PAPUA NEW GUINEA

2020 Budget Review

A Review of the Budget's Major Business Implications

28 November 2019

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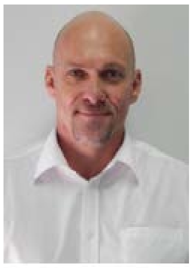

Louwrens Erasmus

Executive Summary

The Marape-Steven Government today presented its National Budget under the recurring theme "**Take Back PNG**". It continued the strong criticism it has had of the budget and economic management of PNG's predecessor government for its excessive expenditure, dramatically increased borrowings and misrepresentation of the true position of the PNG economy. The Government's choice between running continued deficits and abandoning some fundamental social support development appeared stark.

With that context in mind, moving from an adjusted 2019 budget deficit of K3,504m planned pursuant to the 2019 Supplementary Budget handed down several months ago to a projected 2020 deficit of K4,631m certainly was eye catching.

The Supplementary Budget had set out substantial cuts from the Service Improvement Program (K286m), the Public Investment Program (K795m) and K400m from the operational budget.

On the revenue side, the Government budgets for an increase in tax revenue of K713m (to K11,161m) over the amount predicted in the Supplementary Budget (K10,447m). This may be a challenging figure in light of reduced growth expectations for the PNG economy in 2020 of 3.3% real non-resource growth and overall GDP growth of 2.0%, the forex shortage and the tough economy of 2019 and prior.

On the expenditure side total expenditure rises from K16,526m to K18,726m. One component of that, the previous Government's recorded increases in its public service wages bill over the past years seems to continue with Compensation of Employees rising from K5,379m in the 2019 Supplementary Budget to K5,672m in the 2020 Budget. These figures do not include exit payments such as retrenchment and retirement. The Government has however flagged its intention to manage the salary overruns. Gratifyingly, the Government has also telegraphed a clear commitment to meeting some of its outstanding debts to the tune of K1,050m in 2020.

With a deficit of the size of K4,631m projected, the two immediate questions that spring to mind are how the deficit is being financed and what strategies underlie the projected expenditure.

On the first question, the Government has stated it will use some K1,365m in existing concessional loan programs, an Australian budget support facility (publicly announced previously to total K1 billion), budget support facilities from the ADB and World Bank totaling K548m, K967m through an ADB partial guarantee scheme and K757m from issuing new domestic debt.

On the second question the Government has recognized that capital expenditure, which took a significant hit in the 2019 Supplementary Budget, is necessary to grow the economy and budgets an increase of 8% (K5,980m) compared to the 2019 Supplementary Budget appropriation (K5,497m). The Government flags expenditure supporting agriculture and livestock, tourism, forestry, fisheries and SME development. The road network is an important element which gets a K200m 2020 down payment for future development and the transport sector is allocated K1,600m overall.

The Government has shown commendable restraint in not imposing substantial tax increases, with some predicting a GST rate increase and increases in personal tax, in an economy that is apparently struggling. Tax reform measures include the development of a simplified SME tax regime to assist the small business sector while bringing them into the tax net and some selective tax changes such as an increase in excise on some alcohol products and log products. That said, the Government has flagged potential tax increases in the banking and the telecommunications sector and it is understood that they are still considering the imposition of capital gains tax.

However, one tightrope the Government negotiators will have to walk is to deliver on increased tax contributions it seeks from the extractive industries sector while still bringing home the delivery of the Papua LNG project, the P'nyang gas project and the Wafi-Golpu gold mining project, among others. It is also well understood that the P'ynyang and the Papua LNG projects are interdependent. Industry players will be watching closely.

In summary, the Government has shown considerable commitment to maintaining the country's social and economic development, while seeking to fine tune its revenue, expenditure and its borrowing costs. One can only wish them every success, particularly given the current depressed business sentiment.

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.

Agriculture (K/tonne)	2019P	2020P	2021P	2022P	2023P	2024P
Copra	2,386	2,608	2,839	3,086	3,201	3,266
Cocoa	7,793	8,600	9,348	10,161	10,540	10,755
Coffee	9,934	12,120	14,657	15,932	16,527	16,864
Palm Oil	1,746	2,150	2,337	2,540	2,635	2,689
Rubber	4,752	5,119	4,706	4,706	4,706	4,706
Tea	4,233	4,255	4,260	4,260	4,260	4,260
Copra Oil	2,371	2,578	2,802	3,045	3,159	3,223
Logs (K/m2)	322	356	316	343	356	364
Minerals	**2019P**	**2020P**	**2021P**	**2022P**	**2023P**	**2024P**
Gold (US$/oz.)	1,380	1,510	1,536	1,558	1,577	1,596
Copper (US$/tonne)	5,989	5,849	5,900	5,946	5,983	5,994
Oil (US$/barrel)	58	54	52	51	51	51
LNG (US$/thousand cubic feet)	10.5	10.5	10.5	10.2	10.5	10.5
Condensate (US$/barrel)	58	54	52	51	51	52
Nickel (US$/tonne)	10,782	11,034	11,566	11,973	12,395	12,395
Cobalt (US$/tonne)	22,258	23,180	24,050	24,500	25,000	25,000
Consumer Price Index & Real GDP growth	**2019P**	**2020P**	**2021P**	**2022P**	**2023P**	**2024P**
CPI - Year average (%)	4.4	5.7	6.7	6.8	6.5	5.7
GDP rate of growth - Real (%)	5.0	2.0	2.8	2.9	3.2	3.3

Source – Department of Treasury

Revenue

Total Revenue and Grants

Total Revenue and Grants 2019-2020							
K (in millions)	**2017A**	**2018A**	**2019S**	**2020P**	**2021P**	**2022P**	**2023P**
Tax revenue	**9,141**	**10,476**	**10,448**	**11,162**	**12,103**	**13,393**	**14,623**
Taxes on Income, Profits and Capital Gains	5,317	6,119	5,983	6,244	7,078	7,762	8,433
Taxes on Payroll and Workforces (training levy)	11	9	2	-	-	-	-
Taxes on Goods and Services	3,255	3,537	3,693	4,065	4,092	4,657	5,295
Taxes on International Trade and Transactions	558	811	770	852	933	974	895
Other revenue	**943.8**	**1,774**	**1,631**	**2,002**	**1,950**	**1,975**	**2,025**
Grants	**1,440**	**1,836**	**943**	**932**	**1,008**	**1,093**	**1,077**
Total revenue	**11,525**	**14,085**	**13,022**	**14,096**	**15,061**	**16,461**	**17,724**

Source – Department of Treasury

Between 2014 and 2017 Government revenue declined year on year. This trend was reversed in 2018 when total revenue increased by 22%. The 2019 Budget forecasted only a minor increase in revenue to K14.3bn. Flat business trends, the re-emergence of the foreign exchange imbalance issue and the downtrend in mineral and petroleum commodity prices resulted in a lower than expected income tax collection in 2019 and a reduction of K1.24bn in revenue in the Supplementary Budget.

The 2020 revenue forecast is K14.10bn representing an overall increase of 8.2% compared to the 2019 Supplementary Budget. Total revenue and grants for the 2020 Budget consists of tax revenue of K11.16bn, other revenue of K2.00bn and grants of K932m. The forecast assumes a recovery in economic growth (in particular in the agriculture, forestry and fishing sectors), Government spending and private sector credit growth and an expected increase in gold prices. Further, the introduction of new revenue measures is expected to raise K218m to support revenue collections in 2020.

At only 1.1% of GDP it is clear that, although welcome, Government is certainly not dependent on grant funding the way it may have been in the past. Development partners, such as the Asian Development Bank (ADB), European Union (EU), Australian Aid and others are expected to get on board and provide support through higher grant allocations going forward. The majority of grant funding is expected from DFAT as in the past, with the United Nations and European Union contributions expected to reduce.

Tax revenue comprises 79.2% of the overall revenue budget and 12.1% of GDP. Within this category, taxes on Income and Profits is estimated at K6.25bn, being an increase of K261m over the 2019 Supplementary Budget. Personal Income Taxes are expected to increase by K265m to K3.22bn underpinned by employment growth and annual salary increases.

Corporate income tax (CIT) is projected to increase by K198m to K2.09bn underpinned by growth in the non-mining sector and a new banking levy to be collected in 2020. However we note the introduction of the banking levy is subject to a consultation process with stakeholders in 2020. While growth is expected in taxes to be collected from the non-mining sector, this increase is partially off-set by a reduction in mining and petroleum taxes of K272m due to elevated geopolitical tension resulting in a moderately sluggish commodity price trend in 2020. Other income taxes are expected to increase by 16.5% to K421m primarily driven by the collection of non-resident insurers' withholding tax of K33m.

The prohibition of the credit off-set against salary or wages tax liabilities will remain in effect, supporting the cash flow position of the Government.

Indirect taxes are forecast to increase by K372m to K4.07bn primarily in the area of GST (as in previous years) and Excise Duty. Following the freeze of excise base rates for alcohol and tobacco in 2019, the new budget reverses this concession by applying a one-off 10% increase effective from 1 December 2019 and the reintroduction of indexation from July 2020 (5% every 6 months). This is expected to result in a 21% increase in excise revenue to K1.21bn.

Export tax revenue will be boosted to K425m by increasing excise duties on the export of unprocessed logs other than plantation logs. This measure is aimed at balancing the perceived underpayment of corporate income taxes due to alleged transfer pricing activities by certain logging companies.

Under other revenue, dividends from mining, petroleum and gas areas, (specifically K500m from Kumul Petroleum Holdings and K300m from the Ok Tedi mine) represent the major revenue source contributing 76% of total dividends. There is no major change in dividend revenue from 2018 and the 2019 Supplementary Budget. The increase in other revenue derives from statutory transfers of K348m.

The Government's revenue target, excluding grants, is to reach 19.0% of nominal GDP by 2024, above the 14.0% target for 2022 in the current MTRS. The higher revenue growth rate compared with the nominal GDP growth rate reflects expected improvements in efficiency in the tax collection system with a greater share of the revenue mix coming from resource projects.

Key insights

- The revenue targets in the 2019 Supplementary Budget are supported by an increase in IRC revenue collection activities. We expect to see continued and possibly increased activity by the IRC in 2020 given the higher tax revenue targets for 2020. This is highlighted by Government's comments in relation to required oversight by Treasury of administrative reforms and collection by IRC.
- The banking levy has been included in corporate income tax projections although we note its introduction is subject to a consultation process with relevant stakeholders in 2020.
- While Government is not heavily dependent on grant funding there is room to obtain more grants by demonstrating good project management and project delivery on the ongoing grant projects.

Taxation

The 2020 Budget introduces a range of tax measures aimed at helping finance the high level of fiscal imbalance. The changes focus on areas with perceived damaging societal impacts (such as logging and drinking) and seeks to target groups such as the banking and telecommunications sectors rather than ordinary citizens. As expected the tax changes also support the Government's agenda in relation to SMEs. Unless otherwise noted the measures mentioned below apply **from 1 January 2020**.

Income Tax Measures

New and Immediate Tax Changes

Provisional Tax

Currently provisional tax is due in three equal installments on 30 April, 31 July and 31 October. These due dates will be revised to 90 days, 180 days and 270 days after 31 December for companies with a 31 December fiscal year. While the due dates for companies with an IRC approved substitute accounting period will be amended to 90 days, 180 days and 270 days after the end of the substitute accounting period.

Thin Capitalization

The interest deduction available to companies is restricted where certain debt/equity thresholds are not met. Previously a debt equity ratio of 3:1 applied to resource companies while a ratio of 2:1 applied to other companies. This has now been amended to align the ratio applied to resource companies with that of non-resource companies at 2:1.

Effective 1 January 2019

Carry-forward of Losses

The 2019 Budget saw a change in the rules with regards to the carry forward of tax losses. Due to concerns around how taxpayers could be in business without making a profit for over 20 years, the carry forward periods were to be reduced to 20 years for resource and primary production industries and 7 years for all other taxpayers. During 2019 the IRC advised us that there was a flaw in the legislation, which they intended to amend in the 2020 Budget. They advised that it was intended that losses incurred between 2005 and 2018 could be carried forward to 2025.

The draft legislation does not however appear to achieve this aim. Instead, it appears that a carry forward loss will be denied from 1 January 2019 for losses incurred pre 31 December 2018. We understand that this was not the intention and that the proposed draft legislation is also flawed. We expect that this will be further amended in due course.

Effective 1 January 2018

Tax Appeals

Currently taxpayers must pay the full amount of the disputed tax and penalties if they wish to make an application to a Review Tribunal or to lodge an appeal in a National Court. This is being retrospectively amended so that taxpayers have to pay a reduced amount equal to 50% of the disputed tax and penalties on the assessment.

Subject to Gazettal Notice

Small Business Tax

A new small business tax regime is to be introduced for individuals with businesses other than professional services. The regime will apply to taxpayers with a turnover of up to K250,000.

Taxpayers will be subject to an annual flat tax of K400 where their turnover is less than K50,000. This tax is payable annually by 28 January of the following year.

Taxpayers with a turnover of between K50,000 and K250,000 will be subject to tax equal to 2% of total turnover. This is payable quarterly and within 28 days of each quarter.

Taxpayers are required to opt in and opt out of the regime by application in writing to the Commissioner General. Where an individual has been approved to opt out of the regime they cannot opt back in within three years.

Customs & Excise Measures

The Government has introduced a number of specific customs and excise measures largely aimed at increasing revenue.

Tariff Increases on Tobacco and Alcohol

Excise rates applicable to tobacco and alcohol have increased by 39.8% and 21.5% respectively since 2012. The 2019 Budget announced a suspension in the increase in excise tariff rates which was intended to protect its revenue base by combating illicit trade and supporting local manufacturing.

This position is being reversed in the 2020 Budget by applying a one off 10% increase on excise for alcohol and tobacco starting 1 December 2019 to 31 May 2020. Excise indexation will also be re-imposed with a 5% bi-annual increase from 1 June 2020.

In addition the second excise tier introduced in 2019 to assist local tobacco manufacturers against cheap illicit tobacco products will continue for a further two years. Conditions apply for qualification under the second tier.

To combat the sale of illicit alcohol, the Government is increasing the penalties for the production and sale of "home brews" from K200 to between K1,000 and K50,000, to be administered at judges' discretion.

Local Content Tariff Amendment

The description of tariff code 2206.00.10, which has a concessional rate, is to be broadened in order to encourage the use of other local produce, in addition to fruits, in alcohol production.

Duty Increase on Social Drinks

The rate of duty on social drinks, being drinks with high alcohol mixed with stimulants, is being increased by up to 400%.

Reduction in Excise Duty for Motor Vehicles

A welcome change is the reduction in excise duty rates for the importation of new and used vehicles. From 1 January 2020 vehicles that were subject to excise duty of 100% and above will be subject to a reduced rate of 40% while vehicles that were subject to a rate of between 20% and 100% will be subject to a reduced rate of 20%. For example the duty on cars with a capacity of up to 3,000cc will reduce from 60% (new) and 80% (used) to 20% while the duty rate for sporting and luxury vehicles is reduced from 110% (new) and 120% (used) to 40%.

While this will clearly result in a substantial reduction in revenue the Government has introduced the measure so more ordinary citizens can own vehicles, to reduce the cost of doing business in PNG and to reduce the cost of transporting people and goods.

Export Duty on Unprocessed Old Growth Logs

The Government has suspicions that logging companies in PNG may be using transfer pricing activities to create periods of prolonged tax losses resulting in nil corporate income tax payable. To ensure fair tax treatment consistent with the value of logs, to encourage downstream processing and to act as a default corporate tax the 2020 Budget increases the average progressive export duty rate on unprocessed old growth logs to 50%. This measure does not apply to plantation logs.

Passengers' Personal Effects

The concession on passengers' personal effects threshold for passengers arriving by air is to be increased from K1,000 to K6,000 for passengers 18 years and above and from K500 to K3,000, for passengers below 18 years. The change is proposed due to the compliance costs involved.

Technical Amendment

A technical amendment has been made to correct discrepancies in the coding and descriptions for imported margarine (liquid and non-liquid).

Other Measures

Enhancing Land Rental Collections through Compliance Measures

Government estimates outstanding land lease rentals on 48,000 leases to be K400m for 2013 to 2020. These outstanding land lease rentals are due to a lack of compliance by land leaseholders and issues relating to the ICT system used by the Department of Lands and Physical Planning (DLPP). Government intends to engage external consultants to assist with the ICT project and commence back billing in 2020.

Future Policy Direction and Reforms

Revenue Administration

The Government has stated that actions are required to urgently lift revenue performance and close the compliance gap. The Budget Papers state that the Department of Treasury needs to lift its game in overseeing administrative changes within the IRC to ensure the focus returns to revenue collection. It is also stated that the appointment of a permanent Tax Commissioner will help as long as it is a person focused on reforms to lift compliance and revenues. The IMF is providing technical assistance in this area to support PNG's reform efforts.

Revenue Policy

The Budget Papers state that the Department of Treasury needs to increase its taxation policy function through increased capacity building. This will involve transforming its current Tax Policy Branch into a Revenue Policy Division and improving staff capability with specialized training to analyze tax policy outcomes and introduce new tax policies to counter aggressive tax planning.

Re-write of Income Tax Act 1959

The Income Tax Act is currently being re-written with the intention of making it more user friendly and easier to read. The technical team overseeing this includes officers from the Department of Treasury, the IRC and a tax law expert engaged by the IMF. A final phase consultation with tax agents on the draft legislation will take place in early 2020. The legislation is expected to be passed by Parliament in mid-2020 but its implementation will come into effect from 1 January 2021.

Although not mentioned in the current Budget we understand that the proposed introduction of a Capital Gains Tax regime may be incorporated into the Income Tax Act re-write.

Mobile Telecommunications Sector

It is proposed that a new Universal Access Levy will be introduced on telecommunications in 2020. A consultation process will take place in 2020 involving the Government, National Information and Communications Technology Authority (NICTA) and relevant stakeholders. The levy will be based on turnover and the rate will be set in line with international practice and PNG's needs and may be in the range of 0.5%-4%.

The nature of the revenues this will apply to is yet to be determined however certain exclusions will apply and it will not affect important financial services provided by the banks and financial institutions such as the mobile money services.

The Government also intend to develop proposals to increase the charges on telecommunication license fees as current indications are that they are set at a level which is too low and it is noted that international best practice is to auction these licenses.

Banking License Fees

The Government intends to raise the license fees on banks and financial service operators in 2020. Consultations will commence in early 2020 involving the Bank of Papua New Guinea, the Department of Treasury and relevant stakeholders such as the banks and financial service entities.

The Government will also consider a revenue measure based on the level of foreign exchange spread and transactions.

Infrastructure Tax Credits

The Government has announced a review of the revised Infrastructure Tax Credit guidelines will commence in early 2020. The Government is concerned that the revised guidelines do not provide a modality that is acceptable by programme partners and relevant government agencies. The Department of Treasury will take the lead in the review of the ITC scheme together with the Department of National Planning and Monitoring and other relevant stakeholders.

Tax Clearance

The IRC will be reviewing the tax clearance legal framework and administration in 2020. The IRC will maintain the tax clearance as a tax compliance measure but its administration will become system generated and the certificates will be issued directly to commercial banks.

Refined Petroleum and Diesel Imports

The 2018 Budget introduced a K0.10 per litre tariff on the import of refined petrol and diesel. Due to industry concerns that this has led to a negative impact on business, a special cross Government team made up of ICCC, Office of the State Solicitor and PNG Customs and Department of Treasury will examine these issues. This will take place as part of a review of the Napa Napa Project Agreement and Import Parity Price Formula.

Key insights

- Revenue collection by the IRC will continue to be an area of focus and pressure for 2020. It was clear from the Budget presentations that Government is relying heavily on revenue collection by the IRC.
- Government's focus is on targeting industries perceived to be profitable, rather than ordinary citizens. Fortunately the much rumored income tax and GST increases, which would have impacted ordinary citizens, did not materialize. Instead 2020 will see consultation processes in relation to banking and telecommunications license fees and levies as well as a significant increase in excise on unprocessed exported logs.
- In line with Government's agenda of supporting SMEs a new small business tax regime is proposed which should simplify the process for taxpayers. While it is difficult to see how this regime would generate substantial revenue, given the potential implementation and enforcement costs, we note one of the stated objectives is to encourage taxpayers to enter the formal sector.
- There has been a reprieve, for this year at least, from the introduction of capital gains tax. It does however appear that capital gains tax will form part of the Income Tax Act re-write to be introduced in 2021.
- One of the themes of the Budget is connecting PNG. In line with this new measures include substantial reductions in excise duties on the import of new and used vehicles into PNG. This will be a welcome change for ordinary citizens and businesses.

Expenditure

Budget Component (Km)	2019 Budget	2019 Supplementary Budget	2020 Budget	Change on Supplementary	% of total
Operational	**10,637**	**12,104**	**12,746**	**5.3%**	**68.1%**
Compensation of Employees	4,523	5,379	5,673	5.5%	30.3%
Goods & services	3,031	3,519	3,822	8.6%	20.4%
Function Grants	490	490	509	3.8%	2.7%
Interest repayment of Debt	1,979	2,102	2,157	2.6%	11.5%
GST & Book Makers	614	614	586	-4.4%	3.1%
Capital	**5,497**	**5,046**	**5,981**	**18.5%**	**31.9%**
Public Investment Program	2,563	2,398	2,573	7.3%	13.7%
Service Improvement Programmes	1,174	888	1,110	25.0%	5.9%
Loan Drawdowns	943	817	1,365	67.1%	7.3%
Donor Grants	817	943	932	-1.2%	5.0%
Total Expenditure	**16,134**	**17,150**	**18,727**	**9.2%**	**100.0%**

Source: Department of Treasury

Total expenditure and net lending in 2020 is budgeted at K18,727m, of which, K16,429m is funded by the Government and made up of K12,746m for operational expenditure and K5,981m for capital investment expenditure.

Personnel emoluments have been renamed Compensation for Employees (COE) and the Budget is K5,672m or 45% of the operational budget. The COE budget includes salaries and allowances but does not include social benefits such as retirement, retrenchment, gratuities and superannuation. Funding for social benefits expenditure is captured under the Treasury and Finance Miscellaneous Vote.

The District and Provincial Service Improvement Programs (SIPs) are fully funded at K1,110m. The Government's Public Investment Program (PIP) is budgeted to be K2,573m. The new PIP budget has been revised upwards to correct for the severe undercapitalization of public investment in recent years and incorporation of the new administration's development agenda. The Government also plans on drawing down K1,365m in concessional funding tied to capital projects in 2020. Together the Government's planned capital investment is budgeted at K4,862m and donor grants are estimated at K932m.

At K5.98bn, the Capital Investment Budget is the main expenditure plan of the Government to deliver its key economic development priorities under the theme of "securing our future through inclusive sustainable growth". It makes up 32% of the total. It is underpinned by three imperatives:

- The need to sustainably grow the economy through the creation of enabling infrastructures, more opportunities for PNG, and the delivery of vital services. In particular to leverage PNG's comparative advantages in key sectors and thus prioritizing agriculture, fisheries, tourism and SMEs
- The importance and challenge of securing funding to ensure progressive growth
- The need to share benefits equitably or strategically to realize the national vision

K5.4bn of capital investment is required to implement the MTDP III effectively. Whilst K5.49bn was appropriated in the 2019 Budget, a large portion of that was diverted to current expenditure in the Supplementary Budget of October 2019. Accordingly there is a constrained capacity to progress development priorities which will delay the overall implementation in the face of a growing population, rising inflation and increasing 'bills'.

Expenditure by Sector	Operational	Capital	Total	% of total
Administration	852.3	1,307.7	**2,160.0**	*11.9%*
Community & Culture	65.4	45.0	**110.4**	*0.6%*
Debt Services	2,156.9	-	**2,156.9**	*11.9%*
Economic	276.5	462.5	**739.0**	*4.1%*
Education	1,082.1	160.6	**1,242.8**	*6.9%*
Health	1,320.2	491.0	**1,811.2**	*10.0%*
Law & Justice	1,224.2	178.1	**1,402.4**	*7.7%*
Miscellaneous	2,521.7	-	**2,521.7**	*13.9%*
Provinces	2,346.0	1,274.9	**3,620.9**	*20.0%*
Transport	275.1	1,575.8	**1,850.9**	*10.2%*
Utilities	39.8	485.8	**525.6**	*2.9%*
Total expenditure	**12,160.2**	**5,981.4**	**18,141.6**	***100.0%***
GST	586.0		**586.0**	
Total expenditure	**12,746.2**	**-**	**586.0**	

Source: Department of Treasury

Administration

The Administration sector is focused on governance and public sector management including foreign policy, immigration and natural disaster management. Key projects for 2020 include the National Census, NID project, an integrated tax administration system and several other programs.

A total of K1,536m has been allocated, for the sector of which K887m is operational and K649m is capital. The operational budget consists of K597m for COE and K290m for goods and services.

Funding for big ticket capital items that fall under both Administration and other sectors have been classified as 'Miscellaneous' expenditure which includes Government office allocations (K227m), public sector superannuation (K487m), arrears (K430m) and the retirement exercise (K50m).

Community & Culture

This sector is focused on encouraging inclusive socio-economic growth in Papua New Guinea. The primary expenditure and projects include the 2020 Census (K100m); the PNG Games (K15m); and the Pacific Festival of Arts (15m). A total of K114m has been allocated for the Community and Culture sector in the 2020 Budget of which K69m is operational and K45m is capital. The total operational budget for this sector consists of K42m for COE and K27m for goods and services.

Economic

The Economic Sector focus has historically been on the development of PNG's natural resources for the betterment of its people. This has faced challenges in recent years and accordingly has been reformulated to focus on "inclusive, responsible and sustainable" growth. This includes policies to enable agriculture and SME entities that produce crops and resources locally and will be implemented through key programs such as;

- Supporting PNG businesses and SMEs, particularly in agriculture – K220m
- Strengthening PNG's tourism potential – K36m
- Developing a sustainable fishing industry – K17m
- Development of Special Economic Zones – K16m

In 2020, a total of K742m is allocated to the Economic sector of which K271m is for operational and K471m for capital. The operational budget for this sector consists of K183m for COE and K88m for goods and services.

Education

Key education activities for 2020 include the following:

- Delivering high quality education for lower to secondary students – K52m
- Supporting teacher training – K17m
- School infrastructure – K10m
- Supporting alternate pathways – K16m
- Supporting scholarships and training for the public and private sectors – K98m
- Building up tertiary colleges – K55m

The Government's view is that education should be a shared responsibility between the Government and parents and there is a shift in focus towards high quality education for students with a reduction in funding for the Tuition Fee Free and the placement that funding with a new Tertiary Loan Scheme.

A total of K1,611m has been allocated to the Education Sector of which K165m is capital and K1,240m is operational split K378m for COE and K862m for goods and services.

Health

The Budget has a greater focus on basic primary health care, specialist health care and adequate health infrastructure. Key health activities for 2020 include the following:

- Investing in specialist care in the areas of heart, cancer, TB and HIV / Aids – K25m
- Development of adequate provincial hospital infrastructure – K102m
- Funding support for district hospitals – K23m
- Prioritizing health frontlines and strengthening institutions – K13m
- A new hospital in Enga (partly funded by a K105m loan)

A total of K1,611m has been allocated to the health sector for the 2020 Budget. This is to ensure that on-going critical investments are continued and completed and new investments focusing on improving access to quality basic primary health is achieved. The sectors total budget comprises of K1,388m for the operational budget and K223m for the capital expenditures. Of the operating budget, K747m is assigned for COE and K640m is for goods and services.

Law and Justice

This sector remains a key priority for the Government as it is a critical enabler for social, economic and political developments. The sector will continue to benefit from support from the Justice Services and Stability for Development support from DFAT-AU and the police with support from the Australian Federal Police. The areas of focus are:

- Boosting law and justice infrastructure – K100m
- Improving case management systems and capacities – K7m
- Australian Aid supporting infrastructure and institutional strengthening – K32m
- Capital improvement of the Waigani Court complex – K100m

A total of K1,512m has been allocated to the sector, of which K1,284m covers the operational and K229m the capital expenditure budget. Of the operational budget, K886m is for COE and K397m for goods and services.

Provincial

The Provinces sectoral objectives are to provide improved service delivery to the rural population and build and improve capacity development for both institutional and human capital. The Government is focused on building capacity in human capital and infrastructure through the use of the established District Development

Authorities (DDAs) to deliver strategic infrastructure investments of district hospitals, court houses, police stations, markets, district communities and other economic and social facilities. The low Human Development Indicator (HDI) ranking is a source of disappointment and a challenge for the Government.

Provincial expenditure has been set at K3,689m of which K2,362m is operational and K1,327m is capital in nature. Of the total budget for operational expenditure, K1,819m is allocated for COE and K543m for goods and services.

Transport

The Government aims to boost the transport sector by focusing on a number of transport corridors, supported by technology, as a key part of their development strategy to open up the economic potential of PNG. Significant efforts will be put into arresting the deteriorated transport infrastructure assets including reconstruction of sections of the national highway, rehabilitation of selected provincial roads and extension of Port Moresby International Airport.

In 2020 the key targeted focus will be on:

- Increasing the total length of national roads to 10,000 km
- Increasing the number of operational national ports to19
- Upgrading the number of airports for higher seating capacity aircraft to 14

A total of K996m has been allocated for the transport sector of which K381m is operational and K615m is capital. The total operational budget consist of K127m for COE and K254m for goods and services.

Utilities

The Government focus is on providing key affordable utilities as a critical service and economic enabler. Investments will look to improve the quality of lives of citizens through access to effective communication, clean energy, more access to power, and improved water supply and sanitation. Key projects include:

- Delivering national energy grids and powering households – K220m
- Scaling up urban and rural water supply and sanitation – K128m
- Working towards a digital PNG through improved information and communications – K234m

In addition, a number of key projects are being funded by development partners such as the Coral Sea submarine cable due to be completed shortly and the Kumul submarine cable funded by K10m of Government funding and a K115m loan. The Utilities sector has been allocated K194m in the 2020 Budget of which K40m is for operational expenditure and K154m for capital expenditure. The operational budget consists of K29m in COE and K11m for goods and services.

Key insights

- The Budget strikes a balance between the funding of recurring expenditure and the need to boost capital investment to enable future growth.
- The focus areas appear sensible, leveraging off PNG's competitive advantages.
- The Government will seek further grants to finance capital expenditure.

Budget Financing

Financing Requirement

The Government has forecast a net borrowing requirement of almost K3.58bn in the 2020 Budget, or 3.4% of GDP, which exceeds the 2019 revised net borrowing of K2.86bn. Net borrowing is projected to decline to K2.84bn in 2021, or 2.8% of GDP, as revenue is forecast to grow as a percentage of GDP. The summary of key metrics is set out below.

Key financing metrics						
K (in million)	**2019S**	**2020P**	**2021P**	**2022P**	**2023P**	**2024P**
Net borrowing (excl. arrears)	2,863	3,579	2,839	2,304	2,142	2,293
Additional provision for arrears	641	1,052	837	-	-	-
% of GDP (excl. arrears)	*3.4%*	*3.9%*	*2.8%*	*2.1%*	*1.8%*	*1.8%*
% of GDP (incl. arrears)	*4.1%*	*5.0%*	*3.6%*	*2.1%*	*1.8%*	*1.8%*
Total Government debt	32,536	37,187	40,863	43,193	45,335	47,628
% of GDP (incl arrears)	*38.5%*	*40.3%*	*40.5%*	*39.0%*	*38.1%*	*37.6%*
Forecast GDP	84,554	92,206	100,898	110,728	119,113	126,776
Nominal GDP growth (%)	*6.8%*	*9.0%*	*9.4%*	*9.7%*	*7.6%*	*6.4%*
Real GDP growth (%)	*5.0%*	*2.0%*	*2.8%*	*2.9%*	*3.2%*	*3.3%*

Source: Department of Treasury - 2020 National Budget, Volume 1

Legend: S = Supplementary, P = Projected

Additionally, a K1.15bn arrears provision is planned for 2020 which will push PNG to a record debt/GDP level of 41%. Arrears provisions contain the following payments:

- 3% pay increase (K300m) for public servants back to 2017
- Exit arrears of K300m to retire 2,000 public servants, which costs c. K100-120m per annum
- Contractual arrears of K500m

The Government sees the 2020 deficit as an opportunity to correct its estimate of debt stock for the purposes of prudent debt sustainability.

Under the revised Fiscal Responsibility Act, debt to nominal GDP is limited to a range of 40% to 45%. The debt to GDP ratio is estimated at 38.5% in 2019 and is forecast to increase to 40.3% in 2020. This includes a K1.7bn provision for arrears until 2020.

Financing Strategy

Gross Government debt is estimated to increase to K32.5bn in 2019 and to K37.2bn in 2020, as set out below in the allocation of Government debt.

Allocation of government debt				
K (in million)	**2019S**	***% of debt***	**2020F**	***% of debt***
Domestic				
Treasury Bills	9,225	*28.4%*	10,013	*26.9%*
Inscribed Stock	7,722	*23.7%*	8,552	*23.0%*
Loans	1,146	*3.5%*	1,076	*2.9%*
Total	**18,093**	***55.6%***	**19,640**	***52.8%***
International				
Debt securities	1,672	*5.1%*	1,701	*4.6%*
Loans	12,771	*39.3%*	15,846	*42.6%*
Total	**14,443**	***44.4%***	**17,546**	***47.2%***
Combined total	**32,536**	***100.0%***	**37,187**	***100.0%***

Source: Department of Treasury

The Government will release a revised medium-term debt strategy, which will focus on exploiting cheap and concessional financing from bilateral and multilateral sources and with an objective to reduce the debt to GDP ratio to below 40.0% in the medium-term and reduce interest costs in the short-term. Cheaper loan financing is expected to be achieved using an ADB partial guarantee scheme up to US$300m.

In parallel, the Government is committed to rebuilding its fiscal credibility. It will explore the option of an IMF Staff Monitored Program to lift PNG's profile and credibility which may open the door for a greater number of better quality and cheaper financing.

By the end of 2019, the Government was able to secure two external Budget support loans from Export Finance Australia (EFA) of US$300m (K968m) and US$100m (K323m) from the Asian Development Bank.

The Government plans to increase its access to financing through concessional loan facilities already available on planned projects to K1.37bn. The concessional financing meets up to 25% of Government's capital funding requirement for 2020. This will allow BPNG to increase the forex it injects into the local market from US$30m to US$50m per month.

In 2020, external financing of the Budget deficit from grants and support financing, together with concessional, commercial and other sources are likely to be the main support for foreign exchange reserves. Foreign exchange reserve levels are projected by BPNG to decrease modestly by 0.1 per cent by the end of 2020, maintaining total import cover of 5.7 months.

Key insights

- The foreign exchange imbalance issue may be worsened by the forecast decline in the mining sector for 2020.
- The increased level of debt will result in increased interest and debt service for the next few years which may narrow investment opportunities.

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