PAPUA NEW GUINEA

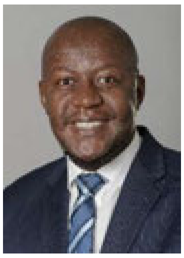
2021 Budget Review

A Review of the Budget's Major Business Implications

18 November 2020

Contents

Zanie Theron



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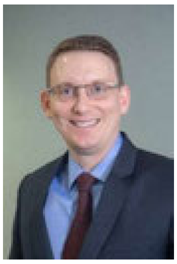
Pieter Steyn



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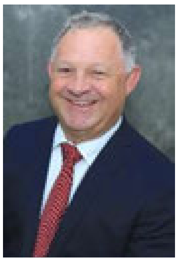


Wayne Osterberg

Executive Summary

The 2021 Budget was delivered unexpectedly yesterday with the usual Budget Lockup and briefing not occurring. In contrast with previous years, the budget documents were not distributed in the usual manner. This has certainly been a year of firsts, and against the backdrop of the global pandemic, very little would surprise business in this land of the unexpected.

The "Consolidation for Growth" message this year under the existing main theme of "Take Back PNG", focuses on the need to consolidate the vision in times of crisis. In this regard the Treasurer's speech makes specific reference to the country having been in an economic crisis since May last year and the effects of the current COVID-19 pandemic. On a positive note the 2021 Budget is described as a responsible and steady approach to debt and deficit levels, while demonstrating growth prospects, and the path to exit the current areas of crises.

The 2021 Budget is comprised of elements of the 2020 Supplementary Budget released in response to the COVID-19 impact and sets the stage for fiscal consolidation over the medium term. This Budget is once again a high deficit budget. In our commentary last year we referred to the projected 2020 deficit of K4,631m as "eye-catching", and this was certainly exacerbated by the Supplementary Budget deficit of K6,630m.

The K6,612m deficit projected for 2021 is perhaps more realistic if achieved, and in line with the actual outcome for 2020. This challenging deficit budget is comprised of revenue of K12,995m and expenditure of K19,607m. This will increase the level of public debt (excluding valuation changes and outstanding arrears) to K46,464m which is 51.5% of GDP. On a percentage basis, the planned revenue growth exceeds the expenditure increase by around 5%, and this element of claw back is consistent with the 'consolidation for growth' theme.

On the revenue side, the K12,995m budgeted is funded through mainly local tax collections of K11,110m and international donor aid of K1,008m. It is noted that international donors may have increased governance and fiscal requirements to provide facilities, such as SOE reforms. On the tax collection front, a point to note is the expected lag in revenue which is highly dependent on the timing of the start-up of resource projects, a point which is acknowledged by the Treasurer. There is therefore very little dependency on the resource sector as a major source of tax revenue over the next two years. It is notable that the Budget is silent on the potential introduction of a Production Sharing Contract regime and its effect on the investment appetite of resource majors.

On the expenditure side total expenditure rises from K18,726m to K19,607m. Health, education, and law and justice are the focus areas as in the past, with the increases attributable to COVID-19 and local debt arrears funding requirements. The payment of outstanding government accounts is vital to get the private sector up and running and availability of forex will continue to be important. The recently established Arrears Verification Committee appears to have made positive progress to start clearing long outstanding local business debt, which will serve to restore some trust in government and improve its ability to source goods and services. To date K143m of a thus far verified K657m in arrears had been repaid. In this vein, Government appears positive that the recent changes to the Central Banking Act will enable it to further improve cash flow management.

During the previous Budget it was noted that the public services wages bill, which is significant, continues to increase year on year. It is evident that a fundamental decision at the institutional level will have to be made in the coming years. It is telling that there is no mention of right-sizing the public service in the 2021 Budget although the compensation of employees cost projections to 2023 show a reduction which may be an indicator of some reform in this sector.

There are no real surprises on the tax front as certain expected tax reforms have again not been implemented. For example, not taken up were the proposal to abolish stamp duty on leases and hire purchases, tailored SWT filing and payment obligations, and mandatory EFTPOS use for sales exceeding K1,000 to avoid GST leakage. The only reform to be implemented is around the collection of prescribed royalty withholding tax directly from resource developers. As in previous recent Budgets there has been another reprieve from the introduction of capital gains tax and also of the rewritten Income Tax Act.

As in the past, with a deficit of this size, stakeholders and businesses need to understand how the deficit will be funded. K4,613m (c. 70%) is expected to be funded through external debt, with debt funding of K2,404m already secured, and the remaining 30% to be funded internally by issuing Government Securities and Bonds. The government appears to have identified potential sources of external debt funding for the remaining K2,209m yet to be funded. The resultant 52.5% debt to GDP ratio is catered for by the amendment to the fiscal responsibility legislation which moved the upper limit of this ratio to 60% from this year. The target has been set to return the debt ratios to below 40% by no later than 2030.

Generally the government is very optimistic about an expected K18,000m increase in the economy over the next two years from the non-resource sector, and significantly boosted by the agriculture sector. Year on year growth of at least 10% per year is expected over the next two years, with an aspirational goal of becoming a K100bn economy in the not too distant future.

KPMG

Key Insights from the 2021 Budget

Economic

- Growth has been badly affected by COVID-19 and the resultant disruptions to commerce, trade, mining production, and international trade.
- Inflation is rising on the back of demand rebound and increased government spending.
- Many of the commodities and minerals produced by PNG have recovered from initial price shocks.

Expenditure

- Expenditure overall grew by 9% to K19.6bn and will need to be financed by a K6.6bn budget deficit.
- Operational spending is forecast to grow by 4.6% and capital spending by 16.9%.
- Sectoral allocations appear reasonable with a strong focus on developing a sustainable economic base.
- The challenge in the future will be to bring down the fixed structural costs of GoPNG.

Revenue

- 2020 Supplementary Budget will not be achieved.
- Additional revenues from IRC compliance measures have not materialized in 2020.
- COVID-19 and turbulent markets may undermine growth expectations which is a major risk.
- There is room to obtain more grants by demonstrating good project management and project delivery on the ongoing grant projects.

Budget Financing

- Concerning gap between proposed financing instruments and the expected budget deficit.
- GoPNG has taken advantage of the concessional loans in terms of availability and cost, such that 50% of the debt will be external. This presents obvious risks – primarily in the event of currency depreciation.
- A key strategy will be to broaden and deepen the domestic debt market to allow a more liquid and efficient secondary market.

Taxation

- The proposed collection of prescribed royalty withholding tax directly from resource developers is the only reform to be implemented. Not taken up were the proposals to abolish stamp duty on leases and hire purchases, tailored SWT filing and payment obligations, and mandatory eftpos use for sales exceeding K1,000.
- Government's continued focus is on targeting industries perceived to be profitable, rather than ordinary citizens and SMEs.
- New small business tax regime is expected to finally be brought into force.
- The Income Tax Act re-write, which includes a new capital gains tax, is yet to be passed.
- Extension of the due dates for provisional tax and advance payments tax.
- Anti-avoidance measure to prevent employees from trying to classify themselves as independent contractors.
- Some of the provisions related to tidying up technical errors in the 2019 and 2020 Budgets to align with policy intent while others were largely aimed at enforcing compliance or easing administrative burdens.

Fiscal Strategy

COVID-19 Emergency Response

In response to the COVID-19 pandemic, GoPNG announced a broad Economic Stimulus Package of K5.7 billion of which K600m million was the quantum of fiscal response carved out from the 2020 operational and capital budgets and directed towards the Government's COVID-19 Emergency Response. K409m has been spent to date across a number of sectors and programs.

2020 Supplementary Budget

The 2020 Supplementary Budget approved an expenditure envelope of K18bn against a revenue envelope of K11.4bn, resulting in a budget deficit of K6.6bn, with a total reduction in appropriations of K2.3bn (K1,6bn in operational and K0.7bn in capital appropriations. Key legislative amendments were made to the Fiscal Responsibility Act 2006 (lifted the upper limit of the debt to GDP ratio to 60% to account for rising public debt); Central Banking Act 2000 (lifted the temporary advance facility limit to one based on a moving average of income over the previous three years, and increased repayment period from three to twelve months); and the Superannuation (General Provision) Act 2000 (provide for one-off voluntary early withdrawals).

2021 Budget Strategy & Medium Term Fiscal Outlook

Budgetary item	2020 SB	2021F	2022F	2023F	2024F	2025F
Revenues & Grants	**11,359**	**12,995**	**15,095**	**17,042**	**18,834**	**20,626**
Operational Expenditure	9,536	9,866	9,971	9,984	10,160	10,426
Capital Expenditure	6,389	7,471	8,197	7,856	8,167	8,966
Interest Payments	2,064	2,271	2,222	2,527	2,799	2,994
(arrears included in total)	*775*	*1,200*	*1,000*	*500*	*0*	*0*
Budgeted Expenditure	**17,989**	**19,608**	**20,390**	**20,367**	**21,127**	**22,386**
Deficit	**(6,630)**	**(6,613)**	**(5,295)**	**(3,325)**	**(2,293)**	**(1,760)**
Debt to GDP Ratio (excl arrears)	**49.4%**	**53.6%**	**54.9%**	**54.9%**	**53.8%**	**52.1%**

Source – Department of Treasury & KPMG Analysis

The broad objectives of the fiscal recovery and repair program is to provide the platform for economic recovery and fiscal consolidation, while continuing with strategic capital formation necessary to sustain growth. In particular, the aim is to diversify the non-resource sector, expand the tax base and strengthen the efficiency of the delivery of public services. The following are the key principles:

- spend the money we have more wisely;
- raise the revenues more fairly;
- finance the debt more cheaply;
- leverage friendly international support more intelligently;
- focus on growth in the agriculture sector and the informal sector;
- distribute resource benefits more equitably;
- stimulate non-resource growth back to 5.0 per cent annually;
- comprehensive Government SOE reform program;
- free up foreign exchange; and
- create at least 10,000 jobs annually.

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.

Key Economic assumptions	Comment	2020 ave	2021
Total Real GDP Growth	In 2020 the domestic economy is projected to contract by -3.8%, down from initial budget projections of +2.0%, and the revised MYEFO expectation of -3.0%. The slowdown is driven by a worsening of business conditions generally, specific COVID-19 related impacts on both mining and non-mining activity; and the impact of the closure of Porgera mine. The outlook is for a rebound in 2021 to 3.5% in 2022 and a reversion to normal growth over the medium term.	-3.8%	3.5%
Non-mining Real GDP Growth	The COVID-19 pandemic and the resultant business disruptions has hit the non-mining sector hard – sector contractions in transport, accommodation, construction and finance. The non-mining sector growth outlook has been revised down from the MYEFO estimate of -0.6% to -1.1%. A rebound to 3.3% growth is expected for 2021 and over the medium term, non-mining GDP is expected to grow at an annual average rate of 3.7% underpinned by the development policies supporting the agriculture, fishing and forestry sectors; and support to SME's.	-1.1%	3.3%
Real exchange rate index	The Kina continues to depreciate against the US$ due to the persistent imbalance in the PNG forex market. Against the AUD the Kina has weakened due to cross currency movements and investor sentiment on Australian economic performance.	133.1	136.1
Monetary Policy & Kina Facility Rate	Monetary policy continues to be accommodative with the Kina Facility Rate reduced by BPNG from 5.0% in Dec19 to 3.0% in Mar20 and the Cash Reserve Requirement reduced from 10.0% to 7.0% as part of the QE programme. This accommodative policy is expected to continue into at least Q1 2021.	5.5%	3.0%
Inflation avg on avg	Projected to be 4.0% for 2020 pushed by higher government spending and exchange rate depreciation. Headline inflation in H120 was 6.0%, driven partly by an 18% rise in alcohol, and tobacco and betel nut. Imported inflation is lower reflecting the low inflation of our trading partners. Inflation of 4.8% is expected in 2021, as demand rebound and improved growth underpin prices. It is forecast to trend towards 4.4% over the medium term.	4.0%	4.8%
Balance of Payments & International Reserves	A positive trade balance, reflecting higher commodity prices in H120, resulted in a current account surplus of K8.8bn. Restricted trade meant fewer imports generally. For 2020 a current account surplus of K14.1bn and a trade surplus of K16.6bn are expected. In 2021 the current account surplus is expected to rise 22% to K15.8bn.	n/a	n/a

	Key Economic assumptions	Comment	2020 ave	2021
	Oil (US$/barrel)	Oil prices dropped sharply in Q1 2020 but have recovered on the back of production cuts and easing of COVID-19 lockdowns globally. YTD20 average prices are 33% down on 2019 & are expected to average US$39.2 in 2020.	39.2	43.9
	LNG (US$/MMBtu)	LNG price projection for 2021 has been revised down. The drop is lower than oil due to long term contracts, the use for non transport vs oil, and premium pricing for PNG LNG.	8.0	8.7
	Gold (US$/oz)	Prices have been very strong during 2020 on rising safe haven demand and low interest rates. Average YTD20 prices are 27% above 2019 and are expected to remain strong into 2021.	1,783	1,961
	Copper (US$/tonne)	Prices fell to a year low of US$4,785 in April on forecasts of lower global growth, but have since recovered on China's economic rebound, production constraint concerns & economic stimulus packages.	6,004	6,584
	Copra (K/tonne)	Copra oil prices are expected to recover in 2020 and 2021 at levels higher than 2019 prices as demand likely to pick up from expected recovery in global economic activity and limited supply conditions.	3,147	3,349
	Cocoa (K/tonne)	Prices broadly stable over H120 with an H2 pickup on the back of demand, limited supply and weather related production disruptions.	8,177	8,506
	Coffee (K/tonne)	Prices have been volatile with initial stockpiles followed by sharp drop as global COVID-19 restrictions impacted demand, and then more recent resurgence as restrictions lifted. Production disruptions globally are expected to support higher prices.	12,195	14,067
	Palm Oil (K/tonne)	Prices declined initially in line with declining oil prices and lower biodiesel demand. They have since recovered and are expected to remain strong on the back of weather related production disruptions.	2,077	2,255

Source – Department of Treasury & KPMG Analysis

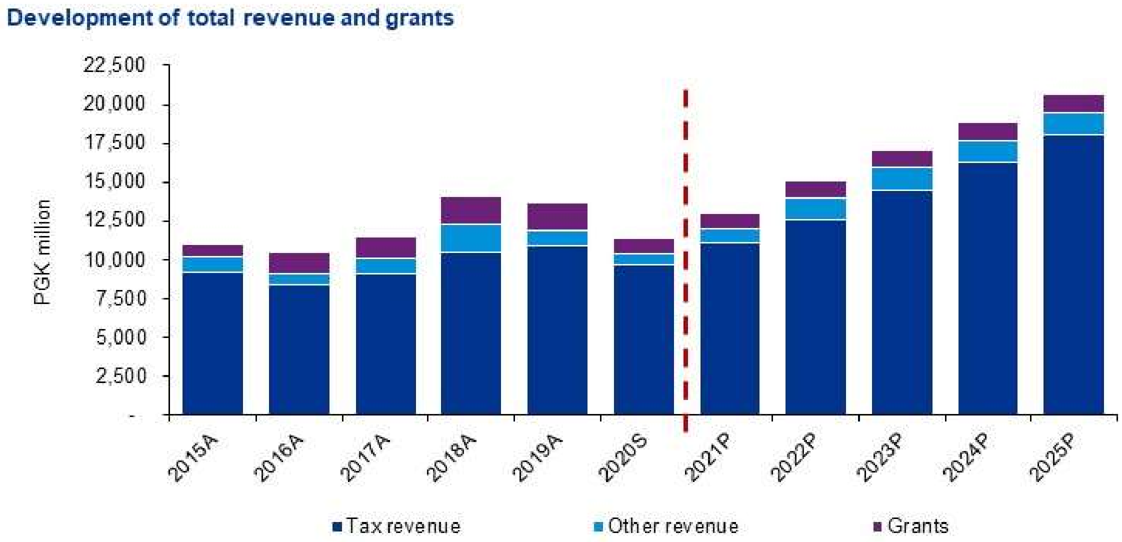
Key insights

- Growth has been badly affected by COVID-19 and the resultant disruptions to commerce, trade, mining production, and international trade. The closure of Porgera Mine has had a particularly large impact.
- Inflation is rising on the back of demand rebound and increased government spending. The planned capital investment program will underpin higher inflation and exchange rate depreciation presents a risk to the inflation outlook.
- Many of the commodities and minerals produced by PNG have recovered from initial price shocks. Agricultural commodities are benefitting from disrupted production globally due to weather, as demand recovers. Gold and metals prices have held firm and risen, and are expected to remain strong into 2021.

Revenue

Total Revenue and Grants

The 2021 revenue forecast is K13.0bn representing an overall increase by 14.4% from the 2020 projection supported by a recovery in economic growth in both the non-mining and mining sector.



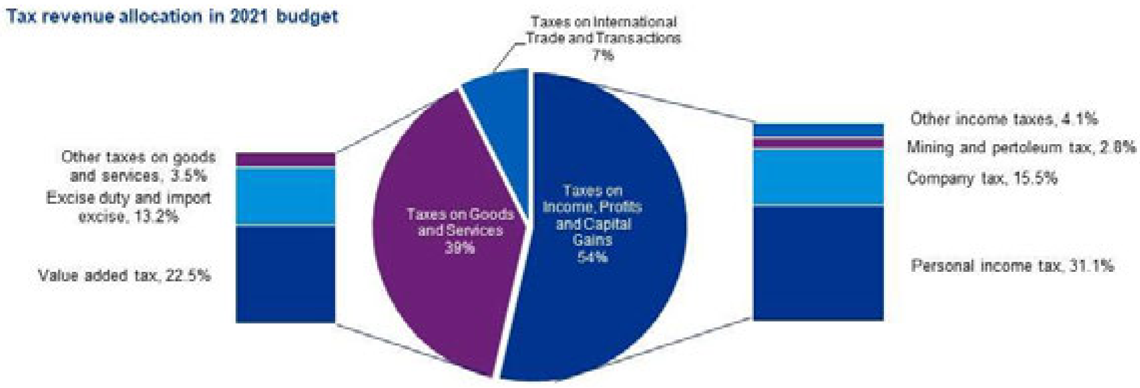
Source – Department of Treasury & KPMG Analysis

Between 2014 and 2016 Government revenue declined year on year. This trend was reversed in 2017 and 2018 when total revenue increased by 9.9% and 22.2% respectively, driven by the tax revenue. Flat business trends, the re-emergence of the foreign exchange imbalance issue and the downtrend in mineral and petroleum commodity prices resulted in a slowdown of the increase in tax revenue, which could not compensate the K0.5bn decline in Government dividend income.

The 2020 Mid-Year Economic and Fiscal Outlook (MYEFO) has reported the estimated 3.0 per cent decline in economic growth. The COVID-19 pandemic reduced revenue in 2020 and the 2020 supplementary budget was revised down considerably by K2.7bn, reflecting expected shortfalls in a number of major tax heads and resulting in a 17% decline in total revenue from 2019.

At 1% of GDP it is clear that, although welcome, GoPNG does not expect to increase its dependency 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 slightly increasing grant allocations going forward.

Tax revenue comprises 85.5% of the overall revenue budget and 11.2% of GDP. The composition of the total revenue and grants for the 2021 Budget is presented in the chart below:



Source – Department of Treasury & KPMG Analysis

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 export commodity prices. This will further be supported by the improved revenue collection mechanisms and strategies from respective departments, which are currently undergoing review.

Personal income tax (PIT) is projected to increase by K148m (4.5%) to K3.6bn underpinned by:

- easing the COVID-19 restrictions and supporting businesses reinstate hiring;
- the compliance activities undertaken by IRC; and
- the anticipated restart of the Porgera mine.

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.

The minor increase (K75m or 4.6% slightly above the real GDP growth projections) in company income tax (CIT) does not seem to be unreasonable. However, it is noted that the 2020 supplementary budget target collection may not be achievable which suggest that IRC needs to increase its compliance activities to achieve the target in 2021.

Mining and petroleum tax (MPT) receipts performed below the 2020 supplementary budget which is driven by the lower oil and gas prices and the reduction in the production of the resource companies (temporary closure of OkTedi, and licensing issues of Porgera). Projections for 2021 shows 97% increase in MPT but falls well behind the level in 2018 and 2019. The projection reflects gradual improvement in the international price expectations for oil and gas in 2021, but stayed conservative and does not raise significant risk of underperformance.

Taxes on Goods and Services (including GST and excise duty) is projected to increase significantly from the 2020 supplementary budget (26.6% or K913m). Considering the significant effect of COVID-19 restrictions on the general consumption, it is better to look at this projection in the light of the 2019 tax income. The average of 10.5% increase compared to 2019 is not unreasonable, however, reflects a full recovery of the economy following the ease of the restrictions supported by administrative efforts to improve compliance (increase the number of registered companies).

No new tax measures have been communicated for 2021 as companies are given breathing space to recover given the impact of the COVID-19 on businesses in 2020. However, we are unsure if the excise duty increase in alcohol and tobacco will remain in effect.

Under other revenue, dividends from mining, petroleum and gas areas, (specifically K300m from Kumul Petroleum Holdings and K200m from the Ok Tedi mine) represent the major revenue source contributing 77% of total dividends which is K150m increase compared to 2019 actual and 2020 supplementary budget.

The Government's revenue target, excluding grants, is to reach 16.6% of nominal GDP by 2025, above the 14.2% 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.

We note that the Government revised its growth strategy compared to the budget 2020 and decreased the revenue projection by 10.5% for 2022 and 7.5% for 2023. This reflects an intense recovery in mid-term.

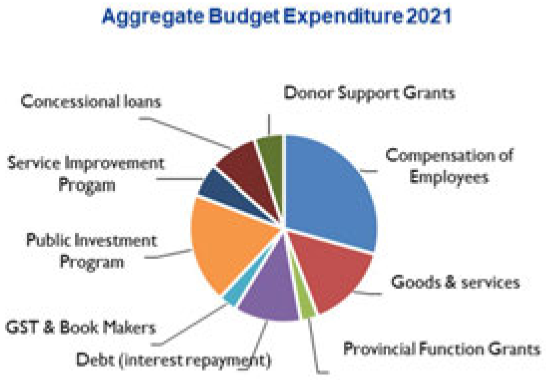
Key insights

- The year-to-date collection data indicates that the 2020 Supplementary Budget will not be achieved primarily due to the downward trend in CIT reflecting the adverse implications of the pandemic on business profitability.
- It is stated that due to the COVID-19 restriction, there have been no inspections and compliance activities undertaken by the IRC and therefore, additional revenues from compliance measures have not materialized in 2020. IRC has indicated that it can generate additional revenues from CIT through compliance activities in 2021 and increase in IRC revenue collection activities. We expect to see increased activity by the IRC in 2021 given the higher tax revenue targets for 2021. This is highlighted by Government's comments in relation to required oversight by Treasury of administrative reforms and collection by IRC.
- We note that despite the good news arriving on the potential vaccines against COVID-19, the current pandemic and turbulent market is expected to stay with us in 2021. This may undermine the growth expectations and considered as major risk on the budget.
- 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. The current pandemic may temporarily affected the capacity of the donor agencies, but it is expected that more resources become available in mid-term.

Expenditure

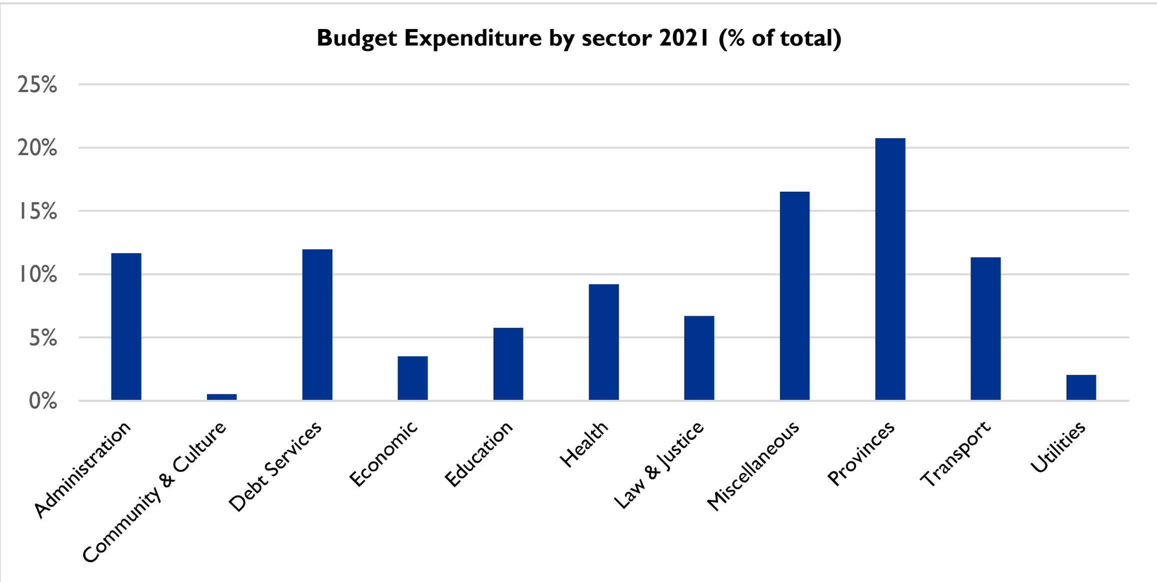
Total expenditure and net lending in 2021 is budgeted at K19,608m. This represents a budget deficit of K6.6bn (on a revenue projection of K13bn) which will be funded through external borrowings (K4.6bn) and domestic borrowings (K2bn).

There are some inconsistencies between the wording in the budget volume and the tables – we have relied on the tables for our commentary.



Budget Component (Km)	2020 Budget	2020 Supp Budget	2021 Budget	Change
Compensation of Employees	5,673	5,763	5,764	0.0%
Goods & services	3,822	2,646	2,892	9.3%
Provincial Function Grants	509	541	584	7.9%
Debt (interest repayment)	2,157	2,064	2,271	10.0%
GST & Book Makers	586	586	626	6.8%
Total Operational	**12,746**	**11,600**	**12,137**	**4.6%**
Public Investment Program	2,573	2,982	3,714	24.6%
Service Improvement Program	1,110	1,110	1,110	0.0%
Concessional loans	1,365	1,365	1,638	20.0%
Donor Support Grants	932	932	1,008	8.2%
Total Capital	**5,981**	**6,389**	**7,471**	**16.9%**
Total Expenditure	**18,727**	**17,989**	**19,608**	**9.0%**

Source – Department of Treasury & KPMG Analysis



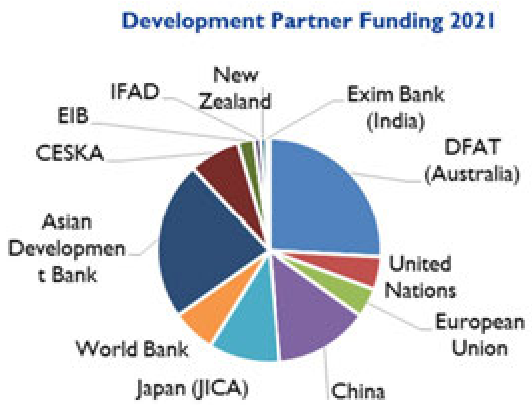
Source – Department of Treasury & KPMG Analysis

Expenditure by Sector (Km)	Operational	Capital	Total	*% of total*	*Comment & major projects*
Administration	731	1,484	**2,215**	*11.7%*	*WaSH (K60m, NID (K30m), Census (K70m)*
Community & Culture	52	51	**102**	*0.5%*	*Various small projects*
Debt Services	2,271	-	**2,271**	*12.0%*	
Economic	224	443	**667**	*3.5%*	*Various projects in renewable resource sector, total capital of K367m*
Education	837	258	**1,095**	*5.8%*	*Australian Awards (K33m), Western Pacific University (K20m)*
Health	1,105	640	**1,745**	*9.2%*	*"Back to Basics" approach*
Law & Justice	1,129	142	**1,271**	*6.7%*	*For Justice - infrastructure development, ICT, legislation reviews & crime prevention. For Defence - air capability, new Hela barracks & defence infrastructure programs*
Miscellaneous	3,136	-	**3,136**	*16.5%*	*COVID-19 (K600m), Public service retirements (K430m), Arrears (K770m), HELP (K150m),*
Provinces	2,542	1,396	**3,938**	*20.8%*	*Focus on improved service delivery & investments which support rural development*
Transport	200	1,949	**2,149**	*11.3%*	*Connecting all of PNG to enable growth and reduce poverty. Civil Aviation Investment (K391m)*
Utilities	37	351	**387**	*2.0%*	*Structural reforms required. Renewable energy generation, extension to household power connectivity*
Total expenditure	**12,262**	**6,714**	**18,976**	***100.0%***	
GST	626		**626**		
Total expenditure	**12,888**	**-**	**19,602**		

Source – Department of Treasury & KPMG Analysis

Compensation of employees (CoE) is the largest component of the expenditure and this is set to remain stable. CoE does not include retirement and related benefits to government employees which is captured under Treasury and Finance Miscellaneous vote. Debt repayment continues to grow to service the growing debt obligations. The capital budget has been increased to cater for existing projects and to fund new initiatives to broaden the base for revenue generation, critical to PNG's development, including the ConnectPNG project. The sectoral expenditure allocations are detailed in the table above and contain a number of important projects, 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.

The Arrears Verification Committee (AVC) is a key reform and is part of the IMF Staff Monitoring Program. It will run for two years and identify, clear, mitigate and manage the incurrence of future arrears. Payment of arrears will provide a much needed boost to the suppliers of goods and services to GoPNG. Of the K657m of verified arrears, only K143m have been paid to date.



Donor funding provides a significant source of revenue to support capital projects. The progress and challenges are acknowledged and the lack of GoPNG counterpart is identified as one of the major challenges as it affects the implementation of most projects and increases the loan amounts and fees. Total Development Partner assistance in 2021 is estimated at K3.3bn, 47% of total capital spending.

Development Partner	Grants	Loans	Counterpart	Total	% of total
DFAT (Australia)	891	16	5	**912**	*25.9%*
United Nations	168	-	-	**168**	*4.8%*
European Union	136	-	13	**149**	*4.2%*
China	27	410	43	**480**	*13.6%*
Japan (JICA)	13	330	22	**365**	*10.4%*
World Bank	-	187	35	**222**	*6.3%*
Asian Development Bank	20	715	70	**805**	*22.9%*
CESKA	-	257	3	**260**	*7.4%*
EIB	-	76	5	**81**	*2.3%*
IFAD	-	32	2	**34**	*1.0%*
New Zealand	29	-	-	**29**	*0.8%*
Exim Bank (India)	-	15	2	**17**	*0.5%*
United States (USAID)	-	-	-	**-**	-
Total expenditure	**1,283**	**2,038**	**200**	**3,521**	***100.0%***

Source – Department of Treasury & KPMG Analysis

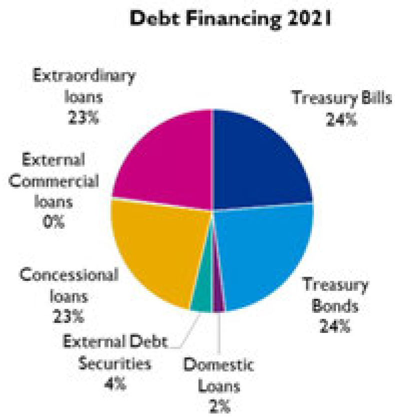
Key insights

- Expenditure overall grew by 9% to K19.6bn and will need to be financed by a K6.6bn budget deficit. There is no material change in the expected budget deficit from the 2020 Supplementary Budget as expected revenues grow to meet the additional requirements and donor support is provided.
- Operational spending is forecast to grow by 4.6% and capital spending by 16.9%. This focus on investment and growing the capital base is encouraging, particularly the focus on small and medium enterprise support initiatives.
- Sectoral allocations appear reasonable with a strong focus on developing a sustainable economic base. This is encouraging.
- The challenge in the future will be to bring down the fixed structural costs of the GoPNG.

Budget Financing

Financing Requirement

The Government has forecast a net borrowing requirement of K6.6bn in the 2021 Budget, this is not materially changed from the 2020 Supplementary Budget but is well up on the initial 2020 budget estimate of K4.6bn. The increase relates to the COVID-19 shock. The response to the initial COVID-19 shock was to negotiate new lines of credit including the IMF Rapid Credit Facility. The strategy is to maintain debt sustainability by exploring concessional sources of external funding and maintain a healthy interest profile with domestic borrowings. Debt sustainability is an issue and requires a reform agenda. Policy options include the Australian Infrastructure Financing Facility for Pacific, the World Bank's COVID-19 US$100m budget support facility, and their Fiscal Emergency Development Policy operations budget, amongst others.



Deficit Financing (Km)	2019	2020SB	2021	% of total	2022
Domestic					
Treasury Bills	10,191	10,519	11,019	23.7%	12,324
Treasury Bonds	7,967	9,662	11,263	24.2%	13,303
Domestic Loans	1,176	1,075	975	2.1%	874
Total Domestic	**19,334**	**21,257**	**23,256**	**50.1%**	**26,501**
International				0.0%	
External Debt Securities	1,701	1,701	1,701	3.7%	1,701
Concessional loans	8,677	9,669	10,773	23.2%	11,726
External Commercial loans	1,970	1,088	149	0.3%	132
Extraordinary loans	1,986	6,137	10,585	22.8%	11,700
Total External	**14,333**	**18,595**	**23,208**	**49.9%**	**25,258**
Combined total	**33,667**	**39,852**	**46,464**		**51,759**

Source: Department of Treasury & KPMG Analysis

GoPNG needs to finance an expected budget deficit of K6.6bn. The following table sets out the expectation of how this will be financed. Of concern is how the gap of K2.3bn will be closed. External financing is expected in late 2020 but the domestic market is showing signs of reduced appetite for short term TBills with periodic under subscription in the first three quarters. This could be related to internal lending limits to GoPNG.

As external budget support inflows increase, less reliance on the domestic market should allow for the restructuring and smoothing the maturity profile of GoPNG's domestic debt portfolio.

Deficit Financing by instrument	Kina m
Total Deficit	**(6,613)**
Net External Loans	**2,293**
World Bank (Fiscal) DPO	*242*
World Bank (Emergency) DPO	*346*
ADB SOE Budget Support	*519*
Bilateral Support	*1,038*
Concession Project loans	*1,638*
Commercial Loans	*44*
Less Repayments	
Concession Project loans	*(535)*
Other external repayments	*(999)*
Net Domestic borrowings	**2,000**
Remaining funding required	**(2,320)**

Source - Treasury

The Medium Term Debt Strategy has, as a key element, to continue to build confidence in the PNG economy through transparent budgeting, which increases the confidence of bilateral lenders and supporters. This is important for an economy reliant on external funding for fiscal stability. The main strategies are:

- Maintain debt at sustainable levels. This is needed to keep the debt within the revised debt to GDP band.
- Maintain financial risk at prudent levels. Foreign currency debt is now 50% of total debt (up from 30% previously) and represents a tradeoff between currency risk and the advantages offered by lower offshore interest rates. Domestic rates (weighted average interest) are currently 8.7% against the external of 3.2%.

Refinancing and rollover risks are the immediate concerns to the strategy. GoPNG recognizes that the domestic securities market needs to be broadened and deepened, with improved infrastructure, and will work to address those issues.

Key insights

- There is a concerning gap between proposed financing instruments and the expected budget deficit.
- GoPNG has taken advantage of the concessional loans in terms of availability and cost, such that 50% of the debt will be external. This presents obvious risks – primarily in the event of currency depreciation – but the large cost differential currently works in the government's favour. However, there has been declining demand for short dated TBills from the domestic market as lending limits to GoPNG are reached.
- A key strategy will be to broaden and deepen the domestic debt market to allow a more liquid and efficient secondary market.

State Investments

The State of PNG holds various commercial investments aimed at optimizing commercial returns as well as providing service delivery for the populace. Investments are held in a portfolio of public utility assets and an investment portfolio. These are held in trust through various Government Kumul Holding structures and Statutory Authorities. GoPNG has directed a review of the performance of the state assets and investment portfolios to assess for nonperforming portfolios, commercial returns, and better fiscal oversight.

General Business Trust Assets	KCHL is the mandated trustee of the GBT assets and maintains oversight on performance and risk management. GBT total asset value as at 31 December 2019 stands at K4.4 billion. Total value of assets decreased from 2019 to 2018 due to decline in large SOEs such as PNG Power, Kumul Telikom and Air Niugini.
Sectoral Policy Reforms	Proposed investment review together with development of an investment registry reporting framework and a sectoral investment plan.
Public Money Management	In the last 2 years GoPNG collected K1b of excess revenue but the Supreme court declared PMMR act invalid and unconstitutional in mid-2020.
Review of the Board Fees and Allowances	A review of board fees and allowances completed in 2020 found that fee structures need adjustments to capture rising costs of goods and services; high performing Boards and agencies need to be rewarded; different fee structures for different state agencies be implemented; and fee structure should be consistent with annual performance
Public Private Partnerships	GoPNG aims to progress ahead with the development of the PPP regulations for implementation.
Sustainable benefits management policy	This policy is aimed at providing guidance around generation, distribution and sustainable use of benefits from resource project for landowners and subnational governments.
Fiscal template for extracting resource projects	A fiscal template has been initiated with the aim of ensuring transparency and consistency in negotiating project agreements with prospective developers.
State equity participation	State equity participation policy is aimed at providing a guide to state investment decisions that are in relation to equity acquisitions and extractive resource projects.
Extractive project Sector updates	• OK Tedi- potential production for another 10 years. • Lihir- production expected for another 20 years. • Ramu Nickel- project extension in abeyance as issues with developer being resolved. • Hidden Valley Mine- pre-feasibility underway to extend mine life by 3 years. • Kainantu Mine- in its 4th year of production, with a 15 year mine life. • Porgera Gold Mine- has ceased operation by mine operator Barrick Nuigini Limited after extension of mining licence refused. • Simberi mine- pre-feasibility study indicates production of 3 more years. • Two proposed mines: Wafi Golpu Project & Frieda Copper Gold mine.
Petroleum Projects	PNG LNG is the only existing project. 6th year of production. Proposed gas projects include Papua LNG, Pasca A, P'nyang & Stanley.
Forestry Sector	Existing reforestation projects consist of 9 plantation developments that have been earmarked by the PNGFA for development and expansion. PNGFA anticipates to collect 20 per cent of Log Export Tax revenue to support operational costs and K20/m3 from forest management levy for reforestation/ afforestation function as part of the national government policy direction.
State Participation and Investment in Agriculture Sector	The Government has launched the Green Climate fund Country Programme and No Objection Procedure Guidelines in 2020 along with support from the US Government. This allows PNG to access climate change financing to manage and build reliance to climate change threats in PNG.

Taxation

The 2021 Budget introduces a range of tax measures aimed at supporting aggregate demand to enable a growth recovery without raising new taxes to close the increased deficit (other than in relation to the banking and telecommunications sectors). Again this year the tax measures focus on supporting SMEs while seeking to target groups such as the banking and telecommunications sectors. The measures also focus on making for a more modern and efficient tax system whilst lowering administrative costs and enforcing greater compliance. Unless otherwise noted the measures mentioned below apply **from 1 January 2021**.

Income Tax Measures

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 inclusive could be carried forward to 2025.

The legislation introduced in Budget 2020 did not however achieve this aim and that legislation was also flawed. The purpose of the legislation proposed under Budget 2021 is to address these transitional issues arising on the carry forward of losses. Provided the losses would otherwise be deductible the new provisions allow the carry forward of losses arising between 2005 and 2018 up to 2025 while the carry forward period for 2019 losses and thereafter is 7 years.

Remittance of Prescribed Royalty Withholding Tax

As flagged recently, resource developers will be required to remit the Prescribed Royalty Withholding Tax directly to the IRC, rather than pay it over to the regulator as part of the royalty payment. It is expected this will expedite revenue recovery and also ease the administration and reconciliation process for the IRC.

Provisional Tax and Advance Payments Tax

Previously provisional tax was due in three equal installments on 30 April, 31 July and 31 October. These due dates were revised in the 2020 Budget 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 were to be amended to 90 days, 180 days and 270 days after the end of the substitute accounting period. The 2021 Budget further amends the due dates for provisional tax to 120, 210 and 300 days after 31 December or the end of the substitute accounting period, as appropriate. Similar timelines apply for Advance Payments Tax purposes.

Small Business Tax

Budget 2020 saw the introduction of the small business tax regime (which is subject to Gazettal notice). 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.

However, the legislation is being amended under Budget 2021 as it did not reflect the actual policy intent.

Micro businesses with a turnover of less than K60,000 will be subject to a fixed tax amount of K250 while a business with a turnover of more than K60,000 and less than K250,000 will be subject to tax of K62.50 plus 2% of turnover above K15,000 per quarter. For the purposes of this formula the K62.50 and the K15,000 are derived from K250 and K60,000 respectively divided by four.

The regime is expected to come into force in 2021 through a Gazettal Notice.

Anti-avoidance Measure – Employees and Independent Contractors

The draft legislation includes a new section with the stated aim of discouraging employers and employees from avoiding tax by trying to classify an employee as an independent contractor to avail of the small business tax regime (discussed above). The section essentially sets out eight scenarios in which a contractor may be regarded as an independent contractor not subject to salary or wages tax, rather than an employee subject to salary or wages tax.

Currently salary or wages tax applies on payments to individuals for their labour or for professional services and consequently captures most scenarios involving payments to individuals. While the draft legislation is framed as an anti-avoidance measure, it will be interesting to see how it will apply in practice given it effectively provides a checklist of ways to ensure a contractor may be regarded as an independent contractor not subject to salary or wages tax.

Customs & Excise Measures

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

Increase Threshold for Counter Clearance

The customs threshold for clearing goods at the counter rather than through the import entry process will be increased from K1,000 to K5,000. The counter clearance process is quicker and less costly and this change is aimed at easing the burden for individuals and SMEs.

In addition the current threshold of K250 below which import duty is not due will be reduced to K50 for excisable goods excluding personal effects.

Increase in Customs Penalties

There is a perception that the customs penalties are not currently high enough to be a deterrent to smuggling. Budget 2021 proposes higher penalties and prison terms for offences relating to smuggling and a breach of customs processes. A new penalty provision will also be introduced to specifically deter the smuggling of tobacco product across the PNG border.

Amendment of Duty on UHT Milk

In 2019 the tariff duty on UHT milk was increased to 25% to support Ilimo Milk and local employment although in reality this was not actually charged due to the inability of Ilimo Milk to supply the nation. As a result, the tariff duty will be reduced from 25% to free.

Introduction of Excise Duty for Hybrid Motor Vehicles

Currently PNG Customs' Harmonised System does not have a tariff code for hybrid motor vehicles impeding importers from importing hybrid vehicles. From 1 January 2020 hybrid motor vehicles will be subject to excise duty of 20%.

Fish Species and Margarine

It is intended to simplify and enhance administration by differentiating various fish species, packaging and the duty rates applicable as the current heading is too general for classification purposes. This change is retrospective from 1 January 2015.

A new national subheading will also be created for margarine used for baking purposes only by local manufacturers. This change is effective from 1 January 2021.

Other Measures

Enhancing Land Rental Collections through Compliance Measures

Last year's Budget had improved land rental collection through enhanced ICT measures as a stated aim. Significant improvements have been made with the digitization of land and valuation files as well as the electronic filing of returns and payments. These measures are expected to curtail corruption and fraud and increase revenue.

Future Policy Direction and Reforms

Review of the Fuel Industry including the Napa Napa Oil Refinery Agreement

Government intend to conduct a review of the taxation arrangements around the fuel industry. The review is intended to ensure existing agreements are meeting policy intent, to examine excise taxes on fuels and to consider options for waste oil. The review will also consider any anti-competitive arrangements concerning the existing Napa Napa agreement.

Changes to Securities Commission

Government intend to expand revenue financing options in 2021 through capital markets reform. These reforms hope to facilitate PNG SMEs to raise funds through domestic and international investment. Capital markets reform will be a key focus area in 2021 and is being kick started through an international recruitment drive for a new Securities Commissioner to lead this reform. Some changes are proposed to the Securities Act aimed at strengthening compliance and governance around the role, the term and conditions for termination.

Telecom Taxation Levy

It is proposed that a new Universal Access Levy will be introduced on telecommunications in 2021. A consultation process will take place in 2021 involving the Government, National Information and Communications Technology Authority (NICTA) and relevant stakeholders. This was originally meant to take place during 2020 but was postponed due to the pandemic. 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.

NICTA will play a key role in ensuring the opening of competition and as part of the reforms a mutualisation policy will be adopted to ensure the sharing of infrastructure. The extent of this arrangement will be determined through consultation but should at a minimum extend to the sharing of towers and support services but may also extend beyond those towers funded by the Universal Access Fund.

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.

Bank Levy

In last year's Budget the Government stated that it intended to raise the license fees on banks and financial service operators in 2020 and it was also going to consider a revenue measure based on the level of foreign exchange spread and transactions. A consultation process was supposed to take place 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. As this was deferred due to the COVID-19 pandemic the consultation process will take place in 2021 with the intention of introducing a new tax on the banking sector during 2021.

Previously Announced Policies Not Yet Implemented

The prior year 2020 Budget announced a number of measures which have not been mentioned in the current 2021 Budget as follows:

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 took place in early 2020 and it was originally expected last year that the legislation would come into effect from 1 January 2021. The introduction of this new Act has however been deferred.

Capital Gains Tax

Capital Gains Tax has been touted for the past few years and although not yet introduced it is featured in the draft Re-written Income Tax Act.

Infrastructure Tax Credits

Although the Government had announced that a review of the revised Infrastructure Tax Credit guidelines would commence in 2020 no changes have been announced in the 2021 Budget.

Tax Clearance

It had been announced that the administration of the tax clearance process would become system generated and the certificates would be issued directly to commercial banks. This has not as yet materialized although the IRC did engage in a consultation process with the banking sector in late 2020.

Key insights

- Of IRC's wish list for tax reforms published in recent weeks, their proposal for the collection of prescribed royalty withholding tax directly from resource developers is the only reform to be implemented. Not taken up were the proposal to abolish stamp duty on leases and hire purchases, tailored SWT filing and payment obligations, and mandatory eftpos use for sales exceeding K1,000 to avoid GST leakage.
- Government's continued focus is on targeting industries perceived to be profitable, rather than ordinary citizens and SMEs. 2021 will see consultation processes in relation to banking and telecommunications license fees and levies although it is noted these were originally due to take place during 2020.
- In line with Government's agenda of supporting SMEs the new small business tax regime is expected to finally be brought into force through Gazettal notice during 2021. 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 and to also ease the compliance burden.
- There has been a reprieve, for the time being at least, from the introduction of capital gains tax and also of the Re-written Income Tax Act. Capital gains tax will feature in the Income Tax Act re-write yet to be passed.
- Companies may welcome the extension of the due dates for provisional tax and advance payments tax.
- A new section touted as an anti-avoidance measure to prevent employees from trying to classify themselves as independent contractors to avail of the small business tax regime may actually in practice provide a checklist to individuals seeking to classify themselves as contractors.
- Some of the provisions related to tidying up technical errors in the 2019 and 2020 Budgets to align with policy intent while others were largely aimed at enforcing compliance or easing administrative burdens.

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