Medium Term Fiscal Strategy 2008-2012

9th July 2008

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1. RATIONALE

1.1 The rationale of this strategy is:

- to provide a stable framework for the Government to use its fiscal resources to serve the National Goals in the Constitution and the objectives of the Medium Term Development Strategy (MTDS);
- to develop further the strategy followed in 2002-2007 for handling varying, volatile and highly uncertain amounts of additional revenue from PNG's commodity exports; and
- to contribute to partnership between the Government and the private sector by making it clear that the Government will conduct public-sector investments and borrowing within a sound fiscal framework.

1.2 This proposed fiscal strategy will be most effective within a broader program to strengthen the Government's balance sheet of assets and liabilities, and to improve the efficiency with which Government resources are used to achieve more rapid and sustained economic development.

> The **Government's balance sheet** can be strengthened by clarifying the roles of agencies responsible for managing its components, and improving coordination among them. This will help the Government to identify and report on financial assets and liabilities, reduce debt to sustainable levels by 2012, mitigate financial risks, reduce the cost of direct and contingent liabilities, and reduce holdings of low-yielding or risky assets.
>
> The **Government's services** can be improved by regularly reviewing the scope and efficiency of expenditure programs, reducing wasteful spending, fostering competition, regulating in ways that encourage and support the private sector, and improving service delivery.
>
> The **Government's institutional capacity** can be improved by increasing accountability, reforming management practices, removing unnecessary functions or numbers of employees in public bodies, and limiting the role of Government to services which the private sector cannot provide.

2. BACKGROUND

2.1 The first Medium Term Fiscal Strategy (MTFS), for 2002-2007, was directed at arresting a decline in economic performance in PNG, and it played a key role in turning around both Government finances and the overall economy.

2.2 During most of the decade to 2002 there were large budget deficits, high inflation, high interest rates and reluctance on the part of private investors to lend to the Government. Now the Budget is in surplus, inflation is relatively subdued, interest rates are low, and public debt is at its lowest in more than 20 years and close to a sustainable level.

2.3 This is mainly due to a combination of favorable international conditions and adherence to the first MTFS. By setting Budget targets, to be met each and every year, with the eventual goal of bringing the Budget into balance, the first MTFS provided a way to put PNG's public finances back on a sustainable footing.

2.4 However, the first MTFS has been overtaken by events. From 2005 to 2007, PNG has enjoyed an extraordinary surge in revenues resulting from the commodity price boom. In this situation, the goal of balanced budgets contained in the first MTFS is less than what is needed for prudent fiscal management.

2.5 A fiscal strategy can now be adopted which will take advantage of these favorable conditions to increase economic growth, and improve the living standards of Papua New Guineans, on a sustainable basis.

2.6 This new MTFS includes –

- a rule for how much of the expected revenue from mining and petroleum operations is reliable enough to fund ongoing spending;
- principles for allocating any additional mineral revenue, whenever it is received, to the best uses for improving PNG's long-term future;
- principles concerning how quickly additional mineral revenues should be spent in order to avoid destabilizing swings in Government expenditures;
- an approach to funding major State investment projects, including gas commercialization and infrastructure developments; and
- flexibility for dealing with changing circumstances, such as a different outlook for commodity prices, during the next five years.

3. MINERAL REVENUE – HOW MUCH IS RELIABLE?

3.1 Mineral revenues, from mining and petroleum tax (MPT) and associated dividends are expected to continue at unusually high levels in 2007 and 2008, then decline in line with production and price movements. Total mineral revenue over the period 2008-2012 is currently forecast at just over K9 billion.

3.2 But commodity prices are highly volatile and no one can confidently predict which way they will move. While there is a possibility of mineral revenue coming in much stronger than projected – as has been the case over recent years – there is also a possibility that prices could fall sharply, and revenue could come in much lower than projected.

3.3 This is the biggest risk in basing plans for ongoing spending on revenue derived from high commodity prices. The Government would have to make difficult decisions to reduce ongoing expenditure if prices were to drop suddenly. On the other hand, the Government also needs to be prepared to effectively allocate high revenue collections in the event of higher than expected commodity prices. Other risks include natural disasters such as droughts and landowner disputes.

3.4 These considerations have been the basis for the way the Government's budgets from 2005 to 2007, including supplementary budgets, allocated the large increases in mineral revenue resulting from unusually high world commodity prices. These recent budgets have:

- not added the additional revenue to ongoing spending;
- ensured that spending funded from additional revenue was one-off in nature;
- contained mixtures of new investments and reductions in State liabilities; and
- included some pre-funding, through special trust accounts, for State equity in the Gas Pipeline Project and for rehabilitation of public infrastructure.

3.5 In formulating the new MTFS, a key step is defining how much of the expected mineral revenue can be regarded as normal — that is, expected even in the absence of a commodity boom, and reliable as a source of funds for ongoing spending. This normal component of mineral revenue can prudently be combined with non-mineral revenue and allocated for spending in the recurrent and development budgets. This should provide for sustainable growth in ongoing Government expenditure that is broadly linked to economic growth and that does not have to be slashed if commodity prices return to long-term values.

3.6 Two methods have been used to estimate the normal component of mineral revenue —

- its average level in the pre-boom years of 1999 to 2003, and
- its expected average level near the end of the medium term (2010-2012), derived by applying forecast prices for export commodities to their projected production levels.

Both methods indicate the normal component of mineral revenue is about 4% of GDP.

3.7 Therefore, the rule in this strategy is that **mineral revenue equal to 4% of GDP will be included in funding of ongoing spending**. The remainder of mineral revenue is to be regarded as additional revenue, to be allocated in ways which can be adjusted, with minimal disruption, when the amounts received vary from their forecasts and fluctuate from year to year.

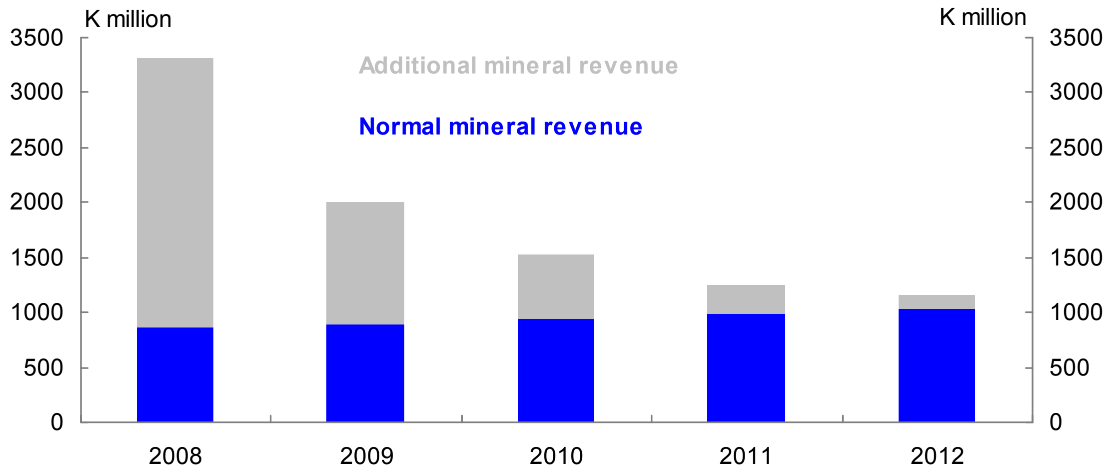
3.8 Another way of expressing this 4% rule, used by the International Monetary Fund (IMF), is that the non-mineral ongoing budget balance will be a deficit equal to 4% of GDP.[1]

3.9 The 4% rule will be reviewed after two years, or earlier if developments such as production shortfalls or changes in price outlook mean that an overall Budget deficit occurs or becomes likely. In those circumstances, ongoing spending plans would be cut, or a temporary Budget deficit would be necessary, or both.

3.10 Chart 1 shows the current forecasts for each year of the MTFS period 2008-2012 of mineral revenue, with its normal and additional components.

[1] The inclusion of interest expenditure in the ongoing budget balance differs slightly from the IMF definition which excludes interest expenditure. Another difference is the use of GDP as the denominator, compared to non-mineral GDP which the IMF uses. However, in this strategy ongoing spending is defined differently from the usual IMF practice — by including both interest expense and the development budget — and the denominator for the 4% is total GDP rather than non-mineral GDP.

Chart 1: Normal and additional mineral revenue, 2008-2012



4. IMPLICATIONS FOR ONGOING EXPENDITURE

4.1 Ongoing spending is constituted by the recurrent and development budgets (in this context the part of development spending funded by the Government's resources including borrowing, but excluding the part of development spending funded by grants from development partners). The main implications of this proposed strategy for ongoing spending are –

- that the amounts of ongoing spending will be fairly stable from year to year, and
- that if forecast ongoing expenditure is less than the sum of normal mineral revenue and non-mineral revenue – what can be called total normal revenue – then ongoing expenditure could be increased up to that sum, while staying within a prudent fiscal framework.

4.2 During the preparation of the 2008 Budget, Treasury forecasts indicated that with no changes in relevant Government policies, ongoing spending would remain less than total normal revenue in the MTFS period. The Government has decided to include in the Budget some additions to ongoing spending for 2008 which brought it up to the forecast amount of total normal revenue. This decision also implied that ongoing spending would continue in 2009-2012 at levels corresponding to total normal revenue.

4.3 It is a crucial part of this fiscal strategy that ongoing spending be kept each year within the limit of total normal revenue. This is vital in order to ensure that ongoing spending can be sustained.

5. PRINCIPLES FOR ALLOCATION OF ADDITIONAL REVENUE

5.1 There are four key principles which apply to the choice of ways in which mineral revenue above the 4% of GDP threshold — referred to here as additional revenue — will be allocated.

Benefits for future generations — because mineral revenue is derived from once-only extraction and sale of PNG's non-renewable resources, it should be used for investments, preferably in line with the MTDS priorities, that will benefit future generations as well as this one.

This is the principle of fairness, as stated in the Constitution's National Goals: "*safeguard the national wealth, resources and environment in the interests of not only the present generations but also future generations".*

Unless this principle is followed, future generations will be left poorer than we are when PNG's mineral resources are used up.

- Some of the best investments for future generations are the basic services and infrastructure which are defined as priorities for spending in the MTDS.
- Therefore, additional mineral revenue should, like the 4% of GDP component included in ongoing spending, be devoted to uses which are MTDS priorities or are at least as worthwhile (in that their demonstrated risk weighted benefits are relatively high) as long-term investments.

Flexibility — uses of additional mineral revenue should be of kinds which will not be disrupted if the amount of revenue received varies from the forecast during the year for which plans are being made. Repayment of public debt is the most obvious use of this kind, and it is already the standing use for additional revenue received too late in the year to be the basis for additional appropriations.

Consideration of impacts on domestic and import demand — uses of additional mineral revenue should be chosen so that they do not make overall demand by the Government for non-government goods and services within PNG fluctuate through time by large amounts. This is dealt with in more detail in Section 9.

Basis for comparison — investment projects which are potential uses for additional mineral revenue should be –

- compared with each other in terms of their expected net benefits, adjusted for the risks which attach to the receipt of benefits; and
- compared with other possible uses of funds in the context of formulating annual budgets, so that Government can make the best informed decisions about how to allocate scarce funds.

6. PREFERRED AREAS FOR ALLOCATION OF ADDITIONAL REVENUE

6.1 Applying the four principles stated just above to PNG's likely situation in the period from 2008 to 2012 suggests that there are two preferred areas for allocating additional revenue, and that each year's budget will involve a carefully balanced choice between them:

- adding to the funds held in trust for additional public investments over the medium term, and
- repayment of public debt.

Additional public investments

6.2 These seem to many people the most attractive option for use of additional revenue. But in order for public money to be well spent, every prospective investment must be carefully assessed:

- **implementation capacity** — whether the project can be implemented effectively, in addition to everything else to which the Government is committed, within the constraint of available capacity in the public service and in relevant areas of the private sector; and

- **net benefit threshold** — whether the expected margin of benefits over costs, with all the associated risks factored into the assessment, represents a better proposition than the assured benefit of reducing public debt and thereby saving on interest cost.

6.3 These assessments represent hard tests. They must be made honestly rather than optimistically, otherwise public money will be wasted. Unfortunately there have been many sad experiences in the past when capacity constraints were ignored, projects were poorly implemented, and little or no benefit was received by the public as a result.

6.4 The average cost of interest on domestic public debt can be regarded as a threshold rate, which must be exceeded by the risk-weighted expected net benefit from an investment project in order to justify allocating additional revenue to that project.

6.5 **Very large prospective investments**, such as State equity stakes in gas commercialization or other resource development projects, should be assessed in the way just described if they are candidates for funding from State revenue or borrowing. But their size introduces some added factors –

- assessing them may be a complex task for which specialist advisers need to be contracted;
- they may need funding from more than one year's additional revenue; and
- the concentration of risks in the State's financial outlook associated with them may represent a constraint on the size of the investment that can prudently be made, in addition to the constraints on available budget and debt funding.

6.6 **Pre-funding** of spending which is ongoing in its nature, such as rehabilitation and maintenance of public infrastructure, can be regarded as part of this category. This has been one of the main uses to which "windfall" revenue was allocated in supplementary budgets in 2006 and 2007. But in the period 2008-2012 under this strategy, there may be enough revenue available to significantly increase streams of ongoing Budget spending for areas such as infrastructure maintenance. That would be preferable because it would make such spending more sustainable.

Repayment of public debt

6.7 This is the other option for use of additional revenue. At the end of 2007 PNG had K6,319.6 million of public debt, with K3,171.3 million in domestic debt and the equivalent of K3,148.3 million in external debt. The advantages of repaying public debt are as follows.

- It would have an immediate positive effect on the spending side of the Budget, continuing every year, as resources are freed from debt servicing. For example, with market interest rates as they were in late 2007, the interest savings from repaying K500 million of debt (in a mixture of domestic and foreign debt) would be some K25 million every year. These funds could be used for service delivery, maintenance of public infrastructure, or new investments.
- Debt repayment strengthens the Government's financial position or "balance sheet", which increases investors' confidence and helps to lower interest rates. This reduces borrowing costs for PNG households and businesses.
- Debt repayment also reduces the interest rate risks and foreign exchange rate risks for the Budget — if interest rates rise, or the currency depreciates, the impact on interest expenses will be smaller. This provides the greatest

flexibility for future Budgets, including for further financing of State investments when necessary.

6.8 Apart from public debt, there are **other State liabilities** which should be similarly repaid or reduced. The State's liability to Nambawan Super Ltd (formerly POSF), in respect of public servants for whom the employer contributions to superannuation are as yet unpaid, is the largest one. But there are two necessary conditions for including the reduction of these liabilities in uses of additional revenue –

- different State liabilities have associated with them different types of risks, related to trends in the economy or to other more specific factors, and these risks should be assessed in comparing the benefit of reducing the liability to Nambawan or other liabilities with the benefit of repaying public debt; and
- it would be harmful to the public interest to reduce the disincentives for fraudulent or unnecessary acceptance of claims, and that could be the effect of specially paying out such liabilities as court orders and payment arrears.

6.9 The **choice each year** between additional public investments and repayment of public debt should be made through –

- rigorous evaluation of prospective public investments,
- allocation to them of appropriate amounts in a regular or supplementary budget process, and
- allocation of the remainder to repayment of public debt.

6.10 Such a process could result in any combination of additional public investments and repayment of public debt. It will depend on what feedback the Government is getting from implementation efforts. It will also depend on the state of the economy, especially if demand is already growing strongly and there are inflationary pressures which additional public investments would worsen.

6.11 But as a guideline or starting-point for the budgeting process, this strategy contains a 70:30 guideline — **70% to pre-fund future additional public investments and 30% repayment of public debt**. The reason for this guideline is the desirability of ending the MTFS period with a lower level of public debt, and correspondingly stronger State finances.

7. IMPLICATIONS FOR OVERALL BUDGET BALANCE

7.1 The overall (or "headline") balance in each year's Budget will depend on –

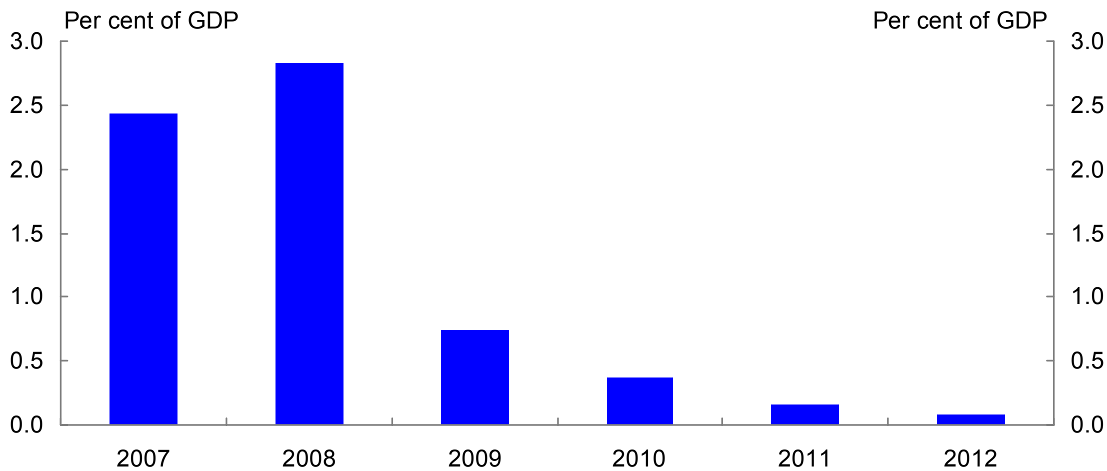
- whether ongoing spending is kept within the limit of total normal revenue, and
- how additional mineral revenue is allocated and appropriated between public investments and debt repayment — since appropriations for public investments are recorded in the Budget as "above the line" spending, while debt repayment is not.

7.2 The overall balance in each year's Budget *will not* be affected by the amount drawn down from the trust accounts for actual public investment expenditure, as for Budgetary purposes, the expenditure is recorded once the funds are transferred to trust.[2]

[2] This differs from the IMF definition of the Budget balance, which records the expenditure only once it has been drawn down from the trust account and actually spent.

Nonetheless, it will be important to consider the expected rate of drawdown while framing the Budget, in order to contain inflationary and other demand pressures.

Chart 2. Implications for overall Budget balance



7.3 Chart 2 shows, for each year of the MTFS period, what would be the overall Budget balance.

- The bars are budget balances derived, after 2008, by setting investment-type spending as 70% of additional mineral revenue, as proposed in this strategy.

7.4 The pattern of balances under this scenario would be a declining series of surpluses from 2009 to 2012.

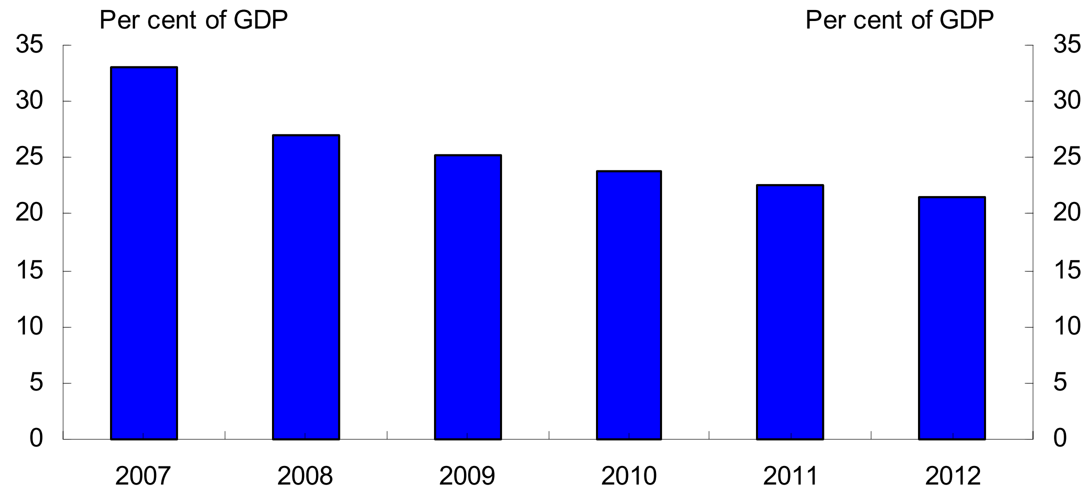
8. IMPLICATIONS FOR DEBT LEVEL

8.1 The counterpart of the series of overall balances described in Section 7 would be a series of reductions in public debt. In 2008 there is the debt reduction of K202 million in the Budget, while in 2009-2012 the debt reductions are equivalent to 30% of additional mineral revenue.

8.2 On the basis of current forecasts of GDP growth, this would mean over the MTFS period a substantial further reduction in the ratio of public debt to GDP, to just above 20% at the end of the period. The projected ratios of public debt to GDP at the end of each year are shown in Chart 3.

8.3 Bringing public debt down to near the 20% level would represent a major fiscal achievement. It would make it more likely that according to the measure used by the International Monetary Fund (IMF), PNG's public debt would be assessed as sustainable. This lower public debt level would also be a positive factor in the rating agencies' ratings of PNG's sovereign debt. These kinds of international recognition for a lower debt level would, in turn, contribute to business and investor confidence in PNG.

Chart 3. Implications for debt level



8.4 Reduction of the State's unfunded liability for public servants' superannuation would achieve largely similar results, in terms of making the Government's public debt position sustainable. This is because the IMF's assessments of public debt sustainability include unfunded liabilities such as this, along with issued public debt and contingent liabilities, in calculations of the present value of public liabilities and their ratio to GDP.

9. Demand Management: Principles for containing actual Government expenditure

9.1 A major consideration for fiscal policy is the impact that Government spending has on aggregate demand in the economy. Too much Government spending over a given period of time can cause excess demand, resulting in sharply higher inflation and interest rates, a surge in imports and crowding out of private sector investment. This has been a major problem for PNG on numerous occasions in the past.

9.2 In general terms (and ignoring under and over spending), the amount of actual Government spending in a year tends to track what has been budgeted for and appropriated. However, over recent years, the use of trust accounts to pre-fund future public investments has widened the gap between annual budgets and actual Government spending. This means the timing of actual Government public investment spending (due to the transfer and draw down of funds in trust) has, and will continue to differ from the amount appropriated in any one year.

- While for Budgeting purposes, the *appropriation* is important, it is the timing and size of *actual spending* that influences economic activity. For this reason, the focus of demand management and macroeconomic stability is on the amount of actual spending undertaken.

9.3 Following the 2008 Budget, the funds either held in or soon to be transferred to trust represent around 17 per cent of GDP. If this was drawn down and spent quickly, it would have substantial negative effects, including significantly higher inflation and a sharp surge in imports.

- The impact of additional Government investment expenditure on the economy over the MTFS period is difficult to predict. This is because it will depend upon the strength of private spending and inflation at the time, as well as the import intensity of Government investment spending (which could be very high on some projects).

- The K600 million (3 per cent of GDP) of Government funding for equity in the gas project which is currently held in trust is expected to be very heavily dependent on imports, and so should not have too great of a direct impact on domestic resources when it is drawn down. On this basis, the draw down of trusts to purchase equity for the gas project has been excluded from the following figuring.

- With 14 per cent of GDP in trusts to be spent on investment type projects (and based on current projections about 4 per cent of GDP more to come), a smooth drawdown over say a 5 year period would result in around 3.5 per cent of GDP of additional Government investment spending each year. However, actual draw downs are likely to be lumpy and are unpredictable at this early stage of the MTFS period.
- With such a large quantum of funds in trust accounts, there will need to be increased levels of monitoring, transparency and compliance to ensure that the funds are managed well. This will require increased scrutiny and investigation of improper behaviour, combined with increased resource allocation for enforcement and monitoring agencies.

9.4 It would be desirable from a demand management point of view for a relatively smooth draw down of funds held in trust in order to prevent large swings in Government expenditure destabilizing the economy. However, given the lumpy nature of projects and the unpredictability of draw downs, this will be difficult to achieve even with improved monitoring and controls.

9.5 In practical terms, a balance needs be struck between allowing the Government to proceed with its investment program in order to improve development prospects, and the need to manage and smooth aggregate demand fluctuations in the economy caused by large swings in actual Government spending.

9.6 In order to achieve this, **actual Government investment spending arising from additional mineral revenue will be limited to 4 per cent of GDP per annum** (currently about K800m).

- This limits the draw downs from trust and any additional public investment outlays arising from additional mineral revenues in any given year.
- If private expenditure or inflation is too high or balance of payments problems arise, actual Government investment outlays should be kept below this upper limit.

9.7 Combined with the 4 per cent of GDP in recurrent spending provided for by normal mineral revenue, the limit of 4 per cent of GDP on actual public investment spending sourced from additional mineral revenue provides for a total non-mineral budget deficit arising from actual Government spending of up to 8 per cent of GDP per annum.

9.8 Recurrent annual Government spending in the outer years is currently projected to be broadly around 23% of GDP. The rule to limit Government investment expenditure arising from additional mineral revenue to 4% of GDP per annum should be consistent with total government spending kept under about 28% of GDP (this provides for some fluctuations in recurrent spending).

10. PREPARING FOR LONG-TERM CHALLENGES

10.1 An important reason for devoting a substantial proportion of additional revenue during the period 2008-2012 to repayment of public debt, even if there are worthwhile public investments which could be effectively implemented, is the prospect that after this period PNG may face more difficult times, which will make greater demands on budgets and the State's balance sheet.

10.2 First, a number of major **resource projects** are due to be wound down within the next decade, significantly reducing mineral revenues. The Ok Tedi mine is scheduled to end production in 2013, and according to current estimates of reserves in major oil fields, they are all due to be depleted by 2015. New mining, oil and gas projects now in development may come into production and improve revenue flows near the end of the MTFS period, but this is far from certain and cannot be relied upon for this strategy. Moreover, the recent reductions in tax rates for oil and gas extraction, and project-specific tax concessions already granted, mean that (with other factors equal) the revenue streams from new projects would be less than from current projects.

10.3 Secondly, the epidemic of **HIV-AIDS** is growing and may not be contained for some time. It is likely to cause large and mounting costs, not only for people directly affected by illness and deaths but also for the public health system, for many types of private businesses, and for the State as an employer.

10.4 Thirdly, further in the future but already in sight is the prospect of having to adapt to **climate change** — affecting both PNG's propensity to natural disasters, and the climatic conditions for PNG's agricultural industries including fisheries. These effects may include new opportunities as well as new difficulties, and they cannot yet be predicted in terms which allow for much planning of counter-measures or adaptations. But it is reasonable to expect climate change to bring, on balance, both reductions in revenue and increases in necessary expenditures.

10.5 It will therefore be prudent to aim at ending the MTFS period with stronger State finances than at present.

11. FUNDING OF INVESTMENT PROJECTS

11.1 The five-year total of additional mineral revenue represents the limit on what will be available from the Budget for funding of investment projects. If mineral revenue is received as currently forecast through the MTFS period — something which is clearly open to many possibilities of change — that five-year total will be K4,549.6 million.

- If additional mineral revenue is received as forecast and allocated by the 70:30 guideline, beyond the 2008 Budget which K1676.0 was appropriated, this would provide K2011.5 million for additional public investments from 2009 to 2012.
- Alternatively, the 70:30 guideline could be over-ridden and the forecast additional mineral revenue in 2009-2012 could be used for public investments.

11.2 Funding for investment projects can come both from the Budget and from additional State borrowing. However, the scope for State borrowing to supplement funds from the Budget, while keeping to a prudent debt strategy, is not great. This is because prudent use of State borrowing would not allow the overall level of public debt to rise again, past its level at the start of the Government's current term in August 2007.

11.3 The *Fiscal Responsibility Act 2006* contains principles of sound fiscal management. One is that the Government will not raise the overall level of public debt during its term

- Each year there are repayments of debt principal (amortization) when they become due, and there are new borrowings, usually related to existing or new projects being funded by loans from the multilateral development banks or other lenders. The effect is that, at year's end, there will be a net difference in outstanding public debt from the level at the end of the previous year.
- The Government's unfunded liability for public servants' superannuation is also relevant here — increases or reductions in it should be included in measuring the overall level of public debt.

11.4 The principle in the *Fiscal Responsibility Act* would be applied if a period of net repayment of debt, while additional mineral revenue was being received in large amounts, was followed by some net borrowing in later years – provided the net borrowing did not raise the level of public debt past its level at the start of the Government's term.

11.5 Through deciding on large amounts of public debt repayment and reduction of superannuation liability in both the Supplementary Budget of October 2007 and the 2008 Budget, the Government has given itself substantial scope for net borrowing later in its term, if that becomes necessary.

11.6 In other words, the principle of preventing an overall increase in public debt during the Government's term contains some flexibility.

- For example, the Government could follow the 70:30 guideline for some years while additional mineral revenue is large, then in the later years of the MTFS period do some net borrowing as additional mineral revenue falls away.
- This would enable the levels of funding for public investments to be more stable from year to year than if they rose and fell with the amounts of mineral revenue received.

11.7 The prospective Liquefied Natural Gas (LNG) projects currently being considered may require a very large equity stake by the Government. As far as possible, this should be funded within the parameters laid out in the MTFS, and in line with the borrowing limit described in the Fiscal Responsibility Act.

11.8 However, the potential size of the equity stake may require borrowing in excess of the FRA parameters. If such a situation eventuates, other options to ameliorate this position should be considered.

12. PROJECT BORROWING

12.1 The limit on funding of investment projects from the Budget and from additional State borrowing does not apply to:

- investment projects by State-owned enterprises (SOEs) which the SOEs fund by themselves, and
- investment projects with funding arrangements fully independent of the State.

12.2 For example, if projects can be designed as public-private partnerships, so that private investors supply the funding needed beyond what SOEs can fund through their own operations, their direct effects would be outside this strategy.

12.3 Similarly, if funding for a project is arranged in such a way that investors will have claims only on the assets and income of the project, and not on the State, those arrangements would be outside the scope of this strategy and not directly affect it.

12.4 However, if project funding arrangements involve contingent liabilities for the State, such as through guarantees, or could reduce the value of State assets including ownership interests in SOEs, they would have actual or potential effects on the State's creditworthiness and ability to borrow when necessary.

12.5 Therefore, when investment projects involve SOEs or are sponsored by the State, the indirect effects of funding arrangements for those projects need to be carefully identified, and the Government's direction of such arrangements needs to be integrated with implementation of this MTFS.

12.6 There are some ground rules for borrowing by SOEs which would contribute to transparency in the funding of investment projects involving them, and help to minimise the risks they contain for the State's balance sheet and credit as a borrower.

- First, borrowings should as far as possible be undertaken in the domestic market, because this avoids foreign-exchange risk – which in the past has proved highly expensive for PNG, and could be so again in the future.
- Second, SOE borrowings should as far as possible be on commercial terms, for two reasons - because the concessions which some lenders offer are intended for the Government to use or to allocate, and because the Government's policy is that SOEs should operate commercially, except where it specifies otherwise.
- Third, SOE borrowings should involve explicit recourse for the lenders to the assets of the borrowing entity, because this avoids the risk of their having recourse to the State – in other words, to the Budget.

13. MAINTAINING THE TAX BASE

13.1 A major challenge for the Government in pursuing this strategy is to maintain the integrity of the tax base.

13.2 The tax system is severely compromised when concessions are provided to specific projects or taxpayers.

- The use of project agreements to create special tax arrangements for individual projects has encouraged a wide range of investors to seek a growing list of tax concessions, even when forms of tax relief are already provided by the tax law for investors in the type of business involved.
- Project agreements containing project-specific tax concessions have created an uneven playing field on which businesses have to operate.
- Often the concessions sought are difficult to cost, but in many cases they could deprive the Government of significant amounts of revenue.

13.3 To enhance the integrity of the tax system, concessions provided to projects should be confined to those available for the relevant industry in the existing tax law.

- This would ensure equitable treatment of projects in each sector, and transparency in tax policy.
- The assurance of equitable treatment for all investors would encourage further investment in the economy.