

SM/06/333
Correction 2

October 20, 2006

To: Members of the Executive Board
From: The Secretary
Subject: **Brunei Darussalam—Staff Report for the 2006 Article IV Consultation**

The following corrections to SM/06/333 (9/29/06) have been provided by the staff:

A. Mischaracterizations of the Views of the Authorities

Page 9, paragraph 14, second bullet, line 10: for “connection with the Sultan’s 60th birthday.”
read “the form of accelerated salary increments
while at the same time maintaining the
existing basic salary scale.”

line 14: remove “a personal income tax and”

Page 10, paragraph 14, line 3: for “carefully assessed.”
read “carefully assessed and that introducing a personal income
tax, as suggested by staff, would be extremely difficult.”

Comment: The text in paragraph 14 has been revised to clarify the nature of the wage increases introduced in 2006 and better convey the authorities’ views on the possibilities of introducing a personal income tax.

B. Factual Errors not Affecting the Presentation of Staff’s Analysis or Views

Page 18, Table 3, rows 15–22: data revised as indicated

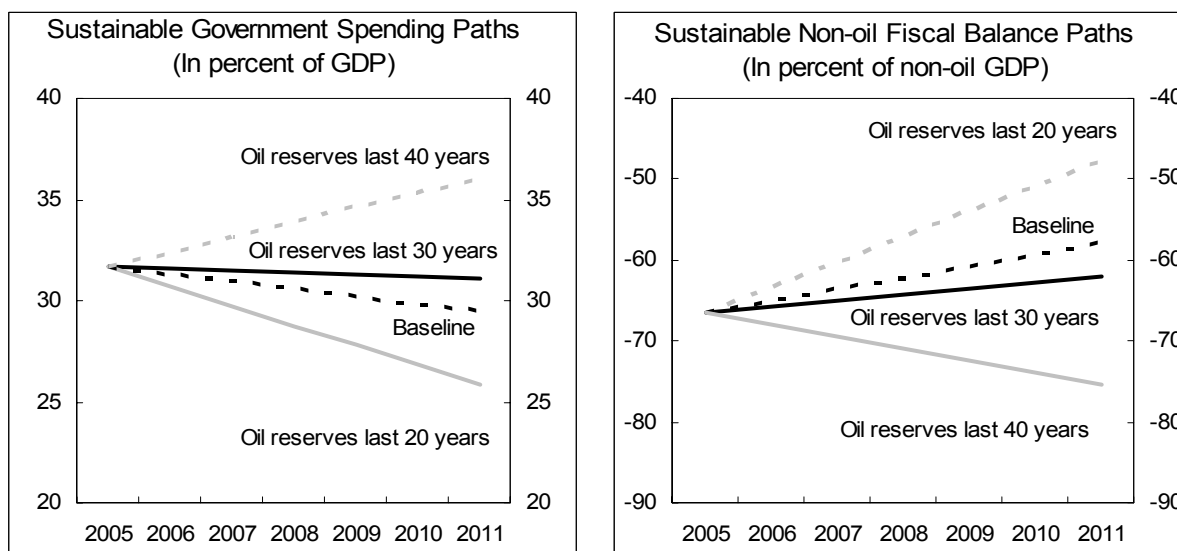
Questions may be referred to Mr. Nakabayashi (ext. 38918) and Mr. Eskesen (ext. 34033), in APD.

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of return on government assets, and other factors.^{5, 6} These uncertainties underline the importance of establishing a fiscal goal based on cautious assumptions and regularly updating the sustainability analysis.



- Expenditure and revenue reforms necessary to support economic diversification, strengthen growth, and meet the medium-term fiscal goal.** On the expenditure side, staff encouraged the government to reduce the wage bill by containing wages and reducing staff, partly through natural attrition. It also suggested cutting the generous fringe benefits, extending the defined-contribution pension system to the entire government, and reducing distortionary fuel subsidies. The savings could create room for higher outlays on education, targeted social assistance, and productive capital expenditure needed to support diversification and economic growth. While the authorities agreed with the thrust of the expenditure measures, they said wages had been kept unchanged since 1984 and were only just increased this year in connection with the Sultan's 60th birthday the form of accelerated salary increments while at the same time maintaining the existing basic salary scale. On the revenue side, a gradual broadening of the revenue base is needed over the medium term to prepare for the eventual depletion of energy-related revenues. The authorities concurred that options include broadening the corporate income tax base, introducing a personal income tax and a general sales & service tax, raising utility charges to reflect underlying costs,

⁵ Staff's sustainability analyses involve, under different assumptions about key variables, determining a path for government savings over the medium term consistent with a sustainable level of real per capita government spending (in line with the permanent income hypothesis). For further details on the methodology applied, see 2003 Brunei Selected Issues paper (SM/03/114).

⁶ Staff's medium-term baseline scenario, presented in text charts and Table 5, assumes that hydrocarbon reserves will last for 30 years. The implied fiscal saving over the medium term in the baseline is larger than strictly needed to achieve the sustainable path. This reflects the need to contain current spending to support diversification and competitiveness, but also some constraints on development spending implementation, despite an assumed strengthening in the capacity to identify and execute these programs.

and strengthening tax administration. However, they stressed that the social and economic impact of such reforms would first have to be carefully assessed and that introducing a personal income tax, as suggested by staff, would be extremely difficult.

- **Fiscal rules to help safeguard the medium-term fiscal goal.** Fiscal rules can help insulate policy from popular pressures for additional spending. Such rules should aim to decouple expenditures from the short-run vagaries of oil prices. From a stabilization perspective, the mission proposed a fiscal rule targeting the ratio of the structural non-oil primary balance to non-oil GDP. The size of the permissible balance should be consistent with long-term sustainability. At the same time, the mission noted that a necessary precondition is a sound fiscal framework and that a fiscal rule is only as strong as the political will to abide by it. The authorities noted that they informally follow a rule by formulating the budget based on conservative assumptions about international energy prices, but that they would be interested in looking further into a formal and transparent rule consistent with long term fiscal sustainability.

15. **The authorities' establishment of the two oil-related funds has helped signal the objective of fiscal stabilization and savings.** However, strengthening the framework governing the two funds, the Consolidated Fund (CF) and the General Reserve Fund (GRF), could help further strengthen fiscal management.⁷ A formal and explicit definition of their purpose and use, rules-based mechanisms for transfers to and from the funds, and integration of the funds into the budget would improve transparency and accountability and provide a stronger institutional base to build up wealth for future generations. In this context, staff pointed out that it is important to establish a mechanism that ensures an efficient allocation of the fiscal surplus between the two funds, taking into account trade-offs between liquidity risk and financial return. The CF currently holds assets in excess of 50 percent of GDP, mostly in liquid low-yielding assets such as bank deposits. Considering this and the large fiscal surplus expected in coming years, the authorities agreed that there is scope to reallocate funds from the CF to higher-yielding assets placed under the GRF.

B. Monetary and Financial Sector Policies: Building Institutions

16. **The currency board arrangement remains a key element of Brunei's macroeconomic management, contributing to price and financial stability.** To further strengthen the credibility of the Brunei Currency and Monetary Board (BCMB), the mission urged the authorities to publish the audited BCMB accounts for 1999–2001 and finalize the auditing of subsequent years. The mission commended the authorities for maintaining the

⁷ CF is a general purpose fund to which budgetary receivables accrue and from which budget allocations are made. The GRF is a savings fund for future generations managed by the Brunei Investment Agency (BIA), a separate government entity. These funds are discussed in detail in Box 3 of the 2004 Article IV Staff Report (SM/04/161).

Table 2. Brunei Darussalam: Fiscal Developments, 2001–06/07 1/

	2001	2002	2003	2004/05	2005/06		2006/07	
				Actual	Budget 2/	Outturn	Budget 2/	Staff Proj.
(In millions of Brunei dollars)								
Total revenue	4,232	4,268	4,930	6,361	4,135	8,441	5,206	10,258
Tax	2,306	2,332	2,600	3,666	2,429	5,252	2,966	6,158
Oil and gas	2,125	2,116	2,393	3,439	2,221	4,988	2,750	5,894
Other	181	216	207	227	208	263	216	263
Nontax revenue	1,926	1,936	2,330	2,695	1,707	3,190	2,240	4,101
Oil and gas 3/	1,498	1,582	1,916	2,376	1,430	2,784	1,966	3,695
Other	428	354	414	319	276	406	274	406
Total expenditure	3,914	4,794	4,032	4,815	5,003	5,086	5,200	5,359
Total expenditure excluding royalties	3,914	3,895	3,613	3,935	4,723	4,253	4,880	4,500
Current	2,745	3,777	3,145	3,957	3,460	4,076	3,600	4,089
Wages and salaries	1,286	1,319	1,340	1,415	1,575	1,476	1,577	1,527
Other 4/	1,459	2,458	1,805	2,542	1,885	2,600	2,023	2,561
Capital	1,169	1,017	887	858	1,543	1,010	1,600	1,270
Of which: Development expenditure	210	435	263	356	900	485	900	630
Primary budget balance	318	-526	898	1,545	-868	3,355	6	4,900
Primary balance excluding royalties	-70	-11	843	1,783	-1,023	3,341	-180	4,885
Non-oil primary balance	-3,305	-3,325	-2,992	-3,370	-4,239	-3,584	-4,390	-3,831
Balance including investment income 5/	4,681	-1,079	1,840	2,199		5,929		6,724
Financing from General Reserve Fund	0	0	0	0	0	0	0	0
Financing from Consolidated Fund	-318	526	-898	-1,545	868	-3,355	-6	-4,900
(In percent of GDP)								
Total revenue	42.2	40.8	43.2	45.6	25.1	51.3	28.2	55.5
Tax	23.0	22.3	22.8	26.3	14.8	31.9	16.0	33.3
Oil and gas	21.2	20.2	20.9	24.7	13.5	30.3	14.9	31.9
Other	1.8	2.1	1.8	1.6	1.3	1.6	1.2	1.4
Nontax revenue	19.2	18.5	20.4	19.3	10.4	19.4	12.1	22.2
Oil and gas 3/	14.9	15.1	16.8	17.0	8.7	16.9	10.6	20.0
Other	4.3	3.4	3.6	2.3	1.7	2.5	1.5	2.2
Total expenditure	39.0	45.8	35.3	34.5	30.4	30.9	28.1	29.0
Total expenditure excluding royalties	39.0	37.2	31.6	28.2	28.7	25.8	26.4	24.3
Current	27.4	36.1	27.5	28.4	21.0	24.8	19.5	22.1
Wages and salaries	12.8	12.6	11.7	10.1	9.6	9.0	8.5	8.3
Other 4/	14.5	23.5	15.8	18.2	11.5	15.8	10.9	13.9
Capital	11.6	9.7	7.8	6.2	9.4	6.1	8.7	6.9
Of which: Development expenditure	2.1	4.2	2.3	2.6	5.5	2.9	4.9	3.4
Primary budget balance	3.2	-5.0	7.9	11.1	-5.3	20.4	0.0	26.5
Primary balance excluding royalties	-0.7	-0.1	7.4	12.8	-6.2	20.3	-1.0	26.4
Non-oil primary balance	-32.9	-31.8	-26.2	-24.2	-25.8	-21.8	-23.7	-20.7
In percent of non-oil GDP	-70.6	-67.4	-61.1	-65.7	-78.8	-66.6	-78.0	-68.0
Financing from General Reserve Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing from Consolidated Fund	-3.2	5.0	-7.9	-11.1	5.3	-20.4	0.0	-26.5
Memorandum items:								
Nominal GDP (in millions of Brunei dollars)	10,035	10,463	11,424	13,945	16,459	16,459	18,492	18,492
Non-oil GDP (in millions of Brunei dollars)	4,683	4,931	4,894	5,133	5,382	5,382	5,631	5,631

Sources: Data provided by the Brunei authorities; and Fund staff estimates.

1/ Fiscal year changed from a calendar year to April–March in 2004; excludes interests and investment income.

2/ Based on an oil price assumption of US\$25 per barrel for FY 2005/06 and US\$35 per barrel for FY 2006/07.

3/ Include energy sector royalties and dividends.

4/ Includes disbursements of royalties.

5/ Includes Fund staff estimates of investment income.

Table 3. Brunei Darussalam: Balance of Payments, 2001–07 1/

	2001	2002	2003	2004	2005	Proj. 2006	Proj. 2007
(In millions of U.S. dollars, unless otherwise indicated)							
Current account balance	2,883	2,484	3,252	3,773	5,339	6,964	7,557
In percent of GDP	51.5	42.5	49.6	47.9	56.0	60.7	61.6
Trade balance	2,542	2,193	3,167	3,721	4,836	6,568	7,007
Exports	3,640	3,702	4,421	5,057	6,249	8,087	8,640
Oil and gas	3,252	3,259	3,876	4,624	5,886	7,691	8,212
Other 2/	388	443	545	433	363	396	428
Imports	1,099	1,509	1,254	1,336	1,413	1,520	1,633
Services (net)	-580	-460	-594	-530	-494	-503	-502
Receipts	489	437	435	544	617	656	719
Payments	1,069	897	1,029	1,074	1,111	1,160	1,221
Income (net) 3/	1,195	1,068	968	890	1,373	1,292	1,465
Receipts	1,383	1,243	1,181	1,117	1,563	1,491	1,675
Payments	189	176	213	228	190	199	209
Current transfers (net)	-273	-317	-290	-309	-376	-392	-413
Capital and financial account balance	-1,040	-866	-1,003	-402	-1,431	-1,592	-2,150
In percent of GDP	-18.6	-15.5	-17.2	-6.9	-21.8	-24.3	-27.3
Capital account balance (net)	-0.8	-0.8	-1.2	-11.3	-11.0	-11.5	-11.5
Financial account balance	-1,039	-866	-1,002	-401	-1,430	-1,591	-2,139
Direct investment (net)	-63	63	-232	232	-122	122	-152
Portfolio investment (net)	-182	8	60	-45	21	15	17
Other investment (net) 3/ 4/	-794	-746	-778	-641	-1,368	-1,773	-1,942
Errors and omissions 5/	-1,860	-2,034	-1,435	-2,036	-1,777	-1,616	-1,599
Overall balance	-17	46	44	24	-11	46	36
Gross official reserves 6/	391	438	482	505	494	540	576
In months of next year's imports of goods and services	2.0	2.3	2.4	2.4	2.2	2.3	2.3
Memorandum items:							
Exchange rates							
Brunei dollars per U.S. dollar (period average)	1.79	1.79	1.74	1.69	1.66	1.59	1.57
Brunei dollars per U.S. dollar (end of period)	1.85	1.74	1.70	1.63	1.66	1.58	1.57
Nominal effective exchange rates (2000=100)	99.8	98.8	97.0	96.4	97.2	99.7	...
Real effective exchange rates (2000=100) 7/	99.1	97.6	95.0	92.9	92.3	93.4	...
Nominal GDP (in millions of U.S. dollars)	5,601	5,843	6,557	7,872	9,531	11,482	12,265

Sources: Data provided by the Brunei authorities; and Fund staff estimates and projections.

1/ Balance of payments data for 2001 onwards were revised after the 2004 Article IV consultation.

2/ From 2004, excludes reexports.

3/ Based on Fund staff estimates.

4/ Includes changes in banks' net foreign assets.

5/ The large scale of errors and omissions reflects the lack of comprehensive balance of payments data.

6/ Includes Brunei Currency and Monetary Board's foreign exchange assets, SDR holdings, and reserve position in the Fund.

7/ Period average. 2006 data is average for the first half of the year.