Papua New Guinea

2016 Budget *Alert*

Executive Commentary

The 2016 PNG Budget has been framed in a much different environment than those preceding it. Prior to 2016 the PNG Government was deficit financing much needed expenditure in key priority areas such as health, education, law and order and transport on the back of substantial expected revenues from its resources taxes and dividend streams. Along with the rest of the world, the Government's commodity price assumptions received a nasty shock in early 2015 when the oil price virtually halved. Among other things, that significantly impacted the revenue of the PNG LNG project which the Government has equity in as the LNG prices were related to oil prices. The PNG LNG project has been producing consistently in excess of its original rated capacity. This has softened the revenue impact to some extent.

To add to that, the country is now experiencing drought conditions which have shut down the operations of the OK Tedi mine, and lately Porgera also, and are already impacting food production in large parts of the country relying on subsistence agriculture.

The Government took some time to communicate exactly what measures it was taking in response to these events but has now clarified that to a much greater degree by announcing a 2015 Supplementary Budget which was handed down in tandem with the 2016 Budget. That Supplementary Budget sets out the areas in which the Government expects to raise additional revenue for 2015 and cut expenditure.

The Government has sensibly elected to defer its intended return to surplus budgets which is now forecast to be reached in 2020 rather than 2017 in light of the reduced commodity prices expected to prevail in the medium term.

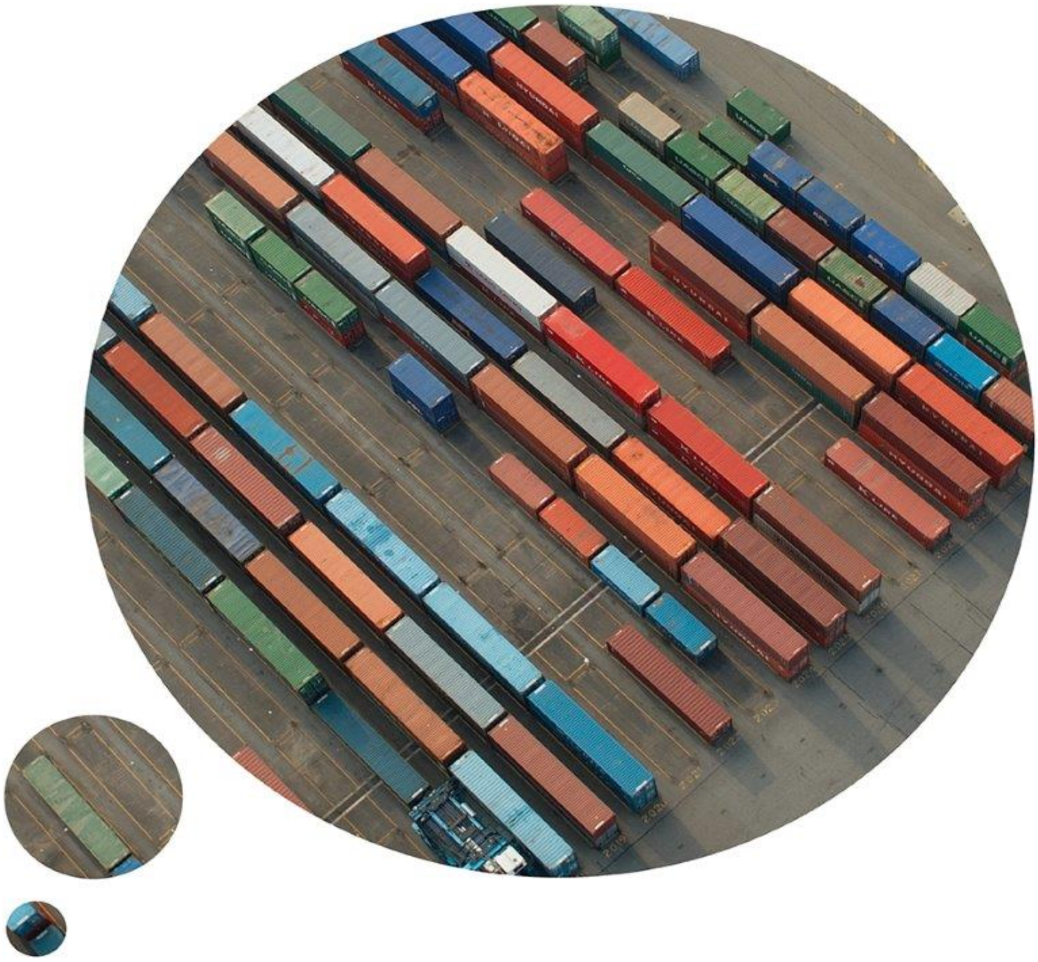
The Government has also announced recently a major revision of the structure of its ownership of its own commercial enterprises and utilities through what it calls the Kumul Consolidation Agenda. This includes a dividend policy which will apply to State Owned Enterprises (SOEs). The mechanics of how this will improve the performance of some of these enterprises, particularly the utilities, were not made clear in the budget documents but observers will know that this issue has been concerning the Government for some time. It also promises continuing focus on the size and efficiency of the public sector.

The Government has restated its enthusiasm for Public Private Partnerships and says it will work to improve the climate for such cooperative ventures.

As the Pacific Games were a centrepiece of Government planning in 2014, its holding of the APEC conference in 2018 will be a centrepiece for this and upcoming budgets. It is noted that the APEC administrative body has received a budget allocation of K80 million in 2016 to this end.

As well as that, the Government has made clear that it does not intend to lose focus on its aims to improve PNG metrics and outcomes in key focus areas of health, education, law and order and transport. Those areas continue to receive substantial allocations in the budget.

In summary, the Government has reacted to the various levels of concern raised regarding the changed economic circumstances it finds itself in, including for example the recent country downgrade by the S & P rating agency, while still seeking to funnel expenditure to the development priorities that it holds dear.



Economic overview of budget

The 2016 PNG Budget

Overall Budget Strategy

The PNG Government has framed its 2016 budget in a relatively weak world economic environment that is still adjusting to lower commodity prices with a GDP growth rate of 3.6%[1], up from 3.1% in 2015. A domestic growth rate of around 4.3% is expected for 2016, which is significantly down from the expected 9.9% growth rate for 2015[2]. The softness in commodity prices is expected to continue over the medium term.

Dramatically reduced commodity prices in early 2015, particularly for oil and gas, severely impacted the Government's estimates in its original 2015 budget necessitating a 2015 Supplementary Budget which is outlined later in this Alert.

The changed environment for commodity prices has prompted the Government to dial back the numbers and the overall revenue and expenditure for 2016 have both declined, as compared to 2015, which has not happened for a number of years. The total Government revenue for 2016 is expected to be K12,650.1 million and total expenditure is planned to come in at K14,762.6 million resulting in a budget deficit of K 2,112.5 million or 3.8% of GDP. The Government now predicts it will return to surplus in 2020 as opposed to its original plans of doing so in 2017, reflecting the altered revenue position it now faces.

Last year the Government made much of its improved debt position with an expected total debt to GDP ratio of 27.8%. In 2016, while the documentation states at various points that the ratio will stay under the mandated 35% guideline provided in the Fiscal Responsibility Act, the Minister stated in his speech that the Government expects total debt to GDP ratio of 35.8% in 2016.

Key focus areas of this budget, which will be familiar to observers of previous budgets, include:

- Expenditure prioritisation and improved quality of spending
- Structural reforms among SOEs and in the size and efficiency of the public sector
- The effective implementation of major projects through improved scoping, design, tendering and implementation processes
- Continued support for key policy areas in education, health, infrastructure, agriculture, law and order and SME areas
- Management of the Government debt profile with specific mention of a forthcoming roadshow to negotiate a sovereign bond in foreign capital markets.

The mood was considerably more sombre than has been the case in recent years, and the Government is seeking to cater for dramatically changed external environmental circumstances while holding true to its desire to improve PNG social indicators in key developmental areas.

[1] The data and tables provided in this alert are sourced from the 2016 PNG Government Budget papers.

Special Areas of Interest

The Government is seeking to rationalise and improve its debt profile and has announced its intention to seek a sovereign bond in foreign capital markets in the order of $US1 billion. Officials leave on a roadshow immediately after the budget sessions. No doubt this has been prompted in part by the increasing domestic interest rates and lower than expected demand for its Inscribed Stock that are applying to its borrowings in the PNG capital markets in 2015. This is a continuation of a policy mentioned in the 2015 budget as well.

The Government expects the Sovereign Wealth Fund (SWF) to commence operations in 2016. Some estimates were supplied of inflows expected into the components of the SWF, being the Stabilisation and the Savings Funds:

- The Stabilisation Fund is expected to receive total revenue of K379.2 million in 2016 of which K129.9 million is from mineral and petroleum taxes and K249 million is expected from mineral and petroleum dividends. 75% of the dividend income is expected from SOEs. The Government announced that its expectation would be that SOE's would adhere to a payout ratio of 70% of after tax profits between 2016 and 2020
- The Savings Fund is projected to receive K83.1 million across the same period from mineral and petroleum dividends, plus interest on those dividends. Last year the Government stated that it believed receipts by the SWF would total K7.5 billion for the 4 years commencing 2016 but, with the declining commodity price position, those estimates now total to K3 billion. One can see the Government's price assumptions in the table below in arriving at that estimate.

KEY MACROECONOMIC INDICATORS	2014	2015	2016	2017	2018	2019	2020
	Act	Est	Proj	Proj	Proj	Proj	Proj
ECONOMIC GROWTH							
Total Real GDP (%)	13.3	9.9	4.3	2.4	2.0	2.7	2.6
Non-Mining Real GDP (%)	1.2	2.4	3.4	3.6	3.6	3.6	3.3
Inflation							
Average on Average (%)	5.2	5.1	5.7	5.0	5.0	5.0	5.0
Dec on Dec (%)	6.7	4.6	5.6	5.1	4.4	4.0	4.1
Exchange rate							
Real Exchange Rate Index (2007 = 100)	153.2	140.9	140.2	143.6	147.0	150.6	154.4
Interest rate							
Kina Rate Facility (KFR)	6.25	6.25	6.25	6.25	6.25	6.25	6.25
Inscribed Stock (3 year yield)	8.0	9.7	9.7	9.7	9.7	9.7	9.7
Mineral Prices							
Gold (US$/oz)	1266	1176	1157	1194	1200	1225	1249
Copper (US$/tonne)	6864	5676	5149	5184	5218	5249	5286
Oil (Kutubu Crude: US$/barrel)	93	52	54	60	65	68	70
Nickel (US$/tonne)	16847	12507	10302	10404	10439	10439	10439
Cobalt (US$/tonne)	30724	29500	30000	30000	30000	30000	30000

The treatment of the Government's trust accounts, which has been a feature of this bulletin for a number of years, also drew mention. As for past years, the Government did not provide any details of trust account transactions in 2015 (although it did show balances in trust and DSIP trust accounts) but did say that more detailed accounting would be provided in the 2015 Final Budget Outcome report. Of last year's trust account appropriation it stated that some K70.7 million is yet to be released and it intends to allocate K792 million in 2016.

The sale of 25.75% of National Petroleum Company PNG (NPCP) for around $US1,024 million to project area landowners announced in 2015 has not been effected and remains on the Government's agenda. The Government also stated that it will discuss with Nambawan Super its shortfall in superannuation contributions to that fund so, as last year, it has not negotiated any specific repayment schedule for this obligation.

Officials announced support for El Nino impacts would total K50 million through the budget plus the K2 million per District which was recently publicised providing for a total support figure in the order of K220 million. It also announced support for the National Agricultural Research Institute to try and develop more drought tolerant species but it is difficult to see how this might help in the short term.

Given the spectacular difference in 2015 between its commodity price assumptions and what actually transpired (which must be said, surprised almost everyone) the budget estimates the Government is currently using will be of some interest. These are set out in the table above.

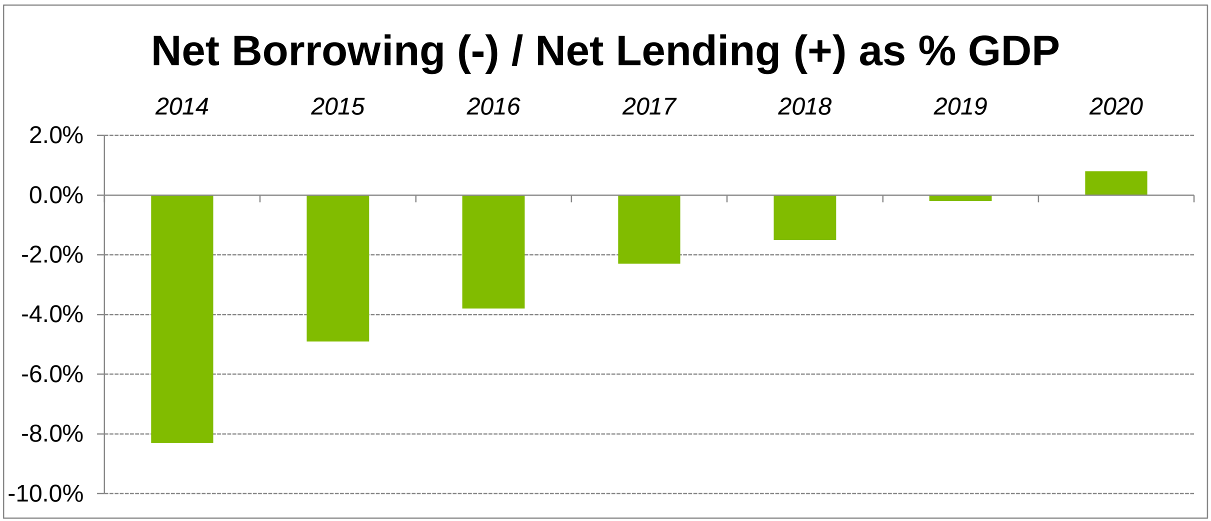
Tax changes were minimal in the budget which was expected since the Government has had very limited time to review the recommendations of the Taxation Review Committee recently presented to it. The Committee conducted the most comprehensive review in some years and next year promises to be a much more active year for tax changes. A summary of some major recommendations of the Committee is provided later in this document.

As with last year's budget, no specific mention was made of the current shortage of foreign exchange which is starting to severely impact PNG businesses importing goods and services.

2016 Budget at a Glance

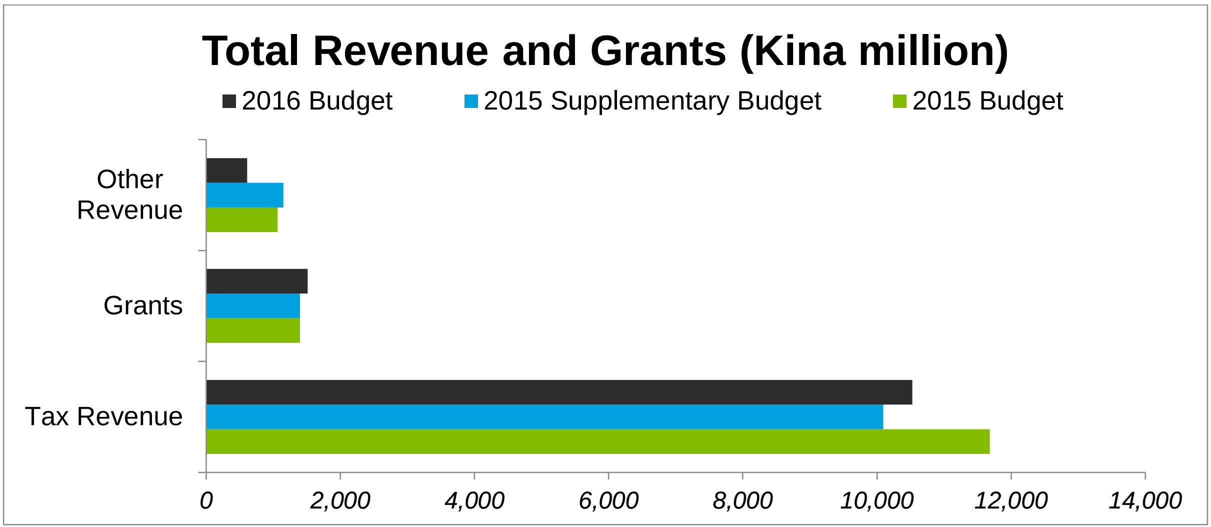
The 2016 Government Budget comprises total expenditure of K14,762.6 million. Budgeted revenue is K12,650.1 million, leaving a net deficit of K2,112.5 million. This results in a net borrowing of 3.8% of GDP and a debt to GDP ratio of 35.8%.

Relatively stable expenditures for the medium term together with projected increases in revenues, means the budget deficit is forecast to decline in the coming years turning into a surplus in 2020. This can be illustrated as follows:



Revenue

Total Government Revenue for 2016 and the medium term is based on a new reporting system, the Government Finance Statistics (GFS). Total Revenue and its source are projected as follows:



Of grant income, K1,134.1 million is projected from donor grants. This is comprised as follows:

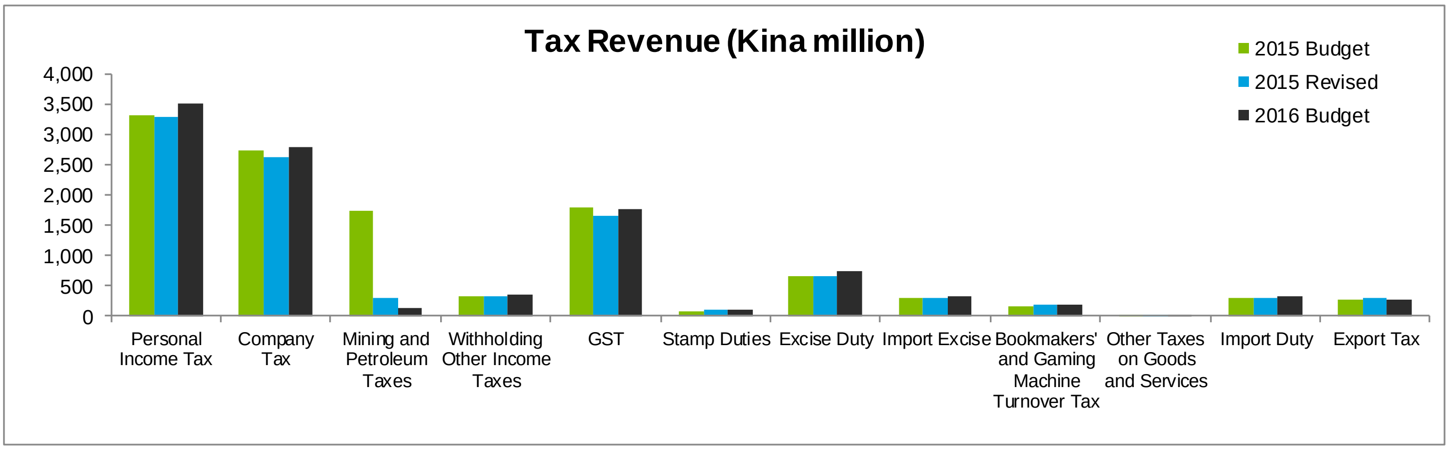
- K998.8 million being grants from Foreign Governments (88%)
- K135.3 million being grants from International Organisations (12%).

In respect of other revenue, this is comprised as follows:

Revenue Type	K Million
Property Income	516.9
Sale of Goods and Services	85.4
Fines, Penalties and Forfeits	0.8
Transfers not elsewhere classified	8.2

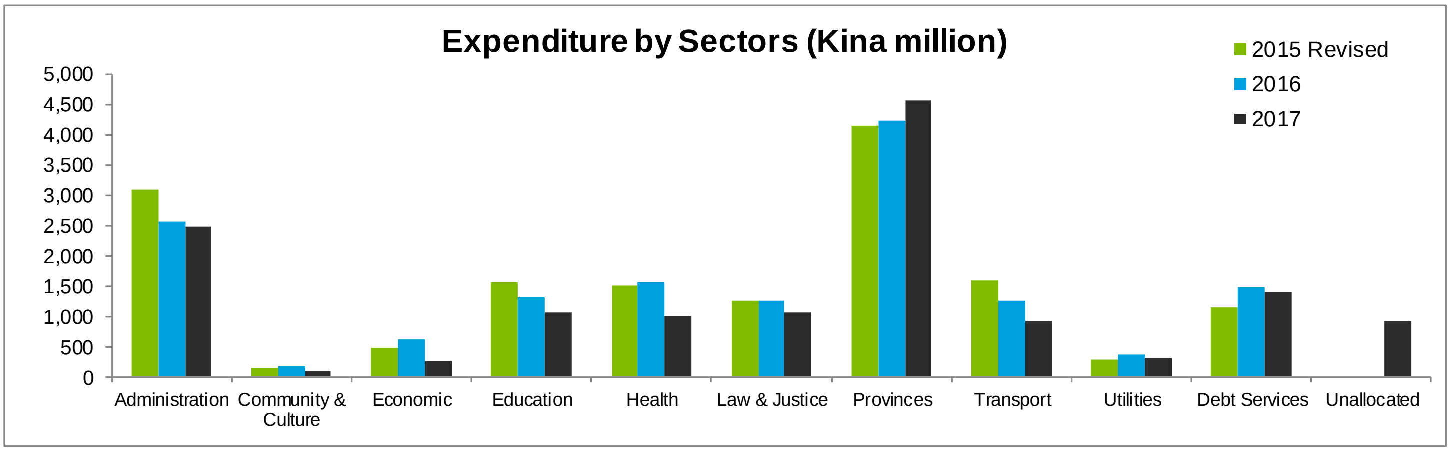
Additional tax revenues arising from the growth in the domestic economy are expected to more than offset a decrease in taxes on international trade.

The components of budgeted tax revenues in 2016 are illustrated below. In our opinion, an unhealthy proportion of the burden of the total tax revenues continues to come from income taxes, and in particular from the taxation of employee salary and wages.



Expenditure

Budgeted expenditure is allocated by sectors as follows:



2015 Supplementary Budget

It has been well documented that the PNG economy suffered a number of major shocks which considerably altered the country's economic position during 2015, compared to what had been anticipated when the 2015 budget was originally drafted. The most notable of these was the massive drop in oil prices which occurred in early 2015, and that had a flow on effect to the pricing of PNG's LNG project earnings. Revenue from mining and petroleum projects which was originally expected to be in the order of K1.7 billion for 2015 is now expected to be in the order of K300 million. The mid-year forecasts had previously predicted a drop in total Government revenue in the order of K2.5 billion.

These developments saw a potential worsening of the deficit to 9.4% had measures not been taken.

The measures undertaken in the supplementary budget are expected to result in a deficit of 4.6% which is much closer to the original 2015 target of 4.4%.

The Government has tweaked additional revenue estimates of around K1,101.6 million for the balance of 2015 from various sources as follows:

Source	K Million
Internal Revenue Commission	250.0
Customs	150.0
IPBC	240.0
Other State Owned Entities	110.0
National Petroleum Corporation	201.6
National Fisheries Authority	50.0
Bank of PNG	70.0
National Gaming Control Board	30.0

On the expenditure side, the Government emphasised that it had not indiscriminately cut expenditure for the balance of 2015 but had been targeted in its approach. It said there was an emphasis on finishing projects that had been started, rather than commencing new ones, and ensuring that growth momentum initiatives and projects with development partners were impacted as little as possible.

Expenditure cuts for the balance of 2015 in the following broad sectors were noted:

Sector	K Million
Social Sector	123.6
Economic and Infrastructure Sector	285.4
Law and Order Sector	165.4
Administrative Sector	756.1
Provincial Sector	46.1

More detail by department was provided in the appropriations bills but there was not a great amount of detail on the cuts in individual projects and programmes affected, as evidenced by one line item “Treasury and Finance – Miscellaneous – K355,722,900”.

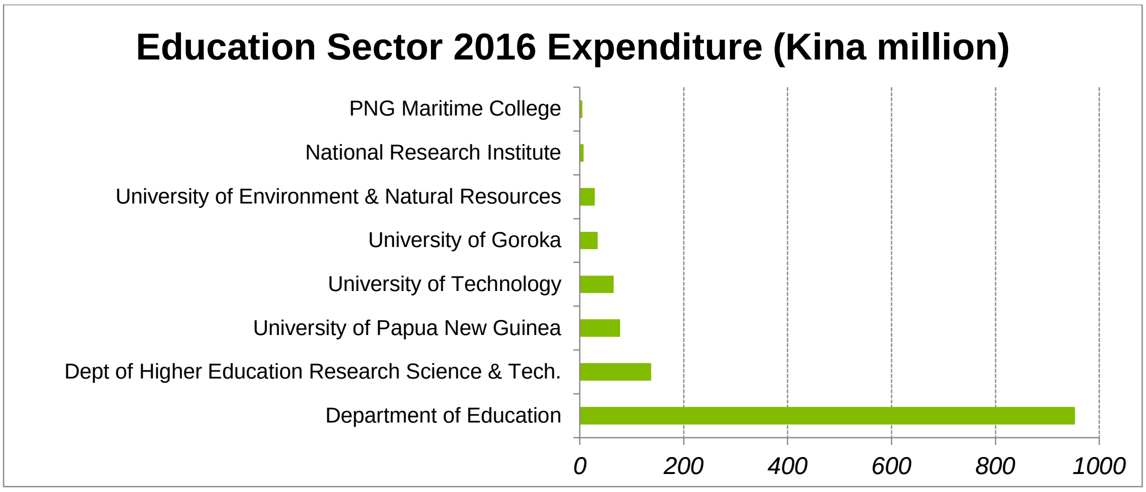
These measures saw the original budgeted revenue of K14,093.5 million return to K12,637.9 million and expenditure originally budgeted at K16,506.8 million return to K15,129.7 million. It is noted that these are still estimates of what will eventuate for 2015.

Key Priorities

Education

The education sector includes the delivery of primary, secondary and tertiary education. Total funding for this sector is K1,312.5 million or 9.2% of the total 2016 budgeted expenditure.

Allocation of budgeted expenditure is illustrated below:



The Government budget has noted that while access to education has improved, quality has become a concern with inadequate planning for an increasing school population. Accordingly there is particular pressure around capacity, including infrastructure and teacher numbers. The Government is working towards addressing these in the 2016 year and beyond with the Department of Treasury to provide and report as part of the first quarter budget review.

Specifically, in 2016, K266.3 million of the Education Department's K953.4 million in funding is allocated to fund ongoing education capital projects, while support for the Tuition Fee Free policy comprises K602 million.

Health Sector

This sector comprises key policy areas run by the Department of Health, being free primary health care and subsidised specialist services.

Total funding for the sector is K1,565.9 million, including K280.9 million in grant funding. There are a number of measures designed to improve rural health services, target HIV prevention and control, and further funds committed to improvement of hospitals.

The major areas of health expenditure include:

Initiative	Allocation of Funding (K Million)
Donor funded Health and Education Procurement Facility	118.0
PNG Health and HIV financing program	30.4
Rural Primary Health Sector delivery	53.5
Angau Memorial Hospital works	40.3
Subsidised free health care	20.0
Other capital works for provincial hospitals	367.3

Transport

The Government budget report notes significant improvements have been made to infrastructure for land, sea and air transport in the past few years. This occurred through collaboration with donors and development partners.

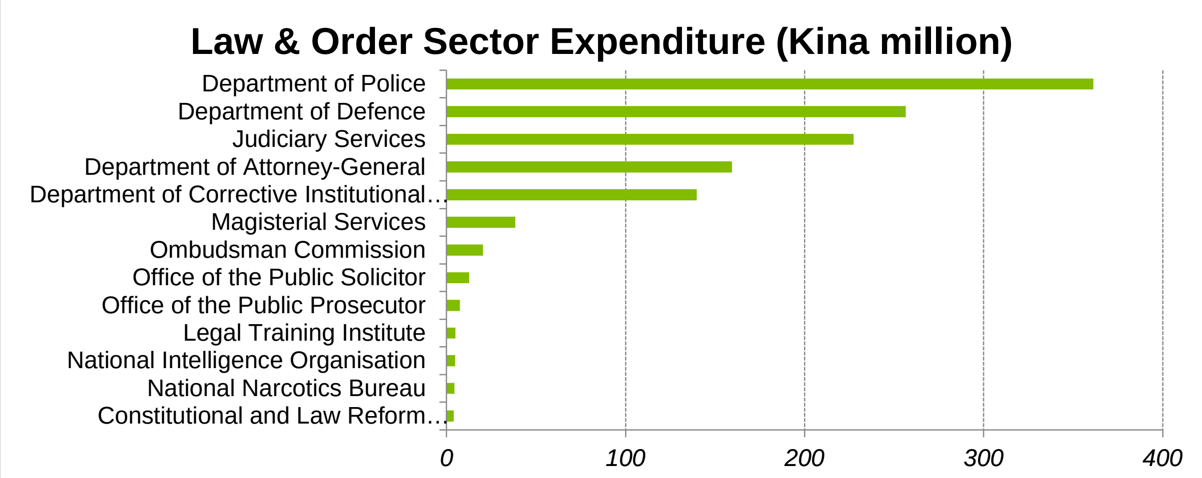
Total transport sector funding will rise in the 2016 year to K1,254.1 million, being 8.8% of total expenditure. While this is above the 2015 funding of K1,074 million, forecast funding after 2016 falls in all later years budgeted to 2019. In 2019, K612.9 is currently budgeted.

The major areas of transport expenditure include:

Initiative	Allocation of Funding (K Million)
Road maintenance and rehabilitation project	82.8
Highlands Region Road Improvement Investment program	84.2
Transport sector support program phase 2	151.2
Lae - Nazab Road	45.0
Lae-Komo Road upgrading and sealing	100.0
Missing Link Roads	20.0
Port Moresby International Terminal Upgrade	10.0

Law & Order

Law and order consists of 13 agencies. The sector is allocated K1,240.9 million, being 8.7% of total 2016 budgeted expenditure. This includes a K1,061 million operational component, a K126 million Government capital investment, and a K53.9 million donor component. Law and order expenditure is allocated as follows:



Major projects include the recruiting of 750 new police, 480 new defence recruits and 200 CIS recruits. The major areas of law and order expenditure include:

Initiative	Allocation of Funding (K Million)
Village Court Officials & Land Mediators Allowances	46
Waigani Court House Complex	80
Security preparations for the 2017 National Election and 2018 APEC Summit	35

Utilities

Ensuring a strong and sustainable utilities sector is required to provide houses and businesses with critical basic services through the coordinated efforts of SOEs and the private sector is seen as a crucial economic requirement. Key commitment areas include:

- Improved access to Water and Sanitation and Hygiene (WaSH)
- Improvement in reliability of electricity supply
- Infrastructure investments in information and communications technology to improve access to households and businesses.

The utilities sector is allocated K378 million, being 2.6 % of total budgeted expenditures. The major areas of utilities expenditure include:

Initiative	Allocation of Funding (K Million)
National Broadband Network	170.3
Port Moresby Grid Development	64.2
PNG Town's Electricity Investment Project	47.6
Upgrading Power Distribution – Ramu Grid	26.9

Taxation

Overview

The 2016 budget produced no major changes in terms of tax rates or composition of the tax base. Such an outcome was not unexpected given that the Tax Review Committee delivered its report and recommendations to the Government only one week before the budget.

We have summarised some of the Committee's key recommendations at the end of the section. However, what follows are actual changes proposed in the budget papers.

Goods & Services Tax

GST Deferral Scheme

The most notable measure tax wise is the announcement of a GST Deferral Scheme, in relation to import GST otherwise payable. The existing arrangements involve taxpayers often having to pay significant sums of GST upfront on importation to the PNG Customs Service (Customs) and then needing to seek a refund of that GST from the Internal Revenue Commission (IRC) in a subsequent month.

Such arrangements create unnecessary administration costs for both the IRC and Customs, and cash flow impacts for affected taxpayers.

From 1 January 2016, proposed amendments to the *Customs Act* and the *Goods and Services Tax Act* will provide powers to the Commissioner General of IRC to administer such a scheme.

The Budget papers do not outline the administrative framework for such a Deferral Scheme, nor indicate if taxpayers must meet certain criteria in order to participate in it. However, it is to be expected that the operation of the scheme will involve a 'contra' or 'wash-through' approach, and that it will result in no net GST revenue loss.

GST Administration Changes

Also effective 1 January 2016, the discretionary powers of the Head of State to exempt or reduce the rate of GST payable for goods and services will be repealed. This measure will guard against any unintended distortionary effects if such powers were exercised and prevent future revenue leakage.

Clarifying amendments will ensure that the IRC's power to amend a GST return runs for a four year period from the date of the return's lodgement or assessment, whichever is the earlier.

Income Tax

Minor Technical Amendments

The Government proposes to repeal Regulation 91A(2) in the *Income Tax Regulations*, and to amend to the definition of “eligible payment” in the Income Tax Act (ITA), to ensure that contracts involving the hire or leasing of equipment will no longer come within the Certificate of Compliance regime.

The Government also proposes to amend section 196B of the ITA which will strengthen the law to ensure that contract income covered by the foreign contractor withholding tax regime has a source in PNG and is subject to PNG Tax.

Redundant provisions in the ITA, dealing with the removal and/or appointment of the Commissioner General and Commissioner of Taxation in the IRC are proposed to be removed. Such processes are now dealt with in the new *Internal Revenue Commission Act 2014*.

Tax Treaties and Conventions

PNG currently has ten bilateral double taxation agreements or tax treaties in operation with other countries. However, there is a current global focus on preventing the occurrence of base erosion and profit shifting (BEPS) in cross border transactions. Given initiatives in this area, driven by organisations such as the OECD and the G20, the Government has suspended negotiation of any new bilateral tax treaties. It also flags the possible renegotiation of some existing treaties.

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters allows the tax administrations of signatory countries to collaborate in addressing tax avoidance. Government has commenced steps designed to allow PNG to ultimately become a signatory to this multilateral convention.

Future Possibilities

Superannuation - Government will in 2016 consider setting up a team to review the taxation of superannuation, plus its retirement income policy. At the same time the Government will review unregulated superannuation funds.

Revenue Reforms - In his Budget Speech, the Treasurer pointed to the need to consider some of the recommendations from the Tax Review Committee.

He pointed to the need to consider moving to a more broad-based tax system that should capture all forms of income, including capital gains that are presently untaxed. He was also keen to ensure that any incentives or concessions are achieving their intended outcome. As an example, he noted the need to assess the public value of the benefits provided under the Infrastructure Tax Credit regime.

Selected Tax Review Committee Recommendations

It is important to note that this Committee is an independent body and thus its findings and recommendations are not Government policy. Nonetheless, the Government has indicated that it will consider these recommendations, with a view to potential inclusion in budget measures for 2017 and beyond. Accordingly, listed on the following page is a selection of just some of those recommendations.

Personal Income Tax

- Move the tax free threshold progressively to K15,000 and ultimately to K20,000, at which ultimate stage most taxpayer rebates would also be removed.
- Simplify the marginal tax rate bands for individuals, when revenue permits, to reduce the lowest rate band from 22% to 20% and have that apply up to K33,000 in place of the current 30% rate band.
- Move over a five year period to fully tax 50% of housing allowance payments to employees, in the interim also increase the statutory taxable values for certain employer provided high cost housing.

Company Income Tax

- Reduce the corporate tax rate from 30% to 25% over time.
- Reduce the foreign company branch tax rate to 42%, to match the effective tax rate paid by resident companies that pay dividends.
- Harmonise the dividend withholding tax rate at 15% across companies in all industry sectors.

Mining and Petroleum Tax

- Limit State equity participation rights in all new resource projects to a maximum of 5%.
- Apply a revised Additional Profits Tax to all new resource projects, to apply on projects exceeding prescribed rates of return and then taxed at single rate of 35%. Differing rates of return to be prescribed for each of the mining, oil and gas sectors in future projects.

Capital Gains Tax

- Introduce a capital gains tax to apply initially only to real property, at the point of actual transfer or disposal. This tax to be set at a flat rate of 15%, for all taxpayer entities (resource projects included).

Small Business and Informal Sector Taxation

- For businesses with turnover under K250,000, develop a flat tax plus a turnover tax regime as an optional alternative to the normal taxable income calculation process, including simplified accounting rules.
- Develop a separate presumptive tax, via a flat tax or annual fee, for certain sectors where taxable income can be reasonably predictable such as for taxis, PMVs and trade stores.

Goods and Services Tax

- Increase the rate of GST to 15%, to allow for personal and company income tax reductions noted above.
- Remove zero-rating for supplies made *to* resource companies, aid organisations and charities.

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