KPMG

cutting through complexity

KPMG 2017 Budget Review

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The 2017 Budget continues in the context of prevailing lower commodity prices (although improving) and forecast modest growth in the domestic economy, driven mainly by the agriculture sector, the mining sector and other non-resource sectors. As in 2015 a supplementary budget was set for 2016, with the budget continuing to be in deficit and the likely timeframe for Government to achieve a balanced budget pushed out to beyond 2021. The budget deficit for 2017 is estimated at 2.5% of GDP or K1.8bn.

Revenue of K11.5bn is projected and is a decrease of K248m against the 2016 supplementary budget. Total expenditure of K13.3bn is based for the first time on the Government Finance Statistics (GFS) 2014 classification. There have been some trend shifts in the projected allocations, and it is noted that for the second consecutive year the health and education sectors are projected to receive smaller slices of the pie, while at the same time the administration sector allocation will increase to 20% of the expenditure budget, which includes facilitation of the 2017 general elections and hosting of the 2018 APEC Summit. In real terms the spending against key development focus areas has continued to decrease over the past few years.

Expenditure by Sector	2016	2017	2018	2019	2020	2021	Trend
Provinces	27%	30%	30%	30%	31%	31%	↗
Community & Culture	1%	2%	2%	2%	2%	2%	↗
Administration	17%	20%	20%	20%	20%	20%	↗
Economic	3%	3%	3%	3%	3%	3%	-
Utilities	3%	2%	2%	2%	1%	1%	↘
Transport	8%	7%	7%	6%	6%	6%	↘
Health	12%	9%	9%	9%	8%	8%	↘
Education	9%	9%	9%	8%	8%	8%	↘
Law & Justice	9%	8%	8%	8%	8%	8%	↘
Debt Services	11%	10%	10%	10%	9%	9%	↘

Government is confident that it remains on track with their debt strategy, maintaining government debt at less than 30% of GDP (28.8% in 2017) and managing refinancing risk by increasing Treasury Bonds on issue by K4.9bn to K12.5bn between 2017 and 2021. There remains a question as to exactly how the 2017 K1.9bn deficit will be funded, although it is assumed that the Treasury Bonds issuance, external financing from Credit Suisse and other international agencies will be utilised for this purpose. The 2016 Budget projected that the 2016 deficit would be funded through the issue of a Sovereign Bond to raise K2.8bn (which has not yet occurred) which together with additional concessional finance of K700m would enable a restructuring of the debt portfolio away from Treasury Bills.

Continuing onto our emphasis of last year around the need for effective public sector reform, it appears that planned reforms (such as amalgamations) to enhance the ability of Government to deliver are not as advanced as anticipated. There has been movement in terms of the Kumul reform, and as part of this agenda Government has indicated their appetite for diversifying their investment base towards more traditional drivers of the economy and encouraging private sector partnership.

The 2017 Budget continues to provide funding for economic and social development programs while at the same time stressing that priority will be given to those projects that are ongoing. In this fifth budget by the current government, ahead of the 2017 General Elections, we are starting to see the introduction of matters included in the tax reform review with nine changes adopted. Several key changes that have been mooted were not adopted, such as GST increases and capital gains tax introduction.

Economic Assumptions

The Budget estimates are based on a range of assumptions including revenue collections, economic growth and commodity prices. Volatility in economic fundamentals presents significant risks for a comparatively narrowly based economy like PNG. Key assumptions underpinning the Budget are presented below.

Prices of main export commodities

Agriculture (K/tonne)	2015A	2016E	2017P	2018P	2019P	2020P
Copra	1,096	1,242	1,257	1,257	1,257	1,257
Cocoa	8,451	9,515	9,558	9,418	9,418	9,418
Coffee	9,756	11,134	12,180	13,110	13,583	13,583
Palm Oil	1,694	2,157	2,166	2,163	2,163	2,163
Rubber	3,933	4,461	4,637	4,616	4,616	4,616
Tea	5,677	5,205	5,358	5,358	5,358	5,358
Copra Oil	2,381	2,698	2,731	2,731	2,731	2,731
Logs (K/m^3)	210	243	246	246	246	246

Minerals	2015A	2016E	2017P	2018P	2019P	2020P
Gold (US$/oz)	1,160	1,267	1,301	1,315	1,331	1,354
Copper (US$/ton)	5,502	4,724	4,832	5,084	5,123	5,294
Oil: US$/barrel)	49	42	50	54	55	57
LNG (US$/Mcf)	8	7	8	9	9	9
Nickel (US$/tonne)	11,831	9,351	10,459	11,374	12,148	12,683
Cobalt (US$/tonne)	29,255	24,212	25,243	25,865	27,046	27,861

Real GDP rate of growth – 15th Consecutive Year of Growth

	2015A	2016E	2017P	2018P	2019P
GDP rate of growth (Real)	11.8	2.0	2.8	2.7	2.7

Actual economic growth for 2017 is expected to be 2.8%, up from the 2.0% for 2016. The Agriculture, Forestry and Fishing industry is expected to add 0.8% to GDP in 2017 and 0.9% in 2018. The Oil and Gas sector are expected to contribute negative growth of 0.2% and 0.1% in 2017 and 2018 respectively.

Growth in real GDP	2017F
Australia	3.3%
New Zealand	3.3%
Indonesia	5.3%
Fiji	3.8%
Solomon Islands	3.3%

Consumer price index

	2015A	2016E	2017P	2018P	2019P
CPI	6.0	6.6	7.0	6.6	5.6

Inflation in 2017 is expected to increase to around 7.0%, largely due to the ongoing depreciation in the PNG Kina.

CPI	2017F
Australia	1.3%
New Zealand	1.4%
Indonesia	5.4%
Fiji	2.0%
Solomon Islands	2.5%

Sources: IMF; Department of Treasury

Legend

A - Supplementary
E - Estimated
P – Projected

Revenue

Total Revenue & Grants

K (in millions)	2015A	2016F	2017F	2018F	2019F	2020F	2021F
Tax revenue	**9,158**	**8,453**	**9,182**	**9,729**	**10,316**	**10,918**	**11,592**
Taxes on Income, Profits and Capital Gains	5,894	5,375	5,818	6,168	6,525	6,887	7,317
Taxes on Payroll and Workforces	18	17	18	19	21	23	25
Taxes on Goods and Services	2,680	2,513	2,762	2,959	3,166	3,380	3,597
Taxes on International Trade and Transactions	565	547	559	582	604	627	652
Other taxes	-	-	24	-	-	-	-
Other revenue	**1,026**	**748**	**1,246**	**200**	**200**	**200**	**200**
Interest	-	4	4	4	4	4	4
Mining Petroleum & Gas dividends	456	300	500	-	-	-	-
Dividends from Statutory Authorities	85	178	375	45	45	45	45
Dividends from SOEs	370	138	125	35	35	35	35
Other dividends	-	-	75	-	-	-	-
Rent	32	33	51	31	31	31	31
Sales of Goods and Services	65	85	91	76	76	76	76
Other	18	9	25	9	9	9	9
Grants	820	1,881	1,045	1,208	1,128	1,091	1,114
Total revenue	**11,003**	**11,082**	**11,473**	**11,138**	**11,645**	**12,210**	**12,907**

Total Revenue and Grants for the 2017 Budget is projected at circa K11.5bn. The largest revenue item is Income Profits and Capital Gains, estimated at K5.8bn. Personal Income Tax collections are expected to be K3bn, Company Income Tax K2.4bn, and K154m in Mining and Petroleum Tax.

Significant items to be drawn out from the 2017 revenue forecast are the decrease in grant income (resulting solely from the reduced cash inflows from the SWF), the significant reliance in dividend income from government entities and the anticipated increase in taxation collections.

Government expects an increase in revenues in personal and company tax in 2017 partly due to an increase in compliance measures, supported by improved business activity from gradual improvements in commodity prices, better growth outlook for the agriculture and the mining sectors, the elections and APEC constructions.

Agriculture, Forestry and Fishing is forecast to add 0.8% annually to PNG's economy from 2017 through to 2021. A risk for forecast revenues will be a decrease in global prices of soft commodities, which may come from an increase in global supply.

Transfers from the Sovereign Wealth Fund (SWF) are expected to be K77m in 2017 reported as Other General Government Units in Grants. There appears to be a double counting of this revenue stream in the 2017 – 2021 forecast.

A 66% increase in Other Revenue collections to K1.2bn is anticipated. This is made up of K500m from Mining Petroleum and Gas Dividends, K375m from Statutory Authorities, K125m from State Owned Enterprises and K75m from Other.

An issue for the Government has been the difference between the projected revenue and actual collections. For example, there is a K866m shortfall in collections from Provincial revenues as few provinces have the capacity to collect revenue.

To compensate for the reduction in revenues from industry, the Government has gone for the low-hanging fruit in consumption tax revenues, increasing the 'sin' taxes on alcohol and tobacco, and the diesel excise. The Government forecasts Taxes on Goods and Services to increase by K248m to K2.8bn.

Key insights

- All SWF revenue from the Stabilisation Fund will be transferred back to the central government until 2020.
- The collections, particularly at a provincial level, continue to be challenging.
- Significant items to be drawn out from the 2017 revenue forecast are the decrease in grant income, the significant reliance in dividend income from government entities and the anticipated increase in taxation collections.

Taxation

The 2017 Budget introduces a number of significant tax measures which are intended to be broadly consistent with the Taxation Review Committee (TRC) recommendations provided to the Government in late October 2015. All of the key measures ***apply from 1 January 2017***.

2017 Budget Key Changes

1) **Standardised corporate income tax rates**

A standardised corporate income tax rate (CIT) of 30% will apply to all PNG resident companies. The key impact will be a reduction in the CIT for a limited number of petroleum companies that attract corporate tax rate of up to 50%, however, partially offset with introduction of dividend withholding tax to all petroleum companies.

2) **Dividend withholding tax (DWHT)**

There will be changes to the DHWT:

A single DWHT rate of 15% will be introduced for all sectors with an exception only for projects with stability clauses. This will result in:

Petroleum companies: increase in DWHT from nil to 15% and the following potential effective tax rates (ETR):

- No expected change in ETR where stability clause applies
- Dividends to non-residents: increase from 37% to 40.5%
- Dividends to resident individuals: increase from 37% to up to 59.4%

- ***Mining companies:*** increase in DWHT from 10% to 15% and the following potential ETRs:

  - No expected change in ETR where stability clause applies
  - Dividends to non-residents: increase in ETR from 30% to 40.5% for companies with 30% CIT and decrease in ETR from 45% and 50% to 40.5% for companies currently on 45% and 50% CIT respectively
  - Dividends to resident individuals: increase up to 59.4% percent

Non-resource companies: decrease from 17% to 15% (except for certain tax treaty countries where the rate is already 15%) resulting in the following ETRs:

- Dividends to non-residents, including Australian companies: decrease from 41.9% to 40.5%
- Dividends to resident individuals: increase to up to 59.4%

- DWHT will be limited to dividend payments to resident individuals, resident trust estate and non-residents, however it appears that dividends to these entities would no longer be a final tax.
- Further consultation will need to be had with Treasury on whether the effect of some of the changes are consistent with the actual intent. For example, the effective tax rate in respect of the dividends to a resident individual on the top marginal tax bracket may now be as high as 59.4%.
- The provisions in relation to DWHT refund for companies will be repealed. This is in line with DWHT no longer applying to payment of dividends from one resident company to another. Companies that may have accumulated refunds, for example, where it has paid dividends to exempt entities such as superannuation funds, should apply to the IRC for refund prior to the repeal on 1 January 2017.

Key insights

- Resource companies: the measures proposed for resource entities, including extending the additional profits tax to all resource projects and increasing the rate, aligning the corporate and dividend withholding tax rates with non-resource companies and removal of the interest withholding tax exemption for non-resident lenders is expected to significantly impact on the long term project forecasts/models as it is designed to collect additional revenue.
- Foreign contractors: the increase in FCWT to 15% in a regime already regarded as high tax, combined with shortage of foreign currency may result in a reduction in the number of foreign contractors and/or increased cost on local projects as contractors factor this into their pricing. The impact on existing project profitably thus viability should be managed.
- Employee taxes: the increase in taxable value of housing benefits is likely to put further pressure on the cost of hiring expatriates
- Consultation: further consultation will need to be had with Treasury to confirm
  - the intent of the effective tax rate increase to 59.4% in respect of dividends to resident individuals
  - the projects that would be included in the extended additional profits tax for resource entities.
- BEPS country by country reporting: this is likely to add to the already high compliance cost of operating in PNG.

3) Salary and wages tax – employee housing benefits

The existing prescribed values that apply for tax purposes to employees in respect of the receipt of employer provided housing were last updated in 2011. The Government is of the view that these have become overly generous, both in the case of high income earners and from the perspective of all employees who receive such support versus those employees who do not.

Accordingly, the amount of such prescribed values, reformulated the rental levels applicable to various housing classifications and increased the range of urban centres to which these values apply. The newly revised Regulation is thus expected to be as follows:

Type of Housing	Area 1 (K)	Area 2 (K)	Area 3 (K)
Very High Cost house or flat (weekly rent K5001 and above)	2,500	1,500	Nil
Up-Market Cost house or flat (weekly rent from K3001 to K5000)	1,500	1,000	Nil
High cost house or flat (weekly rent above K1000 but less than K3000)	700	500	Nil
Medium cost house or flat (weekly rent K300 – K1000	400	300	Nil
Low cost house or flat (weekly rent below K300)	160	150	Nil
Mess/barracks	60	50	Nil
Government mess/barracks	7	7	Nil
Employees in approved low cost housing scheme	Nil	Nil	Nil

It is easy to observe the two new categories of "Very High Cost house or flat" plus "Up-Market Cost house or flat" and the new and much greater prescribed values applicable to such properties.

What may be less obvious is the 'bracket-creep' that has occurred through the application of High Cost values against properties that were previously within the Medium Cost housing bracket, likewise the application of Medium Cost values against most properties that were previously within the Low Cost housing bracket.

For example, at present a family man working as a middle manager in Port Moresby with employer provided accommodation that costs K1,500 per week is taxed on a prescribed value of K400 per fortnight. From 1 January 2017 that prescribed value will increase to K700 per fortnight. Similarly, a single mother working as a sales assistant in Lae and whose employer provided accommodation costs K750 per week is currently taxed on a prescribed value of K160 but from 1 January 2017 that will increase to K400.

The reach and impact of this regime has also been extended geographically. That is by the elevation from Area 2 to the Area 1 list of the urban centres list of Kokopo, Alatou and Kimbe, in addition to the areas of Buka, Arawa, Lihir and Rabaul having been added to the Area 2 list.

The Government's estimated additional revenue from these measures of only K6 million in 2017 looks very conservative in light of the extent of the prescribed value changes.

4) Resource companies

The following measures apply specifically to resource companies to the extent not mentioned in the other sections of this brief:

Additional profits tax (APT): the APT will be extended to all resource projects including mining. Also, there will be a single accumulation rate of 15% (compared to current 17.5% and 20%) and a single APT rate of 30% (compared to current 7.5% and 10%). There is an exception for projects with fiscal stability clauses. This is likely to have a significant impact in the long term project forecasts/models which do not have fiscal stability agreements and requires an update to existing.

The proposed bill issued as part of the budget papers does not contain amendments to the definition of "resource project" for application of APT. We expect the Government will have industry consultation prior to confirming the resource project definition to confirm which projects will be captured.

Non-resident lender: the tax exemption currently in place in respect of interest income derived by a non-resident lender from a company engaged in mining, petroleum or gas operations in PNG will be repealed. This would result in interest withholding tax applying from 1 January 2017. This is likely to result in increased overall tax in respect of inter-group funding where the offshore entity is unable to claim the withholding tax as a credit, for example, where the offshore company is in a loss position.

Exploration expenditure "double deduction": the double deduction for exploration expenditure for mining companies will be repealed. This needs to be factored into project forecasts/models.

5) Foreign contractors

The Government has re-engineered the FCWT regime. The rate of FCWT was previously an effective rate of 12% on gross contract receipts, calculated based on a deemed profit margin formula. The new FCWT provisions involve a flat withholding tax application but at the increased rate of 15% on gross contract receipts.

The revised provisions also state that ascertainment of FCWT by the Internal Revenue Commission (IRC) will not be deemed to be an "assessment", as that term is formally defined within the tax legislation. This change removes some formal objection rights that might otherwise have been available to affected non-resident taxpayers subject to FCWT.

Also worthy of note is the fact that previous provisions allowing foreign entities within the FCWT regime to apply to the IRC to instead lodge annual income tax returns and be taxed at non-resident rates on a profits basis, will be repealed. We expect this option will remain available to foreign entities that have a permanent establishment in PNG and are resident in countries with which PNG has a tax treaty, by virtue of the existence of "Non-Discrimination" Article in such treaties (such as those with Indonesia, Malaysia and Singapore).

It remains to be clarified as to whether the previous option will still be considered by IRC as effectively available, under the separate general provisions of the tax legislation, to foreign entities that are resident in a non-treaty partner country. If not, it will be interesting to see how the IRC deals with such ongoing taxpayers who had previously been given permission under the old regime not to suffer FCWT and instead lodge annual income tax returns.

6) Transfer pricing and new country by country reporting

Consistent with the forewarning comments in last year's Budget, a new Country By Country (CBC) Reporting regime will be introduced.

The OECD has recently concluded its suggested approach to legislative requirements within its Base Erosion and Profit Shifting or BEPS initiatives. Designed to combat international tax avoidance, these BEPS initiatives have been progressively and rapidly adopted by many tax jurisdictions globally. Though not formally a member of the OECD, PNG has also now chosen to implement some of these measures.

From the PNG perspective, the new CBC reporting rules target PNG resident enterprises that are part of a multinational enterprise (MNE) group. There is a monetary revenue threshold below which the rules to do not apply, but at only K2m for the consolidated group, this is extremely low by comparison with even small overseas jurisdictions.

The new regime requires the PNG entities that must lodge a CBC Report to do so within 12 months of the end of the MNE group's annual reporting period. All PNG resident entities that are the ultimate parent entity of an MNE group must file a CBC Report. In addition, any PNG resident entities that are a constituent member of an MNE group may also need to file if any of the following criteria apply, namely:

- The ultimate parent entity of the MNE group is not obliged to file a CBC report in its home tax jurisdiction, or
- If the ultimate parent is resident in a tax jurisdiction that does not have a binding CBC report automatic exchange agreement in force with PNG, or
- Where the ultimate global parent's tax jurisdiction has suspended or consistently failed to honour its CBC automatic exchange agreement with PNG.

  A PNG resident constituent entity may further avoid the reporting requirement itself if the MNE group has appointed a Surrogate Parent entity, in place of the ultimate global parent, and the IRC is essentially satisfied that it will receive automatic exchange of the CBC report from the home tax jurisdiction of that Surrogate Parent entity.

The CBC Report itself has two distinct detailed requirements:

- One is identification of each constituent entity within the MNE group globally, its location tax jurisdiction wise and nature of each entity's business activities.
- The second is aggregate detail on the gross revenues, profit outcomes, tax paid or payable, capital employed, retained earnings, workforce size and tangible assets for each tax jurisdiction in which the MNE group operates.

  The legislation binds the IRC to only use the CBC Report information for transfer pricing risk assessment purposes, for identifying other BEPS related risks or for appropriate economic and statistical analysis. It also stipulates that transfer pricing adjustments by the IRC will not be based on the CBC report.

Customs & Excise increases

Log Export Tax

The rate of tax on unprocessed logs reverted to a flat rate of 28.5% in 2007. However, since that time the incidence of such exports has increased and at the same time onshore downstream processing of timber has decreased. Accordingly the Government is reverting to the previous system of progressive duty rates, rising as does the USD value of the exported timber. The new rates are to apply from 1 January 2017 and vary from 23.75% at an FOB export price above US$25 per cubic meter, to a rate of 61.75% for a price above US$55 per cubic meter.

Excise Duty on Alcohol

In a move expressed in the Budget Papers as driven by social behaviour plus law and order considerations, the bi-annual capped index rate of Excise on alcoholic products will be increased from 2.5% to 5% as of 1 December 2016.

Excise on Tobacco

For reasons stated as primarily concerned with tobacco's negative effects on health and preventable disease, the rate of Excise on tobacco products will see a one-off 15% increase as at 1 January 2017, following the normal fixed 5% bi-annual index increase that will still apply on 1 December 2016.

Excise on Diesel

In a measure to assist road network upgrading and maintenance across PNG, the rate of Excise on both locally produced and imported diesel will be increased from 6 toea per litre to 10 toea with effect from 1 January 2017. Of that 10 toea 4 will be remitted to the National Roads Authority, which previously only received that share from locally produced product.

Other Tax Increases

- Departure Tax: this will increase from K30 to K114.
- Bookmakers Turnover Tax: In a move stated to restore the value of the turnover tax which the Government considers having been eroded by inflation for more than 10 years, the stamp duty impost will be repealed and the rate of turnover tax increased to a flat 15%. This measure, somewhat ironic for its announcement on this budget day which coincided with the 2016 Melbourne Cup, will also commence from 1 January 2017.

  Gaming Machine profits distribution change

  Under relevant legislation the gross profits from licensed gaming machine takings has previously been split 46% to Government, 25% to the machine permit holders and 14% to a Community Benefit Fund. From 1 January 2017 the Government's share will rise to 55%, whilst that of permit holders reduces to 20% and that of the Fund to 10%.

Other changes

- The tax exemption currently available in respect of sale of shares on the Port Moresby Stock Exchange by a non-resident beneficial shareholder will be repealed.
- The tax exemption currently available for certain defence personnel will be repealed.
- Various technical amendments and repeal of outdated sections.

TRC recommendations

There are still significant matters form the TRC recommendations that have not been reflected in the current budget. These include:

- Thin capitalisation rules: alignment of rules for resource companies with non-resource companies.
- Introduction of Capital Gains Tax (CGT)
- Increase in GST rate to 15%

Infrastructure Expenditure

Spending Commitment

The Government recognises that lack of infrastructure in PNG is a significant impediment to economic growth. However in line with the fiscal restraint underpinning the 2017 Budget, capital expenditure on infrastructure is projected at K836m down from the K1.4bn committed in 2016. The Government intends to seek assistance from its development partners in delivering infrastructure.

Key focus areas remain Transport and Utilities.

Transport

Improving the three modes of transport is fundamental to establishing an investment platform as a basis for sustainable economic growth and effective social service delivery in PNG.

The following tables detail capital spending on transport infrastructure and some key projects for 2017.

Transport Infrastructure Spending

Mode	Funding K'm
Air Transport	126
Road Transport	503
Maritime Transport	24
Total	653

Major Transport Infrastructure Projects

Project	Funding K'm
Missing Links	28
Highlands Highway	157
Coastal Roads	60

Sources: Department of Treasury

Utilities

The Government has allocated funding for utilities of K193m. Key projects in the power sector include Port Moresby Grid upgrade K12m, Ramu Power upgrade K30m and the Town Electrification Improvement Program K27m In water K102m has been allocated to WaSH the water, sanitation and hygiene program. There is also provision for further investment in the National Broadband Network.

Public Private Partnerships

Public Private Partnerships (PPP) remain a critical element of the Government's National Reform Agenda.

The pressure on Government spending and the establishment of the necessary legislative and regulatory framework and machinery for implementation will provide an opportunity for increased private sector involvement in delivery of infrastructure.

Key insights

- The 2017 Budget projects a 35% reduction in infrastructure spend, and as this is a key focus area, it is imperative that Government progresses private sector partnerships

Sub-National Expenditure

There are social and economic differences amongst the provinces, and each province has a different cost due to its unique characteristics (for example, population and remoteness). Part of the aim of the expenditure program is to achieve equity across the provinces.

There are also differences in the ability of the different levels of government to raise revenue, and it has been determined that it is more efficient for the central government to collect most of the taxes and the provinces to deliver the services. Thus the national government collects 95% of tax revenues and redistributes it back to the provinces to spend on activities like health centres and schools.

Provincial/District expenditure

K'm	2016E	2017F
Provincial	4	4
% of budget	29%	27%

Source: Department of Treasury

Provincial expenditure has continued to increase both in real terms and as a percent of overall budgeted expenditure, reflecting the importance the government places on delivering services to rural and remote parts of PNG, and allowing greater autonomy at a Provincial and District level.

The K2.2bn operational expenditure consists of K1.5bn in Personal Emoluments and K591m in Goods and Services. Part of this money is used to pay teachers and other public servants.

The K1.4bn capital expenditure funds the Provincial Services Improvement program (PSIP), District Services Improvement Plan (DSIP) and Local Level Government Services Improvement Program (LLGSIP).

K'm	2016	2017
PSIP (per province)	5	5
DSIP (per District)	10	10
LLG (Per LLG)	0.1	0.1

Source: Department of Treasury

The 20 Provinces, 1 Autonomous Region and 1 District Commission will receive K220m in total, the Districts a total of K890m, Local Level governments K32m and Wards K62m in total (K10,000 per Ward), consistent with 2016 allocations.

Fiscal Discipline Capacity and Frameworks

The success of Government's strategy of decentralization hinges on the ability of Provincial and District administrations to become effective implementing agencies. Key implementation challenges to be overcome at a sub-National level continue to be limited focus on strategic planning, inefficient and poorly controlled procurement processes and limited project management capability.

Although there are Minimum Priority Activities (that must be funded from service delivery grants) and Performance Indicators, Provinces are struggling to implement their budgets. In 2016 only 2 out of 20 provinces had spent more than 80% of the funds they had received, and 7 provinces had spent nothing. Whilst 1 province had spent a lot on Infrastructure, another province had spent most of their allocation on Administration and Other services.

Spending money in an economy has a multiplier effect – the injection of money leads to more spending, which creates more income, and so on. The multiplier effect can be large if there is little savings (which reduces the effect).

It is hoped that in 2017 (an election year), more funds are injected into the provinces, stimulating their economies.

Key insights

- Decentralising the distribution of monies remains important to government
- Only a few provinces are distributing most of their allocated budget and there has been no evidence this will change in 2017

Social Development Expenditure

Direct departmental expenditure

K'm	2016E	2017F	2018F	2019F
Health	1,537	1,221	1,132	1,090
% of total	11.6	20	8.0	7.4
Education	1,243	1,066	1,097	1,151
% of total	9.4	7.6	7.7	7.8

Source: Department of Treasury

Health

Health expenditure of K1.2bn in 2017 is compared with the 2016 supplementary budget of K1.5bn which is a 20% decrease.

Key health activities for 2017 include the following:

- Drug Restraint TB emergency operation and MDR TB prevention newly funded with K13m;
- Community Health Workers newly funded with K5m and K10m in funding of Community Health Posts, a K8m increase from 2016; and
- Health and education procurement facility newly funded with K106m and capacity building service centre project funded with K106m, an increase of K25m from 2016.

2017 also sees some cuts in cost / appropriations from 2016 which include:

- A cut of K18m from K30m to K12m in pre-service and in-service training and staff development;
- A cut of K20m from K180m to K160m in medical supplies and procurement and disbursement expenditure;
- A cut of K28m from K30m to K2m in PNG Health and HIV financing programs; and
- Conclusion of the PNG Health and HIV Procurement program and the Rural Primary Health Service Delivery project ended K171m in expenditure.

Education

Education expenditure of K1.1bn in 2017 is set against the 2016 supplementary budget of K1.2bn, a decrease of 14%.

In 2017, the Department of Education continues to receive a significant portion of the Education sector budget (K868.1m or 75%) which includes a capital component of K182.5m (15.7%).

Key 2017 education activities include the following:

- Subsidies paid to support key government policies including the Tuition Fee Free policy are maintained at a cost of K602m. These funds are no longer warranted by the Department of Education, but rather through the Department of Finance due to delays experienced by the schools in receiving funds;
- Development and implementation of education standards through funding K38m in education training, an increase of K17m from 2016; and
- Grant and transfers to individuals and non-profit organisations funding of K46m, an increase of K10m from 2016.

2017 also sees some cuts in cost / appropriations from 2016 which include:

- A cut of K30m from K87m to K56m in the PNG Education Programme under the Basic Education activity;
- A cut of K12m from K51m to K39M in General Secondary Education under the Secondary School Equipment activity;
- A cut of K13m from K34m to K21m in Teacher Education under the Pre-service Teacher Education and Teachers In-Service and Elementary Teachers Training activities; and
- A cut of K57m from K129m to K72m in construction, rehabilitation and building improvements for the West Pacific University, Divine Word University, Pacific Adventist University, the Teacher's College and Nursing College.

Key insights

- New and increased funding to address TB, develop and establish community health posts and workers and education and capacity building centre.
- K602m funding maintained for free education in PNG.
- The conclusion of two significant health programs ceasing K171m of expenditure.
- Significant reduction in the procurement of medical supplies.
- Significant reductions in expenditure for training, development and support of health and educational personnel.
- K57m reduction in construction, rehabilitation and building improvement projects for the country's universities.

Budget Financing

Financing Requirement

Total public debt is estimated to increase to K21.6n at the end of 2017. Of that, domestic debt comprises K13.4bn in 2016, rising to K13.5bn in 2017.

The Government has forecast a net borrowing requirement of almost K1.9bn in 2017. Total government debt will increase by K6.5bn by 2020.

K'm	2016E	2017F	2018F	2019F
Net Borrowing (K'm)	1,839	1,877	1,840	1,570
% of GDP	1.2	2.5	2.3	1.8
Total Central Government Debt (K'm)	19,785	21,623	23,463	25,033
% of GDP	29.4	28.8	28.8	28.1
Forecast GDP (K 'm)	67,300	74,987	81,396	87,240
Implied GDP growth (%)	31.9	11.4	8.5	7.2

Source: Department of Treasury

Under the Fiscal Responsibility Act, debt to nominal GDP is limited to a maximum of 30%. The debt-to-GDP ratio is forecast to decline from the 2016 level of 29.4% to 28.8% in 2017 and 2018.

Financing Strategy

Net domestic raisings in 2017 are forecast to be K217m from Treasury bond issuance and K63m from Treasury Bills (maturities of less than 1 year).

	K'm	2016E	2017F
Domestic	Treasury Bills	5,721	5,658
	% of Debt	28.9	26.2
	Inscribed Stock	7,649	7,866
	% of Debt	38.6	36.4
International	Foreign Bonds	1,656	1,500
	% of Debt	8.4	6.9
	International Agencies	6,415	8,098
	% of Debt	32.4	37.4

Source: Department of Treasury

Local superannuation funds and financial institutions are concerned about internal limits and increasing exposure to government (fixed income) assets, and the auctions for government securities have reflected that – in October 2016 only K5m was bid for K20m offered. This trend is likely to continue in 2017 and consequently the price the Government has to pay on domestic borrowings will likely increase. More importantly, refinancing risk may be an issue.

The 364 day Treasury Bill yielded 7.7% in October 2016. The annual inflation rate is expected to rise to 7.0% in 2017 so investors' real return will be approximately 1.1%.

PNG ran budget surpluses from 2004 to 2012 and during this time accumulated K9.7bn in trust accounts to be used for expenditure programs. In 2016 K792m was appropriated, and K802m will be appropriated for the 2017 Budget.

The 2016 Budget included the issue of a Sovereign Bond to raise K2.8bn which is yet to occur. The Government borrowed US$200m through a syndicated loan organised by Credit Suisse in August 2016, and a second tranche is expected to be completed in November 2016. These raisings satisfy the current requirement for finance, and the Government expects the ongoing requirement to be financed by international agencies (for capital works and infrastructure projects).

Key insights

- Decreased appetite from local superannuation funds and financial institutions for government securities
- Increasing cost of domestic funding for the Government
- US$200m increase in external (international) funding in August 2016, another US$200m expected in November 2016
- K802m of budget deficit to be funded through drawing on trust accounts
- Discussions on the sovereign bond issuance, in order to restructure the debt portfolio, are continuing

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