2018 Budget Strategy Paper

Presented by

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7 NOVEMBER 2017

Acronyms

APEC	**Asia-Pacific Economic Cooperation**
CRF	**Consolidated Revenue Fund**
DPM	**Department of Personnel Management**
DSP	**PNG Development Strategic Plan (2010-2030)**
EITI	**Extractive Industries Transparency Initiative**
FRA	**Fiscal Responsibility Act (2006/2014)**
GDP	**Gross Domestic Product**
GFS	**Government Financial Statistics**
IMF	**International Monetary Fund**
LNG	**Liquefied Natural Gas**
MTDP2	**Medium Term Development Plan (2016-2017)**
MTDP3	**Medium Term Development Plan (2018-2022)**
MTFS	**Medium Term Fiscal Strategy (2018-2022)**
MTDS	**Medium Term Debt Strategy**
MTRS	**Medium Term Revenue Strategy**
PE	**Personnel Emolument**
PNG	**Papua New Guinea**
PFMA	**Public Finance Management Act**
PEFA	**Public Expenditure and Financial Accountability**
RHS	**Right Hand Side (axis)**
SME	**Small and Medium Enterprises**
SOE	**State Owned Enterprises**
StaRS	**Strategy for Responsible Sustainable Development**
SWF	**Sovereign Wealth Fund**
TFF	**Tuition Fee Free**

Contents

Government of Papua New Guinea

2018 Budget Strategy Paper

I. PURPOSE

The publication of the National Budget Strategy Paper is in compliance with the requirements of the *Papua New Guinea Fiscal Responsibility Act 2006.* It is a key component of the Government's Budget Reform agenda which aims to improve the preparation of budgets, provide for efficient management of public finances and further promote transparency and accountability.

The Budget Strategy Paper provides the public with an overview of the fiscal landscape of the country and the Government's fiscal policy responses to these prevailing conditions. It also provides the public with an opportunity to gauge the Government's record on delivering on its promises.

The 2018 Budget Strategy Paper is unique because it marks the beginning of a new five-year term with the inception of the new O'Neill-Abel Government after the 2017 National General Elections. The document is a stepping stone as it sets the framework of the 2018 Budget, which will build on the Alotau Accord 2, the 100 Days Plan and 2017 Supplementary Budget. It marks the first year of the new *Medium Term Fiscal Strategy (MTFS) 2018-2022*; the *Medium Term Debt Strategy 2018-2022* and the *Medium Term Development Plan (MTDP3) and the inclusion of a new Medium Term Revenue Strategy 2018 - 2022.*

More specifically, the 2018 National Budget Strategy will contain:

i. Economic fiscal trends and issues;
ii. The Government's 100 Days Plan and the 2017 Supplementary Budget;
iii. The 2018 Budget Strategy and the indicative fiscal parameters and policies for the 2018 Budget;
iv. The Medium Term Framework and projections;
v. Key budget policies; and
vi. Risks to the economic and fiscal outlook.

Fiscal data included in the Budget Strategy Paper is only indicative and is based on the information available at the time of preparation. The macroeconomic and fiscal forecasts will be updated in the 2018 Budget to reflect any changes in economic and financial conditions as will the key 2018 fiscal strategies outlined in this document.

II. BACKGROUND - ECONOMIC AND FISCAL TRENDS AND ISSUES

The 2017 Budget was framed against relatively weak world economic conditions impacted by a low commodity price environment. The world economy, nevertheless, was expected to recover modestly in 2017 leading to a gradual increase in commodity prices and a commensurate modest lift in domestic economic growth and domestic revenues. Whilst world growth did pick up modestly in 2017, it remained well below longer term averages and the commodity price trends remain mixed.

The decline in real GDP in PNG in 2016 was worse than expected. Furthermore, in 2017 real GDP growth in PNG is again turning out to be worse than expected, even at the time of the Supplementary Budget, with the growth rate now projected to decline to 2.2 per cent. Real GDP has now declined from 12.5 per cent in 2014 to 8.0 per cent in 2015 to 2.4 per cent in 2016.

A. Revenue

In 2016 tax collections were only modestly higher than 2012 levels and this decline in tax collections against nominal GDP is significant, which shows the effect of adverse economic conditions and compliance issues, with tax collections on corporate profits, in particular, down disproportionately more than other tax collections.

In contrast, other revenue collections have improved, which mainly reflects the increased collections of dividends from the petroleum and mining sectors. Despite the introduction of a number of revenue measures in 2016, lower commodity prices, the lagged effects of the drought and the foreign exchange imbalance, all had a substantial adverse impact on tax revenues. This resulted in tax revenues ending the 2016 year well below budget, including the Supplementary Budget estimates, and significantly below collections in the previous year.

As a percentage of nominal GDP, total tax and other revenue collections in 2016 declined to 13.4 per cent from 18.5 per cent in 2012. This is low by historical standards in PNG and low by regional standards, including countries comparable to PNG. For example, revenue (excluding grants) as a percentage of GDP in 2015 was 24.5 per cent for Australia, 25.7 per cent for Fiji, 18.5 per cent for Vanuatu, 13.6 per cent on average for all low-income countries and 15.4 per cent for lower middle-income countries. Some of this decline is due to the increase in the GDP base from the earlier LNG construction boom.

Overall in 2017 the expected recovery in the domestic economy has been hampered by the latent effects of the drought, weak recovery in the prices of key commodities, severe restrictions on public sector spending due to financing constraints and the continuing foreign exchange imbalance. Real GDP in 2017 is expected to increase by only 2.2 per cent, lower than the 2017 budget projections of 2.8 per cent and, as a consequence, domestic revenues will miss 2017 budget targets, but unlike in 2016, they should increase by 4 per cent on 2016 levels. This, however, is still lower than nominal GDP growth rates.

Given the continuation of subdued GDP growth through 2017, PNG continues to be confronted with a serious revenue crisis. The 2017 MYEFO report estimated that revenue would fall short of budget by over K500 million in 2017 due predominately to a shortfall in tax receipts and dividends:

- Corporate tax collections in 2017 are likely to be lower than in 2016– but this is in part due to the continuation of the IRC allowing income tax offsets against GST refunds that have not been paid. Consequently, lower corporate tax collections have in part been offset by higher net GST collections. Nevertheless, little growth in adjusted (for GST offsets) corporate income tax is indicative of the subdued nature of the economy at present. Lower corporate tax collections also reflect the fact that losses are being carried forward from 2015-16 following the drought and lower commodity price environment.

- The subdued economic growth environment at present is also reflected in stagnant GST collections at the ports, although lower receipts at ports have been offset by higher receipts from the provinces indicating greater compliance efforts by IRC.
- Personal income tax collections, however, are expected to be up 5 per cent in 2017, despite the projected decline in employment levels in 2017. This, in part, is due to the higher public sector payroll and some modest pay increases mainly in the private sector.
- Customs collections are also flat, except for excises which are higher due to higher prescribed duties. The impact of the foreign exchange imbalance is also likely to have been an issue here.

B. Expenditure

Over the LNG construction period up to 2014 rising expenditure trends exceeded rising revenue trends, reflecting the optimistic outlook and efforts to fast track economic development. This increased the fiscal deficit and commensurate debt levels substantially resulting in the Government being confronted with a substantial financing constraint from 2015. With the decline in economic growth from 2015, expenditure levels have been curtailed significantly and the fiscal deficit reduced. However sharper than expected falls in revenue collections and the continuing growth in some expenditure categories since 2015 have meant that expenditure constraint has not been sufficient to relieve pressure on the financing constraint and public sector debt levels have continued to mount.

A number of budget expenditure categories have shown increasing trends and are quite rigid in terms of reversing these rising trends. In particular, personnel emoluments as a proportion of non-resource revenue has reached 46 per cent in 2017, up substantially from well below 20 per cent just 5 years earlier. Much of the growth has been in the teacher payroll – a difficult area to control in many developing countries given high proportions of the population in rural areas. The growth in budget deficits and the flow on into higher public debt levels have resulted in a rising trend in public debt interest charges which are predominately locked in. GST transfers to provinces are also locked in. The Government's important development policies relating to tuition fee free education and free primary health care with the associated pharmaceutical needs, whilst critical to development, also lock in significant forward expenditures.

With low GDP and consequent low revenue growth, the result has been that the burden of adjustment has fallen disproportionately on 3 areas:

- the capital budget – including all its components (the Government of PNG PIP expenditures, SIPs and loan drawdowns that generally require counterpart capital funding);
- the goods and services expenditure budget where large cuts have impacted adversely on service delivery and/or substantial arrears have been accumulated; and
- the budget deficit which, given the high existing level of domestic debt, has placed substantial strain on domestic financing with the domestic banks' holdings of domestic government securities reaching limits. The foreign exchange imbalance has

also tied up liquidity and resulted in the decisive movement into shorter dated treasury bills, adding significant rollover risk to the Government's portfolio.

The result has meant that restrictive supplementary budgets have had to be enacted in all recent years. With the shift from capital to rigid recurrent expenditures, this has eroded economic growth and increased fiscal and financial risk. Fiscal overhangs at year end have undermined the subsequent year's budget management and execution which have undermined service delivery.

The 2017 MYEFO report and subsequent estimates showed that expenditure levels were likely to end 2017 K800 million above budget reflecting estimated increases in personnel emoluments (K430 million), rents (K100 million), public debt interest (K150 million), pharmaceuticals (K50 million), Department of Works expenditures (K54 million) and other (K16 million). These increases were all required to be funded in the 2017 Supplementary Budget.

C. Financing

In 2016, with overall expenditures being held relatively constant, the decline in revenue had a substantial negative impact on the fiscal deficit which increased to 4.5 per cent of GDP from the budgeted 3.1 per cent and resulted in a significant fiscal overhang falling into 2017 which was not budgeted for in either 2016 or 2017. Consequently, debt levels increased significantly and the financing challenge for 2017 was exacerbated from the start.

The unexpected rising budget deficit has been difficult to plan and execute. The take up of the first tranche of the Credit Suisse loan helped relieve some financing pressures in 2016 but was not sufficient to offset the rising fiscal deficit. The resulting substantial fiscal overhang at end 2016 was coupled with policy delays due to the election which delayed remedial action on the ongoing structural revenue and expenditure issues. This meant that fiscal management of the 2017 budget generally encountered the same problems as in 2016.

Thus, the majority of the burden has fallen on the domestic financial sector. The rise in domestic securities on issue has been pronounced, placing limits on further expansion of this market and increasing domestic rollover risk – a problem also exacerbated by the trend to shorter duration.

The 2017 MYEFO report issued after the mid-year review estimated that, on a no-policy-change basis, the fiscal deficit would increase to K2,820 million (3.8 per cent of GDP) and even higher if the subsequent K370 million in over expenditures were taken into account.

While efforts were focused on securing external financing such as the second tranche of the Credit Suisse loan; the Treasury and Finance agencies focused on addressing some of the cash shortages and financing constraints with highly restrictive warrant control and the accumulation of arrears.

III. THE 100 DAYS PLAN AND 2017 SUPPLEMENTARY BUDGET

To address a number of urgent priorities and mitigate budget deviations, the new Government introduced its 100 Days Plan in August 2017 which was based on the Alotau Accord 2 which included the formulation of a Supplementary Budget in September 2017.

A. 2017 Supplementary Budget

The Supplementary Budget recognized the shortfall in revenue and focused on reducing expenditures, particularly in those categories where warrants had been withheld. Overall, both Total Expenditure and Net Lending and Total Revenue and Grants were revised downward to K12,855.6 million and K10,979.2 million, respectively. This will result in a financing amount of K1,876.5 million, and maintain the budgeted deficit to GDP ratio of 2.5 per cent and the debt to GDP ratio of 32.1 per cent.

The capital budget appropriation was reduced by K1,268 million (with 80 per cent reductions to the PSIP and DSIP and substantial reductions to the IDG and WSIP) and the operational budget was reduced by K25.8 million. Of this total reduced amount, K800 million was redirected to a number of categories where there were overruns and arrears (personnel emoluments K430 million, public debt K150 million, rental K50 million, pharmaceuticals K100 million, roads and bridges K51 million and other items K19 million). The remaining amount was allocated to meet the estimated revenue shortfall of K494 million.

These revisions in the Supplementary Budget were necessary considering the substantial domestic financing constraints, exacerbated by the foreign exchange imbalance, and the imperative to remove any fiscal overhang at year end which will diminish the Government's potential to execute its development plans and its 2018 Budget agenda. These adjustments were made in line with the fiscal consolidation path initiated in 2016.

In financing the Supplementary Budget, it was urgent to shift the financing burden away from the domestic security market to both reduce rollover risk and to facilitate the reduction in the foreign exchange imbalance.

The Supplementary Budget returned the fiscal balance back to a deficit of 2.5 per cent of GDP, resulting in a debt to GDP ratio of 32.1 per cent, but which still breached the Fiscal Responsibility Act limit of 30 per cent of GDP. This was unavoidable given the adverse economic conditions, although tax compliance issues and relatively poor expenditure control over areas such as personnel emoluments remain critical issues to be remedied.

Importantly, the Government intends to ensure that PNG *"lives within its means"* as stated in the Alotau Accord 2 and the 100 Days Plan. As such the Government's fiscal policy will be managed carefully to ensure delivery of basic services as well as creating an enabling environment for private sector growth.

Nevertheless, to give the Government some flexibility to manage fiscal and financing policies through protracted economic cycles, the Fiscal Responsibility Act was amended from having the single line 30 per cent to debt to GDP ceiling to a range of 30 to 35 per cent of GDP for 2018 and beyond. To ensure a prudent and responsible approach to debt management, the Government has also amended the FRA to compel the Government in its Medium Term Debt Strategy 2018-22 to target the lower 30 per cent boundary and, additionally, to target an average annual non-resource primary fiscal balance of zero over the medium term (out to 2025). These amendments will allow the 2018 budget some flexibility to manage the restructuring of the budget both in terms of revenue initiatives and in efficient expenditure reductions and allocations.

The Medium Term Fiscal Strategy 2018-22 will embody this new approach.

B. 100 Days Plan

To support the Supplementary Budget measures and to progress the Government's 100 Days Plan, the Government issued a number of important directives to departments and agencies in September 2017 which will impact on the 2018 Budget formulation.

The 15 directives are clearly focused on enhancing revenue and gaining a greater appreciation of expenditure categories that have overshot appropriations such that constraints can be addressed efficiently and effectively in the 2018 Budget.

IV. 2018 BUDGET STRATEGY AND MEDIUM-TERM FRAMEWORK

A. Economic Outlook

In 2018, PNG's economy is projected to grow at 2.4 per cent in real terms. This is only marginally higher than the revised 2017 projections and reflects the benign world growth outlook and conservative commodity price and resource project projections.

Baseline real GDP growth is expected to remain in the range 2.0-2.8 per cent per year over the subsequent 4 years and, again, this is a conservative set of projections and excludes all potential major resource projects and a continuation of a subdued commodity price outlook. Moderately higher non-mineral real GDP growth (3.3-3.6 per cent range) is expected over the medium- term, driven by the Agriculture, Fishery and Forestry sector and the non-resource sectors. Deliberate conservatism in the baseline projections is to ensure that fiscal budgets over the projection horizon can be executed and financed as programmed.

The growth prospects of the mineral and petroleum investment projects such as the Elk-Antelope project, the Stanley Gas Project, the expansion of the PNG LNG Project, the Papua LNG project, Petrochemical projects, Frieda Copper mine and the Wafi-Golpu project, although not factored in current projections, are expected to strengthen growth in the medium- term above this conservative baseline. In addition, effective spending on key MTDP enablers will support efforts to broaden the economy and strengthen inclusive growth.

Inflation, on a year average basis, is anticipated to increase in 2018 to 6.9 per cent due to the impact of the hosting of APEC meetings and higher revenue raising measures. Over the medium term, inflation is expected to steady at an average rate under 6.0 per cent.

Table 1 presents the economic parameters that underpin the 2018 and medium term fiscal projections.

Table 1: Economic Parameters

	2016 Act.	2017 Est.	2018 Proj	2019 Proj	2020 Proj	2021 Proj	2022 Proj
Total Nominal GDP (Kina Million)	67,763.8 *	73,860.7 *	80, 113.4	85, 938.9	92, 175.7	99,080.2	106,957.4
Growth (%, real)							
Total GDP	2.0	2.2	2.4	2.2	2.0	2.5	2.8
Non-mining GDP	0.7	1.9	3.5	3.5	3.6	3.3	3.3
Inflation (%)							
Year avg	6.7	5.9	6.9	5.8	5.7	5.7	5.7
Through-the-year	6.6	5.9	6.9	5.1	5.7	5.7	5.7

Interest rates							
Treasury bills (182 day yield)	4.5	4.5	5.0	5.0	5.0	4.5	4.0
Treasury Bond (3 year yield)	9.7	9.7	9.7	9.7	9.7	9.7	9.7
Kina Facility Rate (KFR)	6.25	6.25	6.25	6.25	6.25	6.25	6.25
Mineral Prices							
Gold (US$/oz)	1,248	1,254	1,281	1,293	1,310	1,320	1,346
Copper (US$/tonne)	4,865	5,945	5,960	6,059	6,183	6,272	6,357
Oil (US$/barrel)	44	50	51	52	54	55	57
LNG (US$/thousand cubic feet)	8	8	8	8	9	9	9
Condensate (US$/barrel)	44	50	51	52	54	55	57
Nickel (US$/tonne)	9,595	10,010	10,516	11,065	11,819	12,575	13,757
Cobalt (US$/tonne)	25,639	52,194	50,014	44,238	41,813	40,834	34,728
Agriculture prices							
Coffee (US$ per tonne)	3627	3454	3,488	3,652	3,796	3,796	3,796
Palm Oil (US$ per tonne)	640	630	612	614	614	614	614
Cocoa (US$ per tonne)	2,892	2,025	1,945	2,020	2,020	2,020	2,020
Copra Oil (US$per tonne)	1,459	1,680	1,705	1,731	1,731	1,731	1,731

Source: Department of Treasury – as per the 3rd round of forecast

* Estimates, actuals yet to be provided by NSO

B. The 2018 Budget and Medium Term Fiscal Strategy

Within the medium-term, the O'Neill-Abel Government is determined to ensure that PNG *"lives within its means, yet still pursues higher economic growth rates in a sustainable and equitable way"*. This entails a budget strategy aimed at lifting the declining revenue to GDP trend in 2018 to 15.8 per cent of GDP and then stabilize the revenue (excluding grants) to GDP ratio around 14.0 per cent of over the projection horizon whilst, at the same time, reducing the expenditure to GDP trend from 18.1 per cent in 2018 to 16.0 per cent by 2022. Importantly, the 2018 Budget envelop will support Government's efforts to clear arrears, finance reform programs as well as lift capital spending from the low levels of 2017 and then to maintain capital spending at higher levels over the medium term. This will mean undertaking the difficult task of reprioritizing and reallocating limited public spending to higher value priorities that will enhance overall economic growth and still achieve the development goals of the Government.

With adverse revenue trends being halted and expenditure trends placed on a declining path, the fiscal deficit will be stabilized at 2.5 per cent of GDP in 2018 and then gradually be improved to around 1 per cent in 2022. The total debt to GDP ratio will also improve from 32.2 per cent in 2018 to 30 per cent in 2022 – in compliance with the Fiscal Responsibility Act. The non-resource primary balance will also be placed on a declining path such that the average balance should reach zero over the medium term (ending in 2025) – also in compliance with the Fiscal Responsibility Act. This latter target will ensure that, should resource revenues pick up over the medium term, then inflows into the Sovereign Wealth Fund will be enhanced. The FRA 30-35 per cent debt to GDP boundaries will give the Government some flexibility to manage fiscal and financing policies through economic cycles, It will assist in avoiding major cuts to critical services and personnel, which would adversely affect PNG's most vulnerable resulting in social unrest and lower private sector confidence and consequent collapse in investment levels.

The 2018 Budget, guided by the *Vision 2050*, the *PNG Development Strategic Plan (DSP) (2010-2030)* as well as the *Medium Term Development Plan 2018-2022 (MTDP3)* and the *Alotau Accord II*, will embody this new approach. It is the starting point for the implementation of a comprehensive MTFS calling for a prudent, credible and more effective approach to fiscal management, able to negotiate the fiscal course through difficult economic cycles.

The 2018 Budget will outline the Government's plan to raise substantial additional revenue in 2018 and beyond to fund government priority expenditures within a medium-term revenue framework and within a robust debt sustainability framework to maintain macroeconomic stability.

The overarching framework for the 2018 Budget comprises 4 key pillars:

(i) **a medium-term revenue strategy (MTRS)** aimed at building up a revenue base able to finance the Government's medium and longer-term expenditure plans. Building on the 2015 Taxation Review and the very recent IMF Tax Policy Reform report, the MTRS will incorporate substantial tax and tax administration reforms, but will achieve these in an efficient and fair manner, whilst enhancing international competitiveness.

Based on some significant additional tax measures in 2018, GoPNG revenue (excluding grants) is budgeted to increase by around 15 per cent in 2018 compared to the 2017 Supplementary Budget – driven by a number of one-off non-tax revenue measures, and by an average of 7 per cent yearly going forward. Some of the gains from the reforms will be reinvested back into revenue generating activities. These are expected to stabilize the domestic revenue profile (excluding grants) in the short to medium-term around 14.0 per cent of GDP;

(ii) **a medium term expenditure strategy** wherein higher expenditure in 2018 will be directed at adjustment costs, but where the expenditure to GDP trend is placed on a declining path from 2019 onwards, thereby gradually reducing financing demands over time to sustainable levels. Further, expenditure trends will be decoupled as much as possible from resource revenue volatility, so as to promote longer term expenditure sustainability and stability. However, Government will use the one-off revenue receipts in 2018 to address its arrears, fund its adjustment policies and create the basis for a much improved service delivery, and an increasing but more stable trend in public investment. In addition, the Government is aggressively targeting overrun areas for rationalization and implementing a set of public finance management reform initiatives such as the procurement reforms and the implementation of the PFMA;

(iii) a **fiscal deficit strategy** that targets a zero-average annual non-resource primary fiscal balance over the medium term (to 2025) thereby smoothing expenditure patterns and facilitating accumulations in the Sovereign Wealth Fund once the economy experiences an economic upswing in the resources sector; and

(iv) **a debt management strategy** that delivers low cost financing within prudent risk levels, but that ensures macroeconomic stability and facilitates more flexibility in financing the Government's requirements both through the year and over the economic cycle. This will require a portfolio shift from domestic financing to external financing – both concessionary through the World Bank and ADB budget support operations, and commercial through a USD bond issuance program to fund the deficit through this stabilisation period and to relieve domestic financing and exchange rate pressures over the projection horizon.

It will also require a broadening and deepening of the domestic security market, and a lengthening of the duration of the government security portfolio. Importantly, it will require the removal of foreign exchange market imbalances, as a prerequisite to domestic market development, to reduce uncertainty and lower risk premiums.

These pillars and strategies are derived from, and are consistent with, the Medium Term Fiscal Strategy 2018-22. Additional detail on the 2018 and medium projections and measures are presented below.

C. Revenue Measures and Projections

To meet PNG's development goals, the Government will place a greater emphasis on revenue generating measures, including greater compliance efforts and tax changes, as well as strengthening and modernizing the revenue collecting agencies. Importantly this will be achieved in a fair and equitable manner, whilst at the same time ensuring the competitiveness of the private sector is not eroded.

Revenue (excluding grants) as a percentage of GDP has declined from 19-20 per cent in 2012-14 to an estimated 13.5 per cent in 2017 which is low by international standards, including comparable countries to PNG. On a no-policy change basis this declining trend is projected to continue over the medium term. Consequently, a major effort in the fiscal strategy is to stabilize this trend, increase revenues in 2018 to fund the fiscal adjustment and address arrears and then to lift revenue trends (excluding grants) as a percentage of GDP over the medium term to achieve a target of 14.0 per cent by 2022. This will comprise a broadening of the tax base, new tax measures, alterations to the tax mix and greater compliance efforts in 2018 and beyond. This 14 per cent target will be established in the Medium Term Fiscal Strategy (2018-22).

In general, while efforts to expand revenue collection and the tax base have borne some results in 2017, a number of tax increases and the broadening of the tax base are essential, as is the strengthening of tax administration. The 2018 Budget, building on the 100 Days Plan, will include a number of policy reforms:

i. improving compliance and structural issues relating to taxes on land, corporate income tax, customs and illicit trading;

ii. introduction of taxes in areas deemed to be low contributors but with high capacity;

iii. revising fees and taxes eroded by inflation;

iv. revising the list of excisable goods – including goods classified as luxury goods;

v. gradually revising the list of exemptions and concessions as well as establishing a transparent mechanism to grant/ negotiate fiscal incentives; and

vi. enhancing reporting and controls over revenues collected by public authorities to ensure that at least 90 per cent of collections are transferred to the CRF.

With a number of reforms established, total revenue and grants is estimated to increase by about 14.2. per cent in 2018 and will comprise:

i. taxes on income and profits will remain flat with modest increases in personal taxes offsetting a decline in corporate tax receipts (remembering the GST offsets will continue to place downward pressure on these corporate tax collections and reflecting the carry forward of losses from previous years);

ii. taxes on goods and services will increase significantly due to the GST refund issue that offsets corporate income tax, but also due to greater compliance efforts and other tax increases and strategies that will be presented in the Budget;

iii. growth in international trade and transaction taxes will increase significantly reflecting major efforts to increase compliance. The halting of the TRP should have a neutral impact on collections compared with the previously assumed negative impact of the tariff reduction program;

iv. growth in other revenues (dividends and fees and charges) has been problematic and variable and Government intends to focus on improvements in this area, including the increase in the pass-through from collections and dividends. Projection for 2018 present a significant increase on collections in 2017 and on recent year-average collection trends. Some of the significant increase will be one-off, as the Government implements its 100 Day Plan directive to pass-through 90 per cent of the collections of revenue generating agencies and as large bank balances in some of the agencies are transferred to the CRF. Entities with large trust fund balances have been highlighted for particular attention. Amendments to the respective agency laws will be enacted to implement the directives in the Government's 100 Days Plan on this issue; and

i. donor grants are expected to increase only marginally.

Over the 2019-22 period growth in total revenue and grants is projected to average around 7 per cent per year as the reforms materialize and compliance efforts strengthened. Tax collections are projected to increase from 12 per cent of GDP in 2019 to 12.9 per cent in 2022 with both income taxes and goods and services taxes trending higher. Taxes on international trade will trend lower than GDP rates because of the subdued baseline GDP projections. Donor grants are expected to remain relatively flat, while growth in non-tax revenue is projected to trend above historical trends over the period.

The level of tax and other revenue (excluding grants) is expected to be lifted to above 14 per cent of GDP in 2018, and stabilize around 14.0 per cent of GDP over the medium term.

Table 2: Indicative 2018 and Medium-term revenue projections (kina millions)

	2017	2018	2019	2020	2021	2022
Revenue and Grants	**10,979**	**12,655.7**	**12,698**	**13,667**	**14,781**	**15,991**
% of GDP	**14.9%**	**15.8%**	**14.8%**	**14.8%**	**14.9%**	**15.0%**
Taxes	8,869	9,754	10,680	11,626	12,683	13,835
% of GDP	12.0%	12.2%	12.4%	12.6%	12.8%	12.9%
Taxes on income, profits and capital gains	*5,535*	*5,307*	*5,893*	*6,465*	*7,111*	*7,812*
Taxes on payroll and workforce	*12*	-	*0*	-	-	-

Taxes on goods and services	*2,755*	*3,822*	*4,135*	*4,479*	*4,858*	*5,273*
Taxes on international trade and transactions	*568*	*626*	*566*	*592*	*620*	*651*
Donor Grants	968	1,024.6	943	932	932	932
% of GDP	1.3%	1.3%	1.1%	1.0%	0.9%	0.9%
Other revenue	1,142	1,877	1,074	1,108	1,166	1,224
% of GDP	1.5%	2.3%	1.2%	1.2%	1.2%	1.1%

Source: Department of Treasury

The 2018 Budget will also set the basis going forward for the implementation of the MTRS. This includes a number of administrative reforms which will start in 2018 but may only yield full results over the medium term, such as:

i. continuing to implement the forward changes and reforms in the MTRS on tax and structural change to achieve the stabilization of the revenue/GDP target and its subsequent trend increase to around the 14.0 per cent target over the forward estimates;

ii. ensuring appropriate funding for revenue administrations to effectively improve compliance and enforcement activities;

iii. pursuing compliance efforts, including audit activities in resource and non-resource sectors;

iv. investing in the modernisation of the tax collecting agencies to ensure greater efficiency – notably with a large tax payer office and gradual upgrade of IT systems;

v. refining and simplifying the tax system to maintain tax integrity;

vi. continuing to progress the enforcement of the tax identification number (TIN) registration and the use of bank data to ensure compliance; and

vii. monitoring and enforcing the new framework for the improved collection of non-tax revenues from public agencies.

D. Expenditure Measures and Projections

Total expenditure and net lending is projected to be K14,643 million in 2018, up from the appropriated K12,856 million in the Supplementary Budget.

To improve expenditure productivity, the 2018 Budget will focus initially on areas that have, in the past, exceeded expenditure appropriations which by necessity forced substantial reductions in the capital and development budget to meet financing and other constraints. This led to very low productivity in service delivery and public investment levels – both key to lifting economic growth and improving the lives of the people of PNG.

Underlying the 2018 expenditure projections are the following key reforms:

i. ensuring strong financial management controls over Personnel Emoluments (PE) which will be critical to achieving good budget execution in 2018 and over the medium term. The 2018 Budget will introduce tight control mechanisms to ensure that amounts spent on PE by departments and agencies are within the budgeted allocation;

ii. including the operationalization of the NEC Decision regarding the management of personnel costs, including compulsory National Identity registration for public servants and no back payments of entitlements unless sanctioned by OSPEAC;

iii. ensuring greater expenditure prioritisation and reallocation of spending from non-essential or low value projects to impact projects that spur economic growth and revenue generation. This includes curbing the excessive use of utilities and expenditure by agencies in the law and justice sectors;

iv. enacting the National Procurement Authority Bill;

v. emphasising the monitoring of resource use and outcome evaluation;

vi. increasing expenditure in 2018 for the major task of clearing arrears and, therefore, will not be required to be sustained over the subsequent projection period;

vii. ensuring continuous efforts in service delivery and in maintaining existing infrastructure by closely aligning operational expenditure and capital expenditure; and

viii. ensuring a strategic, effective and timely drawdown of concessional loans and project grants to supplement limited GoPNG capital funding.

Over the medium term, growth in personnel emoluments will be contained and budgeted at around a 2.5 per cent annual growth rate – significantly less than the rate of GDP expansion. Substantive restrictions on recruitment, increases in payroll audits, removal of ghost workers, rationalisation of functions and civil servants and improved administrative and technology systems, will offset very modest expected pay increases. Personnel emolument expenditure is expected to decline from 5.3 per cent of GDP in 2018 to 4.5 per cent of GDP in 2022.

Goods and services expenditures will also be controlled more closely with greater enhancements to the IFMS system and a tighter year end accounts' closure policy with this expenditure as a proportion of GDP expected to remain constant around 3 per cent of GDP by 2022.

Interest expense is projected to be 14 per cent higher in 2018 to account for the increase in debt levels and then to grow in line with the projected increase in debt over the medium term.

Importantly capital expenditure is expected to increase by 51 per cent in the 2018 Budget reflecting the full budgeted amount for the PSIP and DSIP and some moderate growth in domestically funded capital expenditure, including counterpart funding for high priority development projects. Capital expenditure is projected to grow, on average, by around 8 per cent per year over the forward estimates to support economic growth and development.

Table 3: Indicative 2018 and Medium-Term Expenditure Projections (Kina Millions)

	2017	2018	2019	2020	2021	2022
Total expenditure (including grants)	12,856	14,643	14,596	15,343	16,189	17,252
% of GDP	17.4%	18.3%	17.0%	16.6%	16.3%	16.1%
Expense	9,916	10,209	10,149	10,348	10,892	11,279
% of GDP	13%	13%	12%	11%	11%	11%
Compensation of employees	4,382	4,245.8	4,366	4,497	4,632	4,771
Use of goods and services	2,855	3,027.9	2,665	2,656	3,010	3,180
Interest	1,616	1,835.9	2,014	2,090	2,145	2,221
Grant	600	572.3	572	572	572	572
GST Transfers to Provinces	463	527.4	532	532	533	535
Capital Expenditure	2,940	4,434	4,447	4,995	5,296	5,973
% of GDP	4.0%	5.5%	5.2%	5.4%	5.3%	5.6%

Source: Department of Treasury

Building on the implementation of the 100 Days Plan, the 2018 Budget will ensure that high priority expenditure projects will be funded accordingly. These include the hosting of APEC in 2018 and continuing maintenance of priority expenditures such as Tuition Fee Free Education (TFF), Free Primary Health Care, Law and Order, Infrastructure Projects, adequate resourcing of revenue collecting agencies (IRC and PNG Customs) and Agriculture and Small to Medium Enterprises.

These initiatives, along with the other spending constraints and reallocations in the 2018 Budget will continue to promote broad based economic growth and employment in the country and will be implemented in a sustainable macroeconomic environment.

Complimenting these initiatives, it is important from an implementation perspective that the effectiveness and quality of public expenditures are supported by additional reforms. The Government will continue with public finance management reforms to improve the effectiveness of public expenditures. These ongoing reforms are in line with the PEFA roadmap and aim to ensure that the National Budget is transparent, accountable, efficient and responsive to the needs of the people of PNG. This will continue to build an environment that is conducive to development and prosperity of a dynamic and competitive private sector.

In line with these reforms, the 2018 Budget Documents Volume 1 (Economic & Development Policies) and Volume 2 will be reported under IMF's GFS 2014 reporting standards, with the aim of improving transparency and public financial management.

E. Fiscal Deficit, Financing Measures and Projections

Against the background of a subdued economic outlook, fiscal consolidation efforts will take time, particularly in raising additional revenue and in slowing the rate of certain categories of expenditure which tend to be quite rigid over the short term. The challenge is to achieve this consolidation whilst, at the same time, reversing the decline in capital expenditures and fully funding provincial and district services improvement programs. The Government enacted amendments to the FRA in September 2017 that require it to:

(i) operate a debt to GDP ratio within a 30-35 per cent band;

(ii) target a debt to GDP ratio of 30 per cent over the 5-year projection horizon; and

(iii) target a zero average annual non-resource primary fiscal balance over the medium term.

The Budget Deficit for 2018 is projected to be K1,987 million or 2.48 per cent of GDP, which is marginally lower than the 2017 Supplementary Budget estimate of 2.54 per cent of GDP. The stabilization of the deficit at this level in 2018 reflects the difficulty of significantly reducing quite rigid expenditures quickly such as on personnel emoluments, public debt interest and arrears and reversing the declining revenue trends. Maintenance of the deficit at this level in 2018 will result in a modest decline in the debt to GDP ratio from 32.3[1] per cent in 2017 to 32.2 per cent in 2018. This remains within the mandated ratio band of 30-35 per cent (table 5).

Table 4: Budget Deficit Projections 2018-22 (Kina Millions)

	2017	2018	2019	2020	2021	2022
Revenue and Grants **% of GDP**	**10,979** **14.9%**	**12,655.7** **15.8%**	**12,698** **14.8%**	**13,667** **14.8%**	**14,781** **14.9%**	**15,991** **15.0%**
Total expenditure (including grants) **% of GDP**	**12,856** **17.4%**	**14,643** **18.3%**	**14,596** **17.0%**	**15,343** **16.6%**	**16,189** **16.3%**	**17,252** **16.1%**
Net Lending (+)/ borrowing (-) **% of GDP**	**-1,876** **-2.5%**	**-1,987** **-2.5%**	**-1,898** **-2.2%**	**-1,676** **-1.8%**	**-1,408** **-1.4%**	**-1,261** **-1.2%**
Non-resource primary balance % of GDP	-665 -0.9%	-621 -0.8%	-439 -0.5%	-209 -0.2%	-1 0.0%	-4 0.0%

Source: Department of Treasury

Over the medium term, with projected revenue to GDP increasing at a faster pace than the projected declining trend in expenditure to GDP, the fiscal deficit will decline in 2019 and beyond resulting in the debt to GDP ratio declining to the 30 per cent boundary by 2022 as required under the FRA. In addition, the non-resource primary fiscal balance target for 2018 will present a deficit of K621 million (or 0.8% of non-resource GDP), lower than the deficit of 0.9% of non-resource GDP projected in 2017. The non-resource primary fiscal balance will be zero by 2021-22 and will subsequently move into surplus, in compliance with the average balance of zero over the medium term (to 2025). Importantly, if there is stronger growth in the resources sector than projected in the baseline, this will mean that targeting a zero-average annual non-resource primary balance will result in the build-up of financial resources in the Sovereign Wealth Fund much earlier than anticipated.

Table 5: Financing Projections 2018-22 (Kina Millions)

	2017 Supp.	**2018**	**2019**	**2020**	**2021**	**2022**
Net Acquisition of Financial Liabilities	1,876	1,987	1,898	1,676	1,408	1,261
Domestic	1232	414	201	455	816	862

[1] Using GDP figures as revised during the third round of forecast in September 2017

External	644	1574	1697	1221	592	399
Gross Government Debt **% of GDP**	23,820 32.3%	25,808 32.2%	27,706 32.2%	29,382 31.9%	30,790 31.1%	32,051 30.0%
Domestic *% of GDP*	17,065 23.1%	17,479 21.8%	17,679 20.6%	18,134 19.7%	18,950 19.1%	19,812 18.5%
External *% of GDP*	6,755 9.1%	8,329 10.4%	10,026 11.7%	11,247 12.2%	11,839 11.9%	12,238 11.4%

Source: Department of Treasury

The domestic security market is constrained somewhat by the rising percentage of domestic securities on banks' balance sheets and a reluctance by the superannuation funds to take up longer term securities. Liquidity is available but much is tied up in funds awaiting transfer offshore being stymied by foreign exchange shortages. Government will ensure that these issues are addressed over the near term, providing scope for more domestic securities to be taken up by the market in 2018. In this respect there is also scope for some of the arrears, such as to Nambawan Super, to be paid through issuance of longer term domestic securities.

To ease pressure on the domestic market, the MTDS 2018-22 will engineer a portfolio shift from domestic debt securities to foreign currency debt with the foreign debt target of 35 per cent by 2022. This will be achieved through the issuance of World Bank/ADB highly concessionary external budget support loans and through the issuance of a USD 3 year bond program, together with the normal net inflows from donor project loans. The change in the portfolio mix will also mean significant foreign exchange inflows, some of which will be used to clear the foreign exchange imbalance. It will also relieve pressure on the domestic security market, which will provide the opportunity to develop further the longer term security market, thereby increasing the duration of the portfolio and lowering rollover risk. The crowding out impact on private sector credit will also be reduced, lending support for private sector credit growth to this important sector.

Similarly, if the foreign exchange imbalance can be solved without major disruption to the exchange rate, then there is scope for the broadening and deepening of the domestic securities market. As uncertainty over the exchange imbalance recedes and if the Government is able to end the year without significant fiscal overhangs, then reduced macroeconomic uncertainty will provide scope for the lengthening of the duration of the domestic debt portfolio which will facilitate lower rollover risk and increased investor appetite.

The Medium-Term Debt Strategy will encompass these shifts and seek to mitigate the risks involved. Although the amended FRA no longer requires a return to a balanced budget, it does require that debt levels be managed so as to return to the lower 30 per cent debt to GDP boundary over the medium term.

In terms of managing contingent liabilities, the 2018 Budget will propose stringent mechanisms regarding borrowing through a number of policies including centralised borrowing and debt guarantee policies to limit the State's exposure to contingent liabilities.

V. HIGHLIGHTS ON SOME KEY 2018 BUDGET POLICIES

Among many initiatives taken by the Government to promote expenditure efficiency and achieve key Government priorities, the following initiatives are highlighted for 2018 and over the medium-term:

A. Revenue Generating Measures

Revenue generation, as highlighted, will be crucial to the success of the O'Neill-Abel Government in gaining macroeconomic stability and fueling economic growth. This demands significant reforms to ensure an effective tax system coupled with new tax measures and increased investment in the revenue raising initiatives.

The 2018 Budget will mark the first Budget of the new MTRS 2018 -2022 and will present a holistic approach to increase revenue collections; rebalance the tax mix to make the tax regime more growth friendly but fair; widen the tax net; introduce some new taxes; and provide more certainty through simpler and clearer legislation.

To achieve this, the 2018 Budget will make provision for an increase in the budget of revenue raising agencies with a view to enhance both efficiency and revenue generation aimed at arresting the declining trend in terms of revenue to GDP ratios. To achieve this the Government has set a revenue target (excluding grants) of at least 14.0 per cent of GDP over the medium term. This steady but significant adjustment acknowledges that this target will take time to achieve which only underscores the necessity to commence early in the term of the new Government. It also acknowledges the very conservative projections for real economic growth and the difficulties in lifting the tax burden in such an environment without stifling private sector investment and growth.

B. Expenditure Constraint and Policies

i) *The Organisational Staffing and Personnel Emoluments Audit Committee (OSPEAC)*

This is a critical measure contained in the 100 Days Plan and the 2018 Budget will build on the progress made to date. In assessing government expenditure, the public service wage bill is the largest component of the expenditure items. OSPEAC has been re-established with a dedicated interdepartmental secretariat to:

- scrutinise the Governments public service pay bill;
- determine causes of over expenditure; and
- recommend and implement corrective measures.

OSPEAC is working towards a credible 2018 PE budget with the aim of exercising control and rationalising expenditures, without reducing service delivery. The 2018 Budget will present clear mechanisms to ensure that the Budget ceilings are not exceeded.

ii) Public Sector Efficiency

The recently approved NEC Decision 71/2017 clearly outlines the necessary measures to promote efficiency in the Public Sector including strict rules around payment outside of the ALESCO system. The implementation of these measures will be closely monitored in 2018. These include system controls preventing:

- public servants receiving allowances to which they are not entitled, in particular the misuse of domestic market allowances;

- public servants being paid at the wrong grade;
- fraud, including ghost employees, misdirection of termination pay; and
- poor recording of leave taken, resulting in the employee being paid normal pay while not at work and accumulating their leave balance year on year so that, on termination, they are overpaid.

iii) Centralising Payment of Utility Bills

In recent years, over-runs in utility bills have increased substantially and resulted in the accumulation of substantial arrears. To address this issue, the Government took control and has changed the payment arrangement whereby all utility bills are paid by the Department of Finance centrally rather than individual agencies making or not making payments. The settlement function for arrears outstanding will be managed separately to facilitate improved negotiation and settlement arrangements.

iv) Strict Implementation of PFMA

The PFMA sets out requirements to ensure that all expenditure is properly authorized and applied to the purposes for which it is appropriated. The detailed controls over payments are set out in the Financial Management Manual which codifies roles and responsibilities as well as all aspects of public money management across the budget cycle from budgeting to reporting, including procurement.

Commencing in 2018 and over the medium-term, the Government will ensure its strict implementation and ensure that sanctions approved are duly followed. Also, a greater effort will be undertaken to improve the legal arrangements, planning, reliability and accountability of all funds collected by public agencies which will mean changes to the various trust fund management arrangements.

v) Measures to Inhibit State Exposure to Contingent Liabilities

In the context of emerging contingent liabilities, the policy framework for Centralised Borrowing will be presented with the 2018 Budget. This will ensure that loan financing from the private sector or development partners accrue benefits to the State which outweigh the costs and other associated disadvantages.

The benefits will include a reduction in the total cost of projects and enhanced access to technical assistance and know-how as part of the loan packages.

This policy will complement a number of existing policies, such as the approved on-lending and guarantee policies which will be implemented to ensure that a set of standardised operating procedures governing the application to the State for debt guarantees is effective. This will ensure that all Government assets and liabilities are consolidated to determine the net worth of the State.

VI RISKS TO THE ECONOMIC AND FISCAL OUTLOOK

The risks to the PNG Economic and Fiscal Outlook include:

A. Macroeconomic Risks

Uncertainty in the global economy continues to pose a risk for PNG. Fluctuations in commodity prices continue to impact our export earnings especially two of PNG's biggest sectors - the agriculture, fishery and forestry sector and the mining and quarrying sector. In relation to this latter sector, apart from petroleum, there are probably significant upside risks given that there is more than likely the beginning of a commodity price upswing in action. However, there is also the downside risk that conditions for a bond issuance could deteriorate as capital retreats back to the US if world economic conditions deteriorate or uncertainty increases suddenly, or costs could increase on rising international interest rates.

On the domestic front, the noticeable imbalance in the foreign currency market also poses a considerable risk to economic activity and the inflation outlook. Greater coordination between fiscal and monetary policies is needed, as well as a preparedness to inject the required amount of foreign currency into the system to ease market demands. In this respect the Government's 100 Days Plan has prompted the BPNG to inject USD 100 million over the period of the Plan to ease foreign exchange pressures.

Natural phenomena such as weather-related issues and landowner issues and other events can substantially affect output and government revenue, notably through their impact on extractive projects and agricultural production.

B. Fiscal Risks

A number of fiscal risks continue to be present and have become more critical over recent years including:

i. slower than expected implementation of large investment projects could impact adversely on overall economic growth and anticipated revenue growth;

ii. failure to reverse the declining trends in revenue collections and failure to implement reforms plan in particular on non-tax revenue that will affect negatively the 2018 budget and the medium term;

iii. failure to control rigid expenditure categories such as personnel emoluments will prevent fiscal space from being created to support more efficient public investment levels; and

iv. failure to address and control the level of arrears, particularly at year end tend to add to fiscal risk which undermines budget execution and debt management.

C. Debt Related Risks

Exposure through debt guarantees and contingent liabilities is a concern in determining the net worth of the State and, thus, has implications for potential debt servicing levels and PNG's credit rating.

Heavy reliance on domestic borrowing with an increasingly short duration gives rise to rollover risks and potentially volatile interest rates and interest costs to the Budget. In this respect the IMF, in its debt sustainability analysis, has highlighted the risk that total debt distress remains high for PNG.

Any further significant deterioration in debt structures could elevate debt distress indicators which could affect debt sustainability and credit ratings.

VI. CONCLUSION

Although the 2018 Budget Strategy Paper proposes a delay to a return to the debt to GDP ratio to 30 per cent, it builds a solid foundation to strengthen revenue policies and collections, constrains expenditures and restructures debt. It maintains funding for the Government's key priorities as well as increases funding for high-value capital projects. Progress will continue on budget reforms, implementation of PFMA reforms and other complementary policies.

The above set of policies have the specific endorsement and approval of NEC and will guide and direct central agencies and departments in the preparation of the 2018 Budget.