



MEDIUM TERM FISCAL STRATEGY 2018-2022

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ON THE OCCASION OF THE PRESENTATION OF THE
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Acronyms

ADB	Asian Development Bank
BSP	Budget Strategy Paper
CRF	Consolidated Revenue Fund
DoF	Department of Finance
DNPM	Department of National Planning and Monitoring
DoT	Department of Treasury
DSA	Debt Sustainability Analysis
FRA	Fiscal Responsibility Act 2006
GFS	Government Finance Statistics
GDP	Gross Domestic Product
IFMS	Integrated Financial Management System
IMF	International Monetary Fund
IRC	Internal Revenue Commission
LNG	Liquefied Natural Gas
MTBF	Medium-Term Budgetary Framework
MTDP	Medium-Term Development Plan
MTDS	Medium Term Debt Strategy
MTEF	Medium-Term Expenditure Framework
MTFF	Medium-Term Fiscal Framework
MTFS	Medium-Term Fiscal Strategy
MTPF	Medium-Term Performance Framework
MYEFO	Mid-year economic and fiscal outlook report
PFM	Public Financial Management
PNG	Papua New Guinea
SOE	State Owned Enterprise
SWF	Sovereign Wealth Fund
TRC	Tax Revenue Committee
TA	Technical Assistance
TSA	Teaching service Act (1988)

Executive Summary

PNG's current economic situation reflects the downside effects of recent global economic developments and the impact of a series of economic shocks. Against this backdrop and building on the 100 Days Plan, the Government has designed a medium term fiscal strategy with the aim of strengthening the macroeconomic and fiscal fundamentals of the economy, while improving and enhancing living standards of the people to achieve sustainable socio-economic development.

The strategies outlined in this document are formulated to stabilise the economy and strengthen its ability to cope with shocks. They build on the previous Medium Term Fiscal Strategy (MTFS) and have incorporated recent developments as well as appropriate adjustment mechanisms. The 2018-2022 MTFS is framed to enhance the “doing business” environment by de-risking the economy and improving the delivery of basic social and infrastructure services.

Despite a number of challenges, PNG's economic outlook remains positive. Domestic macroeconomic conditions are improving due to the proactive approach of Government and those gains need to be consolidated, notably, through strengthening the ongoing efforts and reforms towards more sustainable and efficient public revenue collections, reallocating public spending toward more productive categories and improving financial and debt management. The strategy operationalises the Alotau Accord 2 and recognises the need to deliberately cushion the effects of these adjustments on the vulnerable, but in a manner, that creates opportunities for job creation, productivity and inclusiveness.

Thus, the goal of fiscal consolidation is to be achieved by halting the marked decline in government revenue (as a share of GDP) over recent years and then maintaining a robust share over the projection period of the plan – 2018-22. At the same time and after allowing for some adjustment costs in 2018, total expenditure (as a share of GDP) will be reduced over the subsequent 4 years, thereby allowing for significantly smaller fiscal deficit which will reduce pressure on the domestic financial system and the exchange rate. Within this constrained public expenditure envelope, expenditures that have grown substantially in recent years without accompanying productivity gains will be wound back to create space for more productive spending particularly on well-targeted capital expenditure projects.

To achieve these goals the MTFS has three major components. These comprise: **(i) a medium-term revenue strategy (MTRS)** aimed at building up a revenue base able to finance the government's expenditure plans on a sustained basis, but that generates these revenues in an efficient and fair manner; **(ii) an expenditure strategy** that is consistent with revenue collection trends and financing capabilities over the medium term and promotes greater efficiency in public spending; and **(iii) a debt management strategy** that ensures funding is available to meet the fiscal needs of the Budget when it is required and at the lowest cost within a manageable risk framework. It will also entail efficient management of both public financial assets and public financial liabilities, the development of the domestic financial sector, recognition of the impacts on the Kina exchange rate and the development of the market for PNG external debt.

The overall fiscal policy is framed to ensure compliance with the Fiscal Management (Responsibility) Act, 2006 (as amended in 2017), which provides a legal framework to contain financing requirements and public debt to achieve macroeconomic stability in the country and sustain higher economic growth rates. The fiscal deficit in 2017 is estimated at 2.5 per cent of GDP. The fiscal deficit will be kept below this ratio in 2018, although the reduction will be very modest reflecting the increased expenditures in 2018 to achieve stabilisation and adjustment. From 2019 the Government will gradually improve revenue trends and reduce spending such that the deficit and consequently the debt to GDP ratio will steadily decline reaching 30 per

cent by 2022. The envisaged fiscal consolidation would help enhance macroeconomic stability and economic growth and attract foreign investment over the medium term.

Table 1: Medium Term Fiscal Outlook 2017-2022 (Kina, million)

	2017 Supp.	2018	2019	2020	2021	2022
Revenue and Grants	10,979	12,731	12,583	13,552	14,666	15,876
<i>% of GDP</i>	<i>14.9%</i>	<i>15.9%</i>	<i>14.6%</i>	<i>14.7%</i>	<i>14.8%</i>	<i>14.8%</i>
<i>Of which: GoPNG revenue (% of GDP)</i>	<i>13.6%</i>	<i>14.6%</i>	<i>13.5%</i>	<i>13.7%</i>	<i>13.9%</i>	<i>14.0%</i>
Total expenditure (including grants)	12,856	14,718	14,480	15,227	16,074	17,137
<i>% of GDP</i>	<i>17.4%</i>	<i>18.4%</i>	<i>16.8%</i>	<i>16.5%</i>	<i>16.2%</i>	<i>16.0%</i>
Net Lending (+)/ borrowing (-)	-1,876	-1,987	-1,898	-1,676	-1,408	-1,261
<i>% of GDP</i>	<i>-2.5%</i>	<i>-2.5%</i>	<i>-2.2%</i>	<i>-1.8%</i>	<i>-1.4%</i>	<i>-1.2%</i>
Non-resource primary balance	-665	-592	-442	-193	-10	98
<i>% of Non-resource GDP</i>	<i>-1.2%</i>	<i>-1.0%</i>	<i>-0.7%</i>	<i>-0.3%</i>	<i>0.0%</i>	<i>0.1%</i>
Debt Stock	23,820	25,808	27,705	29,381	30,789	32,051
<i>% of GDP</i>	<i>32.1%</i>	<i>32.2%</i>	<i>32.2%</i>	<i>31.9%</i>	<i>31.1%</i>	<i>30.0%</i>

Source: Department of Treasury

The key fiscal anchors which will guide Government policy and help monitor progress against this framework include:

- targeting total revenue (excluding grants) to GDP ratio of 14.0 per cent by 2022;
- reducing government expenditure from 18.4 per cent of GDP in 2018 to 16 per cent in 2022;
- reducing the government debt to GDP ratio to 30.0 per cent by 2022 and ensuring the sustainability of the debt profile, including the shift towards external financing;
- maintaining the non-resource primary fiscal balance on a trajectory that will achieve a zero balance by 2021-22 then a zero-average annual balance over the medium term (to 2025);
- ensuring that Personnel Emolument costs are contained and brought down from over 45 per cent of total non-resource non-grant revenue in 2017 to less than 35 per cent by 2022;
- ensuring that two-thirds of primary expenditure is allocated to key MTDP Enablers and that the public investment to GDP ratio is lifted from less than 4 per cent of GDP in 2017 to 5.5 per cent in 2022.

Finally, the success of the fiscal strategy also requires prudent and supportive monetary and exchange rate policies to sustain economic stability.

1 Introduction

Papua New Guinea has experienced unprecedented economic growth, averaging over 7.0 per cent over the last decade. Nevertheless, volatility in the mineral sector and a series of shocks are testing the country's economic resilience. In addressing these challenges, the Government of Papua New Guinea remains committed to the pledge of fiscal prudence and macroeconomic stability as the main basis to deliver growth and sustainable development.

The Medium Term Fiscal Strategy (MTFS) provides the framework for targeted policy interventions and strategies over the 2018-22 period. This document, in line with the requirements of the Fiscal Responsibility Act (FRA) 2006 (as amended) is set to reflect a more strategic approach to budget formulation which is more appropriate to the economic challenges confronting the country currently and over the medium term. The strategy involves a major lift in revenue collections from both policy changes and greater compliance efforts. It restrains expenditure but redirects components to more productive areas. At the same time, it ensures Government social priorities and key enablers are prioritised. It will reduce the demand for deficit financing, particularly from the domestic financial sector.

The MTFS aims to address the current fiscal issues and challenges faced by PNG by ensuring that the annual budgets are guided over the medium term by more realistic estimates of available resources and debt sustainability analyses. The framework is based on conservative baseline projections of economic activity and does not include any of the potential major resource projects. The medium-term approach also enables annual budgets to better reflect the development priorities identified in the Medium-Term Development Plan (MTDP) and enhances allocative efficiencies.

Over the last decade, in its efforts to strengthen Public Finance Management (PFM) systems, PNG has accumulated experience in formulating and implementing budgets within the broader framework of an MTFS. While the MTFS is only one factor in management of the national budget, it is arguable that the MTFSs have contributed positively to budget management and thereby supported economic growth.

Building on the previous three MTFS documents, each addressing significantly different challenges (reviewed below), the 2018-22 MTFS will continue to identify realistic resource envelopes to guide budget preparation. This document also clearly states Government's intention to continue implementing its ongoing PFM reform program which will help ameliorate the cyclicalities of the economy, and promote allocative efficiency and improve the quality of spending. Thus, the MTFS supports the implementation of the Medium-Term Development Plan.

The MTFS will present an overview of past strategies (section 2), the current economic situation (section 3), review of recent fiscal performance (section 4), revenue reforms (section 5), public financial management reforms (section 6), debt strategy (section 7) and fiscal risks (section 8). The fiscal anchors to guide policy and ensure consistency of the strategy will be summarised (section 9).

2 PNG's Previous Medium Term Fiscal Strategies

Since the financial crisis in the late 1990s, PNG has made a wide range of efforts to stabilize the economy and to undertake structural reforms. In the fiscal policy area, the government took major steps toward fiscal consolidation, which was guided by two medium-term fiscal strategies (MTFS). The 2002–2007 MTFS set the target for a balanced budget, which was achieved in 2004, three years ahead of schedule. The 2008–2012 MTFS added rules to mitigate the fiscal impact of resource revenue volatility by imposing a ceiling of 8.0 per cent of GDP on the non-resource budget deficit. Under the guidance of those two documents, fiscal consolidation efforts proved to be successful. Government debt was brought down from 70.4 per cent of GDP in 2002 to 22.3 per cent of GDP in 2011.

Despite these achievements in macroeconomic management, PNG continued to face major development challenges illustrated by low human development indicators. Fiscal policy was altered in 2013, reflected in the 2013–2017 MTFS, wherein the operational rules for the non-mineral budget deficit were replaced by a ceiling on government debt set at 30.0 per cent of GDP. In 2013–2015, the ceiling was lifted to 35.0 per cent.

To fast track development in the period covering the LNG construction boom, public expenditures increased substantially. The resultant increased debt levels were considered manageable given the optimistic outlook for the economy at the time and robust revenue projections. The LNG construction boom did lift non-mining GDP levels substantially and subsequently mining GDP was also lifted markedly as gas production, in particular, ramped up. Although there was an expected normal decline in GDP following the elevated construction boom levels, the fall was much worse than anticipated because of the impact of the drought and fall in commodity prices of both mining and agricultural products.

The lags in terms of corporate tax collections disguised the underlying decline in government revenues and expenditure policy was not able to react early enough, resulting in large unexpected budget deficits and the accumulation of higher debt and debt service levels. Furthermore, within the overall expenditure envelop, a number of categories had expanded which were of a rigid nature, such as personnel emoluments, rentals, utilities and education and health subsidies – the higher expenditure of which was based on reasonable expectations of robust economic growth rates going forward. When the serious downtrend in revenue was realised, overall significant expenditure reductions were implemented in 2015 and further reductions were made in 2016 and in the Supplementary Budget of 2017.

However, given the difficulty of even slowing the growth in these rigid categories of expenditure, especially against a backdrop of the continuation of subdued economic conditions, most of the burden of adjustment fell on: the capital budget, including all its components (government PIP expenditures, SIPs and loan drawdowns); the goods and services budget (where large cuts have threatened service delivery and substantial arrears have been accumulated); and the budget deficit which has placed substantial strain on domestic financing with banks' holdings of government securities now reaching limits and Government being confronted with cash flow constraints.

The result has meant that restrictive supplementary budgets have had to be enacted in all recent years. The strategy employed in supplementary budgets implied delaying development expenditure but maintaining fix commitments given their rigidity. Furthermore, debt levels and debt service levels have been rising substantially, placing limits on the domestic financial sector, a foreign exchange imbalance has developed and has continued and, importantly, the shift in the expenditure mix away from capital and development expenditures towards recurrent expenditures has led to less efficient outcomes which have all impacted economic growth adversely. Importantly revenue (excluding grants) as a percentage of GDP is now near

the bottom of world rankings and, on a no-policy-change basis, is continuing to trend downward as the 2018 Budget is being formulated. Corporate losses are still being carried forward from past years adversely affecting corporate tax collections in the current year, and large GST refund offsets are compounding the problem. In this low growth environment, tax compliance would also appear to have deteriorated.

The MTFS 2018-22 has been formulated against this background and current challenging circumstances.

Table 2: Overview of PNG's past MTFS

	MTFS 2002-2007	MTFS 2008-2012	MTFS 2013-2017
Context	The first Medium Term Fiscal Strategy 2002-2007 was designed to help end a serious economic and fiscal crisis caused by very large budget deficits; high and unsustainable levels of public debt; high inflation; and poor expenditure effectiveness.	The second MTFS was framed amid expectations of high revenue from unusually high commodity prices. The goal of balanced budgets contained in the first MTFS was less than what was needed for prudent fiscal management.	Implementation of the third MTFS took place against a background of slower than anticipated recovery in the world economy and falling international commodity prices. On the upside, the PNG LNG project was due to commence full production in 2015, and providing a significant boost to revenue.
Main Objectives	*Restore fiscal discipline & sound macroeconomic management	* Manage the highly volatile resource revenue * Allow for increases in development expenditure	*Support the Medium-Term Development Plan *Maintain macroeconomic stability
Expenditure rules	*Prioritize expenditures around national & sectoral priorities * Reduce discretionary expenditures	* Allocate normal mineral revenue (equal to 4.0 per cent of GDP) to spending (the 4 per cent rule) *Allocate 70.0 per cent of additional mineral revenue to public investment	*Allocate two-thirds of budget to key MTDP enablers by 2017
Revenue rules		*Mineral revenue beyond 4 per cent of GDP to be considered additional revenue	*maintain equitable taxation regimes with focus on compliance *restrict taxation exemptions and special arrangements
Deficit rules	*Reduce deficits over the medium-term to return the budget to surplus at the end of the period	*Cap the total non-mineral budget deficit at 8.0 per cent of GDP	*Limit deficit to less than or equal to 2.5 per cent of GDP from 2015 onward * Return to a surplus budget at the end of the medium-term
Debt rules	*Government would not add debt in the medium-term	*Allocate 30.0 per cent of additional mineral revenue to debt repayment (the 70:30 guideline)	*Maintain a gross government debt to GDP ratio of less than 30.0 per cent, except in 2013, 2014 and 2015, when the ratio is capped at 35.0 per cent. *Limit gross government liabilities to less than 60.0 per cent of GDP
Implementation	The MTFS provided a fiscal consolidation framework that progressively reduced the large budget deficit to a surplus by 2004 and moved the budget into a sustainable position and consequently reduced debt significantly. The implementation period saw rising commodity exports and increasing commodities prices supporting fiscal position economic growth.	Notably, The MTFS 2008-2012 was critical in allowing PNG to successfully navigate the global financial crisis and the subsequent volatility in the international economy, through a significant reduction in debt levels; while allowing for significant increases in development expenditure	The period was characterized by higher than desirable budget deficits (driven by lower than expected revenue from LNG project) and inflation, rising levels of debt and an imbalance which emerged in the foreign exchange market. The Government was nevertheless successful in undertaking a number of the specific reforms (IFMS, GFS (2014), SWF, focus on key enablers and the integration of the recurrent and development budgets.

3 Domestic Economy

3.1 Gross Domestic Product Performance

The uncertainty in the global economy in recent years has resulted in increased volatility in commodity prices with lower trends than in the previous decade. Historically, PNG's economic growth has reflected the cyclical nature of commodity prices and extractive projects. This is illustrated by the sharp increase in GDP linked to the USD 20 billion construction and subsequent exports of LNG.

Since 2014, with the end of the PNG LNG construction boom, the economy is adjusting to the reality of the new business cycle. The prolonged effects of the foreign exchange imbalance and low aggregate demand and spending in the economy continued to affect activity and growth in the non-resource sector. The economy was also impacted by the severe drought in 2015. In 2017, while the agriculture, fishery and forestry sector is estimated to have grown by 3.4 per cent on the back of favorable production following the drought and some increase in prices of key agriculture commodities, the overall non-resource real GDP is expected to only grow by 1.8 per cent. In contrast the mining and quarrying sector is projected to grow by 15.1 per cent due to higher production from key mines. The non-resource sector has also received some support from election-related spending and preparations for the 2018 APEC meetings.

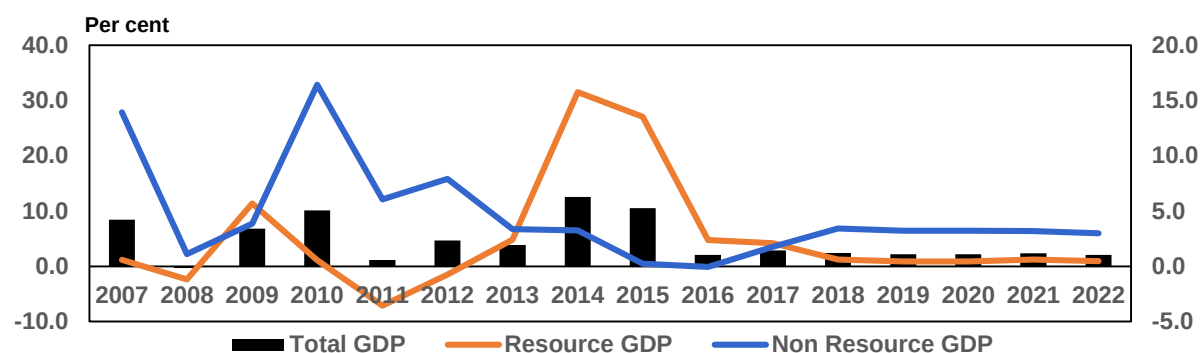
3.2 Gross Domestic Product Outlook

Over the medium-term, in real terms, the economy is projected to grow at an average rate of 2.3 per cent, driven primarily by the agriculture sector. Improved growing conditions, higher levels of productivity, improved quality of agriculture exports, better access to markets, and improved feeder roads are key factors in supporting growth in the agriculture sector. With the projections only assuming modest growth in agricultural commodity prices, the non-resource sector is projected to grow on average by 3.0 per cent.

In the medium term, the economy will be supported by key pipeline projects in the mining, petroleum and gas sectors. Potential projects are Elk-Antelope Stanley Gas, Wafi-Golpu, Frieda and Solwara 1 mining projects including the expansion of the PNG LNG (Pn'yang gas) Project. However, given the uncertainty around these projects and to take a prudent path, none of them are included in the medium-term economic and fiscal projections.

In the non-mining sector, the Government, as stated in the Alotau Accord 2, will aim to diversify PNG's economic base towards a more inclusive and sustainable path through investments in key sectors such as Agriculture. The Government will also progress the implementation of the APEC Agenda on Structural Reforms (RAASR) which deals with reforms around competition policy, ease of doing business initiatives, financial inclusion, energy policy reform and telecommunications infrastructure reform.

Chart 1: GDP Growth Outlook 2007-2022



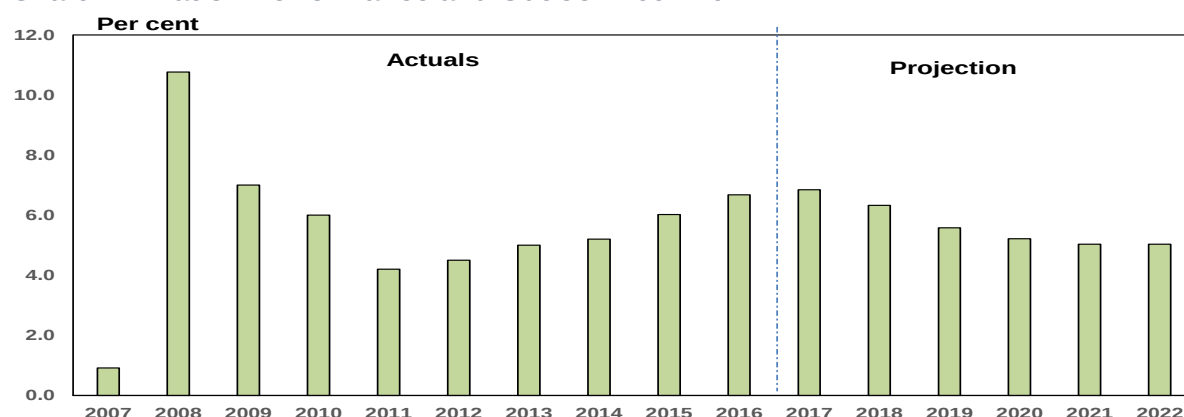
Source: Department of Treasury

Note: The resource sector includes mining and petroleum as well as agriculture, forestry and fisheries.

3.3 Inflation

With the slowing of activity over the last two years, inflation (year average) has declined to 5.9 per cent in 2017 from 6.7 per cent in 2016. Price pressures continue to come from imports due to past depreciation of the Kina against key trading currencies and seasonal items produced in the domestic economy. The Kina depreciated by 11.8 per cent against the US dollar and 10.8 per cent against Australian dollar in 2016 and has continued to depreciate modestly in 2017 (to end October 2017) against the US dollar and the Australian dollar.

Chart 2: Inflation Performance and Outlook 2007-2022



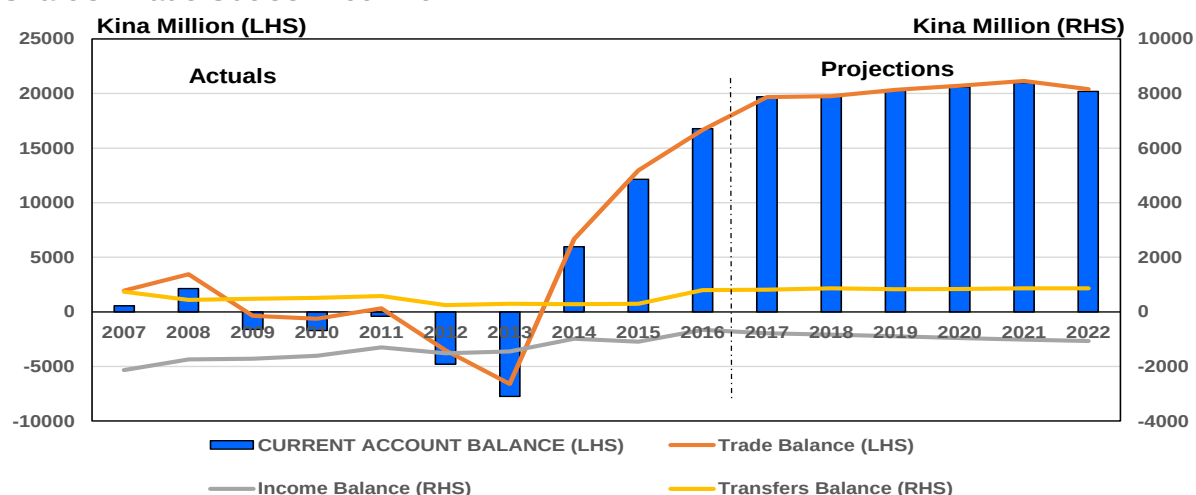
Source: Department of Treasury

Inflation is projected to increase slightly to 6.9 per cent in 2018 reflecting the improvement in the non-resource domestic economy, improvement in key commodity prices and APEC spending. Over the medium-term inflation is projected to remain below 6.0 per cent reflecting moderate growth in the domestic economy and stable Kina against key trading currencies.

3.4 Balance of Payment

PNG's trade position improved significantly in 2014 with the current account balance recording a surplus of K5,963.0 million or 10.5 per cent of GDP due to the first exports of LNG. Prior to 2014, the current account balance was in deficit due to high imports associated with the construction phase of the LNG project.

Chart 3: Trade Outlook 2007-2022



Source: Bank of PNG and Department of Treasury

Over the medium-term, the trade position is expected to continue to remain positive driven by LNG exports as well as exports from the mining and oil sectors, and the agriculture fishery and forestry sector. The benefits of major impact projects such as the Productive Partnership in Agriculture Project (PPAP) and the Coffee and Cocoa Nursery Projects are expected to materialise over the medium-term while palm oil will continue to benefit from the replanting programs. In the mining, oil and gas sectors, repatriation of financial obligations and tax concessions will result in balance of payments outflows limiting the impact of higher export receipts on the balance of payments, domestic economy and revenues to the Government.

Table 3: Key Economic Parameters

	2016 Act.	2017 Est.	2018 Proj	2019 Proj	2020 Proj	2021 Proj	2022 Proj
Growth							
Total Nominal GDP (Kina Million)	67,763.8	*	73,861	*	80,113	85,939	92,175
Real GDP Growth (%)							
Total GDP	2.0	2.2	2.4	2.2	2.0	2.5	2.8
Non-mining GDP	0.7	1.9	3.5	3.5	3.6	3.3	3.3
Inflation (%)							
Year avg	6.7	5.9	6.9	5.8	5.7	5.7	5.7
Through-the-year	6.6	5.9	6.9	5.1	5.7	5.7	5.7
Interest rates							
Treasury bills (182 day yield)	4.5	4.5	5.0	5.0	5.0	4.5	4.0
Inscribe Stock (3 year yield)	9.7	9.7	9.7	9.7	9.7	9.7	9.7
Kina Facility Rate (KFR)	6.25	6.25	6.25	6.25	6.25	6.25	6.25
Mineral Prices							
Gold (US\$/oz)	1,248	1,254	1,281	1,293	1,310	1,320	1,346
Copper (US\$/tonne)	4,865	5,945	5,960	6,059	6,183	6,272	6,357
Oil (US\$/barrel)	44	50	51	52	54	55	57
LNG (US\$/thousand cubic feet)	8	8	8	8	9	9	9
Condensate (US\$/barrel)	44	50	51	52	54	55	57
Nickel (US\$/tonne)	9,595	10,010	10,516	11,065	11,819	12,575	13,757
Cobalt (US\$/tonne)	25,639	52,194	50,014	44,238	41,813	40,834	34,728
Agriculture prices							
Coffee (US\$ per tonne)	3627	3454	3,488	3,652	3,796	3,796	3,796
Palm Oil (US\$ per tonne)	640	630	612	614	614	614	614
Cocoa (US\$ per tonne)	2,892	2,025	1,945	2,020	2,020	2,020	2,020
Copra Oil (US\$per tonne)	1,459	1,680	1,705	1,731	1,731	1,731	1,731

Source: Department of Treasury

* Estimates, actuals yet to be provided by NSO

4 Fiscal Performance

Over the last few years, the decline in GDP following the LNG construction boom and commencement of LNG exports was much worse than anticipated, being impacted subsequently by falling commodity prices and the drought. Lags in tax collections disguised the underlying decline in government revenues and expenditure policy reactions were delayed, resulting in large unexpected budget deficits and higher debt and debt service levels. However, a number of expenditure categories expanded which were of a rigid nature, such as personnel emoluments, rentals, utilities and education and health subsidies. When the serious downtrend in revenue was realised, overall significant expenditure reductions were implemented in 2015 and further reductions were made in 2016 and in the Supplementary Budget of 2017. However, slowing rigid categories of expenditure was problematic and the burden, instead, fell on reductions to capital expenditures, an accumulation in goods and services arrears and rising debt levels. Restrictive supplementary budgets have had to be enacted in all recent years. In addition, a foreign exchange imbalance has developed and has continued. The shift in the expenditure mix away from capital and development expenditures towards recurrent expenditures has led to less efficient outcomes. Importantly revenue as a percentage of GDP has declined sharply and, on a no-policy-change basis, is continuing its downward trend in 2017.

Overall, as expenditures that cannot be deferred (e.g. interest payments and salaries) claim larger shares of annual government revenues, fiscal space is tightened. Thus, over the medium term, the government faces a tough challenge in pursuing effective macroeconomic management while maintaining public spending for delivery of essential public services. The MTFS will address these challenges.

4.1 Recent Revenue Performance

Over the past few years, mobilization of domestic resources has not matched the economic growth experienced in PNG. The years 2015 and 2016 were a good illustration, as the initial targets were usually revised downward through supplementary budgets, and the revised targets still fell short¹. Despite efforts by the government in terms of strengthening the tax policy domain and tax administration, expected results have yet to materialise in a significant increase in revenue. The government is cognisant of the fact that in terms of tax policies and tax administration there are some weaknesses that now need to be addressed. Importantly, it is worth noting, however, that in periods where export production rises sharply but at lower prices, real GDP growth can diverge from growth in national income and, as such, revenue trends can diverge from real GDP growth trends.

4.1.1 Resource Revenue Trends

Commodity prices and resource projects have been key drivers of economic growth and public revenues for decades. In recent years economic development has been fuelled by the LNG construction and subsequent production phases. During the prior period 2007-12 resource revenue² averaged 23.0 per cent of total revenue being supported by high commodity prices. During the subsequent period, resource revenue as a share of total revenue fluctuated between 12.0 per cent in 2012 to 4.0 per cent in 2016.

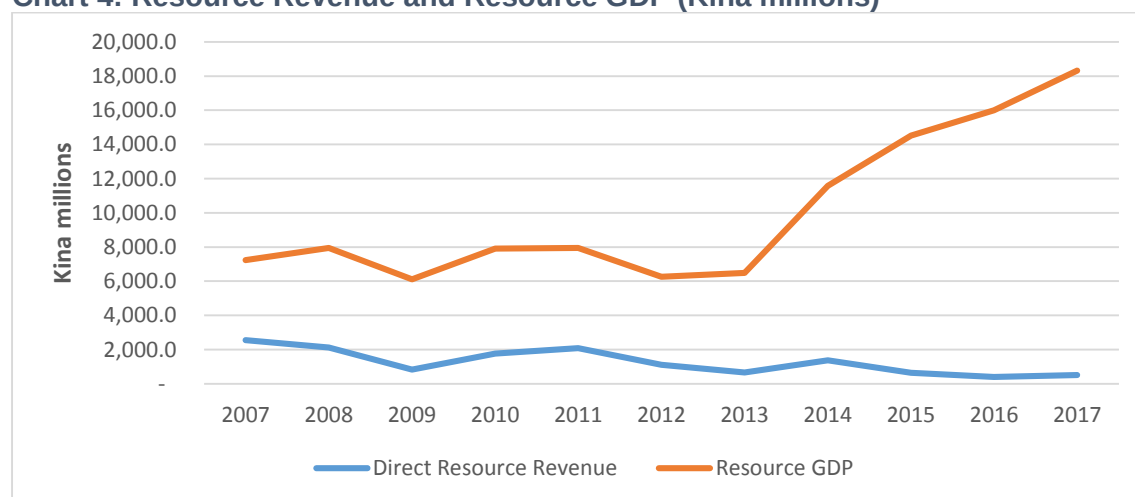
Between 2012 and 2017, expectations were high as revenue from the LNG project was thought to be large enough to fast track the Government's socio-economic development

¹ See Final Budget Outcome reports 2015 and 2016

² Direct resource revenue is defined as Mining and Petroleum Taxes, Mining Petroleum and Gas Dividends, Other Dividends and Grants from other general government units// SWF

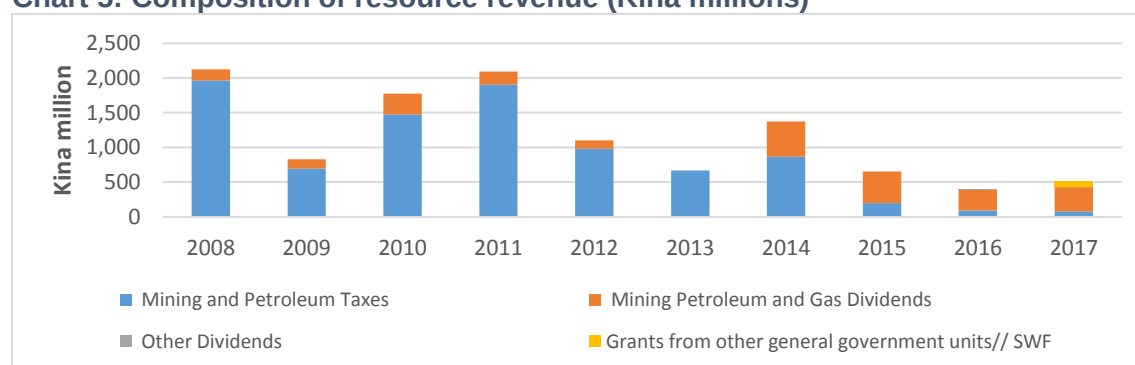
agenda. While the LNG project impacted significantly on GDP, this has not materialised into sustained revenue flows to Government. Compared with historical trends, resource revenues since 2013 have been driven by modest one-off inflows. Similarly, revenue from other sources in this sector, such as oil and mining activities, have been volatile and dependent on international markets and prices, as well as weather related events – such as the closure of the OK Tedi mine in 2015 caused by the drought (Chart 5). Tax policies through exemptions and concessions such as liberal accelerated depreciation allowances and tax holidays have also contributed to lower trends in resource revenue – as illustrated in Chart 4, with a widening gap between resource GDP and revenue collected.

Chart 4: Resource Revenue and Resource GDP (Kina millions)



Source: Department of Treasury

Chart 5: Composition of resource revenue (Kina millions)



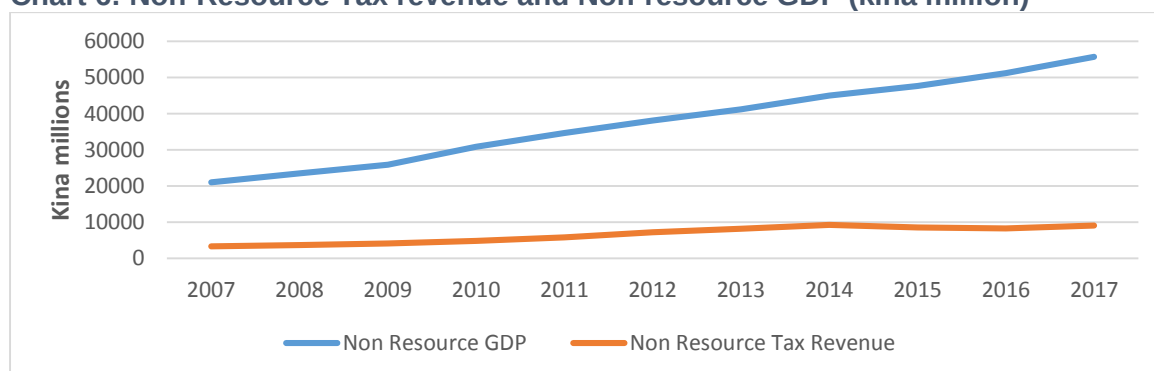
Source: Department of Treasury

4.1.2 Non-resource Revenue

In contrast, non-resource revenue (including grants) has been declining as a share of GDP since 2013, going from 19.4 per cent to an estimated 14.2 per cent in 2017 and was despite reaching an historical peak in absolute terms of K10.5 billion in 2014 (doubling revenue collected in 2008). The peak in 2014, however, was driven by the associated construction of the PNG LNG project. The graph below indicates a divergence between non-resource GDP and non-resource tax revenue which has become more pronounced in 2016 and 2017.

Trends in resource and non-resource revenue clearly show the need to improve taxation arrangements for resource companies and compliance arrangements for non-resource companies. A broadening of the tax base would also support improved revenue flows.

Chart 6: Non-Resource Tax revenue and Non-resource GDP (kina million)



Source: Department of Treasury

4.1.3 Tax Revenues

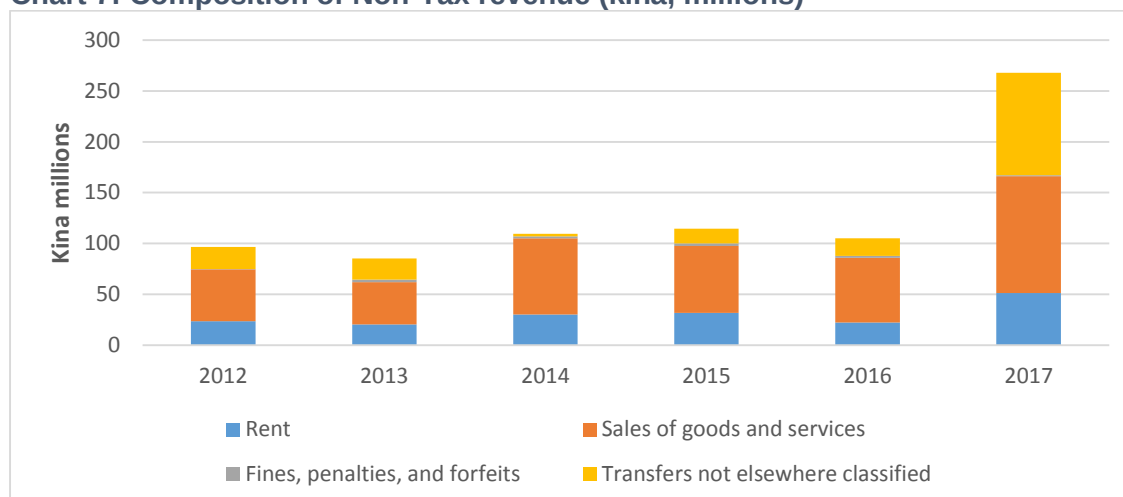
Total tax revenues increased at an average annual rate of 16.0 percent during the period 2007 to 2012. In 2017 tax collections were at similar levels to those in 2013 – a significant decline in real terms. Unlike many developing countries, PNG has a high reliance on direct taxation. During the period 2013-17, direct taxes³ accounted for over 55.0 per cent of total non-resource tax revenues, although in recent years revenue from indirect taxes has grown in significance. Part of this growth reflects the policy of allowing GST refunds to be offset against income tax which tends to inflate GST collections and reduce CIT collections.

4.1.4 Non-Tax Revenues

Non-resource, non-tax revenue has accounted for about 5.0 per cent on average of total revenue over the past five years. The major sources of NTR are dividends from state-owned enterprises (SOEs) and statutory bodies and administrative fees and charges. Revenues have been volatile reflecting sporadic payments from state owned enterprises and statutory bodies unrelated to collections or performance. Many agencies retain revenue, operate large trust account balances and invest in projects that, at times, are unrelated to their primary mandate. In recent years NTR has increased with significant dividends paid by OTML and Kumul Petroleum. As a percentage of GDP, NTR has fluctuated between 0.3 per cent in 2013 and 1.7 per cent in 2016.

³ Direct taxes comprise of company income tax and tax payable by individuals

Chart 7: Composition of Non-Tax revenue (kina, millions)



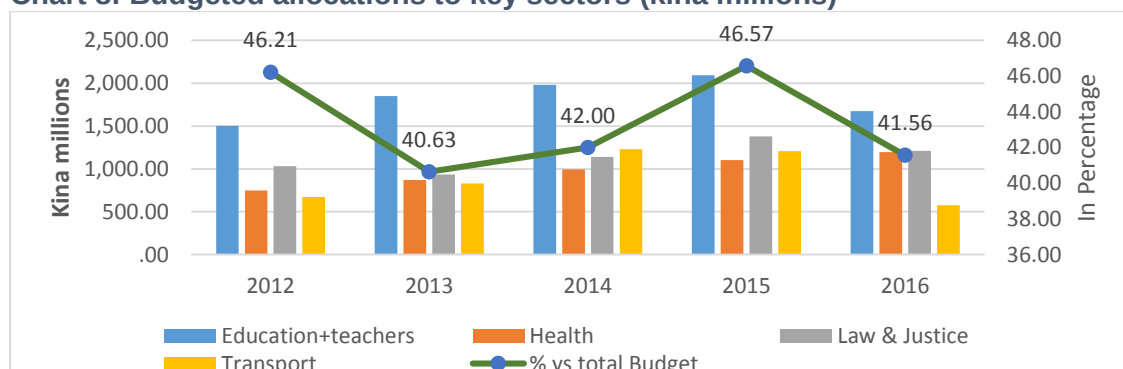
Source: Department of Treasury

4.2 Recent Expenditure Performance

Over the period 2012-17, on the backdrop of revenue inflow expectations from the PNG LNG project, the Government focused on growing the economy and delivering its key priorities as stipulated by the Alotau Accord. The implementation of this strategy was guided by the MTFS 2013-2017, MTDS and MTDP 2 with the aim of improving allocative efficiency of the budget by lifting the share going to the MTDP enablers to reach two-thirds by 2017. The focus was also on a strong move to decentralise spending functions, with an increasing share of it carried out at subnational levels (provinces, districts, and local governments) through the Service Improvement Programmes (SIPs).

As a result, the Government maintained its spending on the Medium-Term Development Plan enablers of health, education, law & order and infrastructure over the years. In 2013 to 2016, an average of 43 per cent of the annual budgets were directed towards improving MTDP enablers. This is illustrated by increased spending on key policies including Tuition Fee Free (TFF) Policy, Free Primary Health Care Policy and SIPs. Between 2012 to 2016, K2,235.8 million has been spent on the TFF, K3,142.3 million on the DSIP and K1,502.7 million on the PSIP.

Chart 8: Budgeted allocations to key sectors (kina millions)



Source: Department of Treasury

In recent years the shortfall in revenue, difficulties in reducing rigid expenditure categories such as personnel emoluments and public debt interest, and financing constraints implied that the burden of adjustment has been borne by three areas:

- the capital budget – including all its components (the Government of PNG PIP expenditures, SIPs and loan drawdowns that generally require counterpart capital funding);
- the goods and services expenditure budget where large cuts have impacted adversely on service delivery and/or substantial arrears have been accumulated; and
- the budget deficit which, given the high existing level of domestic debt, has placed substantial strain on domestic financing with the domestic banks' holdings of domestic government securities reaching limits. The foreign exchange imbalance has also tied up liquidity and resulted in the decisive movement into shorter dated treasury bills, adding significant rollover risk to the Government's portfolio.

The result has meant that restrictive supplementary budgets have had to be enacted in all recent years. With the shift from capital to rigid recurrent expenditures, this has eroded economic growth and increased fiscal and financial risk. Fiscal overhangs at year end have undermined the subsequent year's budget management and execution which have undermined service delivery.

4.2.1 Recurrent expenditure

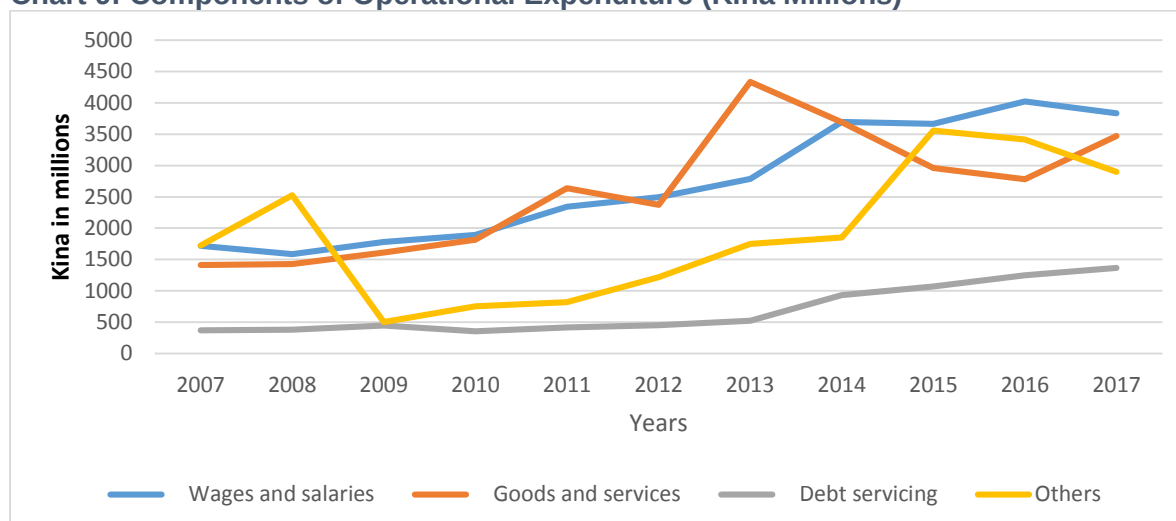
As Government delivers on large infrastructure projects and social programmes, recurrent spending has increased. A number of budget expenditure categories have shown increasing trends and are quite rigid in terms of reversing these rising trends.

Personnel emolument expenditure increased from K2.3 billion in 2011 to K4.4 billion in 2017, with an average yearly growth rate of 13.0 per cent. Personnel costs by 2017 represented the main spending item of government, driven by labour intensive sectors, particularly education and health workers, representing 35.9 per cent and 13.8 per cent of total personnel costs, respectively.

Similarly, the expenditure on goods and services has been on the increase, although it has been more variable reflecting the volatility of revenue collections and cash availability. Over the period, it increased by K2.6 billion to K4.3 billion, growing yearly, on average, by 10.0 per cent.

Debt servicing also increased from K413.0 million in 2011 to a projected K1.46 billion in 2017, growing from 5.0 per cent of total expenditure to 11.0 per cent. This trend reflects increasing debt levels and the composition of the debt stock tilting toward short term treasury securities.

Chart 9: Components of Operational Expenditure (Kina Millions)



Source: Department of Treasury

4.2.2 Capital expenditure

Over the period 2013-17, Government delivered on a number of infrastructure projects linked to the hosting of key national and international events including the 2012 National General Elections, Melanesian Arts Festival in 2014, 2015 Pacific Games, 8th African, Caribbean and Pacific (ACP) Summit and World-Under 20 Women Soccer Cup in 2016, APEC preparations and 2017 National Elections.

The fiscal expansion undertaken by the PNG government over the past three years has also been heavily focused on transport infrastructure, especially roads. This trend is illustrated by the 2014 Budget which appropriated approximately K1.7 billion (12% of total expenditure) for the sector, more than triple the funds allocated in 2011 and a tenfold increase since 2003.

Higher funding for transport infrastructure has helped fill financing gaps in this sector that is vital to enhancing the population's connectivity to markets and access to essential social services. However, the fiscal expansion has also amplified existing shortfalls in institutional and technical capacity – absorptive capacity.

4.3 Fiscal Year 2017 – Budget Outlook

The Fiscal Outlook for 2017 weakened in the first half of the year, with the 2017 MYEFO report indicating a projected K514.0 million shortfall in revenue by year end. Indeed, given the continuation of subdued GDP growth through 2017, PNG continues to be confronted with a serious revenue crisis:

- Corporate tax collections in 2017 are likely to be lower than in 2016 – in part due to the continuation of the IRC allowing income tax offsets against GST refunds that have not been paid. Little growth in adjusted (for GST offsets) corporate income tax is indicative of the subdued nature of the economy at present. Lower corporate tax collections also reflect the fact that losses are being carried forward from 2015-16 following the drought and lower commodity price environment;
- the subdued economic growth environment at present is also reflected in stagnant GST collections at the ports, although lower receipts at ports have been offset by higher receipts from the provinces indicating greater compliance efforts by IRC;

- Personal income tax collections, however, are expected to be up 5 per cent in 2017, despite the projected decline in employment levels in 2017; and
- Customs collections are also flat, except for excises which are higher due to higher prescribed duties. The impact of the foreign exchange imbalance is also likely to have been an issue here.

The 2017 MYEFO report and subsequent estimates showed that expenditure levels were likely to end 2017 K800 million above budget reflecting estimated increases in personnel emoluments (K430.0 million), rents (K100.0 million), public debt interest (K150.0 million), pharmaceuticals (K100.0 million), Department of Works expenditures (K54.0 million) and other expenditures (K16.0 million). These increases were all required to be funded in the 2017 Supplementary Budget.

The 2017 Supplementary Budget was needed to adjust Total Expenditure and Net Lending down to K12,835.6 million and Total Revenue and Grants to K10,959.2 million. This will result in a financing requirement of K1,876.4 million which maintained the deficit at 2.5 per cent of GDP – the projection in the 2017 Budget. The updated fiscal estimates for 2017 are set out in the table below.

Table 4: 2017 Budget Supplementary (Kina, million)

Details	2016 Actual	2017 Budget	2017 MYEFO	2017Suppl.
Total Revenue and Grants	10,485.5	11,473.1	10,959.2	10,979.2
Total Expenditure and Net Lending	13,572.4	13,349.5	13,779.6	12,855.6
Net Lending (+)/Net Borrowing (-)	-3,086.9	-1,876.5	-2,820.4	-1,876.5
% of GDP	4.6%	2.5%	3.8%	2.5%

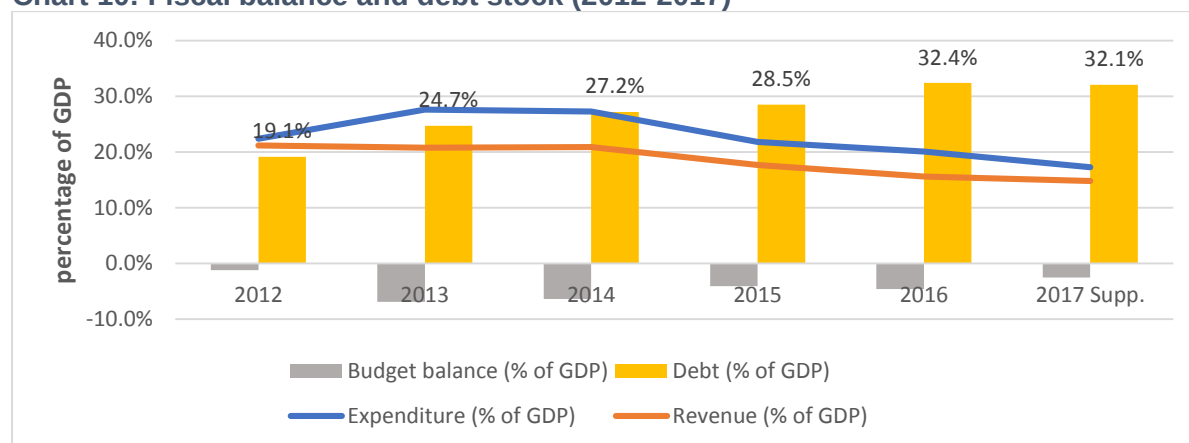
Source: Department of Treasury

*MYEFO figures used revised GDP

4.4 Recent Deficit and Debt Stock

With revenue lower than anticipated in recent years and key government expenditure priorities being maintained, the Government was forced to run higher than programmed budget deficits. While the budget deficits have trended lower since 2013-14, the accumulation of significant debt and associated debt service has placed pressure on the budget and financing demands resulting in significant cash flow shortages at times. Despite these trends, the government remains committed to lowering the deficit and debt to GDP trends over the medium term.

Chart 10: Fiscal balance and debt stock (2012-2017)

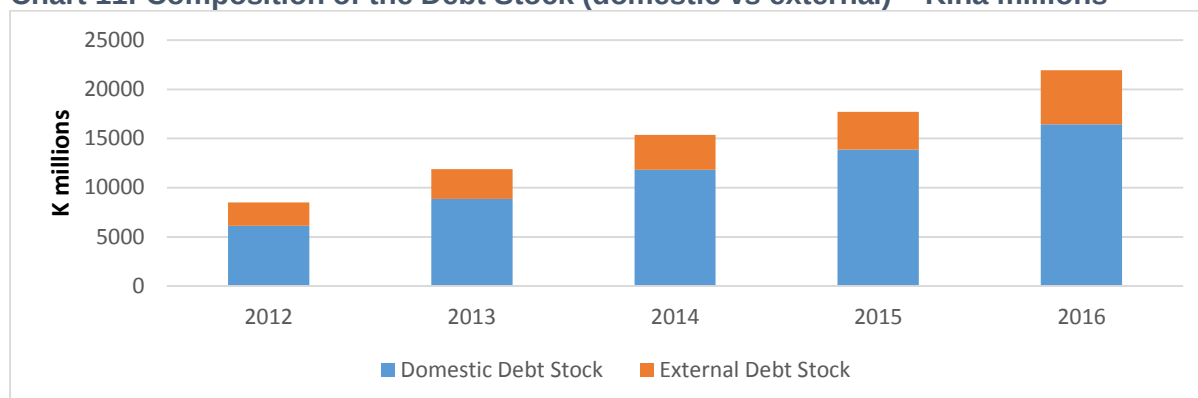


Source: Department of Treasury

To finance these deficits, Government has increased the debt stock from K8,478.5 million in 2012 to K21,944.0 million in 2016. The main source of the increased borrowing has been the domestic market – with an increase in Treasury Bills and Inscribed Stock of 168 percent between 2012 and 2016, from K6,118.3 million to K16,436.9 million. Although the level of borrowing has been assessed as sustainable by the IMF (2016 Article IV report), the debt to GDP ratio of 32.6 per cent recorded in 2016 was higher than the Fiscal Responsibility Act limit of 30 per cent which required amendments to the Act.

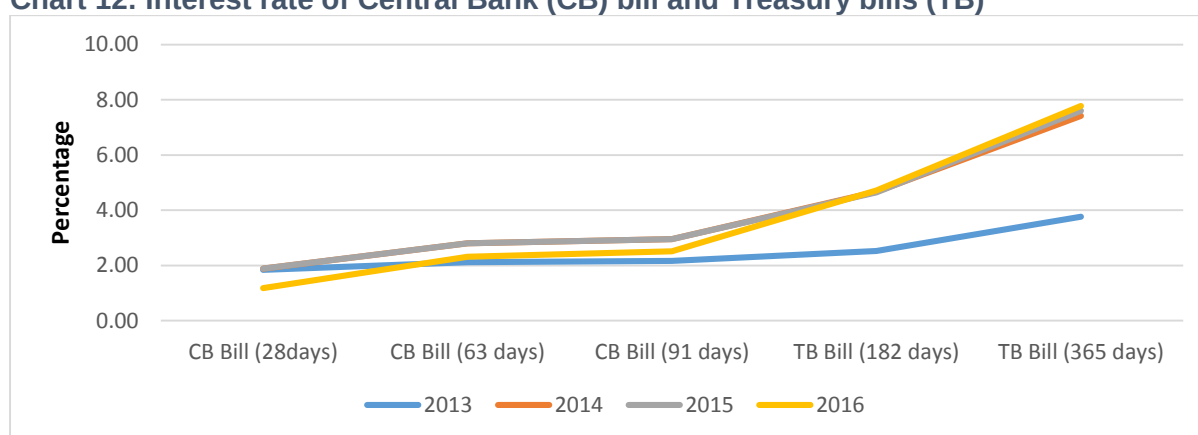
Similar fiscal trends continued into 2017 as presented in the 2017 MYEFO report. The consequent rise in domestic securities on issue has been pronounced, placing limits on further expansion of this market and increasing domestic rollover risk – a problem also exacerbated by the trend to shorter duration and the rising cost of the debt. To manage the financing issue, Government placed strict controls on warrants in 2016 and 2017, but arrears nevertheless accumulated resulting in a fiscal overhang at end 2016 and cash shortages in 2017.

Chart 11: Composition of the Debt Stock (domestic vs external) – Kina millions



Source: Department of Treasury

Chart 12: Interest rate of Central Bank (CB) bill and Treasury bills (TB)



Source: Bank of PNG

The reductions in expenditure in the 2017 Supplementary Budget aimed to hold the fiscal deficit at 2.5 per cent of GDP as programmed in the 2017 Budget, which if successful will result in a debt to GDP ratio of 32.3 per cent. This was unavoidable given the adverse economic conditions and the unanticipated decline in revenue. However, this is in compliance with the FRA Act limit (as amended in 2017).

Given the Government's desire to make the necessary adjustments to ensure fiscal sustainability and to give the Government some flexibility to manage fiscal and financing policies through protracted economic cycles, the Fiscal Responsibility Act was amended from having the single line 30 per cent debt to GDP ceiling to a range of 30 to 35 per cent of GDP for 2018 and beyond.

To ensure a prudent and responsible approach to debt management, the Government has also amended the FRA to compel the Government in its Medium Term Debt Strategy 2018-22 to target the lower 30 per cent boundary. Additionally, it will target an average annual non-resource primary fiscal balance of zero over the medium term. These amendments will allow the 2018 budget some flexibility to manage the restructuring of the budget both in terms of revenue initiatives and in achieving an efficient expenditure mix.

5 2018 Budget and the Medium Term Fiscal Strategy (MTFS) 2018-2022

The goal of fiscal stability is to be achieved by halting the decline in government revenue trends (as a share of GDP), lifting revenue levels in 2018, in part from some one-off inflows, then maintaining higher revenue trends over the projection period. At the same time expenditure trends will be lowered after an initial increase in 2018 to facilitate the adjustment in the expenditure mix towards more productive expenditures. To achieve the goals of fiscal discipline, macroeconomic stability, this MTFS has three major components. These comprise:

- **a medium-term revenue strategy (MTRS)** aimed at building up a revenue base able to finance the Government's medium and longer-term expenditure plans. Building on the 2015 Taxation Review and the very recent IMF Tax Policy Reform report, the MTRS will incorporate substantial tax and tax administration reforms, but will achieve these in an efficient and fair manner, whilst maintaining international competitiveness.

Based on some significant additional tax measures in 2018, tax collections are budgeted to increase by 9 per cent in 2018 and by 8 per cent per year going forward. Non-tax revenue collections are expected to increase substantially in 2018 reflecting one-off transfers from a number of trust accounts and the Government directive in the 100 Days Plan to return 90 per cent of collections to the CRF. The one-off additional inflows will be used to fund the overall fiscal adjustment, clear some arrears and reinvested back into revenue generating activities. These are expected to stabilize the domestic revenue profile around 14.0 per cent of GDP over the medium-term;

- **a medium-term expenditure strategy** that is consistent with longer-term revenue trends, but decoupled as much as possible from resource revenue volatility, so as to promote fiscal sustainability and stability – consistent with the FRA prescribed zero average annual non-resource primary fiscal balance over the medium term. This will enable much improved delivery of services. In addition, the Government is aggressively targeting overrun areas for rationalisation and implementing a set of public finance management reform initiatives.

Importantly, within the expenditure envelop, capital spending trends need to be lifted in 2018 from the low levels of 2017 and then maintained at these higher ratios over the medium term. This implies undertaking the difficult task of reprioritizing and reallocating limited public spending to higher value priorities that will enhance overall economic growth and still achieve the development goals of the Government, particularly in terms of support for key enablers; and

- **a debt management strategy** that delivers low cost financing within prudent risk levels, but that ensures macroeconomic stability and facilitates more flexibility in financing the Government's requirements both through the year and over the economic cycle. This will require a portfolio shift from domestic financing to external financing.

With adverse revenue trends being halted and expenditure trends placed on a declining path, the fiscal deficit will be stabilized around 2.5 per cent of GDP in 2018 and then gradually improved to around 1 per cent in 2022. This supports efforts towards improving the total debt to GDP ratio from 32.2 per cent in 2018 to 30.0 per cent in 2022 – in compliance with the amended Fiscal Responsibility Act.

6 Revenue Strategy - Strengthening Revenue Mobilization

While revenue growth was significant up until 2015, being fuelled by the LNG construction boom, it plateaued in 2016-17 in absolute terms and declined as a percentage of GDP. In contrast special measures taken by IRC and PNGCS around compliance and the collection of tax arrears did contribute to tax collections. However, over recent years, revenue has not met expectations and the gap between GDP growth and revenue collection has widened. These trends indicate that there is potential for significant improvements in the existing tax structures and in compliance.

The formulation of the MTRS 2018-22 was aided by the PNG Taxation Review's findings in late 2015 and a recent report in August 2017 by an International Monetary Fund (IMF) technical team on PNG's tax administration, tax policy and legislation. The IMF Report also provided a high-level road map for a robust medium term revenue strategy. The new MTRS builds on this work and provides a detailed framework for improving the effectiveness and efficiency of PNG's tax system to deliver higher and sustained collections but in an equitable manner. The MTRS also provides a detailed framework for improvements in the collection of non-tax revenues, a number of aspects of which will be implemented in the 2018 budget.

The detailed MTRS 2018-22, briefly summarised here, will be attached to Volume 1 of the Budget documentation. It will define the vision, goals and objectives, approaches, administrative reform measures and improvements in tax and non-tax policies for strengthening the monitoring and evaluation system. It will reflect PNG's economic situation at present and over the medium term with policies aimed at sustaining increases in revenue collections. Specifically, the MTRS entails a strategy aimed at halting the current declining revenue to GDP trend in 2018 and lifting levels significantly to enable a stabilisation of the revenue (excluding grants) to GDP trend around 14.0 per cent over the projection horizon. The 2018 Budget revenue measures mark the first year of implementation of the new MTRS.

6.1 Tax Policy Measures – 2018 Budget

The 2018 Budget will mark the first year of the implementation of the Medium-Term Revenue Strategy 2018-22. Revenue (excluding grants) as a percentage of GDP has declined from 120 per cent in 2012-14 to the 2017 Supplementary Budget estimate of 14 per cent.

However more recent estimates show the rate falling to below 13 per cent by end 2017 reflecting compliance issues and the delayed impact of low economic growth rates. On a no-policy-change basis, revenue growth (excluding grants) is likely to remain at these low rates in 2018.

Thus, the 2018 Budget will focus on lifting the revenue ratio to 14.6 per cent of GDP. Compared to the 2017 Supplementary Budget, total revenue in 2018 is projected to increase by K1,751.5 million (or 16.0 per cent) and a substantial 20 per cent against the most recent 2017 revenue forecast. Excluding the one-off measures presented that amount to an estimated K1,295 million, the increase in revenue amounts to at least 9 per cent compared to the revised estimated outturns for end 2017.

Table 5: 2018 Revenue Outlook (Kina, million)

IRC	2016	2017 Budget	2017 Supp. Budget	2017 Revised Forecast	2018 Projection
Personal Income Tax	2,844.3	3,035.7	3,035.7	2,996.7	3,250.2
Company tax	2,093.8	2,433.9	2,143.6	1,792.2	1,971.5
DWT	132.6	138.8	146.3	134.5	137.4
Mining & Petroleum Taxes	92.0	154.3	154.2	105.0	179.1
Interest withholding tax	78.7	77.8	85.0	79.2	84.2
Other Direct Tax	142.8	156.1	143.8	131.8	129.3
Gaming Tax	163.5	180.5	171.0	171.0	174.4
GST (Net to WPA)	1,089.5	1,035.1	1,035.1	1,284.3	1,471.0
GST& Bookmakers Tax to Provinces	360.9	463.2	463.2	463.2	511.9
TOTAL	6,998.2	7,675.4	73,77.9	7,157.9	79,08.9
Customs					
Excise	603.7	691.1	691.1	618.2	782.3
Other Indirect	3.1	3.8	3.8	3.4	3.4
Import Duty	242.9	230.0	238.6	227.2	296.1
Export Duty	294.0	326.6	326.6	285.7	330.0
Excise Duty on Imports	272.2	300.3	300.3	298.7	395.1
Total	1,415.8	1,551.9	1,560.5	1,433.7	1,806.9
Property Income					
Non-Mining Dividends	228.4	575.0	270	270.0	750.0
Mining and Petroleum Dividends	300.5	500.0	600.0	600.0	500.0
Total	528.9	1075.0	870.0	870.0	1,250.0
Other Property Income					
Income Disbursement from NFA, NGB and others	0.0	0.0	0.0	0.0	565.0
Total Other Property Income	0.0	0.0	0.0	0.0	565.0
Departmental Fees/ Charges and Interest Payments					
Departmental Fees and Charges	112.5	198.7	198.7	137.5	174.6
Interest from Fees and Lending	0.0	4.0	4.0	4.0	0.7
Total	112.5	202.7	202.7	141.5	175.3
Government Internal Revenue	9,055.4	10,505.0	10,011.1	9,603.1	11,706.1
Donor Grants	1,430.1	968.1	968.1	968.1	1,024.6
TOTAL GOVERNMENT REVENUE	10,485.5	11,473.1	10,979.2	10,571.2	12,730.7

Source: Department of Treasury

The 2018 projected revenue profile will be achieved through greater compliance efforts from the revenue collecting agencies which are projected to generate an additional K755 million. Given the slow economic recovery affecting receipts from the main revenue heads, this will be a significant step towards rebuilding and strengthening the tax base. Concurrently, additional tax policy reforms are expected to increase revenue by over K200 million, through specific measures:

- the removal of the training levy and double deduction for training, estimated to amount to K75 million;
- an increase in the duty on refined petroleum products and other imported products to amount to K70 million;
- an increase in the diesel excise rates to 23 toea to align rates more with petrol excise, estimated to amount to K67 million;

- the realignment of the export duty on unprocessed old growth logs to capture resource rents at varying log species, estimated to amount to K20 million; and
- a reduction in fraud in GST claims by educational institutions by removing GST zero rating status for educational institutions, estimated to amount to K6.4 million.

Non-Tax Revenue is expected to increase significantly compared to 2017 and recent year-average collection trends. Out of the projected K2,066.7 million, some of the significant increases will be one-off (estimated to be K1,295 million), as the Government implements its 100 Days Plan directive to pass-through 90 per cent of the collections of revenue generating agencies and as large bank balances in some of the agencies are transferred to CRF.

Entities with large trust fund balances have been highlighted for particular attention. Legislation will be enacted to implement the pass-through of collections to the CRF which is in line with the Government's 100 Days Plan. The Government also will improve collections from public corporations where adequate dividends have not been transferred in the past and, to sustain such inflows, the Government will enhance the performance framework for these entities.

The 2018 Budget revenue policy measures (where no revenue has been recorded in the 2018 budget but where the impact is expected to be positive but will take time) include, among others:

- aligning the taxation treatment of royalties in the resource sector to be a deduction rather than a tax offset;
- establishing a large tax payer office to focus particularly on increased compliance of large tax payers;
- reviewing the use of GST refunds as an offset to corporate tax payments with a view to lowering GST refund amounts and increasing corporate tax collections;
- clarifying the definition of resource company in the GST Act to ensure that only operating licence holders benefit from GST zero rated status;
- 'pay now litigate later' policy to improve compliance and increase receipts;
- providing options for taxpayers to pay their tax liability as they lodge;
- imposing a penalty for incorrect or non-disclosure of losses and deductions;
- simplifying the administration of non-resident insurers' tax;
- legalizing taxpayer identification number registration;
- increasing the tax clearance threshold for sending money overseas to K500,000 to reduce compliance and administration costs;
- ensuring the Extractive Industry Transparency Initiative (EITI) and Financial Analysis and Supervision Unit (FASU) have access to tax data;
- allowing the Commissioner General (CG) for IRC to declare land owner resource trust with approval from the Secretary of Treasury;
- reducing tax on termination payments to align with tax on superannuation payments;
- constructing APEC facilities under a special Infrastructure Tax Credit (ITC) provision; and
- announcing the introduction of Tax Administration Bill.

6.2 Tax Policy Measures – Medium Term

In line with the 2018 efforts, the main thrust of the medium term revenue strategy is to boost revenue to enable the revenue to GDP target to be met, but to engineer the changes in a way that is equitable and maintains the competitiveness of the PNG tax system. To achieve this, over the medium-term, the Government will continue to strengthen the revenue raising

agencies through increased resources to ensure increased compliance and enforcement. Policy measures will include:

- ensuring appropriate funding for revenue administrations to effectively improve compliance and enforcement activities;
- investing in the modernisation of the tax collecting agencies to ensure greater efficiency – notably with a large tax payer office and gradual upgrade of IT systems;
- continuing to progress the enforcement of the tax identification number (TIN) registration and the use of bank data to ensure compliance;
- monitoring and enforcing the new framework for the improved collection of non-tax revenues from public agencies.
- broadening the tax base by assessing the possibility of reviewing GST levels and offsetting income tax levels as well as improving tax collection;
- reviewing GST refunds and offsets and zero-rating categories;
- developing specific strategies for each taxpayer segments;
- controlling tax evasion and tax avoidance;
- improving resource and operational capacities in tax administration;
- legalising taxpayer identification numbers;
- reviewing the implementation of a capital gains tax;
- rationalising tax incentives to finance lower corporate income tax;
- bringing more SMEs into the tax net through a simplification of the tax legislation;
- increasing transparency through improved tax expenditure reporting - publish an annual Tax Expenditure Statement; and
- linking the specific excise duty rates to actual inflation rates as well as reviewing the list of items.

6.3 Non-Tax Revenue

Over the medium term, Government is putting due emphasis on improving the internal management of SOEs and statutory bodies, combined with enhancing external oversight to improve the performance of these entities. In this respect:

- the Departments of Treasury and Finance are working to introduce a dividend policy to ensure that the State gets an appropriate return on its investments;
- the rates of administrative fees and charges have not been adjusted in recent times and the Departments of Treasury and Finance will examine increases as they relate to services provided. The recent amendments to the PFMA now centralises the fixing and review of fees and charges for all public and statutory bodies within the DoF; and
- Section 13 of the PFMA requires that all public money is paid to the Consolidated Revenue Fund, and failure to comply is an offence – (see Section 106A). Under the Government's 100 Days Plan directive, statutory bodies will be required to remit up to 90 per cent of fees and charges collected into the CRF. In addition, starting in 2018 the Government will transfer the accumulated balances in a number of agency trust accounts to assist in the fiscal adjustment. Legislation will be introduced to clarify the new revenue retention processes.

6.4 Tax Administration Reforms

The policy changes contemplated above are dependent on the institutional reform of revenue administration. The tax base in PNG currently suffers from gross under-reporting, non-lodgements and non-payment of taxes. Thus, the IRC and PNG Customs are moving towards more of a corporate structure to ensure greater efficiency and service delivery. This entails

increasing the tax base through a systematic compliance strategy and an overall modernization of the tax administration system.

6.4.1 Legal and Administrative Reforms

The Government's 100 Days Plan refers to the modernisation of the tax laws. Over the medium term, a number of existing tax related Acts will be updated and consolidated, for example the customs and income tax acts will be modernised and simplified, with a greater emphasis on self-assessment and ease of administration.

In addition, Government will pursue more aggressively non-compliant companies to increase the tax base by accessing third party data on bank accounts for active companies, linking the process of opening a commercial bank account to the process of TIN registration and IRC actively identifying registered, but lodgement non-compliant companies, in PNG. Further administrative reforms planned are the synchronization process of business registration at IPA with that of TIN registration and moving more toward self-assessment under CIT.

6.4.2 Developing a Client-Friendly Environment

A client-friendly environment is crucial for voluntary compliance of taxpayers. It involves simplification of procedures, easy access to information and speedy service delivery. In this regard, alongside online submission, IRC has focused on making forms and returns simpler and easily understandable. The IRC is successfully implementing a self-assessment regime whereby tax payers can generate their own returns, file and pay at the time of lodgement without the need for IRC to assess the tax payer. The IRC will also be establishing a large tax payer office to improve engagement with large tax payers and increase compliance.

With this drive to expand the tax base the IRC and Customs are expanding their reach with IRC opening offices in Kokopo and Lae servicing tax payers in the second and third largest commercial cities of the country. Similarly, the PNGCS will be opening additional border posts in the medium term and increasing the number of container scanner systems to expedite customs clearing activities and compliance.

6.5 Medium- Term Revenue Strategy – Summary

The key policies and reforms contained in the MTRS are summarised in the table below – **see the MTRS document for the full set of measures**. The success of the MTRS rests on an effective implementation of the MTRS to meet the revenue targets in an equitable manner.

Abridged Summary of the Medium-Term Revenue Strategy 2018-2022 measures*

PNG's Medium-Term Revenue Strategy 2018-2022*		
Strategic Objectives	• Halt the declining revenue to GDP trend and increase revenues (excluding grants) in terms of GDP to reach 14.0 per cent by 2022 • Clear policies that support national development goals and encourage investment • Broad based taxes that ensure everyone makes a fair contribution to the nation • Clear laws that define the rights and obligations of taxpayers and administrators • Fair and efficient administration that provides high quality services to taxpayers	
Policy Reform	Legal Reform	Administration Reform
Small business regime • Design a simplified system for tax calculation and payment Tax Exemptions/Incentives • Review existing incentives and exemptions and prepare tax expenditure budgets • Adjust arrangements based on economic value Excise and export duty • Review rates for alcohol, tobacco and gaming • Review excisable products, export tariffs • Examine unprocessed products eg fish, sawlogs Expand the tax base • Explore taxes used in other jurisdictions eg Capital Gains Tax • Broaden the GST tax base by limiting the extensive use of zero rating • Review resource revenue regime and limit the scope of taxes for stabilization to major tax heads • Review non-tax revenues and ensure remittances to public account Personal Income tax and GST: • Assess opportunities to Rebalance the tax composition from income to consumption	Update and consolidate existing Acts • Simplify legislation and separate taxing measures from administration measures • Locate all administration laws/regulations within a tax Administration/Procedures Act • Customs legislation modernization International agreements/treaties • Review to ensure economic value • Ensure technological capability to comply exists before committing to new arrangements Asset Registers • Establish definitive registers with respect to real property, shares, government entitlements such as licences Bank Secrecy • Ensure ready access to bank information by tax administration Public Agencies • Amend the respective legislation covering public agencies to enable the full pass-through of fees and charges and much improved dividend flows from SOEs	Effectively manage compliance risk/ Organizational Priorities/Compliance Risk Management • Allocate scarce resources based on compliance risk management principles • Revise Business Processes to ensure greatest efficiency and effectiveness • Establish and fully-staff a large taxpayer office • Segment and service remaining clients by need and size • A Compliance Audit capability is established and fully functional as a Division Improve systems and process: • Upgrade/replace IT system to add e-filing, self-service, case management, automation of case activities, risk identification and treatment strategy actions and data interchange • Regional and provincial Tax Centres are established across the country to decentralise tax administration services • A Taxpayer Services capability is established and fully functional Strategic leadership & management • Develop management and leadership training for managers and supervisors at all levels • Develop leadership training for all managers • Provide specialist training in areas as needed e.g. LTO
Political Support	External Resources	
• Provide strong reform governance and management • Ensure Government-led effort including all agencies • Consult widely to generate community support	• Identify capacity needs for reform development and implementation • Identify available external support from donor partners to provide extra capacity • Formalize agreement with donors on MTRS support	

* The set of measures is available in MTRS document

6.6 Medium-Term Revenue Projections

The medium-term tax revenue projections are based on the economic projections in table 3, current collection capacities and the ongoing/planned implementation of the MTRS. In this respect, the Government will lift GoPNG revenue collections (tax and non-tax excluding grants) to 14.6 per cent in 2018, and then stabilise collections to reach 14.0 per cent over the projection horizon, with all categories required to improve performance, including the pass-through of revenue from public agencies and state-owned enterprises which continue to perform poorly in this respect.

Over the medium term, tax revenue is expected to grow on average by 8.0 per cent yearly. As presented above, while the modernisation effort of tax collecting agencies is ongoing over the medium to longer term, Government will continue consolidating and broadening the tax base. The contribution of the resource sector is expected to remain modest at around 3.0 per cent of total revenue per year. To be conservative, the impact of any new potential projects has not been factored into the medium-term projections.

Non-tax revenue is projected to represent about 16 per cent of total revenue in 2018, reflecting one-off gains, before stabilising around 8 per cent over the medium term. These projections are guided by Government plans to ensure appropriate revenue remittance by statutory bodies and dividends by SOEs to the consolidated revenue fund.

Also, exceptional one-off revenues, like external grants, will be channelled into growth-enhancing investments and the key enablers to generate longer term returns to the economy.

Table 6: Medium Term Revenue Projections 2017-2022 (Kina millions)

	2017 Supp.	2018	2019	2020	2021	2022
Revenue and Grants	10,979	12,731	12,583	13,552	14,666	15,876
% of GDP	14.9%	15.9%	14.6%	14.7%	14.8%	14.8%
Taxes	8,869	9,639	10,565	11,511	12,568	13,720
% of GDP	12.0%	12.0%	12.3%	12.5%	12.7%	12.8%
<i>Taxes on income, profits and capital gains</i>	5,535	5,565	6,151	6,723	7,369	8,070
<i>Taxes on payroll and workforce</i>	12	-	-	-	-	-
<i>Taxes on goods and services</i>	2,755	3,448	3,762	4,106	4,485	4,900
<i>Taxes on international trade and transactions</i>	568	626	566	592	620	651
Other revenue	1,142	2,067	1,074	1,108	1,166	1,224
% of GDP	1.5%	2.6%	1.2%	1.2%	1.2%	1.1%
Donor Grants	968	1,025	943	932	932	932
% of GDP	1.3%	1.3%	1.1%	1.0%	0.9%	0.9%

Source: Department of Treasury

7 Public Finance Management Reforms to Improve the Quality of Spending

The Government in the medium term intends to continue to pursue its fiscal consolidation efforts initiated in 2015 and 2016. The objectives of macroeconomic stability will be pursued concurrently with economic development goals. To achieve this, Government will fast track a number of public finance management measures, in line with the PEFA Roadmap to ensure that within the reduced fiscal space, essential goods and services are delivered, commensurate with PNG's Medium-Term Development Plan.

In this respect, the Government will implement a number of short-term measures while accelerating the implementation of ongoing more complex reforms. As part of the cost minimisation measures, close scrutiny will continue to be paid to the costing of activities and competitive bidding in public procurement, continuous audit of MDAs' operations and other public financial management reforms such as the roll out of the Integrated Management System which has begun to yield results. In addition, as part of the expenditure allocation and prioritization process over the MTFS period, MDAs would be required to identify internal savings within their budget ceilings and programmes, for internal reallocation to defray funding needs for alternative programme activities within the respective vote ceilings.

7.1 Renewed Focus in the Medium Term on MTDP Key Enablers

Government is committed over the medium term to ensure continuous efforts in service delivery and in maintaining the infrastructure built over the past few years. The sectors of health, education, infrastructure and law and order remain the development priorities of the nation in line with the Medium-Term Development Plan II (MTDP II) and will form the basis of the MTDP III – which will be formulated taking into account the reduced fiscal space, thus calling for greater efficiencies.

In line with recent allocations, over the medium term, the Government will remain committed to ensuring that two-thirds of expenditure is allocated to the key development enablers, despite the current economic realities wherein some of these allocations maybe decreasing. Government intends to promote efficiency and value for money through greater monitoring of the use of public resources as well as more effective processes – as discussed in sections below, to ensure improved service delivery.

7.2 Strengthening Expenditure Control

The MTFS is developed within the context of the on-going implementation of the PEFA roadmap. The MTFS will focus on accelerating these on-going reforms as well as implementing some stop-gap measures in the short to medium term to ensure that expenditure is under control, leakages are reduced, and processes modernized to improve the efficiency of service delivery. These measures are summarised in the table below, while some key policies are discussed below.

7.2.1 Implementation of PFMA

The PFMA sets out requirements to ensure that all expenditure is properly authorized and applied to the purposes for which it is appropriated. The detailed controls over payments are set out in the Financial Management Manual and codify roles and responsibilities as well as all aspects of public money management across the different aspects of the budget cycle from

budgeting to reporting, including procurement. In the medium term, the Government will ensure its strict implementation and that sanctions are served when applicable.

7.2.2 Integrated Financial Management System (IFMS)

At the heart of the Government's Public Finance Management strategy is the roll out of the IFMS. From only three departments (Treasury, Finance, and National Planning & Monitoring) directly linked to the system in 2014, the Integrated Financial Management System is now live in most central agencies. It is now expected to be rolled out to the subnational level.

Ultimately, the IFMS will support Government in its efforts to control expenditure and reduce "leakages" including the identification of ghost workers and automated identification of exceptions to normal operations. The IFMS is part of a comprehensive PFM reform plan. It will involve a revised legal framework along with a comprehensive reporting format including requirements for all administrative units at national, regional and local level to adopt a common language in the form of unified budget classifications and charts of account.

7.2.3 Government Finance Statistics (GFS) 2014

GFS (2014) adopted in 2016 is part of this plan. The GFS (2014) will improve government transparency, accountability and financial management. It will provide a more comprehensive view of the Government's financial performance and the cost of government activities. It will help Government to have a better overview of its assets and contingent liabilities. Finally, it will consolidate information, not only on central government ministries and agencies, but all institutional units under government control.

In the medium term, the budget book will be produced using the GFS classification, which will gradually become more comprehensive.

7.2.4 Payroll and Wage Bill Control

As part of the greater control on public finances that the IFMS is introducing, the monitoring and control of the Government wage bill is critical. The Government's wage bill, in 2016 was 7.0 per cent of GDP, up from about 4.0 per cent in 2010. It has been a source of pressure on the country's fiscal balance which needs to be urgently addressed.

The wage bill has grown for several reasons, some of them structural, such as the public sector pay determination process, and others driven by the growth of employees which, to some extent, reflects the expansion and access to public services in health and education. Lastly, the wage bill growth reflects control systems which are fragmented and insufficiently linked to the budget process.

Organisational Staffing and Personnel Emolument Audit Committee (OSPEAC)

The OSPEAC has been re-established to: (i) scrutinize the Government's public service pay bill; (ii) determine causes of over expenditure; and recommend and implement corrective measures. The NEC Decision 71/2017 requires a number of immediate steps to be taken that will be implemented and institutionalised over the medium term. These include:

- ceasing all PE warrants and payments through the PGAS (and all other funding sources outside of ALESCO);
- endorsing the following system controls to offset:

- public servants being paid at the wrong grade or receiving wrong allowances;
 - fraud - ghost employees, misdirection of termination pay, etc;
 - poor recording of leave taken, resulting in the employee being paid normal pay while not at work and accumulating their leave balance year on year so that, on termination, they are overpaid;
 - payment at the resumption of leave when the employee does not return to work; and
 - unnecessary or incorrect payment of higher duties allowance;
- ceasing all unbudgeted back pays; and
 - freezing all reorganization, unless the reorganization will result in cost savings

Underlying the measures in the NEC Decision is the medium-term plan to make sure that the wage bill remains under control and progressively cleaned up by ensuring:

- spending agencies are accountable for respecting a hard ceiling and for keeping payroll costs within the budget appropriations under pain of disciplinary action;
- a more realistic budget process: this will help reduce the “blow -out” observed in the recent years and also put a gradual end to the ex-post warranting mechanism. Agencies would have to explain any major discrepancies against the agreed base; and,
- data cleansing through field inspections, especially in high risk agencies, will be conducted. Additional efforts such as linking access to the payroll to the National Identity Card are ongoing to ensure “one position, one person, one job”. In addition, Government will tackle the chronic and growing wastage on account of the unattached pool by formulating a policy for centrally managing the unattached staff.

In line with the above, PE for teachers will be more tightly controlled as it contributed significantly to the recent increase. Efforts to control the education sector wage bill are ongoing both in terms of curtailing the recent increase by putting a freeze on new positions, while concentrating on unfilled positions and by introducing some efficiency measures such as reviewing leave packages and reducing wastage through measures geared towards performance based salary. These are included in the Parliamentary Referral Committee on Education (PRCE) commissioned by the National Parliament in 2014, which will:

- review the role of the Teaching Service Commission (TSC) and Department of Education;
- review the processes and procedures on teacher appointments, retirement, retrenchment and resignation;
- reconfigure ALESCO to suit teachers’ specifications and entitlements;
- conduct an annual update for teachers in the first quarter of each year;
- empower TSC with budgetary appropriation, financial responsibilities and manpower capacity to manage the payroll system independently as per the TSA; and,
- develop a standardised database system.

7.2.5 Public Investment Programme

Over the medium term, the reduced fiscal space will limit the Government’s ability to pursue large scale projects solely funded through GoPNG resources. The vetting process to undertake any GoPNG project will be stringent, including criteria such as the economic rate of return and socio-economic impact for the different stages of the approval process.

The Department of National Planning and Monitoring will focus on managing ongoing projects through further prioritisation. DNPM will also explore alternative ways to fund development projects. This will include exploring PPP options and ensuring sufficient counterpart funding to leverage donor funded loan projects. Currently, PNG has K8,077.3 million of undisbursed contracted loans, which cost between K15-K30 million annually in commitment fees. The planned gradual increase in undisbursed loans drawdowns will support efforts to address some of the current foreign currency shortage issues.

7.3 Summary of Medium-Term Expenditure Strategy

PNG's Draft Medium-Term Expenditure Strategy 2018-2022		
Strategic Objectives	- Reduce total expenditure to GDP ratio from 18 per cent in 2018 to 16 per cent by 2022 to reduce the budget deficit and debt to 30 per cent of GDP - Reallocate the expenditure mix from personnel emoluments and goods and services towards a higher level of capital expenditures and support for priority enablers and manage the budget to prevent the accumulation of arrears and fiscal overhangs - Clear policies that support national development goals and encourage investment - Ensure human development through policies conducive to infrastructure building, prosperity, business and job creation as well as commitment to universal quality health care and education - Efficient and effective delivery of goods and services to all citizens as well as creating opportunities within a sustainable fiscal framework	
Personnel Emolument	Goods and Services	Capital Investment
Short and Immediate measures: - Implementation of the NEC Decision 71/2017 to bring PE under control Integration of systems - Ensure that all civil servants are registered and paid through ALESCO - Phase out any parallel systems Preparation of realistic Budget Votes - Setting realistic PE votes to reduce budget "blow -out" - Use hard ceiling to ensure discipline among agencies. Enforcing Budgetary Control - Put an end to ex-post warranting - All departments unattached existing staff, recruitment of new staff, overtime allowances etc will not exceed the given ceiling under pain of disciplinary action Linking PE to affordability - NEC with the advice of the Treasury will decide on the yearly PE increase - PE costs will not exceed 40% of non -resource, non-grant revenue to ensure long term sustainability	Procurement reforms - review and present the National Procurement Bill to Parliament and ensure its quick implementation Asset policy - Implementation of policy in line GFS (2014) - The system recording all assets will be managed through IFMS Centralized utilities payment - Payment of utilities will be centralized and channelled through DOF and DOT to avoid arrears and reduce leakages	Vetting of Capital Project - The vetting process for capital projects will be strengthened – with stringent requirements in terms of financial and economic returns - Set up an interdepartmental committee, chaired by DNPM, including the DoT and other relevant departments to appraise and oversee the technical and financial accountability of large new projects. Prioritization of Ongoing Projects - Given the limited fiscal space in the medium term, DNPM will evaluate the existing portfolio of ongoing projects and rank priorities over the medium term. Donor Funded Projects - Drawdowns on a number of concessional loans to implement high return projects, in line with the Debt Management Strategy Monitoring and evaluation - Ensure that all capital projects including SIPs are adequately monitored
Political Support	Cross cutting reforms	
- Provide strong reform governance and management - Ensure Government-led effort including all agencies - Consult widely to generate community support - Implementation of existing Acts	- Roll out of IFMS and implementation of GFS (2014) reporting standards. - Monitor, manage and gradually clear arrears - Pursue the streamlining process of the civil service with the amalgamation programme - Identify available external support from donor partners to provide extra capacity – procurement reforms, payroll	

7.4 Medium Term Expenditure Outlook

In the context of fiscal consolidation, the Government will carefully monitor the use of public funds to ensure increased efficiency and accountability. Over the period, Government spending is expected to increase, on average by 6 per cent yearly. This is based on the aggressive implementation of the reforms referred to above. Total expenditure is projected to decrease from 18 per cent of GDP in 2018 to 16 per cent by 2022.

Recurrent Expenditure is expected to increase on average by 2 per cent over the 2018-22 period. This modest increase reflects the implementation of a number of measures aimed at modernising the public financial management system, reinforcing the performance monitoring and evaluation function, and ensuring efficiency in the use of public funds. Measures cover:

- The **wage bill** which is projected to increase by less than 3 per cent yearly over the medium term against 16 per cent per year over the period of the last MTFS. Substantive restrictions in recruitment, increases in payroll audits, removal of ghost workers, rationalisation of functions and civil servants and improved administrative and technology systems will offset very modest expected pay increases. Personnel emolument expenditure is expected to decline from 5.9 per cent of GDP in 2017 to 4.7 per cent of GDP in 2022;
- **Goods and Services** - Government will decrease expenditure as a share of GDP from 4.3 per cent in 2017 to 3.0 per cent in 2022. In 2018, items such as travel, and subsistence will be reduced, while the emphasis will be on clearing the arrears. Goods and services expenditures will continue to be controlled more closely with greater enhancements to the IFMS system and a tighter year end accounts' closure policy; and
- **Debt service** (interest cost) – this expenditure item reflecting the recent increase in Government borrowing will be managed carefully. Debt service is projected to average 13.5 per cent of total expenditure over the period under consideration.

Capital Expenditure, after an initial lift of 67 per cent in 2018 (compared to the 2017 Supplementary Budget), is expected to increase on average by 6 per cent yearly over the subsequent 4 years. This reflects the willingness to rebalance expenditure towards productive investments. To ensure that the reduced fiscal space does not hamper growth in the medium term, only projects with large socio-economic returns will be funded. Priority will be given to counterpart funding to leverage larger available loan programs.

Table 7: Medium Term Expenditure Projections 2017-2022 (Kina millions)

	2017 Supp.	2018	2019	2020	2021	2022
Total expenditure (including grants)	12,856	14,718	14,480	15,227	16,074	17,137
% of GDP	17.4%	18.4%	16.8%	16.5%	16.2%	16.0%
Expense	10,081	10,074	10,030	10,249	10,769	11,267
% of GDP	13.6%	12.6%	11.7%	11.1%	10.9%	10.5%
<i>Compensation of employees</i>	4,278	4,137	4,266	4,397	4,532	4,671
<i>Use of goods and services</i>	3,286	3,060	2,650	2,641	2,995	3,165
<i>Interest</i>	1,533	1,865	2,010	2,106	2,137	2,324
<i>Grant</i>	600	500	572	572	572	572
<i>GST Transfers to Provinces</i>	384	512	532	532	533	535
Capital Expenditure	2,775	4,644	4,450	4,979	5,305	5,871
% of GDP	3.8%	5.8%	5.2%	5.4%	5.4%	5.5%

Source: Department of Treasury

7.5 Medium Term Fiscal Outlook

Against the background of a subdued economic outlook, fiscal consolidation efforts will take time, particularly in raising additional revenue and in slowing the rate of certain categories of expenditure which tend to be quite rigid over the short term. The challenge is to achieve this consolidation whilst, at the same time, reversing the decline in capital expenditures and fully funding provincial and district services improvement programs. The Government enacted amendments to the FRA in September 2017 that require it to:

- operate a debt to GDP ratio within a 30-35 per cent band;
- target a debt to GDP ratio of 30 per cent over the 5 year projection horizon; and
- target a zero average annual non-resource primary fiscal balance over the medium term (to 2025).

Over the projection horizon, with projected revenue to GDP increasing at a faster pace than the projected declining trend in expenditure to GDP, the fiscal deficit will trend lower each year until the 30 per cent boundary is reached by 2022 as required under the FRA. In addition, the non-resource primary fiscal balance is projected to be zero by 2021-22 and will subsequently move into surplus, in compliance with the average balance of zero over the medium term (to 2025). Importantly, if there is stronger growth in the resources sector than projected in the baseline, this will mean that targeting a zero-average annual non-resource primary balance will result in the build-up of financial resources in the Sovereign Wealth Fund much earlier than anticipated.

Based on the above expenditure and revenue profile, the medium term fiscal position is presented below.

Table 8: Medium Term Fiscal Balance 2017-2022 (Kina millions)

	2017 Supp.	2018	2019	2020	2021	2022
Revenue and Grants	10,979	12,731	12,583	13,552	14,666	15,876
% of GDP	14.9%	15.9%	14.6%	14.7%	14.8%	14.8%
Total expenditure (incl. grants)	12,856	14,718	14,480	15,227	16,074	17,137
% of GDP	17.4%	18.4%	16.8%	16.5%	16.2%	16.0%
Net Lending (+)/ borrowing (-)	-1,876	-1,987	-1,898	-1,676	-1,408	-1,261
% of GDP	-2.5%	-2.5%	-2.2%	-1.8%	-1.4%	-1.2%
Non-resource primary balance	-665	-592	-442	-193	-10	98
% of non-resource GDP	-1.2%	-1.0%	-0.7%	-0.3%	0.0%	0.1%

Source: Department of Treasury

7.6 Financing Requirements 2018-22

Over the next few years the Government aims to increase revenue substantially and rebalance expenditure which will result in the fiscal deficit declining to around 1 per cent of GDP by end 2022. Some of the one-off revenue increases will come from unutilised domestic trust account balances of public agencies which will adversely impact system liquidity and the demand for treasury securities, further reinforcing the need for a switch to external sources. The Debt to GDP ratio is projected to fall to 30 per cent in 2022 in compliance with the FRA.

The net budget financing requirement for 2018 is K1,987.2million. Commensurate with the Medium Term Debt Strategy 2018-22, this budget deficit is projected to be financed through external and domestic sources comprising K1,613.4 million from external sources and K373.8 million from domestic sources. Domestic financing comprises K30.2 million from Treasury Bills and K343.6 million from Treasury Bonds (in net terms). The external financing will be funded from concessionary budget support from the ADB and World Bank, commercial financing through the USD bond program and some minor external loans, and the remaining balance of K337.4million (in net terms) from concessional donor program loans.

The table below shows the composition of financing by instrument for the 2018 Budget and over the projection horizon to 2022.

Table 9: Deficit Financing Projections by Instrument 2018-2022 (kina, millions)

Debt Instruments	2017 Supp.	2018	2019	2020	2021	2022
Domestic Net Financing	912.5	373.8	200.6	454.7	816.2	862.1
Securities	912.5	373.8	200.6	454.7	816.2	862.1
New Instruments	10,258.3	10,388.5	10,580.5	1,1036.5	11,024.2	10,963.0
Amortisation	-9,345.8	-10,014.7	-10,379.9	-1,0581.8	-1,0208.1	-10,100.9
Treasury Bills	694.8	30.2	-108.0	156.0	87.7	-61.3
New Instruments	9,358.3	9,388.5	9,280.5	9,436.5	9,524.2	9,463.0
Amortisation	-8,663.5	-9,358.3	-9,388.5	-9,280.5	-9,436.5	-9,524.2
Inscribed Stock	217.7	343.6	308.6	298.7	728.5	923.4
New Instruments	900.0	1,000.0	1,300.0	1,600.0	1,500.0	1,500.0
Amortisation	-682.3	-656.4	-991.4	-1,301.3	-771.6	-576.7
External Net Financing	963.9	1,613.4	1,696.9	1,221.1	592.3	399.3
Securities	0.0	640.0	640.0	320.0	0.0	-640.0
New Instruments	0.0	640.0	640.0	320.0	0.0	0.0

Amortisation	0.0	0.0	0.0	0.0	0.0	-640.0
Sovereign Bond	0.0	640.0	640.0	320.0	0.0	-640.0
New Instruments	0.0	640.0	640.0	320.0	0.0	0.0
Amortisation	0.0	0.0	0.0	0.0	0.0	-640.0
Loans	963.9	973.4	1,056.9	901.1	592.3	1,039.3
New Instrument	1,236.5	1,273.7	1,456.9	,1803.3	1,534.6	1,961.0
Amortisation	-272.6	-300.3	-400.0	-902.2	-942.2	-921.7
Concessional Loans	298.3	337.4	480.6	808.3	1,123.4	1,389.7
New Instrument	526.5	593.9	816.9	1,163.3	1,534.6	1,961.0
Amortisation	-228.2	-256.5	-336.3	-355.0	-411.2	-571.4
Commercial	703.0	39.8	-17.9	-513.9	-513.9	-337.9
New Instrument	703.0	39.8	0.0	0.0	0.0	0.0
Amortisation	0.0	0.0	-17.9	-513.9	-513.9	-337.9
Extraordinary	-37.4	596.2	594.2	606.7	-17.1	-12.4
New Instrument	7.0	640.0	640.0	640.0	0.0	0.0
Amortisation	-44.4	-43.8	-45.8	-33.3	-17.1	-12.4
Total Net Financing	1876.4	1987.2	1897.5	1675.8	1408.5	1261.4

Source: Department of Treasury

The financing requirement for 2018 will result in total government debt reaching K25,807.6 million by end 2018, equivalent to 32.2 per cent of GDP. By end-2018 the composition of total debt is projected to comprise:

- external debt amounting to 10.1 per cent of GDP (K8,084.4 million) predominantly loans from multilateral, bilateral and commercial creditors. Multilateral debt will account for 62.2 per cent of total external public debt. The largest multilateral creditor is the ADB (79.3 per cent), followed by the World Bank (16.8 per cent). Bilateral debt will account for 27.6 per cent of the external public debt stock. The largest bilateral creditor is China (85.8 per cent) followed by Japan (13.5 per cent); and
- domestic public debt amounting to 22.1 per cent of GDP (K17,723 million) predominantly marketable securities with 53.1 per cent (K9,338.5 million) being in T-bills with maturities of 91, 182, 274 and 364 days and 46.9 per cent (K8,334.7 million) in medium and longer-term Treasury Bonds.

For 2018 PNG's total interest cost on Government debt is low in relation to GDP but quite high in relation to revenue (14.6 per cent) where it is double the average of low middle income countries. Importantly it is projected to increase further over the medium term. Annual interest payments are estimated to be 2.3 per cent of GDP, with interest payments on external debt accounting for 0.35 per cent and interest payment on domestic debt 1.9 per cent of GDP. At the end of 2017, the weighted average interest rate on the total debt portfolio was 7.1 per cent with external being 1.1 percentage points and domestic 6.0 percentage points.

Table 10: Debt stock as a share of GDP 2017-2022 (kina, millions)

	2017 Supp.	2018	2019	2020	2021	2022
Gross Government Debt (K millions)	23,820	25,808	27,705	29,381	30,789	32,051
% of GDP	32.1%	32.2%	32.2%	31.9%	31.1%	30.0%
<i>Domestic</i>	17,349	17,723	17,924	18,378	19,195	20,057
<i>% of GDP</i>	23.4%	22.1%	20.9%	19.9%	19.4%	18.8%
<i>External</i>	6,471	8,084	9,781	11,002	11,595	11,994
<i>% of GDP</i>	8.7%	10.1%	11.4%	11.9%	11.7%	11.2%

Source: Department of Treasury

8 Medium Term Debt Management Strategy (MTDS)

8.1 Review of the Medium Term Debt Strategy (2013-17)

The MTDS 2013-2017 was aimed at maintaining debt and financial risks at sustainable levels while minimising the cost of debt but with revenue lower than anticipated in recent years, the Government was forced to run higher than programmed Budget deficits. The increased debt and associated debt service placed significant pressure on the Budget as well as financing demands. This impacted adversely on the implementation of the MTDS.

To finance these deficits, Government increased the debt stock from K8,478 million in 2012 to K21,944 million in 2016 and to K23,820 million in 2017. The main source of the increased borrowing has been the domestic market – with an increase in Treasury Bills and Inscribed Stock of 184 per cent between 2012 and 2017, from K6,118 million to K17,349 million.

As a result, debt to GDP ratio exceeded the FRA 30 per cent limit in 2016 and 2017, and financial risk has increased as the duration of the domestic debt portfolio has declined and as the stock of treasury bills continued to increase in proportion to total Government securities on issue. In 2017, the proportion of Treasury Bills and Inscribed Stock to total government domestic securities on issue was 53.9 per cent and 46.1 per cent respectively, well short of the 30-70 per cent respective targets in the Plan. In addition, foreign currency debt as a proportion of total central government debt was 27.2 per cent which was well below the target of 40 per cent set in the MTDS 2013-17.

The 2016 IMF Debt Sustainability Analysis concluded that the risk of debt distress in PNG remains low based on an assessment of public and publicly guaranteed external debt. However, factoring in public domestic and private external debt, the overall risk of debt distress remains heightened. In addition, the substantial private sector debt of large mining companies tends to be secured through holding offshore foreign currency accounts and therefore limits debt risk in PNG. The IMF concluded that the ratio of central government debt to GDP remains low, at 30 per cent as of end 2015, but that liquidity risks remain high. According to the IMF a failure to consolidate the fiscal position, including through obtaining more cost effective and longer-term financing, would worsen debt dynamics.

The trend over the last three years signals that there is reduced appetite for Government securities, particularly longer dated Treasury Bonds. In 2017 the significant unplanned increase in the issuance of shorter term treasury bills resulting from the fiscal overhang at the end of 2016, and the need to offset the failure to obtain the planned amount of external commercial financing in 2017 have meant that financial risk (both rollover and interest rate risk) from the domestic market has increased significantly. The persistent foreign exchange imbalance, which tends to tie up banking sector liquidity, has also resulted in substantial constraints being placed on additional issuance over 2018. This coupled with constraints on the level of government securities that can be held on banks' balance sheets because of exposure limits and asset-liability mismatches, implies that these difficulties are likely to extend into 2018.

Importantly, the Government amended the FRA in 2017 allowing the debt to GDP ratio to move within a band of 30-35 per cent, but that the authorities should target a debt to GDP ratio of 30 per cent by the end of the projection period in 2022. In addition, the Government is required to target a zero average annual non-resource primary balance over the medium term (assumed to be somewhat longer than the projection period). The latter target will tend to be more binding on fiscal expansion should resource developments increase significantly above

the baseline assumptions. As such, under the baseline assumptions the 30 per cent debt to GDP target is the main anchor on fiscal excesses.

8.2 Medium Term Debt Strategy 2018-22

The Medium-Term Debt Strategy (MTDS) lays down the plan to achieve the desired funding for the Government's budgets over the 2018-22 period and in managing the Government's debt portfolio. The overall objective of the MTDS 2018-22 is to:

“raise the required amount of budget financing and manage the debt portfolio to achieve prudent risk and cost minimisation objectives, and develop and maintain an efficient market for government securities and diversification of funding sources.”

The MTDS operationalizes this objective in order to achieve the desired composition of the Government's debt portfolio which captures the government's strategy with regard to the cost-risk trade-offs. The major strategies to support the debt management objective comprise:

- Maintaining debt at sustainable levels. The FRA target band of debt to GDP of 30-35 per cent and the 30 per cent target by 2022 will constrain debt to sustainable levels, although the band only applies to central government debt and does not include arrears, SOE borrowings or contingent liabilities;
- Maintaining financial risk at prudent levels. The reduction in the domestic debt target relative to foreign debt is a trade-off between domestic liquidity and interest rate risk against foreign exchange risk, and the lengthening of the average time to maturity is a trade-off between cost and refinancing risk;
- Developing and efficiently managing the domestic debt market involves broadening and deepening the market in domestic securities and improving the market infrastructure; and
- Developing and managing the offshore commercial market, including the inaugural sovereign bond issuance that will diversify funding sources, provide an alternative market based financing instrument, ease domestic liquidity and foreign exchange constraints and provide PNG a sovereign reference price. This will allow international investors to take a position in PNG which will also facilitate non-resident purchases of domestic bonds through a market based assessment of interest differentials.

The MTDS is guided by the legal framework governing Government borrowing including the authority to borrow and to issue new debt, invest and undertake transactions on the Government's behalf. Key legislation governing securities and domestic debt include the Loans and Securities Act 1973, the Treasury Bills Act 1974 and the Central Bank Act 2000. Legislation relating to foreign loans include the *Loans (Overseas Borrowings) Act 1973*, *Loans (Overseas Borrowings) (No. 2) Act 1976* and *Loans and Assistance (International Agencies) Act 1971*. Legislation relating to the authority to borrow is outlined in the *Public Finances (Management) Act 1995*. For fiscal consideration purposes, limits set on debt are prescribed in the *Fiscal Responsibility Act 2006*. The legal framework puts the emphasis on greater accountability and outlines the desired reporting and audit requirements.

The Medium-Term Debt Strategy 2018-2022 is formulated against the revenue and expenditure assumptions presented in the MTFs which target further fiscal consolidation. However, given both the constraints and risks in raising significantly more financing from the domestic market and the conclusions from the IMF (2016) DSA and Treasury's own analysis for 2017 on debt sustainability and risks, the MTDS 2018-22 will:

- engineer a portfolio shift from domestic debt securities to foreign currency debt with a foreign debt to total debt target of at least 35 per cent by 2022 while domestic debt will decline to a target of at least 65 per cent. This will be achieved through the issuance of World Bank/ADB highly concessionary external budget support debt and through the issuance of a USD bond program, together with the normal net inflows of donor project loans. The issuance of a USD bond program will require substantial efforts to arrange and manage the program which will run throughout the projection period; and
- within the domestic debt target, Treasury Bills and Treasury Bonds as a share of total domestic debt will be split at 50 per cent each to give an improved alignment with current investor preferences and market demand. This will be consistent with the goals of minimising the cost of debt and the Government's tolerance for financial risk. To achieve this rebalancing the market in domestic bonds, including access to the market by non-residents, will need to be developed significantly particularly in 2018 where a number of prerequisites will need to be addressed urgently.

The change in the portfolio mix will also mean significant foreign exchange inflows, some of which will be used to clear the foreign exchange imbalance. The crowding out impact on private sector credit will also be reduced, lending support to private sector credit growth in this important area.

8.3 Managing Portfolio Risk and Developing the Bond Market 2018-22

In implementing the financing strategy, Government will be managing a number of risks including exchange rate risk, liquidity risk, interest rate risk, refinancing risk and others. These risks will be reduced through:

- managing the currency composition of external debt, especially as it increases as a proportion of debt, to ensure the composition is aligned with export receipts and foreign exchange reserves;
- continuing the through-the-year practice of accumulating funds in the dedicated debt account to pay debt service and redemptions when falling due and to cover issuance shortfalls;
- smoothing out the maturity and repayment profile of the domestic debt service schedule, within the projected financing envelopes, through debt switches and buybacks and establishing a reduced number of more liquid benchmark issues. To facilitate this measure, the Loans Securities Act 1960 and the T-Bills Act 1974 will need to be amended to clearly state the authority for Treasury to actively manage government debt. The publication of a more detailed and timely borrowing plan will also be undertaken in 2018;
- lengthening the duration of the domestic portfolio to reduce refinancing risk through the development of the domestic bond market and targeting compositional changes between shorter term treasury bills and longer-term treasury bonds;
- addressing a number of preconditions for the development of the domestic bond market including: improving the efficiency of the primary market (the current manual and cumbersome processes will need to be changed to attract non-resident investors and encourage secondary trading); promoting money market and interbank transactions through repurchase agreements; developing automated clearing, settlement and custody facilities; establishing a bond market code of conduct with effective oversight by BPNG; promoting the establishment of pools of liquidity to allow small investors access to the market; improved coordination between monetary, fiscal

and regulatory authorities and market participants; and developing and maintaining a centralised source for bond market information and data.⁴These preconditions will underpin the goals of expanding the existing highly concentrated investor base and promoting a more liquid and efficient secondary market;

- addressing the concerns by non-residents that seek to invest in domestic securities, namely through rectifying the current foreign exchange imbalance and restrictions on access to foreign currency at redemption or repurchase, implementing access and disposal arrangements through improved market infrastructure for automated clearing, settlement and depository functions, and facilitating secondary market liquidity; and
- documenting and monitoring debts of state-owned enterprises and contingent liabilities and providing advice on management and exposure levels, with the more significant being the domestic commercial loans taken out by Kumul Consolidated Holdings (KCH) to finance the Motukea Port relocation, Eda Kopa Solwara 1 Project and the NCD Roads Project. Records relating to these liabilities are available in Statement I of the annual Public Accounts Statement.

Table 11: Percentage of Foreign Currency Debt to total Central Government Debt

Target	2016 Actual	2017 Revised	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
Up to 40%	25.1%	27.2%	31.33%	35.31%	37.45%	37.66%	37.42%

Source: Department of Treasury

Table 12: Percentage of Treasury Bills to Domestic Debt Portfolio

Target	2016 Actual	2017 Est	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
50%	52.70%	53.9%	53.0%	51.8%	51.3%	49.6%	47.2%

Source: Department of Treasury.

Table 13: Average Maturity of the Domestic Debt Portfolio

Target	2016 Actual	2017 Est	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
5 Years	4.4	4.2	4.5	4.6	4.7	4.8	4.8

Source: Department of Treasury.

To undertake the measures presented in the MTDS 2018-22, the Government will establish a high-level debt development and management committee comprising Treasury and BPNG senior staff.

⁴ Refer to World Bank, Review of the PNG Government Bond and Capital Market Development, August 2015

9 Fiscal Risks and Mitigation Strategies

The implementation of the MTFS could be subject to a number of risks that may divert projections from expectations at the time of fiscal forecasts. This section outlines the country's exposure to fiscal risks originating from various channels such as the projections used for budgetary purposes, public debt dynamics, operations of local governments and government corporations, as well as contingent liabilities and unforeseen natural calamities.

9.1 Macroeconomic risks

General macroeconomic risk refers to the exposure of fiscal policy to the volatility of key economic parameters and assumptions compared to levels of parameters that were assumed in the forecast. Projections of medium term growth are compiled by considering a number of variables and assumptions such as public investment, private investment, terms of trade, revenue, interest rates, exchange rates, commodity prices and weather conditions.

Negative shocks to any variable above will have impacts on other variables and hence affect projections. Exchange rate fluctuations influence the country's external trade, external debt service and inflation rates and, indirectly, domestic revenues. Interest rate changes impact fiscal policy through the cost of domestic debt.

In managing macroeconomic indicators (such as inflation and exchange rates), the DoT and the BPNG will strengthen their collaboration to ensure that the fiscal and monetary policy stance remains consistent with its price and financial stability objectives.

9.2 Revenue related risks

Although prices have stabilised over the past few months, the considerable and protracted decline in international prices of commodities, such as mineral and agro-based products, continues to pose downside risks to the country's exports earnings. Both weak commodity prices and the slowdown in external demand have influenced the country's trade performance in recent times. Prospects remain uncertain with subdued growth prospects for emerging market economies and continued excess supply conditions.

Given the country's dependence on the resource sector and its spill-over effect on the real sector, the Alotau Accord 2 highlights the Government's aim to promote economic diversification and the investment climate to attract investors into sectors other than the mineral resource sector. The MTFS is developed with account taken of the eventuality of positive and negative shocks, as well as targeting an average annual non-resource primary fiscal balance of zero over the medium term and operationalising the SWF. These will help delink the economy from resource price volatility.

The MTFS is also based on a significant lift in revenue from both new measures and greater compliance efforts. There is a risk that the significant increases may not be forthcoming, and that greater tax compliance and the expected increased performance from state entities will not be realised.

9.3 Expenditure related risks

Weak expenditure controls have been observed due to the rigid nature of some categories that have expanded substantially in recent years. Categories such as personnel emoluments, off-budget expenditures and exposures, and changes in priorities pose significant fiscal risk.

The unanticipated accumulation of arrears and budget overhangs at year end all increase system risk and erode budget execution and efficient management.

Similarly, the operations of subnational entities create potential sources of fiscal risk. The subnational entities receive significant transfers from the central government which need to be more closely monitored.

By strengthening its public finance management and implementing the strategy presented in the MTFS, Government will exercise improved control over its expenditure. The Government will also ensure the implementation of key laws such as the Finance Act, Budget Act, Fiscal Responsibility Act, Debt Management Strategy and many others to ensure sound policies are pursued to achieve the desired reduction in the fiscal deficit, debt sustainability and structural reforms.

Further, as part of the National Government's efforts to improve spending at the local level, central agencies will issue guidelines and circulars to educate LGAs on how to spend in accordance with the priorities of the National Government and that expenditures are aligned with available resources.

9.4 Contingent liabilities

Contingent liabilities expose the government to the possibility of unexpected and substantial obligations over a short period of time and could lead to a severe strain on its fiscal resources.

In its efforts to better assess risks, contingent liabilities will be closely monitored and managed. The Government, through the strict implementation of the Guarantee and On-Lending Policies, will monitor the rationale and criteria for the provision of state guarantees as well as the framework to manage associated risks. The Government will also monitor legal actions and design a framework to mitigate the risks.

The DoT is mandated to develop a centralised borrowing policy to ensure that some of these risks emanating from subnational government and state-owned entities are carefully managed and mitigated. These risks also include natural disasters.

9.5 Civil Service Pension Liabilities

The main risk under this category is under estimating the Government's unfunded liability and arrears to Nawbawan Super and its approach to manage costs and risks in the pension scheme. The accumulation of government unfunded liabilities is subjected to high interest rates exacerbating fiscal risks.

The government has already made a decision to seek to clear all the arrears with the pension fund over time and continues to examine a preferred approach.

9.6 Natural disasters

There are also economic losses that could be a result of natural disasters which may entail fiscal obligations. This could be a result of a change in weather which may cause heavy rains or any kind of natural calamity that may result in the destruction of infrastructure such as bridges, roads and buildings, or require relief efforts.

The Government acknowledges the importance of creating a climate-resilient environment. As such, through the development of a natural risk management framework, the Government is

making this a priority. The National Disaster Centre will continue developing a strategy to predict, respond and mitigate the costs of disasters – which in some instances represents an implicit risk.

9.7 Debt

The risks and mitigation strategies related to debt management are presented in the Medium-Term Debt Strategy 2018-22

10 Summary of Key Fiscal Anchors

This section presents the anchors that PNG will be monitoring to assess its medium term fiscal strategy.

Revenue

- Grow the revenue base (excluding grants) to 14 per cent of GDP by 2022. Revenue (excluding grants) as a percentage of GDP has declined from 20 per cent in 2012-14 to below an estimated 13.0 per cent by end-2017 and, on a no-policy-change basis is expected to go lower. This is low by international standards, and the downward trend needs to be stabilised and lifted over the medium term.
- Achieve a zero average annual non-resource primary balance over the medium term which will force resource revenue to be accumulated in the SWF over the medium term (to 2025) under baseline assumptions and earlier should new resource projects be commenced and/or commodity price trends improve.

Expenditure

- Total expenditure as a percentage of GDP to decline from 18.0 per cent in 2018 to 16.0 per cent in 2022.
- Allocation to key enablers to be maintained at 2/3 of (primary) expenditure – i.e. excluding debt service. This rule will help ensure that the country's resources are used to address some of the critical development challenges.
- Personnel costs should be reduced from 40.0 per cent of total non-resource non-grant revenue in 2017 to under 35 per cent by 2022 and should not increase by more than 5 per cent yearly (arrears repayment excluded). This is critical to ensuring that the rapid growth observed over the last few years is curtailed. It is an ambitious target which calls for an aggressive implementation of the reform plan.
- Expenditure as per the SWF rule - which stipulates that withdrawals during each fiscal year from the Stabilization Fund shall be made through the National Budget, and shall not exceed the five-year long-term moving average of mineral and petroleum receipts as a share of non-mineral and non-petroleum receipts.

Deficit and debt

- Achieve a zero-average annual non-resource primary balance over the medium term (to 2025). Over the period and under the different scenarios, significant resources are not expected; however, with this rule, Government will ensure that its expenditure pattern is delinked somewhat from resource sector volatility and will ensure increased resource revenues are accumulated in the SWF.

- To give the Government some flexibility to manage fiscal and financing policies through protracted economic cycles, the Fiscal Responsibility Act was amended in 2017 from having the single line 30 per cent debt to GDP ceiling to a range of 30 to 35 per cent of GDP for 2017 and beyond. As an offset, however, the Government has also amended the FRA to compel the Government in its Medium Term Debt Strategy to target the lower 30 per cent boundary by 2022.

Box 1: Update on the Sovereign Wealth Fund

The establishment of the Sovereign Wealth Fund (SWF) is a reform policy of the Government, which is an important part of its institution-building efforts. It is aimed at prudently and efficiently managing the revenue benefits from the resources sector. The SWF has been designed to protect the economy from the volatile cycles that accompany high resource incomes for small economies.

The Organic Law on the Sovereign Wealth Fund (OLSWF) of PNG was passed by the Parliament in July 2015 and certified by the Speaker of Parliament in January 2016. The certification of the OLSWF enabled certain provisions of the law including the establishment of the Board to come into operation. The remainder of the provisions will come into operation in accordance with a notice in the National Gazette by the Head of State, acting with and in accordance with, the advice of the National Executive Council.

The SWF has been designed to be funded primarily by revenue inflows from the mineral and petroleum sector. Although a ramp up in fund balances is not expected in the short to medium term, the Government will continue with the establishment of the SWF as a key policy reform, to enable it to be fully operational when mineral and petroleum commodity prices improve.

The successful establishment of the SWF is a vital macroeconomic policy and good governance tool which will underpin beneficial support from international financial institutions and international credit rating agencies as well as bilateral and multilateral trade and development partners.

Approach to shocks

Negative shock

In the case of a decrease in revenue, Government will take the necessary steps to ensure that the deficit to GDP ratio remains below 2.5 per cent of GDP in 2018 – implying further reductions in domestically financed capital expenditures focused on reducing SIP allocations. This approach should ensure that the basic level of services is maintained and delivered. The Government would have difficulty securing financing for any deficit increase above the 2.5 per cent targeted level. Over this revenue constrained period, the Government will continue to replace domestically financed capital expenditures with drawdowns from the undispersed loan stock.

Positive shock

In the case of positive shocks, particularly from the resources sector, the Government will reduce the fiscal deficit and move to surplus as required under the non-resource primary balance rule.