



2016 Budget Strategy Paper

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Acronyms

APEC	Asia-Pacific Economic Cooperation
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
MTDP	Medium Term Development Plan (2011-2015)
MTDP2	Medium Term Development Plan (2016-2017)
MTFS	Medium Term Fiscal Strategy (2013-2017)
PNG	Papua New Guinea
RHS	Right Hand Side (axis)
SME	Small and Medium-sized Enterprises
SOE	State Owned Enterprises
StaRS	The Strategy for Responsible Sustainable Development
SWF	Sovereign Wealth Fund

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Government of Papua New Guinea

2016 Budget Strategy Paper

A. Purpose

This publishing of the National Budget Strategy Paper is in accordance with 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.

Through the Budget Strategy Paper the general public are provided an understanding of the fiscal landscape of the country and Government's economic and social policy responses to these prevailing conditions. It also provides the public an opportunity to gauge the Government's record on pursuing and achieving its policies.

In respect of the 2016 Budget Strategy Paper, it is unique in that it provides an update on the Governments performance and future direction from 2015, the half way mark of the O'Neill-Dion Government since its inception in 2012 and running into the National Elections in 2017.

More specifically, the 2016 National Budget Strategy will contain:

- i. the principles that will guide the 2016 National Budget;
- ii. the broad fiscal parameters for the 2016 Budget and the key Government policies for the management of revenues and expenditures;
- iii. a discussion on the risks to the budget parameters and the Budget Strategy and the national socio-economic outcomes;
- iv. the medium-term outlook for Government revenues and expenditures; and
- v. a discussion on the progress of the O'Neill-Dion Budget Strategy as it relates to the Medium Term Fiscal Strategy (MTFS), the Medium Term Debt Strategy, The Fiscal Responsibility Act and the Medium Term Development Plan (MTDP);

Fiscal data included in the Budget Strategy Paper is indicative only. The macroeconomic and fiscal forecasts will be updated with the 2016 Budget to reflect any changes in economic and financial conditions.

Volume One of the 2016 Budget will be reported under IMF GFS 2014 reporting standards. These differ somewhat to the GFS 1986 reporting standards which have previously been used for Budget Reporting in PNG, and aggregate numbers for Total Expenditure and Total Revenue figures will be revised to reflect these changes.

B. EXECUTIVE SUMMARY

The 2015 Budget has been significantly impacted by a sharp fall in commodity prices. Downward revisions to tax and non-tax revenue receipts, particularly from the Mining and Petroleum sector have required a firm policy response, and in particular, to reduce expenditure and focus on additional revenue measures to maintain a budget deficit close to the 2015 Budget forecast at 4.5 per cent of GDP.

The 2016 Budget therefore will be framed against a relatively weak world economic environment that is still adjusting to a lower commodity prices outlook and lower than anticipated growth within the domestic economy due in part to the effects of drought in parts of the country.

The Government has responded by continuing to pursue broad-based economic growth whilst ensuring macroeconomic stability and creating a pathway for fiscal consolidation. Consolidation will be achieved through the following:

- i. ensuring expenditure prioritization (in light of the lower revenue scenario) and improving the quality of spending to derive the greatest value;
- ii. refining the tax system to improve efficiency and a broadening of the tax base for a sustainable revenue base;
- iii. managing the Government Debt profile through capital markets structural reforms and including the issuance of a debut sovereign bond;
- iv. pursuing structural reforms in the State Owned Enterprises sector and the size and efficiency of the public sector; and
- v. continuing to undertake budget reforms and other complementary policies.

The pace of fiscal consolidation over the medium term needs to be carefully managed to accommodate high priority expenditure projects that will continue to promote broad based economic growth and employment in the country. This means that deficit levels over the medium term need to be gradually reduced until the budget returns to balance by 2020.

This approach will provide the necessary capacity to fund priority expenditures such as the hosting of the African, Caribbean and Pacific States meeting in 2016, the 2017 General Elections, and hosting the APEC Summit in 2018 while maintaining the Government's commitments to the core development enablers of health, education, law and order, agriculture, and infrastructure.

The Government will continue with budget reforms to ensure the National Budget is transparent, accountable, efficient, and responsive to the needs of the people.

From an implementation perspective, this must be supported by reforms addressing the size and effectiveness of the public service; the service delivery capacity and cost effectiveness of the State Owned Enterprises; and continued institutional development such as the Extractive Industries Transparency Initiative (EITI), the PNG Sovereign Wealth Fund (SWF), and anti-corruption initiatives such as the Independent Commission Against Corruption (ICAC). This will continue to build an environment that is conducive to a strong and competitive private sector.

C. THE 2016 BUDGET STRATEGY

The 2016 Budget will be guided by the Vision 2050, PNG Development Strategic Plan (DSP) (2010-2030), the Medium Term Development Plan 2 (MTDP2) (2016-2017), the Strategy for Responsible Sustainable Development (StaRS), the Medium Term Debt Strategy, the Medium Term Fiscal Strategy (MTFS) (2013-2017), and the *Fiscal Responsibility Act* 2014 (FRA).

The Government will live within its means by producing a budget that is responsible, affordable and sustainable yet responsive to the needs of the country. For the past three years, economic growth has been driven by significant activity in the Mineral & Petroleum sector and supported by the associated high levels of construction.

As this has abated over the last 12 months, the Government has continued the fiscal expansion to support the MTDP enablers. However, consistent with significant falls in commodity prices and the impact of the drought, and taking into consideration strong expenditure growth in recent Budgets which have allowed for significant deficit Budgets, decisive fiscal consolidation is now needed to move the Government Debt to GDP ratio onto a downward trajectory over the medium term.

To achieve this outcome, the 2016 Budget Guiding Principles are to:

- ensure fiscal consolidation through expenditure prioritization that will result in quality spending including the establishment of a Productivity Measure capability to be initially housed in the Department of Treasury;
- adopt a budget that is affordable and sustainable;
- improve monitoring, transparency and accountability mechanisms to ensure expenditure efficiency;
- expand the sources of public debt financing (such as a sovereign bond) to enable the government to restructure its public debt portfolio and to better facilitate the financing of deficit prior to the return to balanced budgets.
- refine the tax system to maintain tax integrity;
- broaden the tax base to fund public outlays on a sustainable basis;
- pursue public sector reform;
- pursue structural reforms and seek increased competition in key markets;

- maintain a gross Government Debt to GDP ratio at 35 per cent in 2016 and gradually reduce this to less than 30 per cent by 2020; and
- achieve a return to balanced budget by 2020.

Given the deterioration in the fiscal outlook in the first half of 2015, a combination of expenditure reductions and increased revenue collections have been adopted to return the level of general government debt to below 35 per cent of GDP in 2015, and to provide a pathway to reduce the level of debt to below 30 per cent of GDP in the medium term.

This will necessitate a revision in the FRA that currently requires debt to GDP to be less than 30 per cent in 2016.

Table 1: 2014-2020 Budget Balances (%GDP)

	2014	2015	2016	2017	2018	2019	2020
MTFS 2013-2017 BUDGET BALANCE	-5.9	-1.6	-0.6	0.1	0	0	0
MTFS 2013-2017 IMPLIED DEBT TO GDP	34.6	28.9	27.5	25.4	23.1	22.3	20.9
2016 BUDGET STRATEGY RECOMMENDED MAXIMUM DEFICIT	-6.9	-4.5	-3.1	-1.8	-1.2	-0.4	0.0
2016 BUDGET STRATEGY IMPLIED DEBT TO GDP	35.5	34.4	34.8	34.6	33.8	32.3	30.2

Source: Department of Treasury

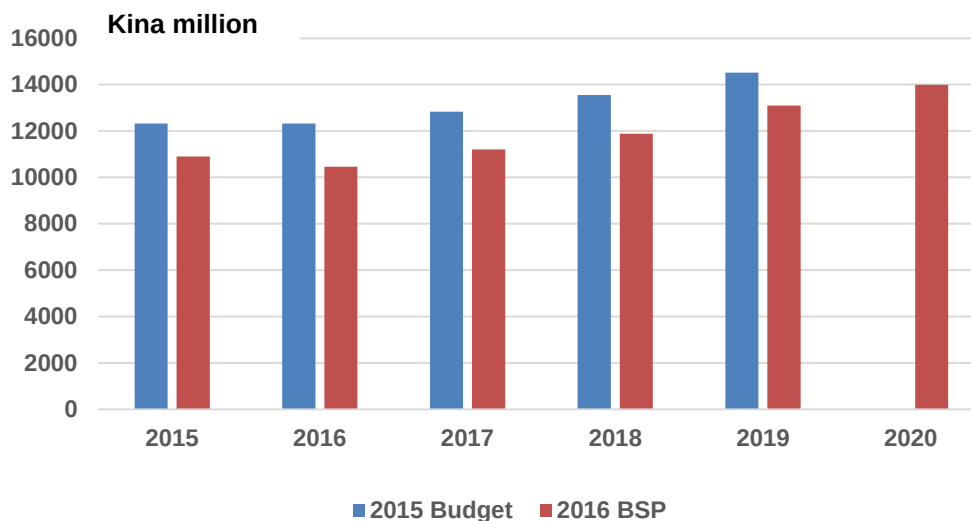
The Government plans to delay the return to a balanced budget to 2020 rather than the previously planned return to surplus by 2017. This approach is to avoid a sharp contraction in the economy which would impact negatively on employment and investment.

D. FISCAL PARAMETERS FOR THE 2016 BUDGET

D.1 Revenue

Total Government Revenue (less donor grants) in 2016 is projected at approximately K10.4 billion comprising of K9.9 billion Total tax revenue and K0.6 billion Non-tax revenue.

Chart 1: Government Revenue 2015-2020



Source: Department of Treasury

Mining and petroleum revenues should start to flow to the SWF in 2016. Funds will be drawn down from the SWF Stabilisation Fund into the Budget based on a formula that calculates mining and petroleum receipts as a proportion of non-mining and petroleum receipts. It should be noted that larger tax revenue collections from the PNG LNG project are not expected until the mid to late-2020s, after the project has written off (depreciated) its construction costs (under the prevailing oil price scenarios).

Revenue Reforms

Whilst major policy changes will be considered after the Tax Review has prepared its final report, Government is taking into consideration a number of early reform options by the Review for the 2016 Budget. These proposals are reform areas that the Government has identified from submissions to the Tax Review or analysis undertaken directly by the Review.

Future reforms to PNG's taxation system will be aimed at improving efficiency and competitiveness of the PNG economy. This will require reducing taxation concessions that can lead to overinvestment in uneconomic projects and attract investment away from projects offering the same or better return.

It will also require moving toward more efficient tax bases. This will involve a move toward broad tax bases with low rates of taxation rather than narrow tax bases with high rates of taxation.

The Government will consider reducing disincentives that discourage workers from joining the formal economy due to the tax they pay on their earnings.

D.2 Expenditure

Total Expenditure and Net Lending in 2016 is projected at K13.4 billion, a reduction from the 2015 Budget figure of K16.2 billion, and a revised 2015 projection of K14.8 billion.

Given the resource envelope, a reprioritisation of Government spending is necessary to ensure that the tangible and sustainable socio-economic benefits expected by all people in PNG are realised.

The 2016 Budget will maintain the Government's key priority expenditures such as Tuition Fee Free Education; Free Primary Health Care and subsidised specialised Healthcare; critical maintenance of existing road infrastructure and funding to support operations for lead up work to APEC 2018, the National Elections in 2017, and the African, Caribbean and Pacific States meeting in 2016 within the requirements of fiscal consolidation and the need to support drought affected regions.

The Government will also address the overruns in personal emoluments by ensuring that all departments reconcile their payroll and staffing structure with the Department of Finance. All Departments are to resolve matters relating to unattached officers within their agencies and must ensure devolution of powers relating to the hiring and dismissal of staff are done in consultation with the Department of Personnel Management. DPM approved agency structures should be considered only within Budget appropriations.

E. FINANCING

In 2016 the Government is projecting a Budget deficit of K1.7 billion, which is lower than both the 2014 outcome of K3.0 billion and revised 2015 deficit estimate of K2.3 billion.

The financing of a reduced budget deficit in 2016 will ease the pressure on the domestic debt market for funds. Over the last 12 to 18 months there has been ongoing concerns that the domestic market is no longer able to finance large budget deficits, because of investment limits being reached by the major investors.

In order to mitigate this risk, and free up funds in the domestic market, a Sovereign Bond will be issued, with a significant proportion of the proceeds used to buyback securities with the objective of repositioning the Government's debt portfolio in accordance with its prudent guidelines. It will also ensure that the portfolio is more robust to weather market shocks going forward. In terms of financing the 2016 Budget deficit funds will be subsequently raised as and when required.

Continued high budget deficits in recent years have led to a sharp increase in the level of debt which has increased from K15.4 billion in 2014 to projected levels of K19.4 billion in 2016 representing an increase of 26 per cent. In terms of the requirements under the FRA, the Government continues to be cognisant of its requirement to meet 'Debt to GDP' limits as stipulated by the FRA.

In recent months credit rating agencies reports that highlighted the risks and challenges for Government to achieve the necessary expenditure reductions and revenue increases to be able to restrict the growth in public sector debt to sustainable levels. This has resulted in the rating agencies revising their rating outlooks to negative meaning a higher likelihood of a downgrade in the absence of appropriate policy responses. The Government will clearly articulate the necessary and credible pathways to return to a balanced budget in the release of the 2016 Budget papers.

In addition the Government, in conjunction with an IMF Technical Assistance team, will be undertaking a debt sustainability review. New debt benchmarks for 2017 and forward years will be determined following the outcome of this review and included in an updated Medium-Term Public Debt Management Strategy.

Given the current financing challenges, the Government will continue to examine ways of expanding the range of financing options over and above the traditional financing methods of domestic debt via Treasury Bills and Inscribed Stock. It will also look to collaborate with Bank of Papua New Guinea, key investors and other key stakeholders to develop, deepen and strengthen the market for Government securities.

F. MEDIUM TERM ECONOMIC AND FISCAL OUTLOOK

2017 to 2020 Economic Outlook

Over the medium term (2017-2020), the PNG economy is projected to grow at its trend rate of 3.0 per cent driven by the traditional drivers of the economy – the non-resource sector. This outlook does not capture the major Mineral and Petroleum projects such as the Elk-Antelope project, the Stanley Gas Project, the expansion of the PNG LNG Project, the second LNG project, Petrochemical projects, the Wafi-Golpu project as well as the construction of infrastructures for the 2018 APEC Meetings. Adjusting for these would provide some upside to our growth forecast for the medium term.

Inflation is anticipated to remain within manageable levels of around 5.0 per cent based on the assumption of effective and coordinated monetary and fiscal policies given that price stability is one of the government's key objectives.

Table 2: Economic Parameters

	2015	2016	2017	2018	2019	2020
Economic Growth						
GDP	11.0	3.0	2.4	2.6	2.7	3.1
Non-mining GDP	3.3	3.4	3.3	3.3	3.6	3.9
Inflation						
Average on Average (%)	4.9	5.6	5.2	5.1	5.0	5.4
Dec on Dec (%)	5.2	5.3	4.4	7.2	5.2	4.3
Interest rate						
Treasury Bills (182 day yield)	4.5	4.5	4.5	4.5	4.5	4.5
Inscribed Stock (3 year yield)	9.7	9.7	9.7	9.7	9.7	9.7
Mineral Prices						
Gold (US\$/oz)	1,192	1,207	1,226	1,255	1,271	1,299
Copper (US\$/ton)	5,818	5,975	6,155	6,290	6,391	6,391
Oil (Kutubu Crude: US\$/barrel)	49	54	59	64	68	69
LNG (US\$ per thousand cubic feet)	8	10	10	11	11	11
Condensate (US\$/barrel)	49	54	59	64	68	69
Nickel (US\$/tonne)	12,926	14,094	15,049	14,906	15,387	15,387
Cobalt (US\$/tonne)	29,500	30,000	30,000	30,000	30,000	30,000

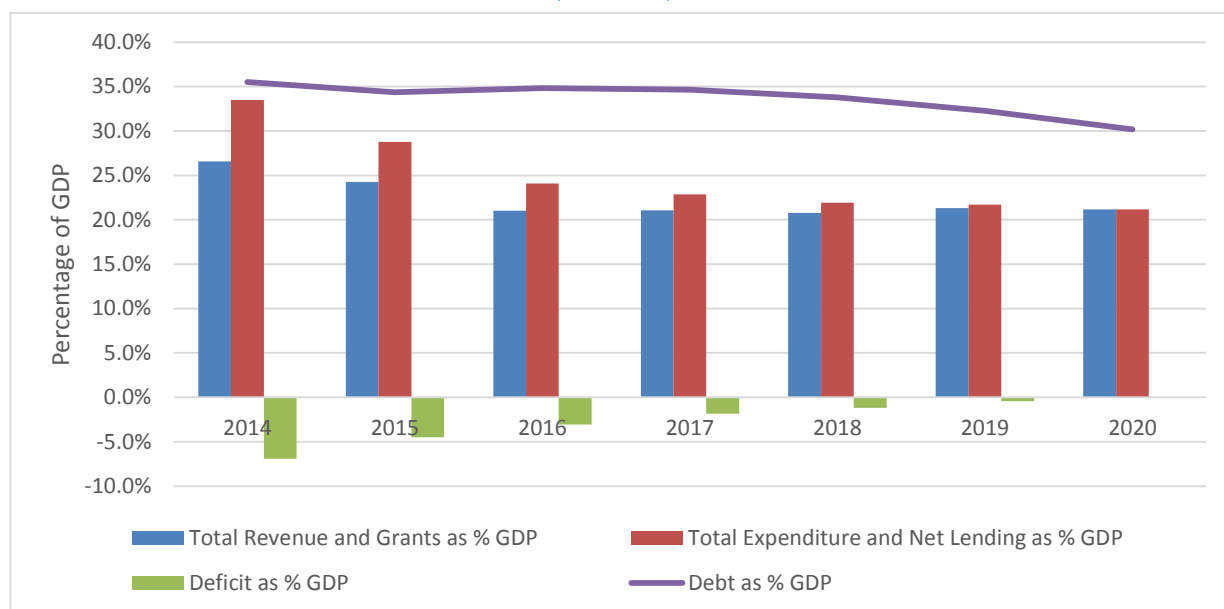
Source: Department of Treasury

The Medium Term Fiscal Outlook

Over the past three years, the Government has invested strongly in provinces, infrastructure, health, education and law and order. Growth in Total Expenditure and Net Lending from 2012 to 2014 has been 44 per cent, while revenue growth was 18 per cent, resulting in estimated deficits of 7.7 per cent of GDP and 6.9 per cent of GDP in 2013 and 2014 respectively.

The Government has adopted a plan to reduce expenditure to more sustainable levels and to return to a balanced Budget in 2020. Reducing deficits to sustainable levels is crucial to enable the Government to better respond to future external shocks and to not unfairly overburden the next generation.

Chart 2: Fiscal Outlook 2014-2020 (% GDP)



Source: Department of Treasury

The Government debt to GDP ratio is estimated to fall to 30 per cent over the medium term. This is largely within the framework set by the Government in the MTFs and the Medium Term Debt Strategy but will require adjustments in the Fiscal Responsibility Act with regard to the debt limits in 2016-2020.

Medium Term Fiscal Strategy (MTFS) 2013 – 2017 (2016 BSP)

Revenue:

1. **Maintain equitable taxation regimes with a focus on compliance.**
2. **Restrict taxation exemptions and special arrangements.**
3. **Broaden and strengthen the Government's tax and non-tax revenue base.**

Expenditure

4. **Increase the share of the total budget allocated to key enablers of the Medium Term Development Plan to two thirds by 2017.**
5. **Improve spending agencies' focus on expenditure effectiveness and transparency in expenditure reporting and public accountability.**
6. **No new infrastructure programs should be funded unless they have gone through a two stage project design and costing process.**
7. **Ensure CSTB procurement processes are within Budget appropriations**

Debt:

8. **Maintain a gross Government Debt to GDP ratio at 35 per cent in 2016 and gradually reduce the ratio to less than 30 per cent by 2020.**
9. **Limit gross Government liabilities to less than 60.0 per cent of GDP.**
10. **Greatly increase the Government's average debt maturity profile.**

Deficits

11. **Ensure a return to a balanced budget by 2020.**

G. RISKS TO THE ECONOMIC AND FISCAL OUTLOOK

The risks to the PNG Economic and Fiscal Outlook include:

- Recent global economic developments continuing to impact PNG through low commodity prices translating into low export earnings for the country and lower revenues for the Government; as well as, posing a threat to economic activities in PNG's two biggest sectors:- the agriculture (through a prolonged drought), forestry & fishing sector, and the mining and quarrying sector.
- Providing tax concessions that distort investment decisions such as tax holidays, exemptions, and Infrastructure Tax Credits without proper costing and policy advice.
- Heavy reliance of the Budget on domestic borrowings has increased financing risks associated with interest rate and refinancing risks. There is also a major risk of crowding out private investment.
- Expansion of the debt levels of State Owned Entities (SOEs) and guarantees issued by the State to SOEs, provincial governments and other entities.
- Loss of momentum in the progress of development of key Institutions.
- Weaker than anticipated market response to the issuance of the Government's debut Sovereign Bond.
- Expenditure approved outside the budget process.
- Natural disasters such as a continuation of the current drought affecting economic activity in certain areas of PNG.

H. BUDGET REFORMS AND COMPLEMENTARY POLICIES

Prudent allocation of expenditure is necessary to realise tangible outcomes and manage sustainable socio-economic deliverables. To achieve this, the Government announced in the 2013 Budget plans for an improved budget process through;

- a. an integrated Budget;
- b. a multi-year budgeting process;
- c. sector led-budgeting; and
- d. performance based budgeting.

Further budget reforms have been implemented in 2015 and will be refined to improve the integrity and efficiency of the Budget process through the alignment of policy priorities and expenditure allocation, in fulfilling the Government's policy objectives.

The 2016 Budget will seek to further advance the strong development of Budget reforms initiated in 2013 through the development of the following reforms:

1. The unification of the budget components (Operational and Capital Investment), so that investments in both physical capital and human capital are effectively supported, maintained and absorbed by operational activities over time;
2. A Ministerial led budget process, to link well informed ministerial strategic policy decisions with expenditure allocation;
3. Multi-year budgeting, to improve the management of resources in the medium term, manage expectations, building better planning arrangements and provide more predictability and policy coherence and consistency to the budget cycle;
4. A sector-led approach, to consolidate the efforts of agencies within each sector to effectively coordinate and deliver on shared goals and targets in line with their sector plans and Medium Term Development Plan targets;
5. A performance based budget, driven by historical achievements with systems and processes in place that explicitly define how the impacts of these investments will be measured.

H.1. Government Financial Statistics (GFS 2014)

The Government is in the process of improving the reporting of its fiscal and financial operations which are currently reported in the outdated 1986 IMF international standard of reporting. The intention to improve the reporting was announced in the 2013 Budget to adopt the 2001 IMF international standard of reporting. Since then the reporting has been updated to the 2014 standard which the Government will now adopt starting in Volume 1 of the 2016 Budget.

PNG as an IMF member country is required to report on this basis. The coverage under GFS 2014 is of all institutional units that materially affect fiscal policy and this includes budgetary and extra-budgetary units as well as activities of the public corporations. GFS 2014 will provide more visibility of the Government's Debt and provides more accurate information on sectoral expenditures such as health and education. GFS 2014 will also ensure international comparability and improve fiscal analysis, government policy decision making, and accountability. It is also consistent with other macroeconomic accounts of Balance of Payments (trade), National Accounts, Monetary Accounts and other Financial Accounts.

GFS 2014 will be adopted for the 2016 Budget Volume 1 and adopted in Volume 2 and Volume 3 for the 2017 Budget.

H. 2 Complementary Policies

The Papua New Guinea Sovereign Wealth Fund (PNG SWF) is an important mechanism to manage revenues generated from the exploitation of minerals and hydrocarbons and to help stabilise and protect the domestic economy and the Budget from commodity price fluctuations and exchange rate swings. The savings fund also ensures that inter-generational benefits are secured and distributed. In 2016 the Government will enter the next phase of operationalising the SWF, with the appointment of an experienced and well-qualified Board and the setting up of a secretariat to support the Board

The PNG SWF will be integrated into the Budget and fiscal policy framework to ensure effective government spending of mineral and petroleum tax and dividends and facilitate fiscal transparency and oversight of public finance management by Parliament.

The Competition Review and the Financial Sector Services Review are currently underway and will help identify areas for future reform. These reforms together with the current transparency and governance reforms will improve the environment for business. The Financial Inclusion and Financial Literacy Strategy, enhanced secured lending arrangements and ongoing efforts to reduce unnecessary regulatory burdens will also help improve the business environment, including for the SME sector.

Under the Extractive Industries Transparency Initiative (EITI) taxes, payments, levies and dividends made by the extractive industry will be disclosed publicly.

The Kumul Consolidation Agenda will manage all State assets including State Owned Enterprises (SOEs) and mining and petroleum interests. Government has now passed the Kumul legislation that establishes three key holding entities. One consolidating the State's mining interests, one consolidating the State's petroleum interests and one housing the more traditional SOEs. This key structural change encourages greater efficiency and improved management through greater commercial discipline as the boards and the key staff of these companies are to be selected on the basis of expertise.

In addition: on-lending and guarantee policies will ensure financing is undertaken on commercial terms, a dividend policy will ensure the State gets an appropriate return on its investments, and a Community Service Obligations (CSO) policy bringing transparency to the cost of community services will be implemented so that the Government can make informed decisions about the most effective method of service delivery.

The lack of access to land, a key inhibitor to private sector development, also remains a focus of the Government. The Government recognises the importance of diversifying the economy and is actively seeking to enhance the enabling environment and development opportunities for the agriculture sector through reforms such as the Functional and Expenditure Review (FER) of the Agricultural Commodity Boards and Agencies with three key outcomes were specified:

- i.** increased domestic and export production and revenue from agriculture activities and businesses;
- ii.** increased numbers of indigenous men and women in small, medium and corporate businesses in agriculture; and
- iii.** increased number and volume of new investments in the agriculture sector.

I. CONCLUSION

The 2016 Budget Strategy Paper proposes a delay in the return to a balanced budget from 2017 to 2020, proposes the consideration of revenue strengthening measures, the restructure of debt, and the continued progress of budget reforms and complementary policies.