INDEPENDENT STATE OF PAPUA NEW GUINEA

2021 BUDGET STRATEGY PAPER

Presented by
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Treasurer

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Contents

Government of Papua New Guinea
2021 Budget Strategy Paper

I. PURPOSE

The publication of the Budget Strategy Paper (BSP) is consistent with the *Papua New Guinea Fiscal Responsibility Act (FRA) 2006* although delayed due to the implications of the COVID-19 pandemic. The 2021 BSP provides the public with the revised fiscal framework for the medium term, under which, the specifics of the 2021 Budget have been designed. In the subsequent sections, it discusses further details of the key elements of the 2021 budget strategy. The 2021 Budget may include some updated economic parameters and a final fiscal framework.

The 2021 BSP will be the second produced by the Government led by Prime Minister, Hon. James Marape and the Coalition Government. The BSP draws from the high-level policy direction of the Treasurer, Hon. Ian Ling Stuckey (CMG, MP), after extensive consultations with the National Executive Committee (NEC), the Ministerial Economic Committee (MEC), the Budget Management Committee (BMC), representatives of the IMF's Staff Monitored Program (SMP) and other private and public sector stakeholders.

The 2021 BSP is being presented shortly before the 2021 Budget. The COVID-19 pandemic has been delaying budget papers around the world and PNG has also been affected. The plan is to have the 2021 BSP issued shortly after the 2021 MYEFO as set out in the FRA.

The 2021 budget strategy will continue to be guided by the doctrines of development espoused by the Five National Goals and Directive Principles, the National Strategy of Responsible Sustainable Development (StaRS), and Papua New Guinea's commitment to the 17 United Nations Sustainable Development Goals (SDGs), that have been captured in the development principles defined by Vision 2050, and Development Strategic Plan 2030, and woven into the prescriptions of Medium Term Development Plans (MTDPs) II and III. In 2020, the Government had put forward the 'Loloata Commitment' as a rescue and reconstruction strategy that began with a fiscal re-adjustment and a revised Medium Term Fiscal Strategy (MTFS) 2020-2024.

In 2021, the MTFS outlook will be revised to 2021-2025 but the principles of "spend the money we have more wisely", "raise the revenues more fairly" and "finance the debt more cheaply" will remain. The strategy also contains a path of fiscal consolidation after the COVID-19 pandemic.

Supporting the MTFS 2021-2025 will be an updated *Medium Term Debt Strategy (MTdS)* and the *Medium Term Revenue Strategy (MTRS);* all working in tandem towards implementation of the Government's reform agenda.

The broad objectives of the fiscal recovery and repair programme under the 2021 budget strategy is to provide the platform for fiscal consolidation while continuing with strategic capital formation necessary to enable the private sector and community at large to grow the economy, in particular the non-resource sector, expand the tax base and enhance the cost effectiveness of the delivery of essential services.

II. WORLD AND DOMESTIC ECONOMIC OUTLOOK

World Economic Outlook

The onset of the COVID-19 pandemic has had a significant impact on the global economy in 2020. The International Monetary Fund (IMF) in its World Economic and Outlook (WEO) Report for June 2020 has projected global growth at -4.9 per cent. A much more significant contraction than its April WEO report citing a more negative impact on activity in the first half of 2020 than earlier anticipated. Since the release of the June WEO, the world is witnessing a major second wave of COVID-19 infections through Europe. The death toll in the US continues to rise. It is likely that global prospects for growth have moved to the downside, with any recovery from the pandemic increasingly being dependent on when a vaccine will become widely available.

According to the IMF in its June WEO report, consumption growth, investment and net exports have been downgraded for most economies reflecting the large adverse aggregate demand shock from lockdowns and an increase in precautionary savings. In particular, investment levels are anticipated to be subdued amid high uncertainty. Policy support has partially offset the deterioration in private domestic demand.

The June WEO expected global economic activity to trough this year as infection rates in economies are assumed to drop coupled with the eased financial conditions in Advanced and Emerging Market economies reflecting policy countermeasures forestalling worse near-term losses. In 2021, global growth was expected to recover partially, increasing to 5.4 per cent.

Regardless, uncertainty still remains at high levels in which policy makers are now left with tremendous challenges towards cushioning out and containing the severity of the effects of the pandemic on economic stability.

The IMF's June 2020 WEO concludes that all countries should work together as a global community through strong multilateral cooperation on multiple fronts. Countries should address the following policy priority areas in order to manage the health emergency and recover from the aftermath of the pandemic:

- Countries should ensure that their health care systems are adequately resourced through international initiatives such as financial assistance to countries with limited health care capacity;
- Economic policy should continue to cushion household income losses with sizable, well-targeted measures as well as provide support to firms suffering from mandated restrictions;
- Stimulus policies need to be provided to lift demand and incentivize the reallocation of resources away from sectors that are likely to emerge persistently smaller after the pandemic;
- Liquidity assistance through debt relief and financing through the global financial safety nets needs to be provided to countries confronted with large external shocks; and
- Policy makers must cooperate to resolve trade and technology tensions that endanger an eventual recovery from the COVID-19 crisis.

The IMF states that the global community must act now to avoid a repeat of this catastrophe by building global stockpiles of essential supplies and protective equipment, funding research and supporting public health systems, and putting in place effective modalities for delivering relief to the neediest.

2020 Mid-Year Economic and Fiscal Outlook (MYEFO) Report

In the 2020 Budget, economic growth forecast for 2020 was projected at 2.0 per cent based on growth in the non-resource sector of 3.3 per cent and a drop in the Oil & Gas sector of minus 4.9 per cent offset by a growth in the Mining sector of 6.2 per cent. However, PNG's economic performance has been adversely impacted by the unexpected global and local events of COVID-19 outbreak and the closure of Porgera mine operations. The COVID-19 containment measures globally have reduced external demand for PNG's major export commodities, while domestically implemented preventive measures have reduced domestic demand.

Consequently, the MYEFO report projects the PNG economy to contract to minus 3.0 per cent, which represents a reduction of 5.0 percentage points from the 2020 Budget forecast of 2.0 per cent. Whilst the impact is significant, it is substantially better than many other countries that have recorded dramatic declines in GDP levels.

Economic activity in the transport, accommodation and construction sectors was hardest hit by COVID-19 related restrictions locally which lasted about three months. Growth in these sectors are projected to contract significantly to - 20.0 per cent, -20.8 per cent and -2.5 per cent respectively. Altogether, these sectors account for 9.0 per cent of total real GDP.

Further, contributing to the contraction in the domestic economic growth for 2020 is the projected slower growth in the agriculture, forestry and fishing (AFF) sector. The AFF sector is projected to grow at 1.9 per cent in 2020 significantly lower than the budget projection of 3.4 per cent. This is despite the expected lift in prices for PNG's agricultural export products over 2020. The lower growth rate is driven by an overall downgrade to all agricultural export production in the first half of the year due to the nationwide lockdown which restricted farmers' mobility to work their farms.

The MYEFO forecast growth in the Mining and Quarrying sector to contract by - 20.2 per cent compared to 6.2 per cent at budget. This reflects a combination of factors including the closure of the Porgera mine due to non-renewal of Special Mining Lease, temporary shutdown in Ok Tedi mine due to COVID-19 cases at site and downgrading of Lihir's production. This sector accounts for 10.0 per cent of real GDP.

The Oil and Gas sector is projected to contract moderately to -1.1 per cent compared to an expected contraction of -4.9 per cent in the budget. This is mostly due to changes to base level production volumes from which sector growth is extrapolated. The 2020 Budget growth estimate was based on higher projected 2019 LNG production volumes. This was replaced by a lower actual volume for 2019 LNG production from which the MYEFO growth projection is estimated. Importantly, the impact of much lower prices will be felt more on nominal GDP or sector income flows.

Presented below are the assumptions on economic parameters for the medium term. The major economic parameters (see table 1) such as GDP is projected to recover in real terms supported by the growth in the non-mining GDP sector of the economy.

Inflation average-on-average in 2021 is projected to increase to 4.8 per cent, up by 1.1 percentage points compared against 3.7 per cent estimated in 2020. The driving factors behind the increase in prices are mainly attributed to the rebound in economic activities translating to increase in the domestic demand for goods and services, rebound in oil prices and a stronger Australian inflation outlook (major source of PNG's imports). The medium term projections have the inflation figures trending towards PNG's long term average inflation rate.

On commodity front, oil prices are projected to increase only slightly from US$35.8 per barrel in 2020 to US$38.1 per barrel in 2021[1]. The continuous outlook of lower oil price is attributed to the global economic recovery relying less on traditional sources of energy, OPEC's decision to trim oil production and the lessening impacts of the trade tensions between the US and China.

PNG's base metals in particular gold prices is expected to increase in 2021 further gaining on the heightened uncertainty globally. Copper and nickel prices are expected to improve marginally after a dismal performance in 2020 as a result of the covid-19 pandemic.

Table 1: Economic Parameters (2019-2025)

	2019 Est	2020 Proj	2021 Proj	2022 Proj	2023 Proj	2024 Proj	2025 Proj
Economic Growth							
Total Real GDP (%)	4.9	-3.0	2.2	2.8	2.6	2.8	2.5
Non-mining Real GDP (%)	2.8	-0.6	2.3	3.6	3.7	3.9	3.5
Inflation							
Average on Average (%)	3.6	3.7	4.8	4.2	4.3	4.6	4.6
Dec on Dec (%)	2.8	4.9	3.6	4.9	4.3	4.1	4.1
Exchange rate							
Real Exchange Rate Index (2007 = 100)	130.7	133.1	136.1	139.9	143.6	143.6	143.6
Interest rate							
Kina Rate Facility (KFR)	5.50	5.50	5.50	5.50	5.50	5.50	5.50
Inscribed Stock (3 year yield)	9.7	9.7	9.7	9.7	9.7	9.7	9.7
Mineral Prices							
Gold (US$/oz)	1392	1688.3	1716	1734	1753	1772	1790
Copper (US$/ton)	6006	5368.6	5215	5285	5356	5419	5473
Oil (Kutubu Crude: US$/barrel)	57.0	35.8	38.1	41.1	43.2	45.4	46.9
LNG (US$ per thousand cubic feet)	10.6	8.3	8.6	9.0	9.5	10.0	10.2
Condensate (US$/barrel)	57.0	35.8	38.1	41.1	43.2	45.4	46.9
Nickel (US$/tonne)	10960	10353.7	11714	11612	11714	11834	11976
Cobalt (US$/tonne)	22836	21691.0	25247	26429	27606	29594	29950

Source: Department of Treasury.

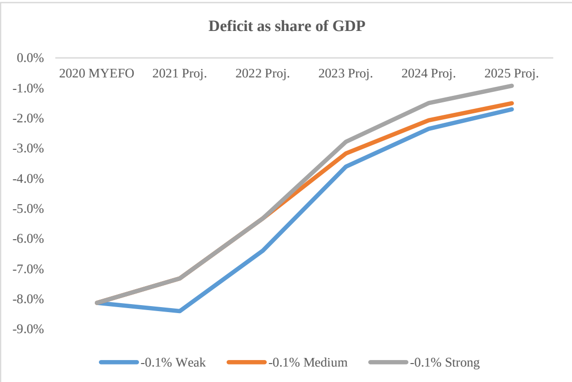
[1] Treasury's oil price assumption for 2021 is higher by 8.6%. The IMF's latest outlook is more optimistic on oil price, forecasting an increase of 12% for 2021. The reason Treasury has taken a more conservative view than IMF is because LNG prices (linked to oil price) have a very significant lag back to earlier lower prices. Given the large weight of LNG relative to oil in the PNG economy, this lagged set of prices is important. At this time of uncertainty, a conservative view allows better fiscal management of risks.

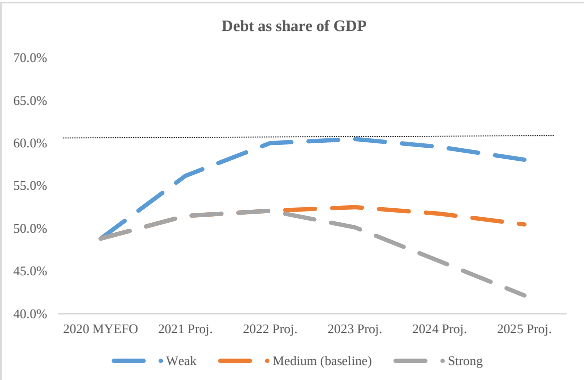
Economic Recovery Scenarios

The uncertainty in economic recovery over the medium term is captured in three scenarios of recovery likely for Papua New Guinea.

(a) The weak scenario represents a gentle recovery over the medium term driven almost entirely by non-resource GDP growth and where mining and petroleum output remains low. This scenario assumes the Porgera saga to continue over the foreseeable future, Lihir's ore output quality to remain low, Ok Tedi's recovery damaged further and LNG output remaining constant at PNG LNG capacity.
(b) The moderate scenario represents the baseline GDP projections presented in the main text under domestic economic outlook and Pogera returning by second half of 2021.
(c) The strong scenario includes optimistic outlook for Porgera to return at the start of 2021, with all of PNG's gold producers ramping up production to take advantage of record high prices, and agricultural exports recovering as well. Then in 2022, non-resource GDP is driven by new investments through LNG projects and Wafi-Golpu.

While the weak and baseline scenario trend towards a long term nominal growth rate for PNG (assumed to be 5.7%), the strong scenario diverges from this because of the outlook on new resource projects. These have an impact on the medium term fiscal strategy via the anchors. Mainly the nominal GDP is associated with the variation in GoPNG's revenue and if the medium term expenditure framework is maintained, then the weak scenario predicts a breach of the FRA's upper limit for debt-to-GDP ratio while the strong scenario predicts lowering of that to 45% by 2025. However, given the uncertainties around the timing of the upcoming projects in a world with dramatic delays in LNG projects around the world, the moderate scenario is appropriate for this BSP.





III. MEDIUM TERM PROJECTIONS

The medium-term projections and consequently the budget strategy for 2021 is driven by expectation of how the recovery of the global and domestic economy might pan out over the next couple of months. The challenge for policy makers is to draft medium term projections and design policies in an environment of peacetime uncertainty not seen for a century.

The 2020 Supplementary Budget that was passed in Parliament revised the 2020 Budget appropriations under a reduced revenue envelope and cash-flow constraint hampering the execution of expenditure strategy. The Supplementary Budget cut Government expenditures in operational expenses while preserving essential service delivery. The expenditure cuts came from goods and services of national government departments (excluding essential services like health, education, and law and order sectors) and marginally from interest savings linked to the Debt Service Suspension Initiative (DSSI) program and domestic debt roll overs. Personnel emoluments was raised slightly to cater for an overrun in teacher's salaries. Largely, the re-appropriations went towards the payment of COVID-19 related expenditures and capital budget expenditure implemented through provincial governments and District Development Authorities.

The significant impact of the 2020 Supplementary Budget is the revision in the macro-fiscal indicators of the Government after a substantial downward revision of the GDP. The 2020 Budget and associated medium term framework was created with a debt to GDP target of 37.5 per cent and achieving a domestic deficit, that excluded concessional loan funded expenditure, of 2.2 per cent of GDP over the medium term. Both the debt to GDP and deficit defined here are part of the Government's FRA. In addition to the core fiscal anchors, in 2020 the government used an expenditure rule (operating budget as % of non-resource GDP) and the non-resource primary balance (as % of non-resource GDP) as anchors to guide expenditure strategy for the medium term.

In 2021, although the anchors remain relevant, the trajectory of macro-fiscal indicators of the Government is substantially revised, due to the macroeconomic shock to GDP as mentioned previously. The changes to the fiscal trajectory were recorded starting with the revision done to revenue at the time of application to the IMF RCF and then adjustments done at MYEFO/Supplementary Budget. The 2020 Supplementary Budget accompanied two critical legislative revisions that will influence the budget strategy in 2021 and the medium term. Firstly, the FRA debt-to-GDP ceiling was amended from 45 per cent to 60 per cent, with a trajectory to bring down the debt to GDP ratio to below 40 per cent in ten years. This allows the Government fiscal room to chart out a suitable recovery from the macroeconomic shock in anticipation of returning to fiscal consolidation over the medium term. Secondly, the *Central Banking Act* was modified to allow the government to secure a higher Temporary Advance Facility (TAF), of up to K1.5 billion[2] for within-year cashflow management (not for budget deficit financing). This allows the Government better capability to execute the national budget plan in the face of within year cashflow constraints that have been plaguing government finances for the last 5-6 years – for example, paying schools at the start of term rather than after the school term is finished.

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[2] The new TAF limit of K1.5 billion is based on the 3 year moving average of Revenue of the 3 recent past years.

Table 2: Summary Medium Term Framework

	2019	2020 Budget	2020 RCF	2020 MYEFO & SB	2021	2022	2023	2024	2025
Revenue and Grants	**13,680.4**	**14,095.4**	**11,395.1**	**11,359.0**	**12,995.0**	**15,095.1**	**17,041.7**	**18,833.9**	**20,626.2**
Of which: policy generated revenue	-	-	-	-	-	-	-	-	-
Expenditure	**17,852.4**	**18,726.5**	**18,726.5**	**17,989.2**	**19,607.8**	**20,390.2**	**20,367.1**	**21,126.6**	**22,386.1**
Of which: Arrears	*641.0*	*1,052.0*	*1,052.0*	*774.8*	*1,200.0*	*1,000.0*	*500.0*	-	-
Operational Budget	9,617.2	10,289.1	10,289.1	9,535.5	9,865.8	9,970.6	9,983.9	10,160.3	10,426.2
Capital Budget	6,088.0	6,280.5	6,280.5	6,389.3	7,471.2	8,197.4	7,855.8	8,167.2	8,965.8
Interest payments	2,147.2	2,156.9	2,156.9	2,064.4	2,270.8	2,222.2	2,527.4	2,799.1	2,994.1
Deficit	**-4,172.0**	**-4,631.1**	**-7,331.4**	**-6,630.2**	**-6,612.8**	**-5,295.1**	**-3,325.4**	**-2,292.7**	**-1,760.0**
Debt to GDP ratio (excluding arrears)	**39.8%**	**40.3%**	**50.2%**	**49.4%**	**53.6%**	**54.9%**	**54.9%**	**53.8%**	**52.1%**

Source: Department of Treasury

The medium-term fiscal projections have now been revised with an added outlook for 2025. Under the revised framework, revenue in 2021 is estimated to be K12,995.0 million with a target revenue of K20,626.2 million by 2025. This largely excludes various policy and administrative measures in revenue to raise funds above the current trend and costings of the medium-term revenue strategy. Similarly, the expenditure ceiling for 2021 has been revised upwards in the medium-term framework to K19,607.8 million (to accommodate COVID-19 spending and the higher level of arrears) with a target expenditure of K22,386.1 million by 2025. Overall, 2021 deficit will therefore be K6,612.8 million but will be reduced down to K1,760.0 million by 2025. Overall, the medium-term framework was created based on the requirement to control debt sustainability and fiscal consolidation over the medium term.

Table 3: Key Anchors of the Medium Term Fiscal Framework (% of GDP)

	2019	2020 Budget	2020 RCF	2020 MYEFO & SB	2021	2022	2023	2024	2025
Budget balance/Deficit (as % of GDP)	-4.9%	-5.0%	-9.0%	-8.1%	-7.6%	-5.6%	-3.3%	-2.1%	-1.5%
FRA deficit (deficit ex. concessional loan exp.)	-3.2%	-3.7%	-6.8%	-6.0%	-5.3%	-3.4%	-0.3%	1.7%	2.2%
Expenditure rule (op. balance as % of non-resource GDP)	20.2%	15.6%	19.7%	18.7%	18.4%	17.1%	16.4%	15.9%	15.3%
Non-resource primary balance (% of non-resource GDP)	-5.4%	-5.8%	-9.0%	-8.2%	-7.8%	-5.6%	-2.4%	-0.4%	0.2%
Debt (% of GDP excluding arrears)	39.8%	40.3%	50.2%	49.4%	53.6%	54.9%	54.9%	53.8%	52.1%

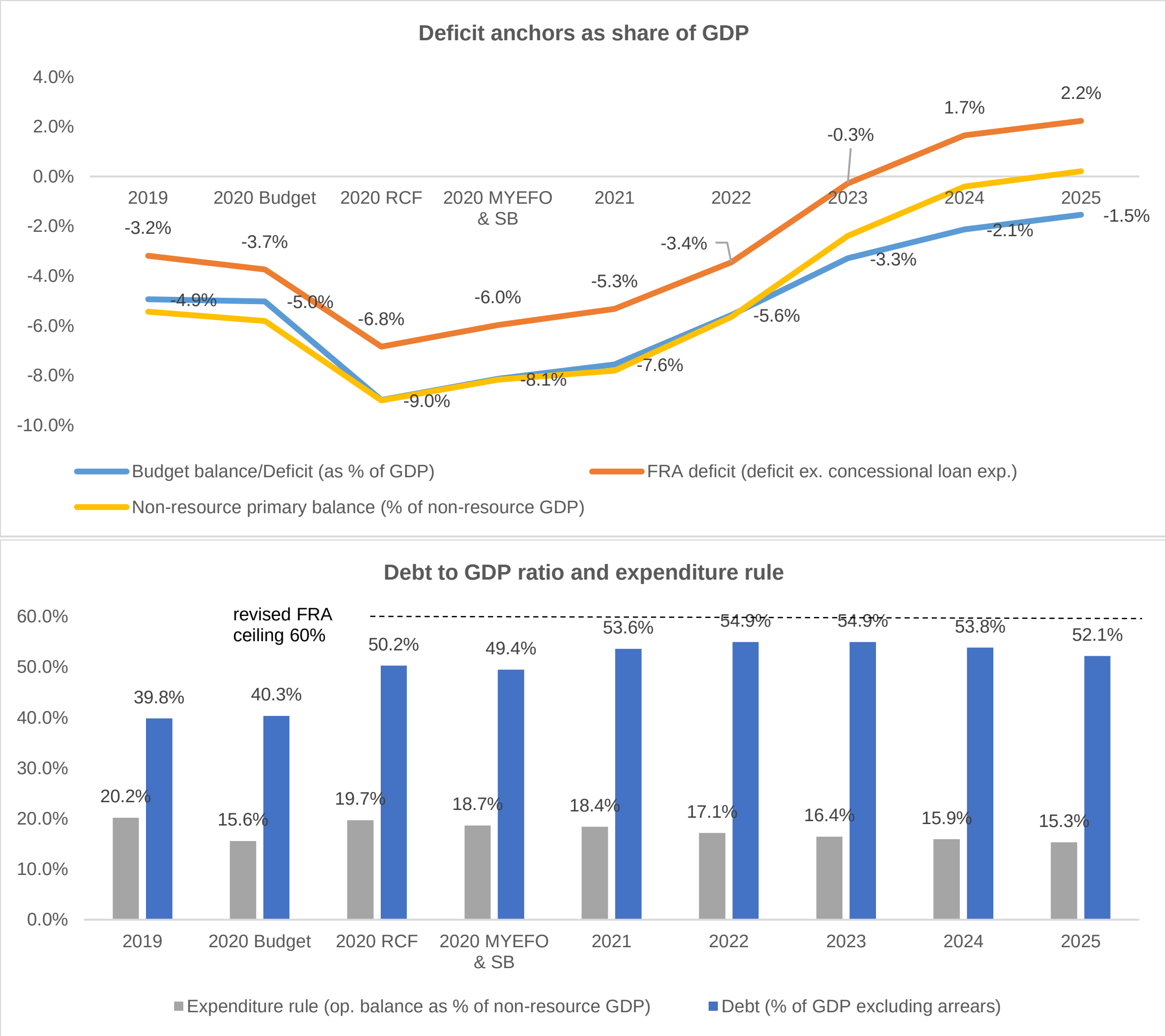
Source: Department of Treasury

The MTFS up to 2025 targets a debt to GDP ratio of 52.1 per cent so that it may be possible to reduce the debt to GDP ratio to under 40 per cent in ten years as per the FRA 2020 amendment. This will allow the government to retain fiscal room on the top in case of further negative shocks to the economy. However, PNG is also poised to receive positive GDP shock from development of new resource projects (not accounted for above due to conservatism in estimates with projects not included in the forecasts until the Final Investment Decision is made) which will in all probability help to reduce the debt to GDP ratio to under 50 per cent within the medium term of 5 years.

In other fiscal anchors, the medium-term framework envisions a reduction in deficit from -9.0 per cent of GDP after the initial COVID-19 shock in 2020 to -1.5 per cent of GDP; a reduction in deficit that excludes concessional financing from -6.8 per cent of GDP to a surplus of 2.2 per cent of GDP; a reduction in operating expenditure as share of non-resource GDP from 19.7 per cent to 15.3 per cent; and a non-resource primary balance as share of non-resource GDP from -9.0 per cent to 0.2 per cent. The Government will remain committed to the expenditure rule which will help grow capital expenditure in the medium term to ensure investments in infrastructure and government service delivery grow.

In the context of the medium term framework, the 2021 Budget Strategy targets consolidation in all deficit related fiscal anchors. The challenge of reducing debt to GDP still remains.

Figure 1: Evolution of key anchors of the fiscal strategy over medium term



Source: Department of Treasury

Revenue

Tax revenue is expected to grow as the economy expands over the medium term, with some potential upside as the Medium Term Revenue Strategy (MTRS) reforms are progressed by the Internal Revenue Commission (IRC) and PNG Customs Service (PNGCS). Similarly, Other Revenues will hinge upon reforms to dividend payments and fees and charges, and the rectification of the *Public Money Management Regularisation (PMMR) Act* in drawing revenues from collecting agencies.

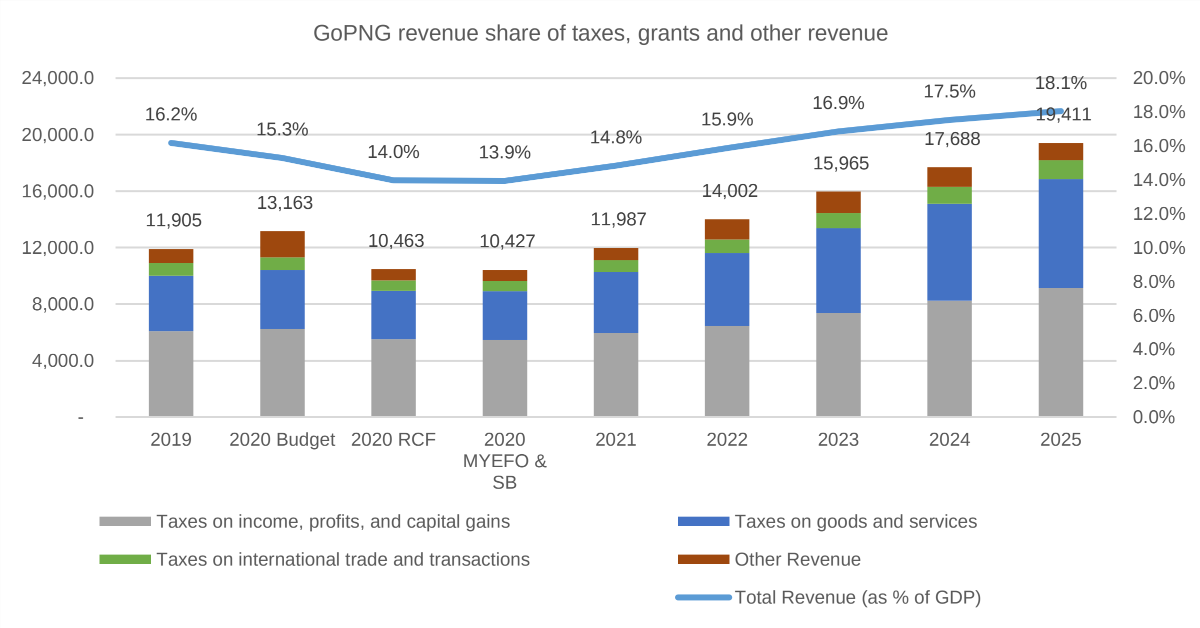
The full scope of returns from the MTRS are not yet included in the projections and therefore represent an upside risk to revenue. The MTRS aims to improve the revenue share of GDP over time.

Table 4: Revenue (Kina, Million)

	2019	2020 Budget	2020 RCF	2020 MYEFO & SB	2021	2022	2023	2024	2025
Total Revenues and Grants	**13,680.4**	**14,095.4**	**11,395.1**	**11,359.0**	**12,995.0**	**15,095.1**	**17,041.7**	**18,833.9**	**20,626.2**
Total Revenue (as % of GDP)	**16.2%**	**15.3%**	**14.0%**	**13.9%**	**14.8%**	**15.9%**	**16.9%**	**17.5%**	**18.1%**
Taxes	**10,918.1**	**11,307.8**	**9,683.2**	**9,647.2**	**11,109.7**	**12,579.7**	**14,441.2**	**16,313.9**	**18,188.4**
Taxes on income, profits, and capital gains	6,070.4	6,229.5	5,506.6	5,470.5	5,945.3	6,471.9	7,357.3	8,259.4	9,155.7
Taxes on payroll and workforce	1.9	-	1.4	1.4	-	-	-	-	-
Taxes on goods and services	3,936.5	4,195.1	3,437.9	3,437.9	4,351.1	5,147.7	6,004.4	6,858.3	7,706.4
Taxes on international trade and transactions	909.3	883.2	737.3	737.3	813.2	960.1	1,079.5	1,196.3	1,326.3
Grants	**1,775.6**	**932.1**	**932.1**	**932.1**	**1,008.3**	**1,092.7**	**1,076.6**	**1,145.8**	**1,215.0**
Other Revenue	**986.8**	**1,855.5**	**779.8**	**779.8**	**877.0**	**1,422.7**	**1,523.9**	**1,374.2**	**1,222.8**

Source: Department of Treasury

Figure 2: Government Revenue over the medium-term (Kina, Million)

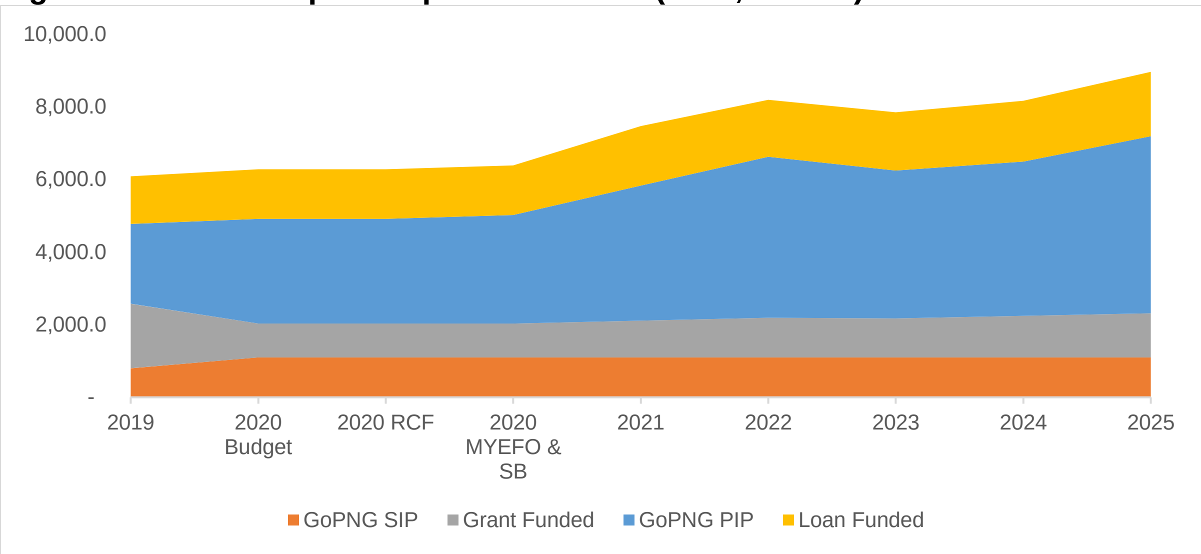


Source: Department of Treasury

Expenditure

Total Expenditure is driven in part over the next few years by the repayment of arrears accrued in recent past years, with the profile expected to be revised depending on the identification of additional arrears, and the validation process the Government will undertake to ensure that arrears are legitimate. There is a need for continuing COVID-19 related expenditure. This will continue strongly supporting our health system as well as actions to support the economy including through shovel-ready projects. The capital budget, which is also supported by concessionary loans, is anticipated to grow strongly, driven by greater drawdowns on committed funds from project partners, which are anticipated to grow at 20 per cent per annum. Partners have approved K6.9 billion in loan funded projects already, which gives the Government scope to expand capital.

Figure 3: GoPNG Capital Expenditure Path (Kina, Million)



Source: Department of Treasury

Table 5: Breakdown of Expenditure (Kina, Million)

	2019	2020 Budget	2020 RCF	2020 MYEFO & SB	2021	2022	2023	2024	2025
Expenditure (MTFS Classification)	**17,852.4**	**18,726.5**	**18,726.5**	**17,989.2**	**19,607.8**	**20,390.2**	**20,367.1**	**21,126.6**	**22,386.1**
Operating Budget	**9,617.2**	**10,289.1**	**10,289.1**	**9,535.5**	**9,865.8**	**9,970.6**	**9,983.9**	**10,160.3**	**10,426.2**
Personnel Emoluments	5,423.8	5,672.8	5,672.8	5,762.8	5,763.8	5,684.3	5,438.0	5,470.8	5,487.5
Other Operating	4,193.4	4,616.3	4,616.3	3,772.7	4,102.0	4,286.3	4,545.9	4,689.5	4,938.7
Capital Budget/PIP	**6,088.0**	**6,280.5**	**6,280.5**	**6,389.3**	**7,471.2**	**8,197.4**	**7,855.8**	**8,167.2**	**8,965.8**
GoPNG PIP	2,200.7	2,883.4	2,883.4	2,992.3	3,724.5	4,436.5	4,067.5	4,248.3	4,877.3
GoPNG SIP	800.0	1,100.0	1,100.0	1,100.0	1,100.0	1,100.0	1,100.0	1,100.0	1,100.0
Grant Funded	1,775.6	932.1	932.1	932.0	1,008.3	1,092.7	1,076.6	1,145.8	1,215.0
Loan Funded	1,311.7	1,365.0	1,365.0	1,365.0	1,638.4	1,568.2	1,611.7	1,673.1	1,773.5
Debt Service	**2,147.2**	**2,156.9**	**2,156.9**	**2,064.4**	**2,270.8**	**2,222.2**	**2,527.4**	**2,799.1**	**2,994.1**
Annual growth rate	**-**	**4.9%**	**4.9%**	**0.8%**	**9.0%**	**4.0%**	**-0.1%**	**3.7%**	**6.0%**

Source: Department of Treasury

N.B: Arrears are appropriated under code 207, but are split here between PE (K430m), other operating (K340m) and capital (K430m) reflecting where they will be expended. COVID-19 expenditures are also under code 207, but are split where they are expended. In 2020, the split of the K600m is estimated to be essentially even between the operating and capital budgets, with slightly more under the capital budget in 2021 as the COVID-19 programs continue.

The retirement program for public servants over the age of 65 has commenced in 2020, but is delayed due to COVID-19. Thus, while the government will not be able to expend all the planned retirement arrears this year, it will be carried forward in 2021 and 2022. The medium term also assumes a hiring cap of K12.8 million. Combined with savings from the retirement program, the government expects net savings in PE in 2022 and 2023 with net positive hiring recommencing in 2024.

Financing

The 2019 Supplementary Budget embarked on a revised debt strategy for the medium term. The elements of the revised strategy was to re-build confidence in PNG through more transparent budgeting according to international standards. This was to open doors to higher levels of concessional financing from bilateral and multilateral sources with an objective to reduce interest costs and improve debt sustainability. This strategy is being updated to accommodate the COVID-19 impacts on financing and will be presented as a revised MTdS 2021-2025. The revised MTdS will also be informed by an internal DSA currently being conducted within the Financial Management Division (FMD) of the Treasury.

The MTdS will operationalise the overarching objective of keeping debt at sustainable levels considering the cost-risk trade-offs. The major strategies to support the debt management objective comprises of the following:

- Maintaining debt at sustainable levels. The revised FRA ceiling of Debt to GDP of 60 per cent with a target of reducing to 40 per cent over ten years will limit debt to sustainable levels. The band applies to general Government debt at book value and includes valuation changes from exchange rate movements and incurring implicit and explicit state guarantees debt as and when they emerge;

- Maintaining financial risk at prudent levels. Lengthening of the average time to maturity is a trade-off between cost and refinancing risk. This would include revising the state guarantee policy with added elements of monitoring, payments and recovery, recording and reporting for contingent liabilities;

- Developing and efficiently managing the domestic debt market. This involves broadening and deepening the market in domestic securities and improving the market infrastructure, including exploring options for market diversification and improved access to international investors; and

- Participate in the G20 (and China) DSSI to maintain sustainability of interest payments from larger unanticipated borrowings due to Covid-19 and mitigate exchange rate risks.

IV. 2021 BUDGET STRATEGY

As well as the medium term fiscal strategy, and revenue and debt strategies, the Government will build the budget around a set of key principles including:

- spend the money we have more wisely;
- raise the revenues more fairly;
- finance the debt more cheaply;
- leverage friendly international support more intelligently;
- focus on growth in the agriculture sector and the informal sector;
- distribute resource benefits more equitably;
- stimulate non-resource growth back to 5 per cent annually;
- comprehensive Government SOE reform program;
- freeing up foreign exchange; and
- create at least 10,000 jobs annually.

Fiscal Strategy

The 2021 Budget strategy is composed of elements of the 2020 Supplementary Budget released in response to the COVID-19 impact and setting the stage for fiscal consolidation over the medium term. This is achieved in a number of ways. Firstly, in 2020 Supplementary Budget the government introduced a number of capital programs (Connect PNG, micro PIP for rural infrastructure, Special Intervention Program) that aim to invest in PNG's infrastructure and generate employment. Secondly, the government is maintaining a skeleton goods and services budget for Government departments in 2020, to initiate some efficiency measures in service delivery and control recurrent expenditure without affecting service delivery. Thirdly, personnel emoluments budget is driven by requirements of controlling the wage bill by expending the overdue retirement program and instituting a government wide ceiling on new hiring.

The overall fiscal deficits and anchors associated to the Government's 2021 budget balance can be compared to the situation facing PNG immediately after the impact of the COVID-19 pandemic reduced revenues by an estimated K2,731 million – known as the 2020 RCF starting point as this was the situation where PNG secured RCF financing from the IMF. The 2020 Supplementary Budget then reflected the start of action to deal with this fiscal shock.

- BUDGET DEFICIT target at 7.6 per cent of GDP (2021) vs 9.0 per cent (2020 RCF)
- FRA DEFICIT (ex. Concessional loans) target at 5.3 per cent of GDP (2021) vs 6.8 per cent (2020 RCF)
- NON-RESOURCE PRIMARY BALANCE target at 7.8 per cent of GDP (2021) vs 9.0 per cent (2020 RCF); and
- DEBT TO GDP target at 53.6 per cent of GDP (2021) vs 50.2 per cent (2020 RCF).

In 2021, the debt to GDP ratio remains well below the 60 per cent ceiling of the amended FRA.

Major risks to the fiscal strategy comes from the revenue shortfall that may be experienced next year. Although the Government has been conservative in estimating revenue, revenue shortfall from delayed policy measures and larger than expected reduction in corporate income taxes represent a significant risk to the execution of the strategy. Another significant challenge experienced in 2020 was the cashflow limitations of the Government to support implementation rate. This is expected to be rectified with the larger temporary advance facility now available from the amended *Central Banking Act 2000* that was passed during 2020 Supplementary Budget.

Table 6: 2021 Budget Strategy

	2020 Budget	2020 RCF	2020 MYEFO & SB	2021 BSP
GDP	**92,206.2**	**81,627.0**	**81,496.7**	**87,557.1**
GDP Nominal Growth (%)	9.0%	-3.0%	-3.6%	7.4%
GDP Real Growth	0.0%	-2.6%	-3.0%	2.2%
Revenue	**14,095.4**	**11,395.1**	**11,359.0**	**12,995.0**
Taxes	11,307.8	9,683.2	9,647.2	11,109.7
Grants	932.1	932.1	932.1	1,008.3
Other Revenue	1,855.5	779.8	779.8	877.0
Expenditure	**18,726.5**	**18,726.5**	**17,989.2**	**19,607.8**
Operational Component	**10,289.1**	**10,289.1**	**9,535.5**	**9,864.8**
Compensation of Employees (PE)[1]	5,672.8	5,672.8	5,762.8	5,763.8
Goods and Services	3,489.1	3,489.1	2,645.5	2,891.1
Provincial Functional Grants	541.1	541.1	541.1	584.0
GST & Book Makers Txfrs	586.1	586.1	586.1	626.0
Interest Payment (Debt Service)	**2,156.9**	**2,156.9**	**2,064.4**	**2,270.8**
Capital Investment Component	**6,280.5**	**6,280.5**	**6,389.3**	**7,471.2**
GoPNG PIP	3,983.4	3,983.4	4,092.3	4,824.5
Donor Support Grants	932.1	932.1	932.0	1,008.3
Concessional Loans	1,365.0	1,365.0	1,365.0	1,638.4
TOTAL BALANCE	**-4,631.1**	**-7,331.4**	**-6,630.2**	**-6,612.8**
TOTAL FINANCING	**4,631.0**	**7,331.4**	**6,184.6**	**6,612.8**
Net External Borrowing	3,373.8	6,073.8	4,261.6	4,612.8
Net Domestic Borrowing	1,257.2	1,257.6	1,923.0	2,000.0
Net Use of Trust Fund Balances	-	-	-	-
DEFICIT (% of GDP)	-5.0%	-9.0%	-8.1%	-7.6%
FRA DEFICIT (% of GDP)	-3.7%	-6.8%	-6.0%	-5.3%
Debt/GDP (%) (excl. arrears)	40.3%	50.2%	49.4%	53.6%

Source: Department of Treasury

Revenue Strategy and Forecasts

The effects of COVID-19 in 2020 are expected to continue to impact revenue in 2021. Primarily, the loss in business income will manifest in reduced corporate income tax earnings next year as filings for 2020 assessable year become payable in 2021. A significant reduction in corporate income taxes is therefore expected from earlier estimates (projecting a 0% nominal growth in corporate income tax which means a fall in real terms). However, international trade and GST are estimated to recover with the economic recovery. A modest oil and LNG price estimate also means that dividends and taxes from PNG LNG are likely to remain low given the project is still writing off depreciation costs and debt repayments.

In 2021, revenue is expected to be around K12,995.0 million. In order to raise revenue further next year – three priority actions are required which represent additional K260-280 million in revenue. First is the approval and implementation of the revised SOE dividend policy that improves the flow of funds of SOE earnings to the budget. The second is the correction, passing and implementation of the PMMR Act, which the Supreme Court ruled as unconstitutional in 2020. The Department of Finance is currently revising the draft legislation which is expected to be passed by Parliament shortly. A conservative assumption is that only 25% of the annual projection of PMMR revenues are included in the revenue estimates for 2021.

Table 7: 2021 Revenue

	2020 Budget	2020 RCF	2020 MYEFO & SB	2021 BSP
Total Revenue	**14,095.4**	**11,395.1**	**11,359.0**	**12,995.0**
Taxes	**11,161.5**	**9,683.2**	**9,647.2**	**11,109.7**
Taxes on Income, profits, and capital gains	6,243.7	5,506.6	5,470.6	5,945.3
Taxes on payroll and workforce	-	1.4	1.4	-
Taxes on goods and services	4,065.5	3,437.9	3,437.9	4,351.1
Taxes on international trade and transactions	852.3	737.3	737.3	813.2
Grants	**932.1**	**932.1**	**932.0**	**1,008.3**
Other Revenue	**2,001.8**	**779.8**	**779.8**	**877.0**
Of which: Resource Revenue	**1,322.5**	**511.2**	**511.2**	**813.6**
Mining and Petroleum Taxes	522.5	161.2	161.2	313.6
Mining, Petroleum and Gas Dividends	800.0	350.0	350.0	500.0

Source: Department of Treasury

The expected pick-up in international trade taxes and GST will depend critically on a pick-up in domestic business and retail conditions and on a resumption of inward investment flows. The assumptions are that recovery in trade taxes and GST are likely to be staggered over the next 12 months (as opposed to abrupt increase). The non-resource recovery projected in 2021 is mostly GST. Substantial risks to fiscal outlook are a deterioration in global economy and further Covid-19 infection periods.

The MTRS measures have not been costed in the revenue forecasts as this is under review. These will be included once policy prescription is available for implementation next year. A review is also underway of the MTRS to prioritise policy initiatives for 2021. Under administrative provisions, the IRC is expected to implement the taxpayer services development strategy – a plan that operationalises improvements in service delivery to tax payer to support voluntary compliance. The Government will ensure provision of adequate resources to drive the MTRS reforms, including ensuring the effective operations of the MTRS Steering Committee.

Expenditure Rules and Guidelines

The 2021 Budget expenditure is expected to be around K19,608.0 million. This will mainly support the key reforms introduced in 2020 that relate to the 'Loloata

Commitment' focused on connecting PNG, supporting rural communities, supporting SMEs, providing responsible government tuition fees (GTF); and strengthening SOE through smarter and targeted reforms.

It will continue to fully fund government service priorities in the health, education, law and order and infrastructure. K600 million is allocated to cater for further Covid-19 related expenditures in 2021 anticipated to arise, either for response in health as required or as a fiscal stimulus to the economy, or both.

Overall, the targets for 2021 are that the government's recurrent budget is controlled, the capital budget is increased, there is an on-going buffer to respond to the COVID-19 crisis, arrears continue to be paid down and on aggregate the FRA defined deficit is declining in 2021.

The Government is committing in 2021 to continue drawdown in the level of arrears that will end up reducing both debt stock as well as stimulate the economy. Since 2020, all arrears are being addressed through a process of verification and identification by the Arrears Verification Committee that sits weekly and makes recommendations to the Treasurer and Budget Management Committee on payment of these arrears. The stock of government arrears may be revised upon subsequent identification and verification.

In 2020, the government has also made fiscal room for an additional K1492.8 million in arrears payment to be paid in 2022 and 2023. This is purely anticipatory fiscal room created to protect against fiscal risk and provide assurance that the government remains committed to pay all its debts. The stock of such arrears will be revised frequently through the AVC's work.

Table 8: Payment of domestic arrears (Kina, millions)

	2019	2020 Budget	2020 RCF	2020 MYEFO & SB	2021	2022	2023
Opening stock	**2,623.0**	**1,982.0**	**1,982.0**	**1,982.0**	**1,207.2**	**1,500.0**	**500.0**
Personnel Emoluments	-120.0	-552.0	-552.0	-263.0	-430.0	-320.0	-
Goods and Services	-200.0	-200.0	-200.0	-336.0	-340.0	-360.0	-250.0
Capital Budget	-321.0	-300.0	-300.0	-175.8	-430.0	-320.0	-250.0
Anticipated new arrears	-	-	-	-	1,492.8	-	-
Closing stock	**1,982.0**	**930.0**	**930.0**	**1,207.2**	**1,500.0**	**500.0**	**-**

Source: Department of Treasury

Debt Strategy

The 2021 Budget expenditure will require K6,613 million in financing from external and domestic sources whereby external financing is planned to cater for about 70 per cent of the deficit while the remaining 30 per cent is planned to be sourced domestically by issuing T-bills and T-bonds.

In external sources, multilateral financing facilities that are currently available include World Bank's COVID-19 emergency DPO; ADB's SOE reform linked policy loan; and pre-signed project based concessional lending worth at least K1,638.0 miillion. Further financing is being explored at this time.

In domestic market, demand for Treasury bills and bonds can be supported by further quantitative easing by BPNG. A major policy initiative to support market liquidity is securitization of commercially held T-bills and T-bonds in a secondary market. The current planning is for net Treasury Bond issuance of K1,600 million and net Treasury Bills of K500 million.

Table 9: 2021 Net incurrence of liabilities and debt stock

	2020 Budget	2020 RCF	2020 MYEFO & SB	2021 BSP
Net financial transactions 5/	**4,631.0**	**7,331.4**	**6,630.2**	**6,612.8**
Net acquisition of financial assets	**-**	**-**	**-445.6**	**-**
Net acquisition of financial liabilities	**4,631.0**	**7,331.4**	**6,184.6**	**6,612.8**
Domestic	**1,257.2**	**1,257.6**	**1,923.0**	**2,000.0**
Treasury bills	328.1	328.1	328.1	500.0
Treasury bonds	1,029.6	1,030.0	1,695.4	1,600.5
Loans	-100.5	-100.5	-100.5	-100.5
BPNG Temporary Advance	-	-	-	-
External	**3,373.8**	**6,073.8**	**4,261.6**	**4,612.8**
Debt securities	-	-	-	-
Commercial	85.5	-882.2	-882.2	-983.2
Concessional	992.5	992.5	992.5	1,638.0
Extraordinary	2,295.8	5,963.5	4,151.3	4,004.4
Gross government debt	**37,184.0**	**40,998.4**	**39,851.6**	**46,464.4**
Domestic	20,140.3	20,591.2	21,256.6	23,256.6
External	17,043.7	20,407.2	18,595.0	23,206.8

Source: Department of Treasury

Other initiatives that may improve debt include:

- Participating in the DSSI with Bilateral partners to give us breathing space on debt repayment exercise in 2021 amidst the Covid-19 pandemic;
- Expansion of the long term domestic borrowing, and a move towards utilising the domestic market to a greater extent. This will be supported by efforts to expand the accessibility of the local securities market to overseas investors;
- Continue the drawdown of undisbursed balance of concessional project loans as a boost for capital investment;
- Recent Supplementary Budget, Government approved the amendment to the FRA. This came about due to dramatic fall in the revenue means we have little choice but to borrow further and this is what other governments around the World are doing in light of this global pandemic;
- With Revenue falls, increase in financing is needed to support expenditure. The borrowing will be from reputable creditors and multilateral partners who can offer concessional terms and we can rely on to work closely to address the fiscal gap;
- The debt to GDP ratio is forecast to rise again in 2021 and 2022 because of continuing global economic conditions due to Covid-19; and
- These changes will necessitate a set of additional reporting, including tables of valuation changes, other flows and arrears movements in order to ensure full transparency and accuracy.