2013 Budget *Alert*

Executive Commentary

The 2013 PNG National Budget represents a substantial change in strategy by the government compared to previous years.

In previous years the government had an annually increasing flow of income from strong commodity prices and continuing support from lenders and the challenge was to apply those funds to a veritable mountain of development requirements in a young country with low per capita income, declining infrastructure and low standards, by world measures, in health, education and other social metrics. The governments of days gone by have made efforts to plan prudently, using the funds at their disposal, and even set aside revenue flows in years of high commodity prices in trust funds to smooth out expenditure requirements and assist planning. Those trust funds became in themselves an object of considerable concern when past governments conceded that they were unable to track the majority of the expenditure out of them. That concern has not dissipated.

This year the government finds itself in a different place. As the LNG project gets nearer to completion it is becoming clearer that the population is becoming increasingly eager to see an improvement in the delivery of services to outlying areas. The economic environment is historically strong. There is clearly liquidity in the financial system and the level of foreign reserves is robust, The debt repayments of past years have placed the government in a relatively strong position and it has decided to use these conditions to attack the development issues impacting PNG and finance a deficit budget beyond anything it would have contemplated in the past.

It's reasoning is that now is the time to put measures in place which will assist the lives, health and social development of its citizens as best it can and invest in the infrastructure which will promote economic development as far as it is able. The government believes the additional expenditure and resultant borrowings will still see it in a relatively strong debt position through to the time that it can look forward to increasing revenue flows from the LNG project and potentially other major developments that will be built.

In a sense, despite natural reservations, it may in fact be very conceptually sound to go into deficit at this time, given those conditions.

One can't help wondering though, as in past years, whether policy is enough. PNG in prior years has not been able to get the money to areas that it needed to due to an absence of financial controls, planning and execution at the ground level of public service delivery. If PNG will indeed come into the class of resource rich countries in the future then these disciplines will be vital or the disparity between those citizens with access to mineral wealth and those without will become increasingly glaring.

In summary, this is a brave budget, founded on a sound analysis of the current economic climate and we can only hope that all stakeholders work hard for its success.

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Economic overview of budget

The 2013 Budget

Budget Strategy overall

The 2013 PNG national budget projects total revenue and grants of K10,481.9 million – the highest on record and an increase of some K324 million or 3.2% over the revised 2012 estimate.

In a major departure from policy in recent years, it will be a deficit budget showing a shortfall against revenue of 7.2% of GDP, which equates to a K2,548.9 million deficit. By far the lion's share of the deficit for 2013 will be met from domestic borrowings (K2,230.0 million). In fact the government expects to run continuous deficits for several years before it returns to a small surplus in 2017. It has stressed that it believes that these borrowings are considered sustainable by the International Monetary Fund and the World Bank.

There are three major thrusts underlying the deficit planned in this budget. The first is that the budget is designed to be in deficit to greatly increase expenditure on its Medium Term Development Enablers which are Health, Education, Law & Order and Land. Support of the first three enablers will increase by some 50.9% over 2012 levels from K5 billion to K7.5 billion. Secondly there will be a major commitment to key "Nation Building" infrastructure investments with some K12.1 billion to be committed over the next 5 years. Lastly, there will be a substantial 87% increase in funding to sub-national levels of government, particularly the districts, through a programme of direct funding totalling K1,492 million. In recognition of the multi year focus on the expenditure plans for these key areas the government is implementing multi year budgeting across all areas.

As part of these reforms, which effectively include transferring significant responsibility away from the national government, the government says it will seek efficiencies "within Waigani". This includes implementing recommendations of a right sizing review. The government plans to reduce the number of agencies from 117 to 100 by 2014. It has also indicated disquiet at what it says are the growing number of independent state entities and will conduct a review in 2013 to roll back some statutory authorities into government departments and bring their funding back into consolidated revenue.

It will insist on commercial returns on funds lent for commercially viable activities conducted by State owned enterprises and cites the installation of the fibre optic system and the upgrade of Jackson Airport as examples.

The government promises a taxation review in 2013 focussed on the mineral sector and better funded IRC and Customs so they can commence more comprehensive audit programmes. It will also establish 5 key reform priorities for public enterprises in 2012 in attempt to improve their performance. Those priorities are:-

- Dividend policy
- Public Private Partnership policy
- On-lending policy
- Guarantee policy
- Community Services Obligations policy

Specific issues of interest

One of the sleepers in this budget may turn out to be that the government has stated it has as yet made no allocation for the shortfall in its funding commitment to the LNG project arising as a result of cost increases anticipated in the construction of that project.

Interestingly also, while the suggested priorities all seem well considered and strategic, there has been no great emphasis on power generation as an area for infrastructure development. Whether the assumption is that the sector will be funded through PPP arrangements or through borrowings by PNG Power Limited is not clear but this sector does not appear to have had quite the same emphasis as other key infrastructure areas have.

However, as outlined above, expenditure on the identified enablers will rise in 2013. Greater detail is provided later in this report but in broad the increases are as follows:-

	2012 (million Kina)	**2013 (million Kina)**
Education	1361	1844
Health	710	888
Law & Order	874	979

Some of these increases are reflected in the increase of personnel emoluments, i.e. the wages bill of the national government. The wages bill of the government will rise from K2,324 million in 2012 to K3,013 million in 2013 which is an increase of 29.6% for national government, provincial governments and statutory authorities. The national government itself will see an increase of some K312 million in its wages bill but 60% of this will be coming from the three priority areas described above. This reflects the recruitment of substantial additional personnel in these areas to assist the government realise its planned initiatives.

Traditionally the budget is divided into recurrent and development sections. The recurrent element, called Service Delivery Expenditure, rises from K5,346.7 million in 2012 to an expected level of K7,325.0 million which is an increase of K1,111.9 million. The development section rises from K3,249.2 million to K5,795.8 million reflecting the government's commitment to a substantial boost in development expenditure. Some of that development expenditure comes in the following areas:-

- Provincial Services Improvement Programme – K445 million
- District Services Improvement Programme – K890 million
- Local Level Government Support – K157 million
- Infrastructure Investment Projects – K569 million

The government also says it is mindful of the pitfalls in shifting expenditure away from the national centre and has increased allocations to various areas to increase the rigor in the management of such budget operations, including establishment of an Infrastructure Development Authority (K10 million), increased funding for audits by the Rural Development Authority (K10 million) and the Audit Office (K5 million).

As mentioned above, strategically the government has placed great emphasis on upgrading various infrastructure in PNG. It has estimated these costs on a multi year basis and not just for 2013. Examples include:-

- It has allocated an amount of K470 million for the Lae-Nadzab Road over the next three years. The extension of this highway all the way to Koroba and Wabag is estimated to cost K1,560 million over the next 5 years
- K930 million to be set aside for the maintenance of the Highlands Highway
- K500 million to be set aside over the next 3 years to deal with the traffic congestion in Port Moresby
- K184 million to restore Lae City roads over the next 2 years
- K300 million for a comprehensive restoration of the Port Moresby General Hospital and a further K1.4 billion in additional priority infrastructure over the next few years

The government also hopes to work closely with development partners Ausaid, ADB, China and Japan to secure an additional K1.5 billion funding over the next 5 years. Concessional loans will increase from K644 million in 2013 to over K1 billion in 2017. The government hopes to fund key national infrastructure to the extent of K12.1 billion over the next 5 years financed by internal funding (K6.6 billion), concessional loans (K4 billion) and counterpart funding (K1.5 billion).

The government continues to espouse the development of a competitive private sector and has listed a number of initiatives to assist in this. Some of them are:-

- Increased reviews by ICCC to enhance competition
- Sugar and various agricultural price reviews
- National land development programme
- Review of the Companies Act 1997
- Review of the impediments to business
- Further examination of implementation of the Extractive Industries Transparency Initiative

The government continues to focus its attention on the historically poor financial performance of its State Owned Enterprises. It intends to develop a strategic framework around 10 core principles established in a recent conference organised by the National Research Institute and they are:-

- Public enterprises to maximise profits subject to 3 constraints being (1) minimum delivery standards (2) a hard budget constraint and (3) operating within a competitive framework
- The State will support competition in the marketplace particularly in industries with market power
- The State will facilitate unbundling of services to increase competition and improve access and quality
- Any exceptions to the above principles will be clearly articulated and justified
- The State will over time divest its majority stake in public enterprises
- The State will support mobilisation of savings for investment in the resources sector with public equity and where possible will favour citizens in that
- Appointments to public enterprises will be conducted transparently and on merit
- Each enterprise will have the same disclosure requirements as apply to publicly listed companies on an international stock exchange
- Introduce competency in the management of public enterprises and state investments
- Financing for public enterprises and state investments will be diversified

Debt Requirements

The PNG government expects a substantial deficit in 2013 to the extent of K2,548.9 million (7.2%) compared to a very small achieved deficit of K65.7 million (0.2%) in 2011 and K402.6 million (1.2%) expected in 2012.

The 2013 deficit will be largely financed by an increase in domestic borrowings of K2,230 million or 35.8% which had itself increased by K1,101 million in 2011. At the end of 2012 domestic debt was expected to be in the order of K6,222.1 million.

The funding requirements of 2012 saw an increase in the build up of Treasury bills to 45.9% of total domestic debt but the government hopes to shift the balance of the debt portfolio to longer term debt in 2013 and going forward.

External debt is expected to be K2,431.1 million at the end of 2012 and is expected to grow by K475.9 million in 2013 (K140.3 million in 2012).

None of these figures include the proposed Chinese Exim Bank loan which is still being negotiated. It is expected to become available some time in 2014.

Trust Accounts

The purpose of trust accounts was to spread public investment expenditure over time to avoid inflationary and demand pressures in the economy and give implementing agencies time to make expenditure decisions. Deposits into the trust accounts come from three sources being additional priority expenditure, supplementary budget expenditure and annual budgets.

Some K1,095 million was spent out of the trust accounts up to September 2012 with deposits from the three above sources totalling K826 million resulting in an overall drawdown of K269 million. A further amount of K292 million is expected to be paid into the trust accounts by the end of 2012. The 2013 budget plans for additional appropriations of K450 million.

Recent Economic Performance & Assumptions

The PNG economy grew strongly in 2012 with many industries still benefiting from the economic activity resulting from the LNG construction boom both from direct contracts and indirect multiplier effects.

The overall growth rate for 2012 is expected to be 9.2% compared to the original 7.8% predicted. On a sectoral basis the performance of the different sectors is expected to be:

	2012 %	
Mining & Quarrying	6.0	
Oil & Gas	(16.4)	
Construction	24.0	
Wholesale & Retail Trade	15.0	
Transport Storage & Communication	16.0	
Electricity, Gas & Water	12.0	
Manufacturing	10.0	
Finance Real Estate & Business Services	10.0	
Agriculture, Forestry & Fisheries	(0.2)	(+ 8% in 2011)

The 2013 outlook remains positive with strong growth predicted for the year. The mining sector should reflect increased gold production plus the ramp up of production in the Ramu Nickel mine. This will be offset to an extent by declining production in the oil fields but mining GDP is still expected to grow 13.0% compared to non mining GDP which is expected to rise 3.4%.

The powerful flow through effects of the LNG project construction are expected to abate in 2013 as the construction winds down and this will be most reflected on the sectors directly providing services to that sector. Expected growth rates for 2013 include:

	2013 %
Mining	17.8
Oil & Gas	(6.0)
Construction	4.4
Wholesale & Retail Trade	5.0

The principal economic assumptions in the budget for this year are as shown below. In line with the new philosophy of multi year forecasts, the government sets out its expectations in these parameters on a multi year basis as well.

Summary of Economic Parameters							
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Economic Growth (%)							
GDP	11.1	9.2	4.0	5.5	20.0	3.7	3.7
Non-Mining GDP	13.2	9.8	3.4	1.1	4.2	4.4	4.9
Inflation (%)							
Year average	8.5	4.1	8.0	7.4	5.6	5.2	5.0
Interest Rate (%)							
Kina Rate Facility	7.8	6.8	6.8	6.8	6.8	6.8	6.8
3 years Inscribed Stock	9.0	5.0	5.0	5.0	5.0	5.0	5.0
Mineral Prices							
Gold (US$/oz)	1,569	1,648	1,701	1,605	1,538	1,510	1,526
Copper (US$/tonne)	8,823	7,824	8,047	7,866	7,672	7,449	7,424
Oil (Kutubu:US$/bbl)	104	96	103	104	102	100	98
Nickel (US$/tonne)*		17,453	18,681	18,681	18,681	18,681	18,681
*Nickel prices from 2013 onwards reflects the 10 year average (2002-2011)							

In the medium term the government expects economic growth to rebound in 2014 and grow substantially in 2015 with the commencement of full gas production from the LNG project. The government is seeking to promote the growth of agriculture/forestry/fisheries in the medium term through the impact of policy initiatives.

Key Priorities – Medium Term Development Plan Enablers

Law and Justice

Under the Medium Term Development Plan 2011-2015 (MTDP) improving law, order and justice is one of the key enablers of achieving the government's development goals. Through the Law and Justice Sector Strategy Framework, the government aims to reduce crime rates by 8.3% by 2015 with key strategies to achieve this being accessibility to law and justice services, retention of key personnel, effective use of restorative justice and early dispute resolution.

In order to achieve the planned reduction in crime the infrastructure challenges continue to be a focus of the government's development budget. In addition the government has committed to adding Police 400 recruits per annum, funding the Independent Commission Against Corruption (ICAC) and funding Taskforce Sweep.

Development expenditure allocations for Law & Justice includes:

	Govt	Grants	Total
Peace Building	0.0	5.7	5.7
PNG-Australia Law & Justice Partnership Program	4.0	67.5	71.5
Rural lock-up Program	2.0	0.0	2.0
Police Housing Program	10.0	0.0	10.0

Transport

The transport sector continues to be the highest funded sector in the development budget. Despite this, funding is still short of the major capital investments required in all three sub sectors – land, air and water. In addressing this, 2013 Development Budget has adopted a five year outlook towards building and maintaining a "comprehensive transport network" which is recognised in the budget as the key enabler for the other key enablers under the MTDS.

In keeping with the 2013 Budget's claims to have moved away from previous budgetary approaches by being more "outcomes oriented" the focus is on large scale infrastructure projects which will act as a catalyst to finance the resource gap by the economic activity that is generated.

As in prior years a number of issues continue to plague the sector including allocation of funding, poor prioritisation of funding, procurement delays, staffing deficiencies, landowner issues and governance failures.

The specific development expenditure on Transport maintenance and rehabilitation includes:

	Govt PNG	Grants	Loans	Total
Roads				
Transport Sector Support Program (AusAID)	10.0	179.4	0.0	189.4
1st Stage Highlands Highway Lae - Nadzab Road (4 Lane)	150.0	0.0	0.0	150.0
Highlands Region Roads Improvement Investment Program (ADB)	30.0	0.0	100.0	130.0
NCD roads	100.0	0.0	0.0	100.0
Lae city roads	100.0	0.0	0.0	100.0
Highlands Highway (Maintenance)	80.0	0.0	0.0	80.0
Air Transport				
Civil Aviation Development Investment Programme	16.0	0.0	153.5	169.5
Airport Upgrade and Rehabilitation - Jacksons	30.0	0.0	0.0	30.0
Communication, Surveillance & Air Traffic Management Replacement	14.3	0.0	0.0	14.3
Sea Transport				
Lae Port Development Project (Tidal Basin)	20.0	0.0	93.7	113.7
Coastal Vessels Program (purchase vessels for maritime provinces)	20.0	0.0	0.0	20.0
Wharves & Jetties Rehabilitation & Construction	15.0	0.0	0.0	15.0
Total Sea Transport	**55.0**	**0.0**	**93.7**	**148.7**

Primary and Secondary Education

In 2013 the Government will extend the Universal Basic Education Plan (UBE) which will now aim to provide all children the opportunity to obtain fee free education up to grade 12. Furthermore the Government aims to increase teacher housing in rural areas, improve teacher training, provide IT infrastructure to rural schools, and promote sporting activities at schools. The long-term educational goals being a gross enrolment ratio of 74.3%, retention ratio between grade one and six of 40% and youth literacy of 70%.

The Government recognises that the capital cost of new school facilities and the recurrent costs of additional teachers and educational materials will be significant and will pose significant capacity challenges for the lower levels of Government.

Specific development expenditure allocations include:

	Govt	Loans	Grants	Total
Community College	0.0	16.3	0.0	16.3
Education Infrastructure Development	0.0	0.0	0.0	0.0
Enhancing Quality in Teaching through TV Programme Project	2.0	0.0	4.7	6.7
Educational Awareness on UBE	0.0	0.0	1.0	1.0
HRDP I	0.0	0.0	19.9	19.9
Inspectors Housing and Transportation	10.0	0.0	0.0	10.0
PNG education programme	0.0	0.0	163.8	163.8
Qualification Upgrading Skills Development	5.0	0.0	0.0	5.0
Reading Education Project	0.0	0.0	24.9	24.9
UN Assistance to Education Sector	0.0	0.0	9.2	9.2
Total	**17**	**16.3**	**223.5**	**256.8**

Higher and Technical Education

As the country is experiencing major developments, the government is acutely aware of the growing demand for Higher and Technical Education and its importance in supplying PNG's manpower requirements in all sectors of the economy. It is absolutely crucial to have a skilled workforce to drive the growth and development of the country.

The quality and quantity of graduates continues to be far short of what is needed and this is largely due to inadequate resources, deteriorating infrastructure and a range of governance and general service quality issues.

However we note that the 2013 Development Budget shows a decrease of K174 million to Higher and Technical Education with the focus to be on funding trade skills scholarships, improving essential infrastructure in colleges and universities. Significant funding will be for the TVET program run by the Department of Education and the Trade Skills Scholarships administered by the Office of Higher Education.

Utilities

The government recognises that fundament public utilities of water & sanitation, energy development and information and communication technology are essential to the growth and development of all sectors of the economy. In keeping with the main themes of the 2013 Budget, the Development Budget for utilities (Water & Sanitation, Electricity, Information & Communication Technology) focuses on the decentralisation of service delivery, partnerships with the private sector and increasing the effectiveness of lower levels of government in service delivery.

The government's medium term goals in these areas include:

- Increasing the total population's access to improved water sources to 47% by 2015
- Improving access to improved sanitation to 51% by 2015
- Ensuring that 27% of households have access to electricity by 2015
- Increasing the number of mobile subscribers to over 700 per 1000 people by 2015
- Improving internet access by 20% by 2015.

Some of the major expenditure items of the 2013 Development Budget for utilities include:

- Rural water supply
- Rural electrification program
- Government's new information system, the Integrated Government Information System (IGIS)
- PNG LNG fibre optic cable.

Total Water & Sanitation development expenditure allocation was K71.6 million:

Specific Energy development expenditure allocations include:

	Govt	**Loans**	**Grants**	**Total**
Port Moresby Grid Development	4.0	0.0	0.0	4.0
Rural Electrification Program	10.0	0.0	0.0	10.0
PNG Town Electricity Investment Project	3.0	43.5	0.0	46.5
TOTAL	**17.0**	**43.5**	**0.0**	**60.5**

Specific Information and Communications development expenditure allocations include:

	Govt	**Loans**	**Grants**	**Total**
IGIS	6.0	32.6	0.0	38.6
Rural Communication Project	3.0	10.8	0.0	13.8
PNG LNG Fibre Cable	55.0	0.0	0.0	55.0
PNG Media Program	0.0	0.0	8.6	8.6
Rural Communication Project	10.0	0.0	0.0	10.0
TOTAL	**74.0**	**43.4**	**43.4**	**126.0**

Primary and Preventative Health Care

The government has again recognised that government run health services have regressed to a point where out of the total health services provided in the country 47% are managed and operated by churches. Consistent with the MTDP the the Department of Health has developed a Medium Term Development Plan 2011-2015 to guide health infrastructure investment to 2015.

In 2013, the Development Budget continues to be focused on the rehabilitation of existing infrastructure, training of community health workers, effective management of drugs and medical supplies or equipment especially in the rural areas. The Development Partners particularly AusAID, NZAID and the UN continue to contribute significantly to the health sector.

The Development Budget provided no specific expenditure plan on Primary and Preventative Health for 2013.

Economic sectors

Agriculture

The 2013 Budget recognises that around 85% of the country's population are dependent on agriculture to sustain their livelihoods and the sector itself accounts for 32.2% of the GDP. The National Agriculture Development Plan (NADP) 2007-2016 provides the governments overall policy and planning objectives for the agriculture sector.

The government's focus in 2013 is on improving transport infrastructure to enable better access to markets for producers and enabling access to finance through support of micro-credit schemes. Other major areas of focus include rehabilitating cash crop farming, fresh food storage, infrastructure, commodity board restructuring, promotion of downstream processing to international investors.

Fisheries

PNG has the largest fisheries zone in the South Pacific with an Exclusive Economic Zone of 2.4 million square kilometres. In recognising the significant potential of this sector the Government endorsed the National Fisheries Development Plan Framework (NFDPF) 2006-2016. The key priorities under the NFDPF include:

- Increasing the volume and value of downstream processed products
- Promoting fish products of internationally recognised quality
- Encouraging sustainable fishing
- Improving fishing communities access to markets
- Encouraging the vertical and horizontal linkages between supportive markets

Under the NFDPF the Government has committed to increase processed fisheries exports from K189 million to K450 million and increase PNG vessels share of total catch from 1% to 5%. Significant investment is required with the Pacific Marine Industrial Zone (PMIZ) in Madang being the first of such investments.

The Development Budget provided no specific expenditure plan for Fisheries for 2013.

Forestry

The Government is committed to ensuring PNG's forest resources are managed so as to derive maximum sustainable benefits while minimising any detrimental impact to the environment and society at large. The forest sector contributed 2.6% of total export earnings in the first quarter of 2012.

A significant issue in the forestry sector is land availability for plantations which has been addressed in amendments passed in 2012 to the *ILG Act* and *Land Registration Act 2009*. The amendments are aimed at enabling landowners to easily convert their land to commercial activities however the Government is aware that there needs to be a strong policy and regulatory framework to ensure sustainability.

The Development Budget provided no specific expenditure plan for Forestry for 2013.

Tourism

Tourism is an important and strategic contributor to the economy of Papua New Guinea. The Government sees significant potential to increase the value of tourism sector over the medium term. Visitor arrivals in 2011 for business and holiday travellers grew by 12.8% according to the 2011/12 Business and Investment Guide cited by the 2013 Budget. Cruise ship numbers also continue to show positive signs which have been lucrative for coastal tourism operators.

The government's focus in 2013 will be on product development and investment, marketing and destination, transport and infrastructure, human resource development and industry partnerships.

The Development Budget provided no specific expenditure plan for Tourism for 2013.

Mining

Mining continues to dominate the export sector contributing over two thirds of total export revenues over the years and is a key contributor to Government income.

In recent years, as indicate by the 2013 Budget, the Mining industry's legislative and policy framework has been subject to reviews, amendments and additions in the case of development of offshore mineral deposits. The general aim is to achieve consistency with the PNGDSP 2010-2030 goal of doubling mineral exports while minimising adverse impacts on the environment.

The Government recognises that the increased growth in the mining sector will in turn place greater demands on Government agencies to effectively implement their roles and responsibilities. It is crucial for Government agencies to therefore be adequately resourced to be in position to deal with developers.

The 2013 Budget makes assurances that in 2013 the Mineral Resources Authority (MRA) and Department of Mineral Policy and Geohazards Management (DMPGM) will continue to administer the operation of the mining sector. The DMPGM is also tasked to review the Mining Act 1992 "in full consultation with stakeholders" with a view to increase benefits flowing to resource owners, local level governments and provincial governments.

The Development Budget provided no specific expenditure plan for Mining for 2013.

Oil and Gas

The Oil & Gas Sector is one the largest contributors to GDP in the PNG. It is currently attracting significant interest from international players with applications for 71 PPL's currently pending approval in many parts of the country. The 2013 Budget anticipates several oil and gas projects in the next five years if current levels of interest are maintained.

A Petroleum License Database Management System to be maintained by the Department of Petroleum and Energy will be funded in the 2013 Budget. This is aimed at improving data recording management to improve the Departments interactions with stakeholders.

The Development Budget provided no specific expenditure plan for Oil and Gas for 2013.

Manufacturing

In PNG the manufacturing sector is dominated by industries processing natural resources (agricultural and non-renewables) to finished products such as canned fish, furniture, biofuel, refined palm oil, canned meat, plywood and veneer. PNG's manufacturing is highly concentrated in Port Moresby and Lae and to a lesser extent Madang with these three centres containing about 70% of the manufacturing sector.

The Government aims to transform the sector from a predominantly light manufacturing to higher value production as well as adapting new technologies. Strategies to achieve this goal consistent with the MTDP include promoting export orientation, promoting the tuna processing industry in PNG, attracting foreign investment in PNG, removing inefficiencies and other measure to lower the cost of doing in business in PNG.

In 2013 the government will be focused on reducing the cost of doing business by addressing issues such as law and order, regulatory constraints, entrepreneurial capacity building, access finance, environmental effects in production and perhaps most interestingly, subsidies to reduce the impact of fluctuations in global prices.

The Development Budget provided no specific expenditure plan for Manufacturing for 2013.

Land Development Sector

At present in PNG only 3% of land is owned by the state and the remainder is customarily owned therefore the MTDP has recognised unlocking of customary land as a key enabler. This task will be carried under the National Land Development Program (NLDP).

The Government's number one priority to be addressed through the NLDP with regards to land as stated in the 2013 Budget is to address outdated land related legislation and an inefficient land administration system.

Taxation and Customs

Overview

In a year of relatively few tax specific measures in the Budget, the most noteworthy would be:

- The introduction of thin capitalisation regime for companies
- The recognition of a Nil assessment for certain tax law purposes
- The effective abolition of Provincial sales and services taxes

In a move designed to prevent tax avoidance and which may also promote ‘home-grown’ financing by PNG based financial institutions, a “thin capitalisation” ratio of 2:1 will be introduced from 1st January 2013 for all companies other than finance companies or resource companies (and for resource companies the ratio remains at 3:1). However, the impact of the relevant interest disallowance under this new regime will only be felt where such interest amounts are paid to a non-resident lender. This initiative will have ongoing compliance and monitoring costs for taxpayers with significant foreign debt.

A welcome move is to formally recognise ‘Nil’ tax annual notices as “assessments” for certain purposes of the tax law. This measure will apply from 2013 prospectively, but only for current and future year returns. It gives taxpayers in receipt of such notices roughly equivalent rights as those in receipt of tax payable assessments. In respect however of any claims for carry forward losses for all taxpayers, carry forward allowable exploration expenditure or allowable capital expenditure for resource companies and residual capital expenditure for timber operations, these will not be automatically confirmed by such recognition and will be subject to extended IRC review.

In another welcome move from a tax policy perspective, any incentive for Provincial Governments to impose inefficient sales or services taxes within their own boundaries has effectively been removed. That has been done by new legislation which in the case of any Province enacting such sales or services taxes forfeits that Province’s full GST entitlement under national revenue sharing laws, and redistributes that GST revenue amongst all other Provinces that do not have such taxes in force.

The one area of tax policy development signposted in the Budget Papers for consideration in 2013 is that of a review of the present mining and petroleum tax regime in PNG. Noting that the current regime has been in place since 2000, Treasury states that it has secured technical assistance from the IMF to conduct this review. The review will include looking at the appropriateness of PNG’s current regime by comparison to those in place in other resource rich countries.

On the customs and excise fronts, the measures of note are:

- The temporary increase in the rate of import duty on poultry products and plywood
- The permanent increase in the rate of excise imposed on tobacco products and on used motor vehicles

In the case of the poultry and plywood custom duty measures, the increased rates will be K2.20 per kilo and 50% respectively, but these will only apply for the 2013 calendar year. These are being put in place temporarily to support PNG domestic manufacturers in the face of what they see as unfair import price pressure. During 2013 the Government will try to assess the appropriate support mechanisms for these industries and the impact of the temporary rate increases.

The rate of excise on tobacco products is being increased by 10% immediately. This is in line with the recognised adverse health impacts of smoking and the fact that in recent years inflation has reduced the real level of excise impositions.

The excise rates on imported used or reconditioned motor vehicles will be increased by either 10% or 20% in the main, depending on the category they fall into. This is in response to increasing traffic congestion and to instances of deliberate excise avoidance through import valuation manipulation for used cars.

There will also be a review of PNG's future attitude to the Tariff Reduction Program is presently engaged on by virtue of its membership of international trade and customs organisations.

Income Tax

Thin Capitalisation

The term "thin capitalisation" refers generally to the situation where a taxpayer is funded or capitalised by means of debt financing that is significantly in excess of its equity base.

Since the abolition of mandatory central bank approval of foreign loans in 2007, there has been no effective limit on the amount of interest bearing debt that most PNG companies, including PNG branches of foreign companies, can carry. For "resource companies" however, being mining, oil or gas operators and which are specifically covered already under Division 10 of the *Income Tax Act* 1959, there has always been a 3:1 maximum thin cap ratio by virtue of the provisions at 155H of the Act.

The Internal Revenue Commission (IRC) and Treasury have identified instances of gross abuse of this situation by a number of companies in sectors outside the resource industry. Accordingly, an even tighter maximum ratio of 2:1 is to be introduced as of 1st January 2013. It will apply to all interest bearing debt, both existing and new and whether sourced from third parties or related entities, from that point onwards. The new measure will be inserted by means of a new section 68AF in the Act. However "financial institutions", as defined at subsection 35(1) of the Act, will in addition to resource companies be exempt from this 2:1 ratio limitation for interest deductibility purposes.

Where the 2:1 ratio is exceeded, then any interest applicable to that excess amount and which is payable to a non-resident lender will be disallowed as deduction. We do note though that it seems any such excess amounts actually paid will still be subject to deduction of IWT.

We further note that, again almost mirroring Division 10 existing provisions, the IRC will if it sees fit, in conjunction with the central bank, have the power to review the arms length nature of interest rates and fees or charges set in related party debt financing situations. Any excess amount of these charges, over what the IRC determine to be market levels, may be disallowed as a deduction.

So it appears likely that many companies will need to fairly closely monitor balance sheet movements in debt and equity as a result of these measures, particularly where such foreign debt is not denominated in Kina.

As part of the thin capitalisation measures, new definitions of the terms “debt” and “equity” will be inserted into the general definitions at section 4 of the Act. To further support the mechanics and integrity of this measure, additional new definitions of the terms “interest”, “security” and “washing arrangement” will be inserted at section 4 of the Act.

Onshore debt and any interest expenses related thereto will remain unaffected by this new regime, on the basis that it will not affect the total tax paid within PNG between the borrower and lender taxpayers. This could provide a boost to the local finance industry and would be in keeping with the Government’s general pronouncements as to generating greater opportunities for PNG businesses.

Nil Assessments

This is a welcome and probably overdue move, and indeed one that delivers on indications given in the 2011 Budget papers. The amendments proposed will ensure that the defined term “assessment”, at section 4 of the Act, includes a formal IRC notice that no gross tax is payable. Previously such ‘Nil’ assessments did not get that recognition. This had meant that taxpayers in receipt of such notices had little certainty going forward. By contrast, taxpayers in receipt of an assessment notice which indicated either taxable income of tax payable could rely on a general maximum IRC review period of either 3 or 6 years, depending on levels of disclosure (and absent pure fraud). Those review terms are provided for at section 232 of the Act and will now equally apply to Nil and taxable assessments in general.

This amendment will apply prospectively, commencing from 1st January 2013 for the 2012 and future income years only. Importantly however, this initiative will not automatically extend that review period certainty to deductions claimed for:

- Carry forward losses under the general provisions of section 101 of the Act
- Carry forward allowable exploration expenditure or allowable capital expenditure for resource companies under Division 10
- Residual capital expenditure for timber operations

For these carry forward amounts the period of review permitted to IRC, as consistent with section 232, will commence from the year in which those amounts are utilised by being claimed as a deduction against taxable income.

Oil to Gas Ratios for tax rate purposes clarified

Currently Regulation 10 I of the *Income Tax Regulations* 1959 prescribes the conditions for where a petroleum project changes from being taxed as an oil operation to that of a gas operation. These are generally taxed at rates of 45% and 30% respectively. The present provisions focus on the ratios of gas to oil extracted or produced from the relevant project. However, the new amendments will change that focus to the ratio of resources sold. This will remove any unintended consequences, including the potential for a project site only selling oil to be nonetheless taxed as a gas operator and thus gain an unintended tax benefit.

This measure will restore policy intent in this area and will apply from the date of Gazettal of the revised Regulation.

Other tax technical amendments

In a move apparently associated with the thin capitalisation measures already noted, the IWT provisions at section 186 of the Act will also be amended. This is designed to ensure that in circumstances where both IWT and foreign contractor withholding tax (FCWT) could potentially apply to the same payment, then FCWT only will be payable.

With the repeal of the *Bookmakers Act* 1974 in 2009, there was on oversight in not also dealing with a cross-referenced provision on the *Gaming Control Act* 2007. This has prevented the IRC since that time properly returning bookmakers' turnover tax collections to the Provinces they emanate from. The relevant provisions in the *Gaming Control Act* 2007 are now to be remedied, retrospective to the relevant date in 2009.

All technical amendments will apply from 1st January 2013.

Goods & ServicesTax

This measure was in fact proposed in last year's budget, but failed to pass through Parliament.

Now re-introduced, but in an importantly different form, it removes any incentive for Provincial Governments to impose piecemeal sales or services taxes within their own boundaries. As noted in the Overview above, it does so by proposing measures which forfeit that Province's full 60% share of GST collections, as provided for under the revenue sharing arrangements by legislation which includes provisions in the *InterGovernmental Relations (Functions and Funding) Act* 2009.

In cases where any Province has such archaic taxes in force, its full 60% share of GST will now be redistributed, on a pro-rata basis, to all other Provinces that have no such tax laws in force. This is a more wide-reaching sanction that that previously proposed.

The reasons for its formulation for 2013 are firstly that the National Government is providing hugely increased direct funding to all Provinces in 2013. Secondly it is to remove any future consideration at the Provincial level of such taxes which are, from both a policy and administration perspective, widely considered to be inequitable and inefficient.

We note that this measure in no way affects the independent powers of the Autonomous Region of Bougainville to implement such taxes, as they have already done to some degree.

Customs & Excise

Poultry & Plywood

As alluded to in the Overview, the import duties levied on poultry and plywood will temporarily rise by 10% for poultry, from K2.00 to K2.20 per kilo and by 15% to a rate of 50% of value for plywood.

Though vastly different products, they have in common that PNG domestic manufacturers of both have in recent years felt heavy pressure from cheaper imported supplies. In part that is attributed to appreciation of the Kina against the currencies of the main countries from which the import competition occurs. So the Government has effectively decided to apply moderate interim relief over 2013.

Tobacco Products

The rate of excise on tobacco products is being increased by 10% with effect from the 30th November 2012. This increase has been applied in addition to the twice yearly automatic indexation increase, being the lesser of 6 monthly CPI or 2.5%, as occur at the end of May and November each year.

The Government believes such an increase is necessary to both offset inflationary impacts that had reduced real rates of excise, plus to provide for the expected higher primary health care costs it will incur to treat smokers.

Used Motor Vehicle Imports

From the 1st January 2013, excise rates on imported used motor vehicles will be generally increased by either 10% or 20%, depending on the category they fall into. So for example trucks, tractors and motor vehicle with a current rate of 10% excise will increase to 20%, whilst open-backed double-cab and mid engine sized cars will increase from 40% and 60% respectively to 60% and 80%.

In addition, the new rates in the *Excise Tariff Act* will have set further excise rates for escalating import USD free on-board value thresholds. This is to both restore some parity with new vehicle import situations and to remove the potential for value under-declaration situations identified in the past.

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