grants to public and non-government entities, and grants for community-level capital works. Past assessments of social benefit payments have found limited impact on poverty reduction as the majority of transfers are paid to a relatively small group. The 2015 budget proposes a 54.0% increase in payments to veterans and few changes to other social benefit programs.

- The 2015 budget also reduces education spending by 19.2%, with lower spending on school renovations and cuts in allocations to the Ministry of Education and to the Human Capital Development Fund. Electricity sector spending remains high, with a net transfer of $68 million for new infrastructure and $100 million for operating subsidies. This highlights the need to improve electricity sector efficiency and free up fiscal space.

- Infrastructure upgrades remain a priority, with planned capital investment from 2015 to 2019 totaling $3.3 billion—equivalent to more than 200% of non-oil GDP. The bulk of this amount is allocated to an infrastructure fund, which provides a multi-year funding mechanism for large projects. Over 60% of the fund's 2015 budget is allocated to four major projects: national road and bridge upgrades ($70 million), infrastructure in Oecusse ($62 million), the Tasi Mane project to develop the south coast ($38 million), and the national electricity network ($58 million).

Timor-Leste

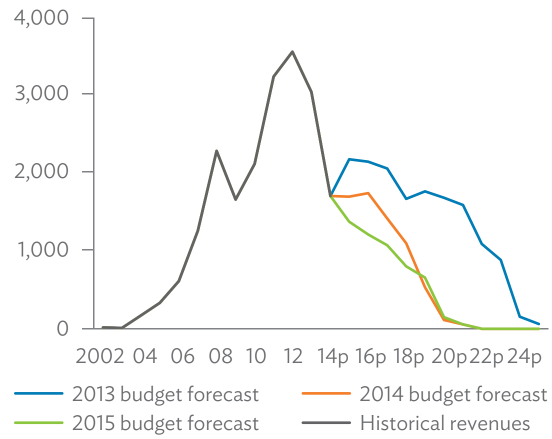
Recent developments

- Rising public spending has provided a strong stimulus in 2014, with total spending on track to be up to 30% higher than in 2013. Growth in recurrent spending appears to have supported increased household consumption, with the value of food imports up 15.6% (y-o-y) despite lower international prices, and the value of vehicle imports up 18.6% (y-o-y).
- Several large foreign investment projects are progressing towards final clearance. This includes a major hotel and resort development near Dili, an international scale cement plant, and a planned $40 million brewery and bottling plant by Heineken.
- Inflation averaged 0.9% in the first 3 quarters and fell to 0.5% (y-o-y) in September. The continued strength of the US dollar against the rupiah, and stable or falling prices for rice and other foods, have contributed to price stability in the face of demand pressures from rising public spending.

Key issue

- The governments of Timor-Leste and Australia have resumed discussions on the development of the Greater Sunrise oil and gas project. However, the outcome of these discussions is uncertain and revenues from existing fields are projected to fall faster than previously expected. The 2015 budget has cut the (discounted) forecast of future oil revenues by $896 million compared with the 2014 budget. Given these lower revenues, it is important to adjust expenditure to a fiscally sustainable level to avoid depletion of the Petroleum Fund.

Petroleum revenue projections ($ million, annual)



Sources: Timor-Leste national budget documents (various years).

Lead author: David Freedman.

Tonga

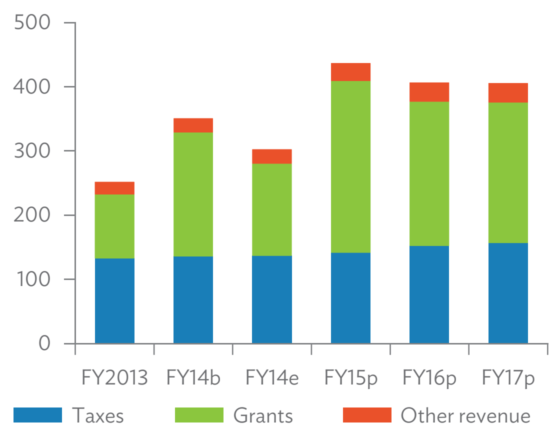
Budget performance FY2014

- The government achieved a fiscal surplus equivalent to 1.7% of GDP in FY2014 (ended 30 June), roughly half the budget target. Despite a 67.5% shortfall in grants, tax revenue was slightly higher than the budget target due to improved income tax and consumption tax collections. Non-tax collections performed to expectation.
- Overall government spending was 13.1% lower than planned as a result of delayed project implementation and deferred repayments for the Export-Import Bank of China loan. The government has established a sinking fund of $2.6 million toward loan repayment. Although the government implemented a 5.0% cost-of-living allowance adjustment, this was funded within the budgeted wage bill allocation rather than through a supplementary appropriation.

Budget FY2015

- A fiscal deficit of $7.1 million is targeted in FY2015. Total revenue, including grants, is forecast to increase by 11.3% to $223.2 million, with 61.2% expected to come from grants, 32.4% from tax revenue, and the rest from other non-tax revenue. However, the expenditure target is $230.3 million. The increase in government expenditure covers the planned $40 million post-cyclone reconstruction work in the Ha'apai Group of islands, the upgrading of Fua'amotu International Airport, among others.

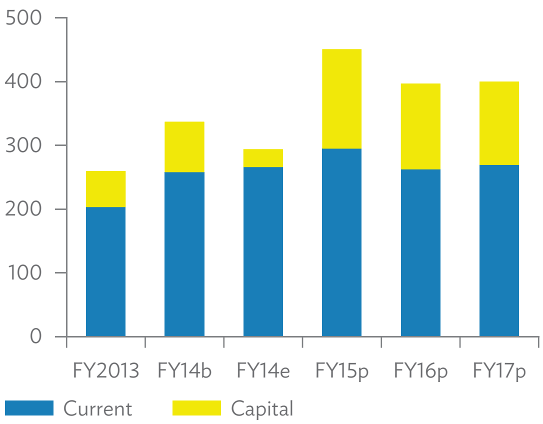
Revenue performance (million pa'anga, annual)



b = budget, e = estimate, FY = fiscal year, p = projection.
Source: Tonga Budget Statement 2014–2015.

Tonga

Government expenditure
(million pa'anga, annual)



b = budget, e = estimate, FY = fiscal year, p = projection.
Source: Tonga Budget Statement 2014–2015.

- The government anticipates that this shortfall will is be financed by development partners, particularly through budget support grants under the government-led Joint Policy Reform Matrix. Total budget support grants are expected to increase by $19.3 million (or 11.6%, y-o-y) in FY2015. However, this is contingent on the continuation of economic reforms, as well as wage restraint and commitment to future business regulatory and public enterprise reforms.

- In the first 3 months of FY2015, total revenue tracked the budget target. Grant receipts are well below target, but are seen to improve once the World Bank and the Government of Australia disburse their budget support before the end of 2014.

Recent developments

- Tourism receipts, adjusted for inflation, grew by 4.9% in FY2014, as visitor arrivals continued to increase. International air arrivals grew by 16.1% in July 2014 (y-o-y) mainly due to increased arrivals from Australia and New Zealand. Conversely, remittances, adjusted for inflation, declined by 2.3% in FY2014.

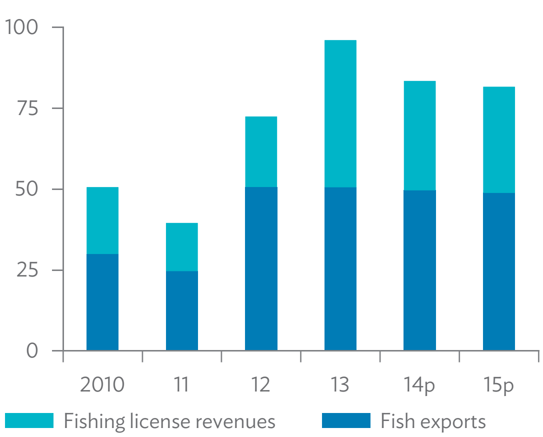
Key issue

- There are rising pressures on fiscal management and reform momentum is slowing. Any further reform slippage could derail the provision of future budget support from development partners and undermine long-term growth prospects, including the potential for new businesses and jobs.

Lead author: Saia Faletau.

Tuvalu

Earnings from fisheries
(% of GDP, annual)



p = projection.
Source: International Monetary Fund. 2014. *Tuvalu: 2014 Article IV Consultation—Staff Report*. August. Washington, DC.

- Actual revenue collections for 2014 are projected to be substantially above (68%) budget estimates. This is driven by higher-than-expected income tax collections as a result of improved compliance, and rising rates under the vessel day scheme for fishing license fees. Unlike in recent years, however, it appears that windfall fishing license revenues are now being used to fund unsustainable growth in public spending.

- Projected expenditures for 2014 are 34% higher than actual outlay in 2013, largely driven by a 26% increase in the government wage bill. This sharp rise in civil servants' salaries has also prompted a similar increase in pay rates of SOE employees, pushing operating costs further upward. The reopening of the Tuvalu Cooperative Society, which had previously closed amid greater competition from private retailers of basic goods in the outer islands, adds another potential fiscal drain. Actual expenditures, however, are on track to be slightly lower than budget estimates.

- The government projects a fiscal surplus of $14.4 million (equivalent to 43% of GDP) for 2014—13% above budget estimates. This will add to the consecutive surpluses realized in 2012 and 2013, which allowed for much-needed deposits into the Consolidated Investment Fund (CIF) equivalent to 9% and 25% of GDP, respectively. Further injections into the CIF are necessary to progressively rebuild fiscal buffers, particularly in light of emerging medium-term fiscal risks. These risks include possible declines in fishing license revenues due to overfishing and climate change, and a narrowing of the tax base with a scheduled tariff rate cut under the Pacific Island Countries Trade Agreement by 2017.

Lead authors: Malie Lototele and Rommel Rabanal.

Vanuatu

Budget performance 2014

- Although a small surplus was originally planned, the government now expects a fiscal deficit equivalent to 1.9% of GDP in 2014 due to supplementary budgets. As of August 2014, the government still had a fiscal surplus equivalent to around 1.2% of GDP ($9.6 million).
- Total revenue, including grants, reached $115.1 million in the first 8 months of the year, over 67.0% of targeted annual revenue for 2014. This represents a 4.8% increase over collections during the same period last year, despite a 2.8% drop in import duties. Collections of value-added tax—a major revenue source—rose by 3.8% (y-o-y) due to increased economic activity and improved tax compliance and coverage. Excise tax collections also rose by 1.5% (y-o-y).
- Total government expenses stood at $107.6 million as of August 2014—63.0% of the spending target for 2014. Recurrent government expenditures were 4.1% above the expenses recorded during the same period in 2013. This increase largely represents higher purchases of goods and services, including some unprogrammed items such as allowances, airport and vehicle maintenance costs, and internet and satellite communications.

Budget 2015

- The government projects a fiscal deficit of around $8 million in 2015. Government expenditures are set to increase by 10.0% from the 2014 target, while revenue is seen to rise by only 2.2% due to a 23.0% drop in external grants. This would be the fourth budget deficit in the past five years despite legislation requiring the government to target budget surpluses.

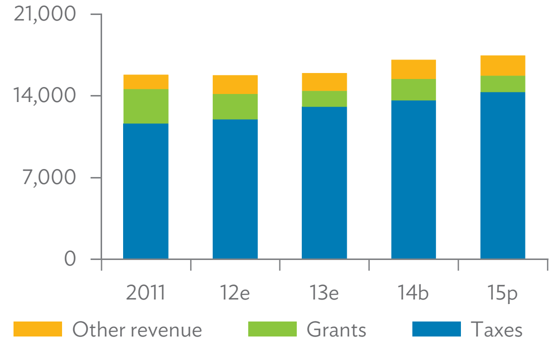
Recent developments

- Inflation remains at the lower end of the Reserve Bank of Vanuatu's 0%–4% target band due to low international commodity prices and moderate economic growth. In the second quarter of 2014, inflation was only 0.6% (y-o-y) with clothing and footwear (1.7%) and recreation (1.4%) costs registering the largest increases.
- Total visitor arrivals declined over the first 8 months of 2014 compared with the same period in the previous year. Visitors arriving by air were down by 1.5% (y-o-y) to 68,676, while those arriving by cruise ship fell by 8.2% (y-o-y) to 149,424.

Key issues

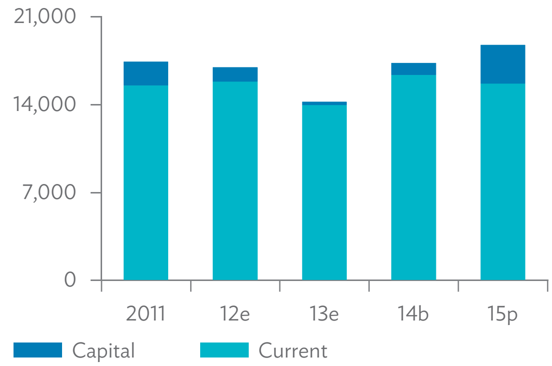
- The Vila Central Hospital exhausted its annual budget in the first 6 months of 2014, highlighting shortcomings in budgeting and planning for operating and maintenance costs of major projects. This forced the closure of Vanuatu's only intensive care unit and left $14.6 million worth of newly modernized facilities largely unused. A supplementary budget has allocated additional funds to the health sector. Given the large infrastructure pipeline for the next 5 years, ensuring adequate resources for implementation, operation, and maintenance of these projects will be essential to their success.
- Another area that warrants closer scrutiny in the budget is tertiary scholarships for overseas university study. This line item was increased by over 40% from 2014 in the 2015 budget.

Government revenue (million vatu, annual)



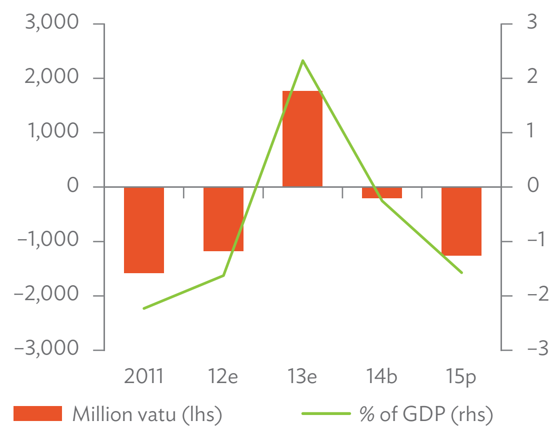
b = budget, e = estimate, p = projection.
Source: Vanuatu Department of Finance and Treasury.

Government expenditure (million vatu, annual)



b = budget, e = estimate, p = projection.
Source: Vanuatu Department of Finance and Treasury.

Fiscal balance (annual)



b = budget, e = estimate, GDP = gross domestic product, lhs = left-hand scale, p = projection, rhs = right-hand scale.
Source: Vanuatu Department of Finance and Treasury.

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Long-run growth forecasts for Asia: Opportunities and challenges for the Pacific economies

This article foreshadows a joint research study by ADB and the ADB Institute, *Leveraging the Benefits of Asia's Integration and Growth for Pacific Economies,* scheduled for publication in early 2015.

Asia could produce more than 50% of total global output by 2050—a large change from the current share of about one-third—according to forecasts reported in Asia 2050: Realizing the Asian Century (ADB 2011). The average per capita income in Asia is seen to rise from about $3,000 in 2010 to over $40,000 in 2050, despite a sizable population increase, about the level found in many OECD countries today. However, the study cautions that realizing this progress will require measures to promote technological progress, sustain middle class expansion, and support human capital development.

This paper considers the implications of these developments for ADB's Pacific developing member countries (DMCs). It commences with a brief discussion of projections by the Asian Development Bank Institute (ADBI 2014) for long term growth in Asia; this is followed by a review of economic links between Asia and the Pacific and a consideration the possible impact of prospective Asian growth on Pacific DMCs. The penultimate section examines possible constraints to realizing benefits of Asian economic growth, and the paper concludes with recommendations for reforms.

Growth prospects for Asia

In a 2014 study, ADBI developed detailed growth projections until 2030 for Asia using sophisticated forecasting models. According to these projections, growth in Asia is expected to be sustained at an average annual rate of 5.6%. This strong growth is seen to be driven by the economies of the Association of Southeast Asian Nations (ASEAN), the People's Republic of China (PRC), and India, which as a group are forecast to grow by 7.0% over the same period. These developments are of particular significance because this group of countries currently accounts for 48% of the world's total population, and almost a quarter of global economic output.

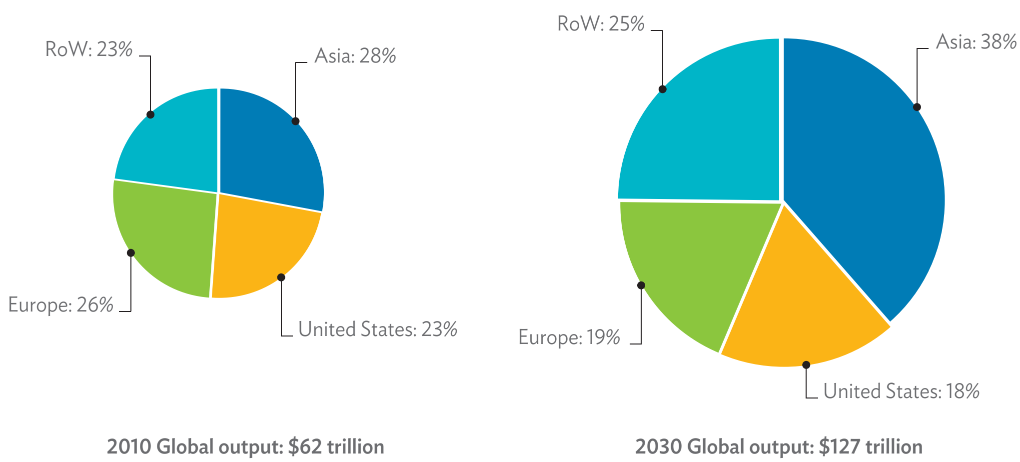
The ADBI (2014) study projects that the ASEAN economies will grow at 5.6% per annum over the next 2 decades with low-income member countries (Cambodia, the Lao People's Democratic Republic, Myanmar, and Viet Nam) growing by more than 7%, middle-income countries (Indonesia, Malaysia, the Philippines, and Thailand) growing by between 5% and 7%, and high-income countries (Brunei Darussalam and Singapore) by under 4%.

Similarly, growth rates in the newly industrialized economies (the Republic of Korea and Taipei,China) are projected to decelerate to 3.4%, as their income levels reach those of developed economies.

Although the PRC's growth is forecast to average 7.1% over 2010 to 2030, it is expected to be declining over the period as its labor force shrinks and productivity growth moderates. Conversely, average growth in India, which is forecast at 7.6%, is expected to increase as the labor force grows and workers shift from agriculture to industry and services.

The ADBI study suggests that investment and productivity improvements are likely to drive Asian economic growth. It anticipates that productivity improvements will make the largest contribution to growth in India, while in the ASEAN economies and the PRC capital accumulation is projected to be more important. The study forecasts that the contribution of labor force growth will turn negative in the PRC towards the end of the projection period.

Figure 2: Share of global output by major economies, 2010 and 2030 forecast



GDP = gross domestic product, RoW = rest of the world.
Source: ADBI. 2014. *ASEAN, the People's Republic of China, and India: The Great Transformation.* Tokyo.

Long-run growth forecasts for Asia

Asia's economic development will be accompanied by a rising middle class, expanding urbanization, as well as an aging population—trends that carry important implications for Pacific DMCs.

Growing linkages between the Pacific and Asia

Over the past few decades, Pacific DMCs have made considerable progress in strengthening economic relations with Asia. Total trade in goods (imports plus exports) with Asia increased from $3.8 billion in 1990 to $4.8 billion in 2000 and $30.7 billion in 2012. Although trade between Pacific economies and the region's traditional trade partners—Australia and New Zealand—is still larger than Pacific-Asia trade, the total trade of the latter is growing more rapidly. An analysis of South Pacific trade with Asia comes to a similar conclusion; ASEAN, India, and the PRC are gaining in importance for the South Pacific economies' trade (ADB 2013).

Although the Pacific is unlikely to become a major supplier of goods and services to Asian markets, additional demand from large, growing Asian economies has huge potential to be an important source of growth for the small Pacific island economies. Many Asian economies are densely populated. They are also intense resource users and spend a relatively large share of their income on food.

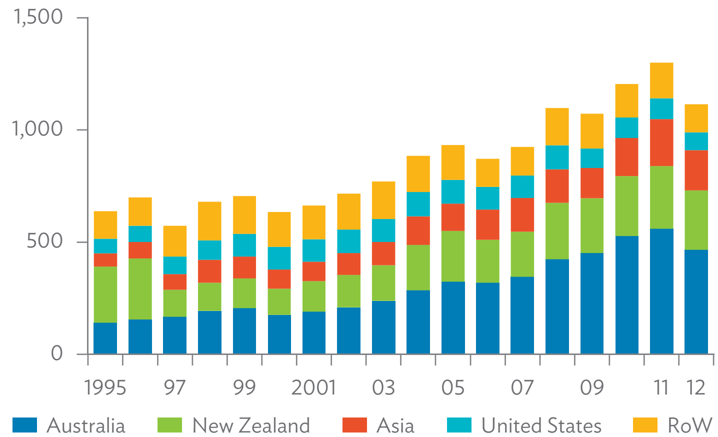
Simulations by ADBI suggest that as incomes rise, following the precedents of developed economies, Asian economies will become increasingly dependent on international trade and self-sufficiency rates will decline. They are likely to spend heavily on imports of resource-based raw materials, such as timber, cash crops, and fisheries—traditional exports from the Pacific.

Given the pristine nature of the Pacific, there would appear to be considerable scope for expansion of aquaculture to meet growing Asian demand for high-value marine produce (e.g., sea cucumber, shrimp, South Sea pearl). Furthermore, potential for development of other high-value products such as artesian water, coffee, and distinctive handicrafts will likely increase with rising Asian incomes. Emerging producers in Pacific DMCs will have opportunities to identify and deliver goods and services best suited for dynamic markets in Asia.

Between 1990 and 2008, developing Asia's middle class (defined as those with income per capita per day between $2 and $20) has expanded from 21% to more than half of the population. This compares with a middle class of around 90% in Japan, the Republic of Korea, and Europe. Sustained and rapid economic growth in Asian economies will lead to further expansions of their middle-income classes, with a considerable expansion of their spending power. Based on earlier evidence, the expanded income is likely to be spent on luxury goods and services, including travel and niche products.

Trade in services, especially tourism, plays a vital role in several Pacific economies (notably the Cook Islands, Fiji, Palau, Samoa, Tonga, and Vanuatu). The number of visitor arrivals in the Pacific has increased from less than 0.6 million in 2000 to over 1.3 million in recent years. In most cases Australia and New Zealand have consistently been the principal source of tourists. Despite strong economic growth, arrivals from Asia remain a relatively small proportion of total arrivals averaging less than 15% of the total over the past decade (Helble 2014). In contrast, benefiting from its geographic proximity, visitors from Asian countries to Palau have been increasing. In 2013, nearly 9 of every 10 visitors to Palau came from Asia, according to the Palau Visitors Authority.

Figure 2: Visitor arrivals to Pacific DMCs, by source (annual, thousands of persons)



DMC = developing member country, RoW = rest of the world.
Source: ADB calculations using data from *Data on Outbound Tourism*, World Tourism Organization.

Studies suggest that as income increases, demand for tourism and tourist-related services is highly income elastic (i.e., demand increases with income more than proportionately). Income elasticity of demand for high income countries in Asia is around 4.5 (Crouch 1995). This means that for every 1% increase in income, tourism spending increases by 4.5%. Although, this was based largely on studies of Japanese overseas travel, it seems likely that similar results can be expected for other Asian countries as the incomes increase. Another interesting finding was that Oceania was a favored destination, with income elasticity of around 3.4.

This has important implications for those economies in the Pacific with existing or potential tourism sectors. Major destinations currently include the Cook Islands, Fiji, Palau, and Vanuatu, while the Federated States of Micronesia, Samoa, Timor-Leste, and Tonga are promising destinations.

UN population projections show that Asia faces a rapidly aging population. The proportion of population over 60 will rise from 10% in 2010 to almost 20% in 2030 and nearly 30% in 2050. These demographics will have implications for consumer demand. In recent years, a number of Pacific economies (e.g., the Cook Islands, Fiji, and Vanuatu) have attracted retirees, primarily from Australia and New Zealand. A favorable climate, hospitable people, and cheap services make many Pacific islands attractive vacation and retirement destinations.

Long-run growth forecasts for Asia

Foreign direct investment in Pacific DMCs has increased rapidly in recent years, averaging an equivalent of about 16% of total output. Stable macroeconomic environments and open trade regimes in most Pacific DMCs have attracted heavy investment from a number of Asian countries, especially in fisheries, mining, and timber. The continuation of this trend will be likely given the growing pool of financial resources from Asia that can be invested abroad. ADBI (2014) simulations project that the share of Asian economies in international markets will increase rapidly across many sectors. Asia's share in global investment is expected to rise from around 25% in 2010 to almost 50% in 2030. Although the Pacific DMCs' combined size is small, Asia's continued growth could usher in substantial foreign investment in the Pacific and bolster existing Asian business interests—particularly in natural resource extraction and tourism. More inflows of foreign direct investment hold the promise of creating new jobs and providing technological spillovers, and are also likely to be important in deepening linkages between the two regions.

In connecting with global markets, overall trade costs figure highly in Pacific DMCs competitiveness. International comparisons suggest that trade costs across Pacific economies are among the highest in the world. Although they have fallen in recent decades, trade costs remain relatively high and transportation infrastructure is still inadequate. As a response, governments in the Pacific have started to upgrade their road networks, ports, and airports. Improved infrastructure can be expected to enhance the competitiveness of Pacific DMCs but further actions are required. In addition to hard infrastructure, customs procedures could be simplified and clearance procedures expedited in many Pacific economies. Since tourism plays an important role in several Pacific DMCs, measures to facilitate trade in services are also necessary. These measures include easing visa requirements for tourists or making it easier for foreign service providers to enter and operate.

Improved connectivity in terms of upgraded telecommunications is an important way of addressing physical isolation of Pacific island economies. Better interconnection between the Pacific and Asia could enhance the Pacific DMCs' ability to tap into the Asian tourism market. They can also benefit in terms of new telecommunications-based enterprises.

In recent years, several Pacific DMCs have made major moves towards creating a conducive environment for private sector activity, to render their economies more competitive. These included reforms to liberalize the telecommunications and air transport sectors. Improved communications between small business owners and their staff, clients, and suppliers enhance efficiency and lower operating expenses. In Samoa, for instance, reforms to improve access of the private sector to "secured financing" were introduced in 2013. In Solomon Islands, registration of new companies now takes only 1 to 2 days from 3 months after the passage of a modernized Companies Act in 2010. In PNG, introduction of a competing service provider and expansion of the mobile network enabled farmers in remote areas to easily check prices of their produce.

Concluding remarks

To benefit from the projected rapid growth in Asia, Pacific DMCs need to continue reforming their business environments. Abolishing loss-making state-owned enterprises can open up new opportunities for private businesses. It can also lead to improvements in service quality, reduce fiscal burdens, and lower prices. Caution, however, must be taken to guarantee contestable markets and to ensure regulations are appropriate.

In many Pacific DMCs, the standard of education and skill-development are relatively poor. In consequence, economic activities are constrained, particularly in the provision of goods and services that are skill-intensive. Overseas employment opportunities and hence remittances are reduced. Educational institutions and governments need to give substantial consideration to improvements in education and training.

Lead authors: Matthias Helble (ADBI), Robin Boumphrey, Prince Cruz, Christopher Edmonds, and Ruth Francisco.

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Fiscal management challenges in Papua New Guinea and Timor-Leste

The large increases in commodity prices seen since 2005 have helped Papua New Guinea (PNG) and Timor-Leste to become the fastest-growing economies in the Pacific. This provided governments in both countries with an unprecedented opportunity to invest in public goods and build fiscal buffers. In recognition of poor human development outcomes, both countries have pursued ambitious national infrastructure plans and have expanded health, education, and other social welfare programs. However, institutional capacity shortfalls have created a number of fiscal and economic challenges that have limited the benefits of higher government spending.

Figure 3: International commodity prices (Index: January 2000=100, monthly)

Source: World Bank Commodity Price Data (Pink Sheets).

This policy brief examines the recent experiences of PNG and Timor-Leste in managing rapid growth in government expenditure. Elements of a strategy to improve budget implementation and promote long-term fiscal sustainability to ensure that key services and macroeconomic stability can be maintained as the commodity boom fades are then outlined.

Similar but different…

While PNG and Timor-Leste have faced similar challenges in scaling up infrastructure and human capital investments, there are also important contextual differences.

Having recently gained independence, Timor-Leste entered the commodity boom with no public debt. A sovereign wealth fund—the Petroleum Fund—was established in 2005 to support transparent and responsible management of the income from offshore oil and gas production. Initial estimates placed the total value of future production at $2.3 billion and the sustainable level of annual withdrawals from the fund at $70.0 million. However, by 2013, these have risen to $26.2 billion and $787.0 million, respectively. Since 2007, successive governments have responded to this windfall by increasing public spending, which rose by a factor of six between 2006 and 2013. Fiscal policy provides almost the only link between offshore production and the domestic economy. Rising spending saw non-oil GDP growth average 12.6% between 2007 and 2011. Growth fell to 7.8% in 2012 and likely fell in 2012 as public spending declined.

In contrast, PNG entered the resource boom with substantial public debt. Fiscal discipline, and rising revenues from existing mineral and petroleum projects, saw the share of public debt fall from the equivalent of 72% of GDP in 2002 to 22% in 2011. At the same time, high commodity prices stimulated investments in resource exploration and development. Most notably, the commencement of the $20 billion liquefied natural gas (LNG) project construction in 2009 provided strong economic stimulus and a further boost to domestic revenue collection.

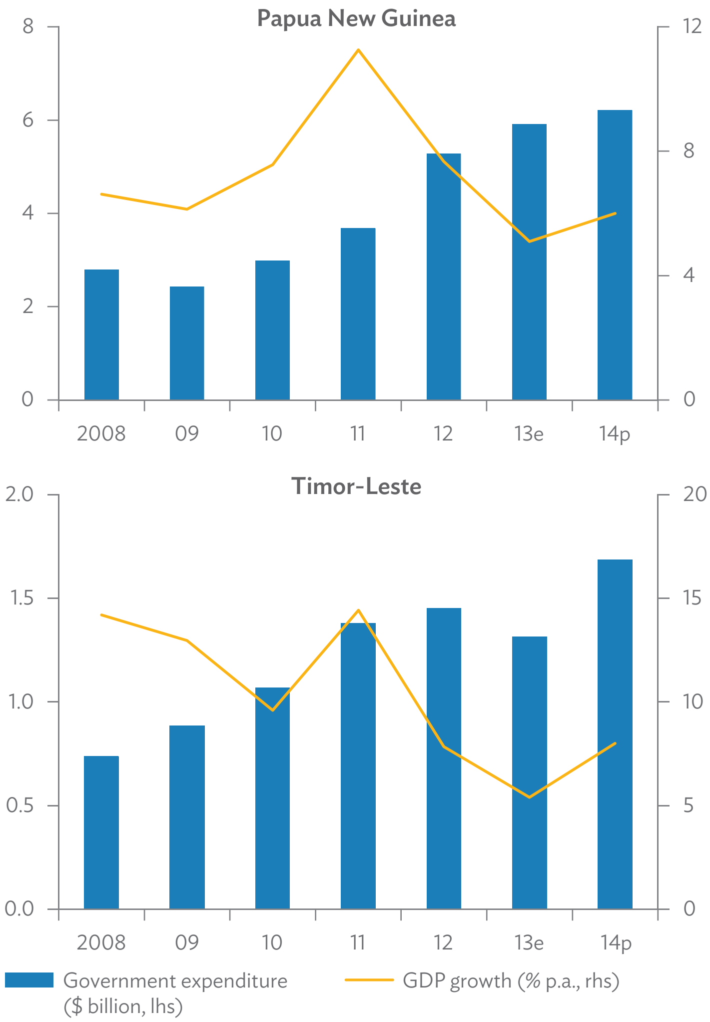
Differences in the nature of resource production have also had important implications for fiscal management in the two countries. In PNG, the large onshore investment associated with new resource developments such as the LNG project, have stimulated local economic activity but also placed growing strains on national infrastructure. Demand for skilled labor—in particular, for engineers and project managers—has driven up wages and made it harder for the public sector to retain and recruit skilled staff. In contrast, the offshore nature of Timor-Leste's LNG production has meant that while the burden imposed on the local skilled labor market has been smaller, resource investment has created little spillover into the local economy.

Growing pains

Macroeconomic costs of fiscal expansion. The fiscal expansions undertaken in both countries have created a number of macroeconomic pressures. Expansionary fiscal policy has seen PNG's public debt rise from an equivalent of 22% of GDP in 2011 to an estimated 37% by the end of 2014. This debt level now exceeds the government's Medium Term Debt Strategy (2013–2017) ceiling of 35% of GDP, which had already been revised upward from 30% in 2013. Large infrastructure projects have also sharply increased demand for imports, further weakening the PNG kina. This, combined with fiscal stimulus, has stoked price pressures, and inflation is seen to reach 8.0% by the end of 2014 from 2.2% in 2012. The private sector has also begun to respond to the government's rising debt by pricing in additional risk to local sovereign debts, driving government borrowing costs up to 14% toward the end of 2014.

Fiscal management challenges

Figure 4: Gross domestic product growth and government expenditure (annual)



e =estimate, GDP = gross domestic product, lhs = left-hand scale, p = projection, p.a. = per annum, rhs = right-hand scale.
Source: *Asian Development Outlook* database.

Likewise, while Timor-Leste enjoys an enviable level of national savings, a continuation of the spending growth seen in recent years would not be sustainable in the long term. Rising public expenditure contributed to double-digit inflation over 11 consecutive quarters between 2011 and 2013. Such high inflation is unusual given the country's use of the US dollar, and undermined the competitiveness of non-oil exports. Further, estimates of the size of the offshore Bayu-Undan gas field—which brings in 95% of Timor-Leste's oil and gas royalties—has recently been downgraded. Production appears to have peaked in 2012, and the relatively conservative official projections show that Bayu-Undan will be exhausted by 2021, which is 4 years earlier than previously forecast. Public spending must shift to a more sustainable path to avoid a rapid depletion of the Petroleum Fund.

Budget implementation challenges. Perhaps the most striking similarity between PNG and Timor-Leste's efforts to translate resource wealth into improved development outcomes, however, has been the challenges faced by their bureaucracies in implementing rapidly growing budget allocations.

Experience from the 2013 PNG national budget clearly illustrates this point. The 2013 budget allocated $2.6 billion for the government's annual Public Investment Program, but this was revised to $1.8 billion mid-year due to slow implementation. By November 2013, only 52% of the revised allocation (or 35% of the original budget allocation) had been spent. Likewise, the ratio of actual to planned expenditure in Timor-Leste has averaged only 57% between 2010 and 2013.

This type of budget underperformance has been particularly severe in agencies tasked with delivering major infrastructure projects, which require detailed project preparation and supervision. For instance, the PNG Department of Works and Implementation, which is responsible for approximately 85% of the government's 2014 land transport program, disbursed only 52% of its original development budget appropriation in 2013, and only 38% in 2012.

Consequences of implementation shortfalls. A lack of implementation capacity has raised a number of challenges for obtaining value for money from higher levels of public expenditure. Most immediately, implementation shortfalls result in slow project delivery, exposing major national infrastructure projects to cost overruns and delaying benefits to the people. In some instances, frustrated officials have also used these challenges to advocate unproductive reforms that push public funding outside the budget system, posing a broader threat to the accountability and transparency of public financial management.

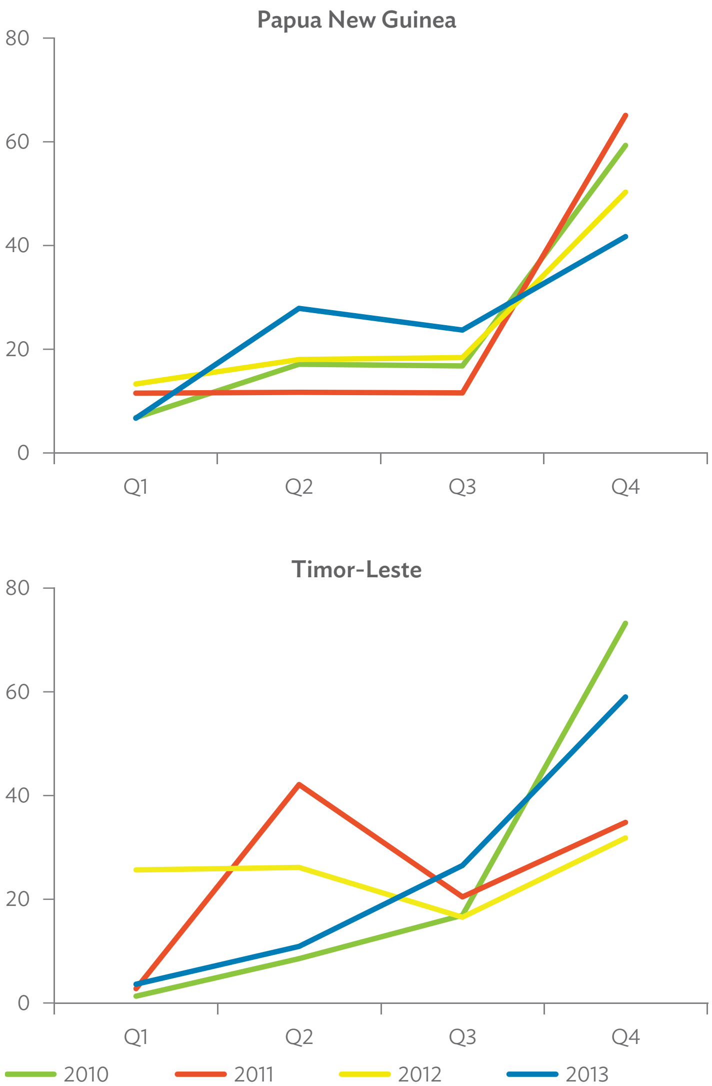
Limited implementation capacity has also encouraged both countries to adopt a process of pushing unused annual budget allocations "out the door" before the close of the fiscal year. In 2012 and 2013, around half of PNG's total capital budget was disbursed in the final quarter of the fiscal year. While under PNG's 1986 Government Financial Statistics standards these transfers were recorded as expenditures, they have typically been placed in project-specific trust accounts that have lower levels of oversight and control. Idle trust deposits have often been transferred to pay for alternative spending priorities, further reducing the overall transparency and development impact of public spending.

Similarly, between 30% and 70% of Timor-Leste's capital budget is usually spent in the last 3 months of the year. Timor-Leste's Infrastructure Fund has been designed to help ease the cyclical pressures caused by the budget cycle by providing a multi-year funding mechanism. However, the budget execution patterns since 2011 suggest that this has yet to fully occur.

Causes of budget implementation challenges. PNG and Timor-Leste each have a relatively narrow pool of qualified government personnel administering growing numbers of infrastructure and development projects. In PNG, government agencies have

Fiscal management challenges

Figure 5: Government expenditure, by quarter (% of total annual expenditure)



Q = quarter.
Sources: ADB estimates using data from Papua New Guinea Department of Treasury; Timor-Leste Ministry of Finance.

particularly struggled to recruit and retain skilled staff in the face of strong competition from the private sector, particularly amid the construction of the PNG liquefied natural gas project.

Institutional capacity to prepare, implement, and maintain rising public investment has also been constrained by an emphasis on funding new capital projects, with lower priority given to operational and maintenance costs. In Timor-Leste, personnel expenditures in ministries charged with infrastructure development (the Ministry of Public Works and the Ministry of Transport and Communication) did not keep pace with rising capital budgets during the late 2000s. The ratio of personnel to planned capital expenditures fell from about 5.0% in 2008 to just 2.5% in 2010. Since 2010, however, greater resources have been allocated to increase the staff complement of these ministries.

In PNG, between 2009 and 2014, the proportion of recurrent to total budget allocations fell from 60% to 51%. Again, this trend is particularly evident in the transport sector, with recurrent spending comprising just 11% of the Department of Public Works and Implementation's expenditure in 2014, down from 33% in 2011. This has limited the ability of sector agencies to expand their human resources in response to demands of growing investments, and jeopardizes the sustainability of investments by limiting routine maintenance.

Politicization of the budget process has also amplified some of these challenges. In recent years, agencies in PNG have highlighted that national budget processes have frequently resulted in the selection of projects that were not included in sector agencies' budget submissions. A lack of alignment between sector agency budget submissions and the approved budget has often required agencies to hurriedly prepare and implement unfamiliar projects. Further, limited feasibility and design work before projects are financed have frequently led to unrealistic cost estimates, tendering delays, and difficulties in attracting sufficient private-sector construction capacity.

Fiscal sustainability beyond the resource boom—Policy suggestions

A sound and coherent strategy is necessary for both PNG and Timor-Leste to address current budget implementation issues and ensure long-term fiscal sustainability. Key elements of this strategy could usefully be focused on (i) controlling expenditure growth, (ii) managing off-budget expenditures, (iii) avoiding unsustainable public infrastructure assets, and (iv) maintaining debt sustainability.

Controlling expenditure growth. Credible plans to control future spending growth need to be developed in both PNG and Timor-Leste. In particular, a period of more moderate funding growth for the transport sector may be appropriate. This would give sector agencies a chance to catch up with their investment backlog and to focus on building the technical and institutional capacity required to deliver cost-effective and sustainable infrastructure.

Improving transparency of public expenditures. Fiscal risks created outside the budget process also need to be managed more transparently. In PNG, a previous reduction in public debt was largely offset by a rise in off-budget borrowing, which is now the equivalent of between 15% and 20% of GDP. Major contributors to this debt are the state's equity and contingent liabilities associated with the liquefied natural gas project, and large unfunded social security liabilities. Reflecting these liabilities explicitly in public debt figures will be important for the transparent management of fiscal risks, and will help inform strategies for gradually reducing the total debt burden.

Fiscal management challenges

In the case of Timor-Leste, all government liabilities remain subject to the formal budget process. The level of transparency in the management of the Petroleum Fund also remains exemplary, and extra-budget fiscal risks appear minimal at present. The government is, however, entering into long-term expenditure commitments such as pensions for veterans of the fight for independence. Clarifying these commitments, and recognizing ongoing long-term fiscal liabilities in annual budgets, would help reduce uncertainty in the fiscal outlook.

Avoiding unsustainable levels of public infrastructure. Both PNG and Timor-Leste must be mindful that rising government spending, driven by a bias for new capital projects, may push national infrastructure stocks to levels beyond an affordable and sustainable level of expenditure on operation and maintenance (O&M). Further, the tendency to focus on new infrastructure in PNG—instead of providing sustainable funding for O&M of existing assets—has amplified budgetary pressures, contributed to higher overall costs, and undermined the quality of service delivery. New facilities sit idle as funding remains insufficient for adequate O&M of these assets. Restrictions on government spending on purchases of goods and services, and wages and salaries, started in the 2013 budget are further amplifying this trend.

Similarly, Timor-Leste has focused on building new infrastructure, including a national electricity grid with large excess capacity that now requires a net operating subsidy that will be equivalent to approximately 5.7% of non-oil GDP in 2015, or 11.9% of the sustainable fiscal envelope. Plans to develop the south coast and upgrade the national road system must be phased gradually, and at scales consistent with near term demand. Careful appraisal of new projects is crucial to ensure high rates of return and avoid placing further pressure on public finances.

Managing risks and ensuring debt levels are sustainable. Risks and opportunities associated with increasing public debt in PNG and, to a lesser extent, Timor-Leste, must be carefully managed. For PNG, large budget deficits in recent years—mostly financed through domestic borrowing—highlight the importance of debt restructuring to reduce refinancing risks. PNG's external debt is mostly long term and highly concessional, but its domestic debt stock (roughly 70% of the total) has an uneven maturity profile. About 30% of domestic debt is composed of Treasury bills with maturities between 3 and 6 months. The rest is longer-term debt, but with bunching maturities, which means much of it will need to be refinanced around the same time. If government revenues fall unexpectedly, or if any of the three major commercial banks decide to reduce their exposure to government debt, rolling over existing debt may become difficult. Adjusting the domestic debt stock toward a longer-term maturity profile with a smoother repayment schedule would help lower debt refinancing risks significantly, and bolster the economy's ability to withstand economic shocks.

With large savings in its Petroleum Fund, Timor-Leste currently has little need for additional financial resources. However, it can benefit from tapping external development resources that help to ensure high-quality implementation of new infrastructure and human capital investments. Since 2012, it has taken concessional loans from ADB, Japan International Cooperation Agency, and the World Bank to fund road construction. An added benefit of this financing is that the cost of borrowing is below the expected rate of return on Petroleum Fund assets. Where borrowing replaces funds that would otherwise have been withdrawn from the fund, the lower cost of capital for concessional loans provides an added financial benefit.

Institutional and capacity development—Important first steps

Reform efforts must be supported by institutional development and efforts to address public sector capacity constraints. Strengthening senior and middle management and supervisory skills, office management and administration, common and central services, and local governance and administration, requires sustained efforts over the long-term. For agencies tasked with delivering priority national infrastructure projects, significant investments will also be needed to attract skilled engineers and project supervisors away from the private sector.

Fortunately, there are already some solid practical steps being undertaken in PNG and Timor-Leste. Both countries have passed laws that define the legal basis for public-private partnerships (PPPs) and are in the process of establishing specialized units to prepare and manage PPP transactions. PPPs can help ease implementation risks and alleviate current capacity constraints through greater use of private sector expertise. They can also provide a useful mechanism for project financing, although contingent liabilities that result from PPP transactions must also be carefully managed.

In PNG, central government agencies are working toward improved infrastructure budget coordination and planning, assisted by continued efforts to integrate the recurrent and capital budgets and by publishing 5-year forward spending estimates for all new projects. The 2014 budget also introduces measures to control the use of trust accounts to hold, and at times reallocate, unspent project funds. The government is reviewing all trust accounts to identify funds that can be returned to the consolidated revenue fund. Further, the transfer of unspent funds to existing or new trust accounts has been prohibited starting with all 2013 development projects.

In Timor-Leste, the rise in public investment has occurred in parallel with the development of the institutional framework for public financial management. Major changes were made in 2011 with the establishment of the Infrastructure Fund as a multi-year funding mechanism for new infrastructure, and the creation of the Major Projects Secretariat, the National Development Agency, and the National Procurement Commission. These institutions are designed to strengthen planning, appraisal, procurement, and implementation associated with large infrastructure projects. Institutional design adapts to scarce public sector capacity by centralizing key functions that had previously been distributed among several line ministries.

Fiscal management challenges

Timor-Leste also continues to adjust its legal and institutional arrangements to strengthen public financial management. The Ministry of Finance has begun implementation of a detailed plan to upgrade systems and processes used across government. Annual budget appropriation bills have also been used to pilot new regulations to enhance budget execution and spending quality. These include a 10% limit on the use of single-source procurement, new rules concerning budget execution rates (i.e., if year-end execution is projected to be below 80% by the third quarter, government is required to reduce allocations by rectifying the budget), and controls on the timing of excess withdrawals from the Petroleum Fund (i.e., execution must be above 75% by the end of the third quarter to allow an excess withdrawal).

The Timor-Leste National Procurement Commission provides an interesting example of a gradual and long term approach to reform. Upon establishment, it initially outsourced its core functions to a reputable international firm. Since then, it has moved gradually to build capacity by recruiting international specialists to fill key roles and to transfer skills to newly recruited Timorese staff. Given the time needed to develop new institutions, both countries will face trade-offs between a gradual approach to improving capacity and performance, and more sweeping changes that aim to address key constraints by creating new institutions.

Concluding remarks

As PNG and Timor-Leste navigate through the resource boom, increased efficiency in budget planning and implementation will be vital building blocks for long-term fiscal sustainability. However, to truly promote inclusive growth, fiscal policy should do more than just expand budget allocations to priority sectors. Increased efficiency of budget implementation is required. This entails strengthening the systems and institutions charged with executing budgetary plans and building the human resources needed to implement government programs and investments. The quality of expenditure must also be raised by balancing O&M with capital investments, distributing expenditures more evenly across the budget period, and increasing transparency and predictability in public spending.

Lead authors: Aaron Batten, Christopher Edmonds, David Freedman, and Rommel Rabanal.

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Batten, A. and C. Edmonds. 2013. Managing fiscal risks amid resource booms: Lessons from Papua New Guinea and Timor-Leste. Devpolicy Blog, Development Policy Centre, Australian National University. May.

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Update on fiscal modeling efforts in the Pacific

Fiscal management models (FMMs) being developed under ADB's Pacific Economic Management Technical Assistance (PEM TA) project medium- to long-term effects of policy decisions on a government's budget position and targeted fiscal ratios. These comprise a "baseline" scenario, which hinges on macroeconomic assumptions in the government's latest budget; and "what-if" scenarios, which estimate policy impacts against the baseline. Developed using readily available spreadsheet software and based on government data, FMMs are relatively easy to set up and maintain.

The structure of the FMM is illustrated in Figure 6 and was outlined in a brief in the March 2012 issue of the *Monitor*. The center of the FMM is the fiscal worksheet, which mirrors the summary of government operations that is included in the government's official budget document. Several worksheets feed into the fiscal worksheet. These include the budget, debt, and loan amortization worksheets.

This simplicity means that FMMs cannot capture policy changes' second-round effects, or account for interactions between revenues and expenditures. FMMs are therefore best treated as gateways to more sophisticated models. The FMM's value lies in plainly showing how policy decisions may have lasting implications on the fiscal position.

Background

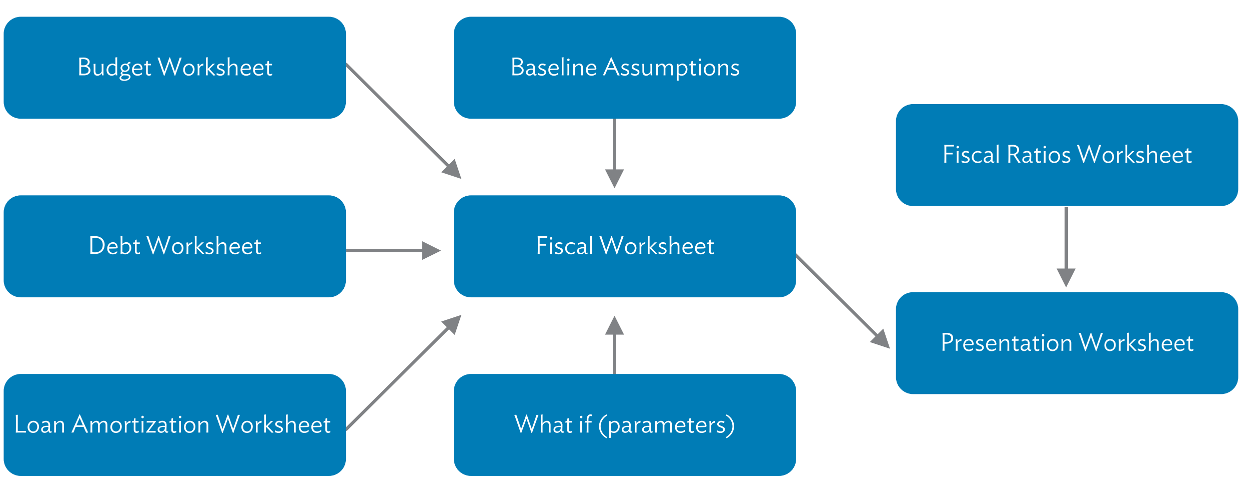
The first Pacific FMM arose from the Cook Islands' Ministry of Finance and Economic Management request to ADB's PEM TA for a simple model to illustrate policy changes' impact on key fiscal performance measures and to provide inputs to annual budget documents. Ministry and PEM TA representatives presented the resulting FMM at the Regional Medium Term Budgeting Workshop in November 2011 in Nadi, Fiji. Participants appreciated the model's usefulness and relative simplicity, and called for PEM TA to help develop similar models in other Pacific countries.

Delivery and assistance modalities

Most FMMs to date have been developed through extended in-country missions (Table 1). The budget preparation unit within a Pacific finance ministry requests assistance from PEM TA, and designates technical staff as focal points to undertake pre-mission data exchanges and evaluation with PEM TA economists, to ensure that necessary data is available to construct the model. The mission proper entails the following key activities: (i) briefing budget unit officials, including ministers of finance; (ii) discussing fiscal policy options under deliberation to determine whether the FMM could address these; (iii) customizing the generic FMM framework to consider country-specific context and concerns; (iv) jointly developing the FMM with technical staff, and helping build their capacity to update and maintain the model; (v) preparing a user's manual to document steps in FMM development and updating, and promote the model's sustainability; and (vi) presenting policy simulation results to a wider audience, including policymakers and concerned high-level government officials. To date, PEM TA has fielded FMM missions to seven Pacific developing member countries (DMCs).

In December 2012, PEM TA, in collaboration with the Pacific Financial Technical Assistance Centre (PFTAC) and the Pacific Island Centre for Public Administration of the University of the South Pacific, held a regional workshop to develop and discuss FMMs for long-term fiscal planning in six Pacific countries. The workshop involved a mix of group lectures and breakout sessions where country teams worked closely with PEM TA facilitators in developing their FMM. The gathering also provided a unique opportunity for budget practitioners to share experiences regarding common fiscal issues facing the Pacific, and their ministries' approaches to address these challenges.

Figure 6: Fiscal Management Model Structure



Source: ADB. 2012.

Update on fiscal modeling efforts in the Pacific

Table 1: ADB fiscal management model missions

Country	Date	Sample applications
Cook Islands	09/2011	Fiscal ratios update
	09/2013	VAT and wage rate adjustments
Fiji	05/2012	Tracking capital expenditure share
Regional*	12/2012	Model development
RMI	10/2013	Compact grant decrements
FSM	11/2013	Compact grant decrements
Palau	10/2014	Tourism-GDP linkages
Solomon Islands	06/2013	Tracking recurrent expenditure shares
Tonga	02/2012	Consumption tax adjustment
Regional**	forthcoming (12/2014)	Model development

GDP = gross domestic product, FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands, VAT = value-added tax.
* Participating countries: Fiji, RMI, Solomon Islands, Tonga, Tuvalu, and Vanuatu.
** Participating countries: Cook Islands, Fiji, RMI, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, and Vanuatu.
Source: ADB.

Related efforts by development partners

A number of development partners active in the Pacific region are also providing technical assistance to support the development of long-term fiscal forecasting and planning models. PFTAC, the World Bank, and Graduate School USA are leading these related efforts.

PFTAC has been working with goverments in developing simplified versions of the International Monetary Fund's (IMF) financial programming frameworks. This involves staff from ministries of finance or treasury, and central banks of countries with capacity to support core monitoring and projection activities. The frameworks are tailored to the unique aspects of each country's economic structure. Financial programming principles ensure consistency between the four sectors (macroeconomic, fiscal, external, and monetary). The frameworks use national accounts (on an expenditure basis) and the main categories of tax revenues, as the bases for revenue forecasting. In many cases, the evolution of outstanding debt (specified for each loan) is incorporated into the framework, to generate debt profiles consistent with the macro-fiscal framework under baseline and alternative scenarios. Such frameworks are now functional in Fiji, Samoa, Solomon Islands, Papua New Guinea (PNG), and Vanuatu.

The World Bank also supports capacity building to improve country debt management. World Bank staff have undertaken technical assistance missions to Samoa and Tonga, and organized a regional workshop on debt sustainability frameworks in the first half of 2014. The World Bank has produced a tailored spreadsheet tool to Samoa and Tonga to help them to (i) understand fundamental drivers of debt levels treated in the full debt sustainability framework, (ii) inform national assessments of debt levels and sustainability, (iii) carry out basic debt diagnostics and model how alternative fiscal policy decisions affect debt outcomes, and (iv) improve their debt reporting. Similar to the loan amortization feature in the FMM, the tool is intended to accompany a macroeconomic model—not to replace one. It includes present value indicators to take account of the degree of concessionality in loans.

In the North Pacific (Republic of the Marshall Islands, the Federated States of Micronesia, and Palau), the Graduate School USA is supporting similar fiscal modeling efforts.

These models focus on analysis of fiscal adjustments required in response to planned decrements in US assistance with the expiration of compacts of free association.

The Commonwealth Secretariat supports countries in managing sovereign debt through its Debt Recording and Management System—an integrated tool for recording, monitoring, analyzing, and reporting public debt. The system has been installed in the Cook Islands, Fiji, Nauru, PNG, Samoa, Solomon Islands, Tonga, and Vanuatu. The Commonwealth's system links with financial management information systems and the debt sustainability analysis and debt management frameworks.

Collaborations and future plans

Development partners are working to ensure that their various models and training activities complement each other. Well-coordinated efforts can help to effectively address capacity limitations in fiscal modeling, and facilitate application of the models in policy making by authorities across Pacific economies.

As part of these efforts, PEM TA, along with PFTAC, Pacific Islands Centre for Public Administration, and the Pacific Islands Forum Secretariat, will conduct a second regional fiscal forecasting and modeling workshop in December 2014. The workshop aims to replicate and build on the achievements of the 2012 workshop.

PEM TA also continues to offer assistance through in-country missions to update existing FMMs, develop new ones in other countries, and build capacity in Pacific long-term fiscal planning.

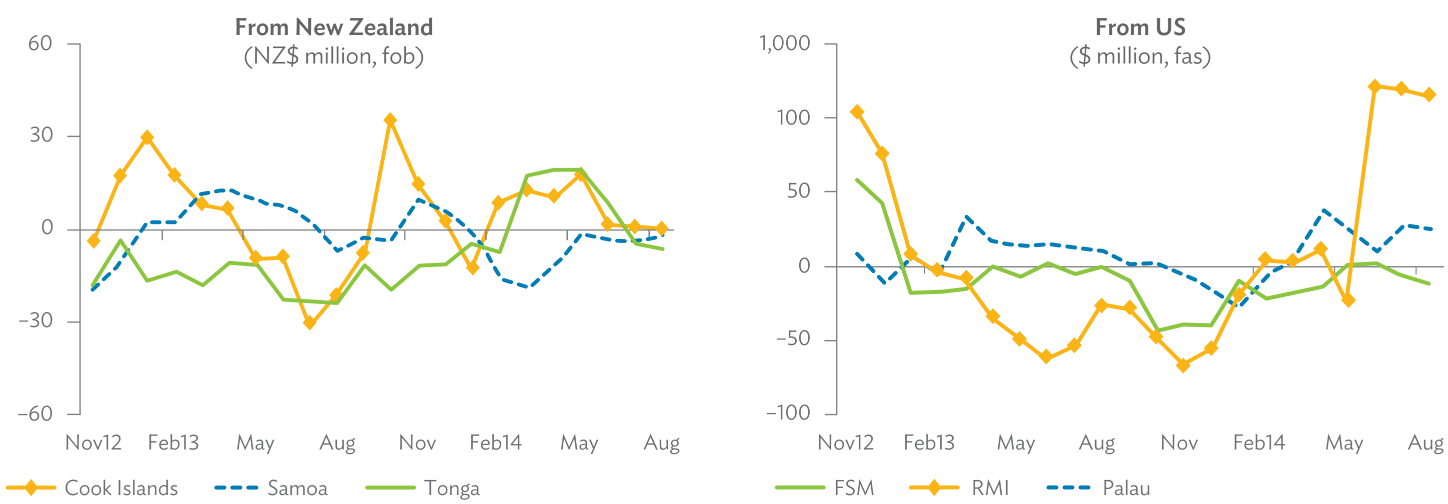
Lead authors: Christopher Edmonds, Cara Tinio, and Johannes Wolff.

Reference:
ADB. 2012. Fiscal Management Models for the Pacific, *Pacific Economic Monitor.* March. Manila.

Nonfuel merchandise exports from Australia
(A$; y-o-y % change, 3-month m.a.)

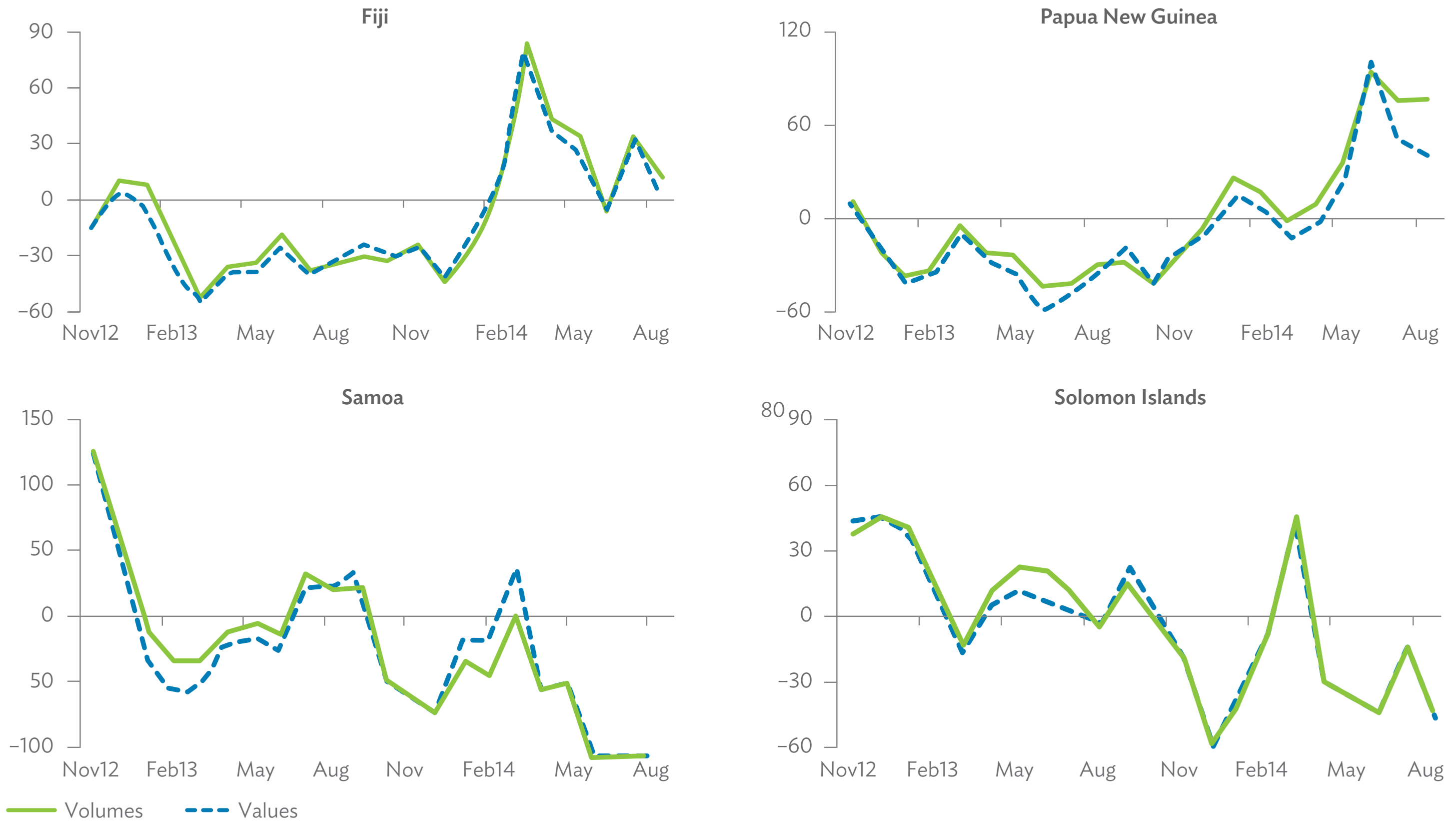
A$ = Australian dollars, lhs = left-hand scale, m.a. = moving average, rhs = right-hand scale, y-o-y = year-on-year.
Source: Australian Bureau of Statistics.

Nonfuel merchandise exports from New Zealand and the United States
(y-o-y % change, 3-month m.a.)



fas = free alongside, fob = free on board, FSM = Federated States of Micronesia, m.a. = moving average, NZ$ = New Zealand dollar, RMI = Republic of the Marshall Islands, US = United States, y-o-y = year-on-year.
Sources: Statistics New Zealand and US Census Bureau.

Diesel exports from Singapore
(y-o-y % change, 3-month m.a.)



m.a. = moving average, y-o-y = year-on-year.
Source: International Enterprise Singapore.

Gasoline exports from Singapore
(y-o-y % change, 3-month m.a.)

m.a. = moving average, y-o-y = year-on-year.
Source: International Enterprise Singapore.

Departures from Australia to the Pacific
(monthly)

persons ('000) y-o-y % change (rhs)

rhs = right-hand scale, y-o-y = year-on-year.
Source: Australian Bureau of Statistics.

Departures from New Zealand to the Pacific
(monthly)

rhs = right-hand scale, y-o-y = year-on-year.
Source: Statistics New Zealand.

Latest Pacific Economic Updates						
	GDP Growth (%, 2014p)	Inflation (%, 2014p)	Credit Growth[a] (%)	Trade Balance (% of GDP)	Import Cover (months)	Fiscal Balance (% of GDP)
Cook Islands	2.2	1.6	–7.6 (Q2 2014)	–31.6 (FY2013e)	—	–12.1 (FY2014e)
Fiji	3.8	1.5	15.8 (Sep 2014)	–36.0 (Jan–Aug 2014e)	4.7 (Oct 2014)	–2.0 (FY2014e)
Kiribati	3.0	2.5	—	–56.6 (2013e)	—	–19.3 (2014e)
Marshall Islands	3.0	1.5	1.1 (FY2013)	–34.2 (FY2013e)	—	–1.2 (FY2014e)
FSM	0.5	2.0	–4.8 (FY2013)	–41.7 (FY2013e)	—	3.6 (FY2013e)
Nauru	10.0	5.0	—	—	—	3.9 (FY2014e)
Palau	2.3	4.0	—	–56.5 (FY2013e)	—	–1.2 (FY2013e)
PNG	6.0	6.0	5.2 (Aug 2014)	5.4 (1H-2014e)	7.7 (Aug 2014)	–5.9 (2014e)
Samoa	2.0	–1.2	1.5 (Q4 2013)	–40.7 (FY2014e)	5.5 (Q4 2013)	–4.8 (2014e)
Solomon Islands	–1.0	6.0	15.6 (Q4 2013)	–2.1 (1H-2014e)	9.3 (Q2 2014)	–1.7 (1H-2014e)
Timor-Leste[b]	8.0	3.0	5.0 (Q2 2014)	–56.8 (1H-2014e)	3.9 (Q2 2014)	6.2 (2014e)
Tonga	1.5	2.3	–0.6 (Oct 2014)	–28.3 (FY2014e)	8.9 (Oct 2014)	8.7 (FY2014e)
Tuvalu	2.0	2.5	0.8 (2014p)	–2.9 (2014p)	7.9 (2014p)	43.0 (2014p)
Vanuatu	3.5	2.5	6.7 (Q2 2014)	–28.1 (Q1–Q3 2014e)	7.1 (Oct 2014)	–0.3 (2014e)

— = not available, e = estimate, FSM = Federated States of Micronesia, FY = fiscal year, GDP = gross domestic product, H = half, p = projection, PNG = Papua New Guinea, Q = quarter.
[a] Credit growth refers to growth in total loans and advances to the private sector.
[b] Timor-Leste GDP is exclusive of the offshore petroleum industry and the contribution of the United Nations.
Notes: Period of latest data shown in parentheses; import cover for PNG is months of nonmining and oil imports.
Sources: ADB. 2014. *Asian Development Outlook 2014 Update.* Manila; and statistical releases of the region's central banks, finance ministries and treasuries, and statistical bureaus.

Key data sources:
Data used in the *Pacific Economic Monitor* are in the ADB PacMonitor database, which is available in spreadsheet form at www.adb.org/pacmonitor

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About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to approximately two-thirds of the world's poor: 1.6 billion people who live on less than $2 a day, with 733 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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In this publication, "$" refers to US dollars.