2014 Budget Strategy Paper

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CONTENT **PAGE**

Government of Papua New Guinea

2014 Budget Strategy Paper

A. PURPOSE

The purpose of the 2014 Budget Strategy Paper (BSP) is to assist public understanding of the fiscal situation and the Government's proposed budget strategies. It contains:

- the principles that will guide the 2014 budgetary process;
- the broad fiscal parameters for the 2014 Budget and the key Government strategies and policies for the management of revenues and expenditures;
- a discussion of risks to the budget parameters and the Budget Strategy;
- the medium-term outlook for government revenues and expenditures;
- a discussion of how the Budget Strategy relates to the Medium Term Fiscal Strategy (MTFS) and Medium Term Development Plan (MTDP); and
- a framework for the preparation of departmental Budget forward estimates and the development of detailed budget policies.

This is an important component of the Government's approach for improving the preparation of budgets and the management of public finances in Papua New Guinea (PNG). This document has been made available to the public, consistent with the Government's approach to improve transparency and accountability. The document is required under the *Papua New Guinea Fiscal Responsibility Act 2006.*

The fiscal data included in the BSP are indicative only. They may be adjusted if and when circumstances change during budget preparation. The macroeconomic and fiscal forecasts will be updated closer to the 2014 Budget to reflect any changes in economic and financial conditions.

B. PRIORITIES

The 2014 Budget will have six key priorities:

1. Maintain Papua New Guinea's macroeconomic stability through the adherence to the principles (including amendments discussed later) of the Medium Term Fiscal Strategy 2013-2017.

2. The implementation of major infrastructure projects under construction as well as the efficient expenditure of the new higher levels of Provincial funding.

3. Ensure an appropriate alignment between the construction of new roads and the provision of money to maintain them. Likewise ensure funding is

available for staff when new health or education buildings are constructed. The integration of the 'Recurrent' and 'Development' Budget in 2014 will be a key step towards achieving this.

4. Continue to expand funding in the education sector. This will include the continuing expansion of fee free education policies, funding for vocational education and ensuring enough teachers are available to meet increased demand for access to education.

5. Continue to expand funding in the health sector.

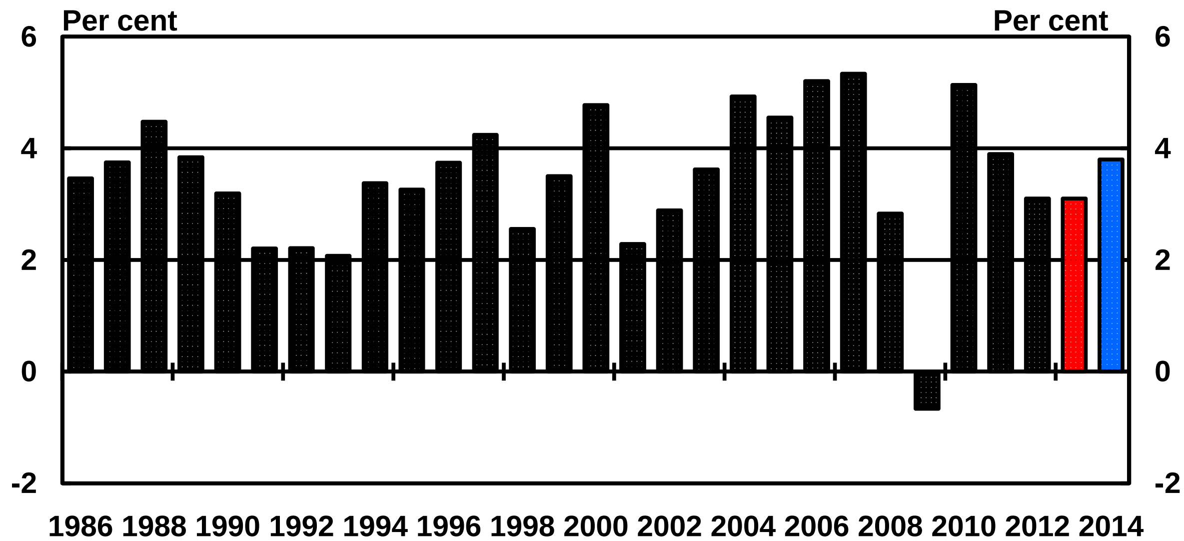
6. Improve the enabling business environment for the agriculture sector as well as small to medium enterprises.

C. THE ECONOMIC OUTLOOK

International Economic Outlook

The global economy remains subdued and new risks have emerged in 2013. According to the International Monetary Fund (IMF) 2013 July World Economic Outlook (WEO), the world economy is projected to grow by 3.1 per cent in 2013, the same rate as in 2012. This is a downward revision from the 2012 October WEO forecast of 3.6 per cent and 2013 April WEO of 3.3 per cent for growth in 2013, a result of a slowing down of growth in the advanced and emerging market economies, a prolonged Euro area recession and a possibility of the US economy slowing down in 2013.

Chart 1: World Economic Growth (1986-2014)



Source: International Monetary Fund, World Economic Outlook (July 2013)

Looking ahead to 2014, the world economy is projected to grow by 3.8 per cent, up from the 3.1 per cent in 2013 due mainly to a stronger growth forecast projected for the US economy. It is anticipated that private demand in the US economy will be the driving force of growth given that household wealth has been on the rise owing to the recent household recovery and the continued supportive financial conditions. Euro growth will only rise to just under a percentage point in 2014, as the weakness in demand persists and policy action remains yet to be implemented in key areas. In contrast, Japan's growth is expected to ease in 2014. Overall, advanced economies are expected to grow by 2.1 per cent in 2014.

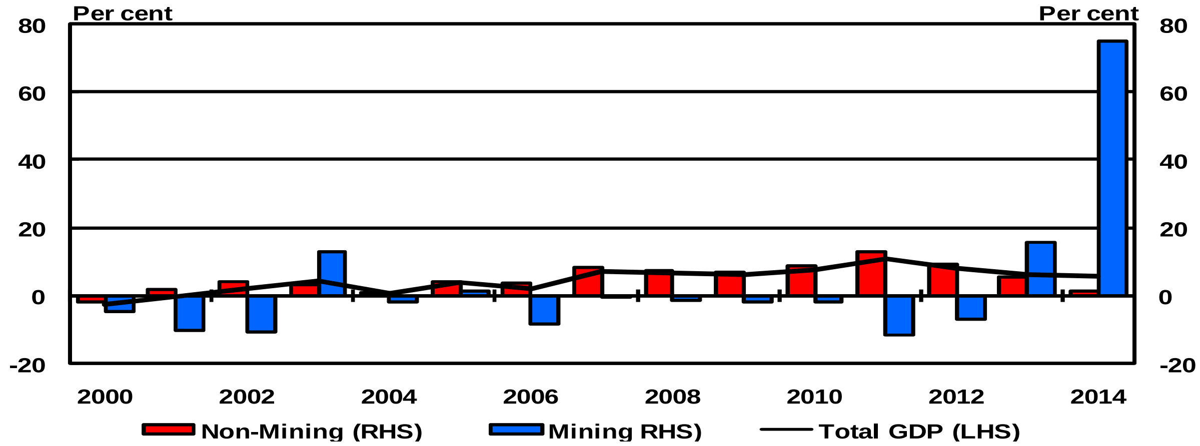
Also supporting the growth in 2014 will be the growth in emerging and developing market economies which is expected to pick up slightly by 0.4 percentage points from 2013. The moderation in growth reflects weaker prospects across all regions. In general and to varying degrees, it reflects infrastructure bottlenecks, capacity concerns, slower external demand growth, lower commodity prices, financial stability concerns and weak policy support.

Forecasts for global inflation have moved in line with the general weakening of global demand and the fall in commodity prices. Inflation in advanced economies is projected at 1.5 per cent in 2013 and will pick up to 1.9 per cent in 2014 owing to an improving US economy whilst inflation in emerging and developing market economies is projected at 6.0 per cent in 2013 and will ease to 5.5 per cent in 2014.

The Outlook for the Domestic Economy

In 2013, the PNG economy is expected to grow at 6.1 per cent, an upward revision from the 2013 Budget estimate of 4.0 per cent. This upward revision is due largely to an expected rebound in the mining and quarrying sector, the ongoing PNG LNG construction phase and the higher than expected stimulus effect of the increased Government spending. The fiscal stimulus is expected to boost activity in the non-mining sectors notably the construction sector with spending on projects expected to pick up in the latter half of the year. It is observed that small businesses to large entrepreneurs are benefiting from the positive impacts of an economy that is supported by the Government's fiscal stimulus, the ongoing PNG LNG construction phase and the increasing activities in the mining and petroleum sectors.

Chart 1: Economic Growth: 1999– 2013



Source: Department of Treasury

In 2014, the PNG economy is projected to maintain a strong growth of 6.0 per cent with total mining GDP growing by a massive 74.8 per cent due to the commencement of production from the PNG LNG Project. This strong growth is reflected in the oil and gas sector which is projected to grow at a historic rate of 354.8 per cent in 2014. Supporting this strong growth is the continued rebound in production expected from the mining and quarrying sector with a projected growth rate of 14.7 per cent.

On the other hand the non mining GDP is projected to grow at a rate of 1.3 per cent. The key driving factor behind this low growth is the winding down of the PNG LNG construction phase. The immediate effect of this shock is reflected in the construction sector projected to fall by 8 per cent in 2014. Other non mining sectors while at high levels are expected to maintain steady growth in 2014.

Inflation Outlook

In 2013, inflation is forecast to be around 5.6 per cent, a downward revision from the 2013 Budget estimate of 8.0 per cent but higher than the 2012 inflation outcome of 2.2 per cent. The downward revision reflects low 2012 inflation outcome of 2.2 per cent, weak global economic activities, falling commodity prices, low and stable inflation in major trading partner countries and the lagged impact of the appreciation of the Kina exchange rate.

D. 2014 BUDGET STRATEGY

The 2014 Budget will be guided by the Vision 2050, PNG Development Strategic Plan (DSP) (2010-2030), the Medium Term Development Plan (2011-2015), the Medium Term Debt Strategy (Debt Strategy), the Medium Term Fiscal Strategy (2013-2017), and the *Fiscal Responsibility Act 2006*.

Consistent with these overarching frameworks and taking into consideration strong expenditure growth in the recent budgets, the importance of maintaining growth in expenditure for key MTDP enablers, the 2014 Budget will be a deficit of 5.9 per cent of GDP.

Significant falls in commodity prices, though, since the time of the 2013 Budget mean that there will be less revenue available, than previously thought, to be spent in 2014 as well as in the ‘forward estimates’ years of 2015 – 2018.

The Medium Term Fiscal Strategy 2013 – 2017 (MTFS) sets out the fiscal rules that the Government has set itself to abide by. These rules are designed to ensure ongoing confidence in the Government’s fiscal position and the PNG economy more broadly.

The key rule which provides the overall fiscal anchor for the macroeconomic stability of PNG is in relation to debt levels:

a. *'Maintain a gross Government debt to GDP ratio of less than 30.0 per cent, apart from in 2013 and 2014, when it will not exceed 35.0 per cent.'*

In addition, the MTFS set out proposed maximum deficits as a share of GDP over the period of 2013 – 2017. It is possible, however, that if high rates of GDP growth continue and commodity prices do not fall further, slightly higher deficits could be supported, while still maintaining debt at less than the desired 30 per cent of GDP ratio.

Medium Term Fiscal Strategy 2013 – 2017 Guiding principles and proposed amendments

Expenditure

1. Increase the share of the total budget allocated to the key enablers of the Medium Term Development Plan to two thirds by 2017.
2. Improve spending agencies' focus on expenditure effectiveness and transparency in expenditure reporting and public accountability.

New:

3. No new infrastructure programs should be funded unless they have gone through a proper design and costing process.

Revenue

1. Maintain equitable taxation regimes with a focus on compliance.
2. Restrict taxation exemptions and special arrangements.

Debt

1. Maintain a gross Government debt to GDP ratio of less than 30.0 per cent, apart from in 2013 and 2014, when it will not exceed 35.0 per cent.
2. Limit gross Government liabilities to less than 60.0 per cent of GDP.
3. Greatly increase the Government's average debt maturity profile.

Deficits

~~1. Ensure a return to surplus by the end of the MTFS period in 2017.~~

New:

1. Limit deficits to a maximum of 2.5 per cent of GDP from 2015 onwards.

E. CURRENT FISCAL DEVELOPMENTS AND OUTLOOK

As outlined in the 2013 MYEFO, the fiscal outlook for 2013 is expected to be a deficit of K2,701 million or 7.7 per cent of GDP compared to an estimated deficit of 7.2 per cent of GDP in the 2013 Budget. This reflects higher than expected spending, in particular on personnel emoluments at the Provincial level.

This deficit presents the Government with an immediate challenge to make tough decisions to maintain fiscal discipline throughout the year. Immediate steps will need to be taken to contain expenditure pressures in 2013 to ensure that the planned deficit of 7.2 per cent of GDP is not exceeded.

F. FISCAL PARAMETERS FOR THE 2014 BUDGET

As shown in Table 1, the 2014 BSP recommends adopting a Budget deficit of 5.9 per cent in 2014 and no more than 2.5 per cent of GDP from 2015 onwards, provided that the debt to GDP limit of 30 per cent is not breached.

Table 1: 2013 – 2018 Budget balances

Year	2013	2014	2015	2016	2017	2018
MTFS 2013 – 2017 Budget balance (per cent GDP)	-7.2	-5.9	-1.6	-0.6	0.1	0.0
MTFS 2013 – 2017 implied debt to GDP*	32.0	34.6	28.9	27.5	25.4	23.1
2014 Budget Strategy recommended maximum deficit	-7.7	-5.8**	-2.5	-2.2	-1.8	-1.8
2014 Budget Strategy implied debt to GDP	32.7	35.0	29.4	30.0	30.0	30.0

Note: '-' represents a deficit.
*Based on MYEFO GDP estimates.
**Any potential rollover of unspent funds from the 2013 Budget would increase the size of this deficit.

The Budget balance for 2014 is recommended to not exceed the 5.9 per cent set out in the MTFS, with the exception that some unspent monies from 2013 be rolled over to be spent in 2014. This would only apply to selected major infrastructure projects that had commenced construction in 2013 but not yet been completed. Taking some money from 2013 and shifting it to 2014 would have the effect of reducing the size of the deficit in 2013, but increasing it in 2014.

With almost all of the planned expenditure in 2014 already allocated by the Government as part of the 2013 Budget, there is very little room for new spending. There is no room to increase the size of the deficit beyond 5.9 per cent in 2014 to fund additional spending as this could place at risk PNG's fiscal and economic stability.

In general, any new policy proposals funded in the 2014 Budget will need to be instead of an existing area of expenditure.

F.1 Revenue

Total Government of PNG revenue in 2014 is estimated to be K10,939.0 million. This is K529.9 million higher compared to the 2013 MYEFO revenue estimate of K10,409.1 million and reflects strong non mineral revenue which in turn is due to strong tax on domestic goods and services and international trade.

Non-mineral revenue is expected to grow total revenue in 2014 and is expected to be K8,305.6 million. This is K338 million higher compared to the 2013 MYEFO non-mineral revenue estimate of K7,967.5 million. This reflects strong growth in personal income tax, company tax, domestic taxes on goods and services and taxes on international trade. The strong growth in the non-mineral revenue is also supported by improved tax compliance in 2014. Mineral revenue is expected to be at K1,303.4 million in 2014.

Grants

Project support grants for 2014 are estimated at K1,200 million. A more accurate estimate of grants will be provided in the 2014 Budget.

F.2 Implication for Expenditure

In 2014, total expenditure and net lending is projected to be K13,257 million (including project grants).

Expenditure Priorities

The MTFS 2013-2017, MTDP, Vision 2050 and PNGDSP 2010-2030 are the key policy documents that will guide the Government funding decisions. The Vision 2050 and the PNGDSP 2010-2030 provide the overarching development plan, while the MTFS 2013-2017 sets out the resource envelope available for recurrent and development expenditure.

In the 2014 Budget the priority for the Government will be delivery of key priorities for Education; Health; Infrastructure; and Law and Order as announced in the various government occasions and consistent with the overarching development frameworks and the MTFS 2013-2017. The Government will also seek to ensure a greater percentage of funding is available and is used effectively for the four key MTDP enablers.

The Government is continuing its commitment to funding tuition fee free education up to grade 10 and subsidising tuition fees for grades 11 up to tertiary level in 2014.

Further, the Government is committed to delivering major impact projects such as a nationwide restoration and maintenance of run-down educational and health institutions, creating a centralised national medical supplies base, repairing, rehabilitating and maintaining key highways, and supporting key ports and airfield infrastructure.

While funding for service delivery has increased in recent budgets, poor management practices within agencies continues to limit improvements. Service delivery will not improve without significant reform of poor work practices across the public service. Poor performance by staff contributes to a culture of poor service delivery. The Government will ensure that the Heads of agencies exercise their managerial powers to effectively address these issues and hold them accountable for poor performance.

Effectively managing spending is only part of responsible Budget stewardship. Enhancing and protecting the Revenue base is equally as important. In preparing the 2014 Budget, the Government will also consider measures to improve revenue collection.

F.2.1 Service Delivery Expenditure

The 2014 Service Delivery Budget will be prepared in an environment of significant financial constraints. Growth in the cost of the public sector in recent years has not translated into improved service delivery. The Government recognises that this cannot continue, and will seek to ensure any increase to the Recurrent Budget will improve productivity in the public sector and will deliver improvements in the lives of all PNG citizens.

In preparing a sustainable Recurrent Budget the Government will apply the following three principles:

1. The Government will require agencies to live within their budget to the greatest extent possible;
2. The Government will ensure that any request for additional funding will be assessed on the basis of it being good value for money; and
3. The performance of agencies in delivering their responsibilities will be assessed against requests for increased funding. Under performing agencies will be held to account.

In preparation for the 2014 Budget, agencies and Provinces Personnel Emoluments ceilings will be held constant. Proposals for any increases will be closely scrutinised by the Government, with a requirement that increases be matched by improvements in productivity and service delivery.

Persistent overspending by agencies (especially Provincial Governments) on Personnel Emoluments continues to represent a major risk for the Budget. Overspending is often the result of thousands of employees who either do not exist; receive multiple salaries; are retired or retrenched; do not regularly attend work; or are employed outside of the Budget appropriation.

Overspending of this nature is made possible by the lack of hard limits on agency spending. The Government will carefully consider the option of recovering such overspends from agency appropriations in subsequent years and surcharging responsible officials.

Expenditure ceilings for Goods and Services for National Departments have been increased by 2.5 per cent on selected specific expenditure items. Statutory Authorities have been held constant at 2013 Budget levels. Ceilings for Provincial Administrations have been increased in accordance with the Review of Inter-Government Financing Arrangements (RIGFA) with adjustments following the establishment of the new provinces of Hela and Jiwaka.

All requests to increase Goods and Services funding beyond these approved amounts will be carefully reviewed and agencies will need to demonstrate how any increase will improve service delivery. The Government will require agencies to demonstrate restraint in spending on discretionary items such as travel and consultants which will be reviewed closely with a view to eliminating unnecessary expenditures.

To improve agency performance, accountability and transparency, the Government has issued a number of non-financial instructions in the Budget context for implementation in 2013 and beyond. Substantial progress is expected and agency progress with implementing these decisions will be considered in determining 2014 Budget allocations.

The Government will require all Commercial and Statutory Authorities to remain within their 2014 ceilings. The Government will ensure that any request by a National Department for additional funding will be assessed on the basis of it being good value for money and delivering meaningful improvements in services.

F.2.2 Development and Capital Investments Expenditures

The 2014 Annual Budget of PNG will be the fourth year of implementation for the MTDP 2011-2015 (currently under review after the full review of the SDP) as part of the ongoing commitment to sustainably meeting PNG's national plans.

The MTDP 2011-2015 identifies the Key Enablers that will establish PNG on a path towards prosperity. These are the Government's key development focus areas for the period of the first MTDP, with a particular focus on improving and maintaining infrastructure to ensure long-term welfare enhancing benefits to Papua New Guineans. Thus, the Government's development priorities in 2011-15 are:

1. Unlocking land and providing affordable housing for development;
2. Improving law, order and justice;
3. Establishing quality national transport corridors that connect rural populations to markets and services;
4. Higher and technical education to redress the severe skills shortage within PNG's labour force;
5. Universal access to quality primary and secondary education;
6. Provision of key utilities of electricity, clean water and sanitation and communications; and
7. Improving primary and preventative health outcomes.
8. Enhancing sustainable economic development.

These eight aspects of the PNGDSP 2010-2030 will continue to be given considerable emphasis in the first MTDP and in the 2014 National Budget. These enablers for inclusive, pro-poor and sustainable growth will lay the foundation for PNG to progress toward middle income status by 2030. As such the 2014 Budget will channel and focus funds into projects and programmes aimed at easing social and structural impediments to growth and development and ensure that high impact projects from the 2013 Budget continue to be effectively implemented in 2014. In line with the MTDP Key enablers the 2014 Public Investment Programme will concentrate funding to projects and programmes designed for sub-national empowerment and development.

Furthermore, building on the 2013 Development Budget, the 2014 Public Investment Programme will be a truly strategic Budget with a medium term outlook. Funds will be allocated to projects and programmes that meet key deliverables and targets within sector and provincial plans and the MTDP, and that demonstrate clear milestones to be achieved.

Additionally, the 2014 Public Investment Programme will continue to invest in high impact infrastructure investments, ensuring consistency in funding from the 2013 Development Budget to deliver these projects over the 5 year investment outlook. The 2014 Public Investment Programme will focus on outcomes oriented projects and programmes across sectors, with an emphasis on major road infrastructure, health, education, SME and agricultural support, utilities such as water, sanitation, energy and telecommunications, the modernization of the police force and continued support of Task Force SWEEP in the interim before the establishment of ICAC and public sector reform.

The 2014 National Budget will continue to fund fixed commitments including constitutional grants (e.g. District Support Grants), direct funding to the provinces, districts and LLGs through DSIP, PSIP and LLG funding, fixed grants (e.g. MoAs) and the Government's renewed financial development package of K500 million to ABG over five years, of which K115 million has been allocated for the 2013 Development Budget. BSA Infrastructural Development Grants of K120 million annually for over period of (10) years. High Impact Projects such as for the Southern Highlands and Hela Provinces are also being financed as part of the fixed commitments. Moreover, the Government will continue to use its Expenditure Sequencing Strategy and Matching Funds Strategy to ensure that expenditure is prioritised efficiently across the MTDP key enablers.

To ensure the continued effective implementation of ongoing and high impact infrastructure projects from 2013, and new projects in the 2014 Public Investment Programme, thorough monitoring, reporting and evaluation processes and systems will be strengthened and institutionalized within DNPM, in coordination with the Department of Treasury, Finance, PM&NEC and all implementing agencies to fully account for the usage of public funds and deliver the priorities of the Government of PNG.

G. FINANCING

The 2014 Budget will require additional debt issuance beyond that which is required to refinance maturing debt and the budget deficit to meet the Government's financing needs. The financing task will comprise:

- additional borrowing through foreign currency denominated concessional loans from our development partners to fund projects on MTDP Enablers,
- increase issuance of domestic debt to finance the budget deficit, and
- restructuring the portfolio of domestic debt to increase its average term to maturity and reduce rollover risk.

The 2014 Budget estimates increased borrowing in foreign currency denominated concessional loans from our development partners as activity on new and existing projects increases, comprising the Lae Port redevelopment; work on improving provincial roads connected to the Highlands Highway, electricity; water; and other infrastructure projects.

This increase is primarily from signed loan agreements with the Asian Development Bank, the World Bank and the Chinese Export Import Bank. However this increase in concessional loans might not translate to expenditure in the current year due to existing capacity constraints. Previous years have shown underspends in loan projects and this trend is expected to continue especially for large infrastructure projects.

New borrowing denominated in foreign currency is subject to approval criteria to control the exchange rate risk from borrowing in foreign currency and to ensure that PNG receives value through this borrowing. The Debt Strategy also imposes a target limit on the value of foreign currency loans to the total debt portfolio of 40 per cent. Over the last few years the appreciation of the Kina has seen the value of PNG's foreign currency loans decrease. With the new borrowings expected in 2014 and the increase in domestic borrowing to finance the budget deficit the value of the foreign currency portfolio is expected to be within the target limit.

For the domestic debt the financing task will focus on increasing domestic debt issuance to finance the large budget deficit and restructuring the debt to extend the average term to maturity of the domestic debt portfolio. Extending the average term to maturity reduces the level of refinancing risk (the risk of not being able to roll over debt when it matures) and interest rate risk in the portfolio.

In 2013, there have been significant increases in Treasury Bills to finance the budget deficit of K2.5 billion. Again in 2014, there will be significant increase in Treasury Bills to finance the budget deficit.

The increased domestic debt issuance also increases the portfolio above its target limit of 60 per cent. Therefore the focus will be on reweighting the domestic portfolio to avoid refinancing risk and interest rate risk.

The domestic debt also has a narrow investor base for Government securities and increasing issuance pose a risk of not raising required funding through the domestic market. Therefore the focus in 2014 will be increasing the investor base. There will also be some considerations on developing new products particularly in relation to the need to significantly increase the average debt maturity profile.

H. RISKS TO 2014 ECONOMIC AND FISCAL OUTLOOK

Risks to the PNG economy in 2014 remain modest. Internal drivers are the main drivers of economic growth and currently they are generally positive and stable. External factors cannot be ignored particularly further movements in commodity prices and the possible impact of further exchange rate movements.

Key risks to the 2014 Economic and Fiscal Outlook include:

- The continued depressed global economic conditions which have increased the downside risks to commodity prices. If continued in 2014, it would further affect Government revenue
- Disruptions to the construction completion stage and first gas production of PNG LNG including any disruptions to other major mines
- Inflation moving higher in response to possible further depreciations of the Kina
- Risks in being able to fully finance the deficit from domestic funds (considered a low risk in 2013 but higher in the outer years)
- Loss of fiscal discipline including the possible emergence of off-budget expenditure pressures
- Capacity constraints preventing full implementation of the 2014 Budget and the risk of any possible under-expenditures being redirected towards less effective expenditures

Early assessment of the implementation of the capital component of the 2013 Budget shows a trend toward low expenditures with many projects facing delays. As part of the 2014 Budget Strategy, the Government will consider shifting the funds from such timing delays from 2013 to 2014 and future years. This would be consistent with good project management.

I. MEDIUM TERM ECONOMIC AND FISCAL OUTLOOK

2015 to 2018 Economic Outlook

Economic activity over the medium term (2015 to 2018) is underpinned by the winding down of the PNG LNG project construction phase in 2013 and the commencement of the PNG LNG project production towards the end of 2014 leading to a ramp up to full production in 2015.

Growth is projected to ease to 6.0 per cent in 2014 with the winding down of the PNG LNG project construction phase in 2014 before increasing to 21.5 per cent in 2015 reflective of the commencement of PNG LNG project production towards the end of 2014 before returning to a growth of around

3.0 per cent thereafter. Other sectors of the economy are also expected to grow over the medium term in line with the major drivers of the economy.

Inflation is projected to pick up slightly to 6.5 per cent in 2014 and ease slightly to 5.0 per cent thereafter, assuming credible monetary policy and restrained fiscal policy.

Table 2: Economic Parameters

	2012 Actual	2013 Est	2014 Proj	2015 Proj	2016 Proj	2017 Proj	2018 Proj
Economic Growth (%)							
Total GDP (est)	8.0	6.1	6.0	21.5	3.1	3.3	1.9
Non-Mining GDP (est)	9.1	5.5	1.3	4.3	4.3	4.5	2.4
Inflation (%)							
Year average	2.2	5.6	6.5	5.0	5.0	5.0	5.0
Interest Rate (%)							
Kina Facility Rate (KFR)	6.75	6.25	6.25	6.25	6.25	6.25	6.25
3 year Inscribed Stock (IS)	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Mineral Prices							
Gold (US$/ounce)	1,668	1,409	1,412	1,429	1,449	1,475	1,507
Copper (US$/tonne)	7,959	7,238	7,385	7462	7529	7592	7640
Oil (Kutubu:US$/barrel)	105	96	95	92	90	87	86

Source: Department of Treasury

2014 to 2018 Fiscal Outlook

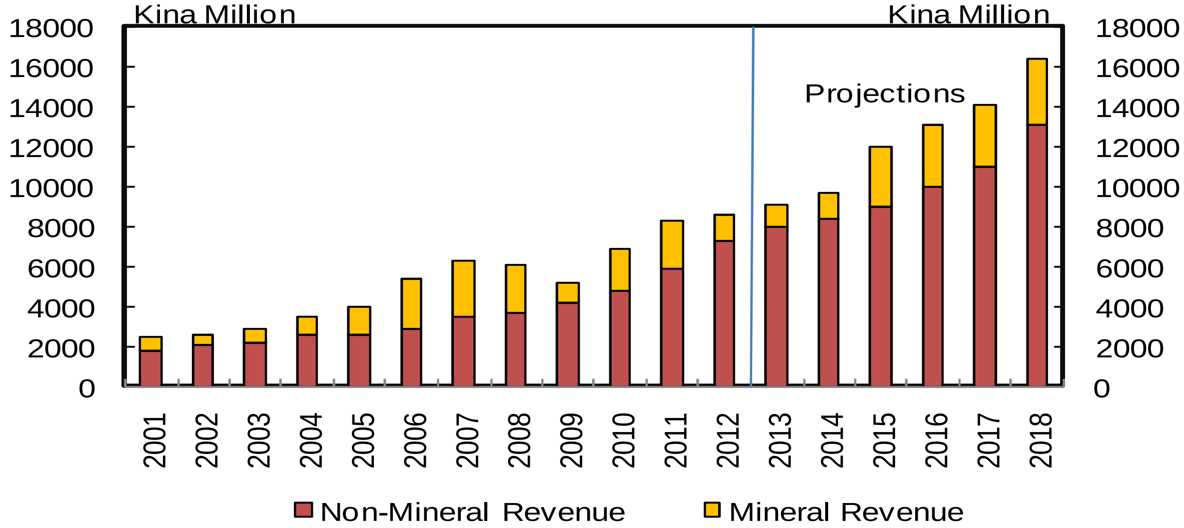
Fiscal pressures are expected to mount prior to revenue contributions from the production phase of the PNG LNG project. This is due to an expected decline in mineral revenue in the first half of the medium term and the pipeline of planned development expenditure under the MTDP.

Mineral revenue is expected to decline prior to revenues arising from the PNG LNG project in 2015, as presented in Chart 3. This reflects the depletion of oil and copper reserves and an assumed moderation of commodity prices back to long-term levels.

While the first gas production from the PNG LNG project is expected in late 2014, tax revenue from the project is not expected until 2015. Once this occurs, mineral revenue collections are expected to rise, as revenue from the PNG LNG project replaces diminishing revenue from other mineral projects. However, larger tax revenue collections from the PNG LNG project are not expected until the mid 2020s, after the project has written off (depreciated) the initial construction cost.

Total revenue is expected to grow modestly in nominal terms over the medium term driven by solid continued growth in non-mineral revenue as shown in Chart 3.

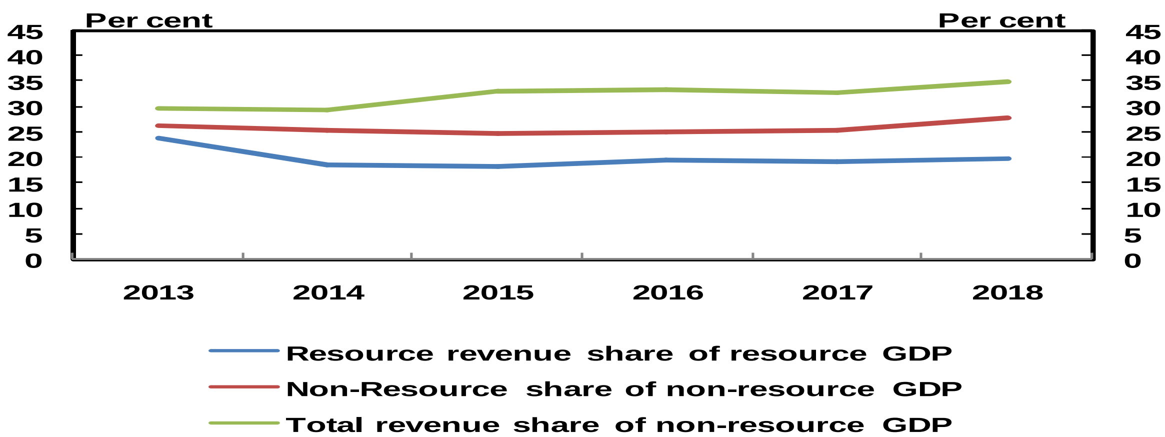
Chart 3: Mineral and Non-Mineral Revenue 2001-2018



Source: Department of Treasury

However, total revenue is projected to remain stable as a share of non-resource GDP over the next medium term as can be seen in Chart 4. These revenue projections indicate a declining share of revenue as a proportion of the economy that is available to finance development. While Total Revenue as a share of the economy is relatively stable, resource revenue as a share of resource GDP is expected to fall significantly over the MTFS from 23.7 per cent to only 19.8 per cent.

Chart 4: Revenue Projection over the Medium Term

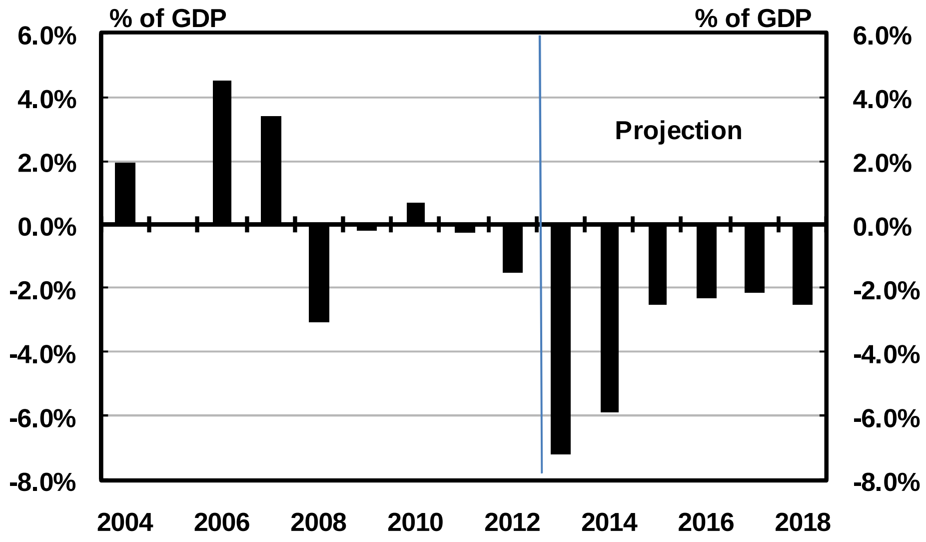


Source: Department of Treasury

The pressure to support the four main MTDP enablers (including education; health; infrastructure; and law & order) and Government's outstanding fixed commitments including PNG LNG related (UBSA/LBSA/IDG) will remain over the medium term. Funding for these activities will be increased over the medium term.

However, revenue growth will be insufficient to meet all outstanding pressures and will require difficult decisions to fund critical and necessary expenditures. The budget is expected to be a deficit of 5.9 per cent of GDP in 2014 and 2.4 per cent of GDP thereafter (Chart) 3.

Chart 3: Budget Balance over the Medium Term



Source: Department of Treasury

Projected population growth or likely flow-on costs of current policies, such as the tuition fee free education; implementation of the National Health Plan; and road maintenance & rehabilitation will require additional funding.

Without significant additional revenue, meeting these obligations, or improving services, is not achievable. In the medium term, the Government will need to balance the allocation of additional funding between funding priorities identified in the MTDP including funding the four main MTDP enablers.

The Government is committed to integrating the old 'Recurrent' and 'Development' Budgets for the 2014 Budget as well as pushing ahead with the ongoing implementation of Multi-Year begun in the 2013 Budget.

J. MICROECONOMIC REFORMS

Microeconomic (or structural) reform can be summarised as providing an economic environment that encourages and enables the private sector to flourish – simply, it's about improving productivity and international competitiveness, which will generate economic growth and increase GDP. A microeconomic reform agenda must look both at the performance of State Owned Enterprises (SOEs) and beyond their operation and the markets in which they operate, to look at the whole economy. Consider where the impediments or blockers are to private sector development and growth, or conversely identify what the enablers of that growth might be and put them in place and to facilitate incentives for innovation and development.

SOE reform strategies should include removing legislated monopoly rights for SOEs; introducing competition where possible; privatising SOEs or their businesses that operate in competitive markets; 'contracting out' where feasible; and regulating them stringently to ensure efficiency. These strategies will 'make more space' for the private sector which is generally more efficient than the public sector; spur SOE efficiency which reduces private sector costs; and make domestic industry more internationally competitive, while reducing costs for consumers and increasing their spending power from the resulting surplus.

Microeconomic reform must be a deliberate and ongoing process with a high degree of interconnectivity between various market reforms that ultimately drive increased productivity and economic growth. The reform strategy must be comprehensive and provide a logically sequenced approach to reform over the short, medium and long-term. A microeconomic reform agenda should encompass:

- encouraging SOEs to be efficient and increasing the nature and level of competition in the markets in which they operate, with a particular focus on the telecommunication, electricity and transport sectors;

Ensure that a strong regulator enforces the competition and consumer protection law so that markets operate competitively, and ethical traders, small businesses and consumers are not treated unfairly; misled or deceived.

- build the productivity of sectors particularly important to the rural and remote area of PNG such as tourism and agriculture;
- reduce the cost of doing business and remove regulatory impediments to private sector growth;
- facilitate the development of the small and medium enterprise sector; and
- encourage the operation of the informal economy and the transition of informal economy participants to the formal economy.

J.1 A competitive and dynamic private sector

Having sound macroeconomic policies, and an economy that is robust and resilient to external shocks, are essential building block to economic growth and prosperity. But, the primary driver of such growth is a competitive and dynamic private sector. Importantly, this means a private sector that is not reliant on a few large scale projects, but is diverse and encourages participation and innovation within the Papua New Guinea population and all levels. The Government remains committed to growing and building the private sector by creating an environment that is conducive to private sector development, to encouraging innovation, and to supporting a competitive private sector. As part of the ongoing effort and commitment, the Government will monitor, review and realign existing policies, including the introduction of new policies to promote private sector growth.

The provision of effective public infrastructure is essential for boosting economic activity and contributing to the global fight towards alleviating poverty amongst its citizens. The Government has demonstrated its commitment to public infrastructure through policy initiatives and reforms such as secured lending, microfinance, service utility reforms and encouraging greater private sector participation to deliver public goods through Public Private Partnerships (PPP).

Public Private Partnerships (PPP)

The Public Private Partnership (PPP) policy is expected to enhance infrastructure and service delivery by utilizing private sector capital, management, innovation, technology and other resources. In 2013, it is expected that a PPP Bill will be submitted to Parliament after which it will be possible to establish a fully operational PPP Centre. The main objective of the PPP Centre will be to vet PPP project proposals and provide the private sector certainty when entering into project agreements to deliver much-needed public infrastructure services.

Access to Finance

The Government recognises that to start, consolidate or grow a business there is often a need for financial capital and that access to finance has not always been easy for people in PNG, and in particular for the SME sector. The Government remains committed to financial inclusion and facilitating access to finance through promoting microfinance, the Centre for Excellence in financial inclusion and encouraging a progressive, competitive and customer friendly financial sector.

After establishing legislation in late 2012, it is anticipated that 2014 will see the full implementation of the Personal Property Securities Registry. The Registry is anticipated to bring significant benefits to the financial sector (by making it easier for them to assess lending risks) and the private sector (by facilitating the use of collateral to obtain finance), which combined is like to drive economic growth. Ensuring successful implementation will be a priority for 2014.

Encourage Business Opportunities for Citizens

In 2013 the Government identified a range of initiatives focusing on encouraging ordinary Papua New Guineans to become involved in business activity, both within the formal and informal economies. These initiatives, highlighted in the small and medium enterprise 12 point plan, the Madang Summit Declaration and the Informal Economy Policy, will be further considered and developed in 2014. Through promoting the small and medium enterprise (SME) sector, undertaking appropriate changes to legislation and administrative processes and streamlining and better coordination of government agencies to improve the support for citizens and reducing the regulatory impact and cost on businesses, the Government will provide an environment conducive to business development.

Competition - General

Encouraging and promoting competition within the private sector will encourage growth and opportunity, which previous reforms, such as in the telecommunications sector, have demonstrated. It is important that the Government continue to consider and identify areas for further reform as a major driver of economic and employment growth, with the transport sector (aviation and shipping) obvious candidates.

Like telecommunications, the Government recognises that power security is a critical factor in the ability of the private sector to grow. Without reliability in power supply, significant unnecessary expense is incurred. Implementation of key aspects of the Electricity Industry Policy, including promoting more competition to take place in the power generation segment and a “third-party access code” to be overseen by the industry regulator, the Independent Competition and Consumer Commission (ICCC), will provide the foundation for a more accessible, reliable and affordable electricity supply.

The Government has also committed to undertaking a comprehensive review of the competition policy framework, including the ICCC Act. While work on this review is expected to commence, and be well advanced during the course of 2013, implementation of any of the findings is likely to form the basis of a substantive reform agenda during 2014. The primary focus will be on ensuring PNG has an efficient and effective competition regulatory and policy regime.

Land and Housing

Access to land is a key blocker to private sector development and accordingly, remains a focus of the Government. Much work has already been completed with the National Land Development Program (NLDP), with legislative changes and policies and processes in place to facilitate the registration and commercial use of customary land. Combined with improvements in the Land Information System (improving land administration) and an enhanced understanding of the value and commercial potential of land, the priority action for 2014 will be maintaining momentum in implementation to bring about substantial economic benefits to Incorporated Land Groups (ILGs) and the broader economy.

During 2013, NEC considered and endorsed the findings of an ICCC report on the housing industry and supported the establishment of a Housing Policy Implementation Taskforce (HPIT) to oversee the response to the recommendations of the ICCC Report. This will be a focus for 2014, with priority recommendations to be identified and implemented and comprehensive implementation plan for all recommendation to be established. The HPIT will work constructively and cooperatively with the Housing Ministerial Committee that was also established in 2013.

J.2 Reforms for State Owned Enterprises

The Government is currently developing various overarching policies to improve the performance and commerciality of SOEs. These include the on-lending, guarantee, dividend, and CSO policies. These respective government policy initiatives underpin one prime objective, and that is for SOEs to behave just like any other business. The overarching public outcome that these policies seek to achieve is the sustainable provision of public services to the people of Papua New Guinea.

Community Service Obligations (CSO) Policy

One of the barriers to improving the performance of State Owned Enterprises (SOEs) is the lack of clarity in the delivery of CSOs by the SOEs. This lack of clarity in the CSO process by the Government in terms of identifying, costing, funding the CSOs has resulted in reduced efficiency incentives for SOEs, confused accountabilities and a negative impact on SOEs commercial performances. There is a need for the Government to better manage the purchase of CSOs and to ensure that the SOEs clearly identify the CSOs that they are providing, the cost incurred in the provision of the CSOs and the resulting effect on their financial performance. The provision of informal and unfunded CSOs makes it impossible for the Government to know what the true cost of the CSO is and whether the CSO is actually achieving the benefits sought.

The Government is working in partnership with all key stakeholders and development partners in developing this important policy reform. The policy has been finalised and a Government's approval is expected in late 2013 for its implementation.

Dividend Policy

The Government is also committed to having a comprehensive dividend policy in place. The dividend policy will allow the State to set its expectations about the returns it gets from its investment. The purpose of this policy is to provide SOEs with the necessary guidance on the Government's expectation on returns from the General Business Trust (GBT) assets through the commercial investments. The dividend policy seeks to ensure that the opportunity cost of SOEs retaining funds for reinvestment (namely, the State's other funding needs) is recognized in SOEs dividend distribution decisions. Implicit in this is that SOEs are expected to make capital investment decisions that aim to maximize the return to that capital, just like any profit-maximizing business not owned by the State.

On-lending Policy

The on-lending policy relates to the terms on which the State will lend to SOEs, This policy relates to the debt financing activities of the SOEs.

A Working Group that was designated to design and develop this policy has completed the policy formulation process and a Government's decision on its implementation is expected in late 2013.

Guarantee Policy

The guarantee policy relates to the terms on which the State will guarantee borrowings of SOEs. Likewise, the on-lending policy, this policy relates to the debt financing activities of SOEs. Total guarantees and liabilities, including debt, must not exceed the 60 per cent of GDP limit set by the MTFS 2013 - 2017.

A Working Group has been formed to design and develop this policy and the formulation process has already commenced.

J.3 Public sector reform

Public sector payroll overruns on Personnel Emoluments.

Personnel Emoluments is comprised of salaries and allowances, wages, overtime, leave fares, retirement benefits, pensions and contract gratuities. The 2013 Budget for Personnel Emoluments was set at K3,013.5 million. This reflects costs associated with wage agreements for public servants and costs associated with pay agreements negotiated with workers not covered by the Public Employment Association agreement.

In previous years inadequate controls on the payroll system have been identified as a cause of overspending by agencies and the government has agreed to remedial action. However, sufficient corrective action has not been taken by the responsible agencies. If current expenditure trends continue, expenditure on Personnel Emoluments will again exceed appropriation.

The 2013 MYEFO report estimates potential overspend of K78.9 million, all of which is accounted for by overspending by Provincial Governments on Personal Emoluments in 2013. Historically the rate or expenditure on personnel emolument tends to rise over the course of the year. Significant changes in behavior or the introduction of robust expenditure controls will be required to stop agencies spending in excess of their personnel emoluments appropriation.

It is estimated that several thousands of the Government's 89,000 plus employees are employed illegally, ghosts employees, one person receiving multiple salaries, long retrenched or retired employees, staff recruited without budgetary appropriation, unattached officers and officers who are absent without permission for extended periods of time.

The Departmental heads responsible for Department of Personnel Management, Department of Treasury and Department of Finance will take a proactive approach to ensure expenditure in personnel emoluments in the Public Service is kept within budget and that over-expenditure is prevented from happening. Tough actions will be taken to strengthen Audits and

Reporting, Data Cleansing and Demarcation of Responsibilities. Resources will be provided to facilitate these outcomes.

J.4 Sovereign Wealth Fund

The key to improving development outcomes in PNG is prudent management of public finances especially the volatility of revenue flows from the mining and petroleum sector including the PNG LNG project. They will fluctuate with the movements of international commodity prices which has been evident in the recent history.

The structure and institutional framework for the Papua New Guinea Sovereign Wealth Fund (PNG SWF) established by the National Government is such a mechanism to manage these revenues and ensure it helps insulate the PNG economy and the budget from this volatility. The PNG SWF provides a possible funding source to help ensure infrastructure activities receive greater priority.

The design of the PNG SWF is consistent with international best practice as it will be managed onshore, with investments made offshore. Its overall design intention is to buffer PNG from the high price volatility experienced in the mining & petroleum sector, in particular the impact of this volatility on the exchange rate and Government revenues. At the same time it ensures that over time the Government has the access it needs to the revenues it is receiving from the mining sector.

All funds drawn down from the PNG SWF will flow into the National Budget. The withdrawal rules have been designed to be consistent with the Government's Medium Term Fiscal Strategy.

The overall objective of the PNG SWF is:

- to support macroeconomic stabilization;
- to support the development objectives of the Government including long-term economic and social development; and
- to support asset management in relation to financial assets accrued from natural resource revenue.

The PNG SWF will consist of two funds: a Stabilization Fund and a Development Fund. The Stabilization Fund will manage the impact of fluctuating mineral and petroleum revenues on the PNG Economy and on the Budget; and the Development Fund will provide a definite and ongoing funding source for the provision of development in key economic and social priorities in accordance with the development plans as determined by the Government, from time to time. The PNG SWF will be established under an Organic Law to promote good governance and accountability. The Organic Law will incorporate only the essential high level policy issues.

The Government is aiming for the Organic Law to be re-introduced in the Parliament as soon as possible during the remaining 2013 Parliament sessions to meet some constitutional requirements. It is also a constitutional requirement that the Organic Law go through three readings in the Parliament with at least two months period between the second and third reading. This implies that PNG SWF will become operational in 2014 if the Organic Law is supported and passed by the absolute majority of members of Parliament.

J.5 Multi-Year Budgeting

The 2013 Budget introduced multi-year budgeting for the first time at a 'Budget overview' level. In 2014 and the following years, this implementation will be further strengthened, including at an Agency level.

Multi-year budgeting is important as it enhances the ability of the Government and its Agencies to plan expenditure over time as well as to give individual Departments the ability to better manage their Budget allocations from year to year.

A key example of where multi-year Budgeting will lead to better expenditure decisions is in the case of infrastructure construction projects that take longer than a year to implement. In this case the Government will be able to clearly see the cost over of number of years of each project as well as the associated ongoing maintenance cost.

A move to multi-year budgeting can also help deal with the annual end-of-year surge in expenditure where agencies simply spend money to avoid losing it. A modest level of carry-over will help to create better incentives for effective spending.

J.6 Budget Integration

The 2014 Budget will be Papua New Guinea's first integrated National Budget for a number of decades.

By combining the old 'Recurrent' and 'Development' Budget into a single Budget there are expected to be a number of advantages:

- The Government will be able to make more informed decisions about overall expenditure priorities – for example ensuring increases in the share of funding going to the MTDP enablers or selected sectors.
- Departments and other Government organisations will be able to better plan to have enough 'ongoing' expenditure for staff, maintenance and other associated costs when undertaking new capital expenditures.
  - With two separate Budgets there were many cases of buildings being built, but not enough money being put aside to ensure staff, such as health workers, to occupy them.
- Ministers will have greater authority over the expenditure in their Departments and their role in bidding for money for new proposals within the Budget process.

J.7 Other Important Complimentary Action Items for 2014 Budget

Among major policy reforms for 2014 Budget, the Government will consider these important reforms in the context of the 2014 Budget:

- For 2013 development projects, cease the practice of transferring unspent funding into an existing or new trust account.
- Conduct a review of all trust accounts to determine accounts to be closed and the funds to be returned to the Consolidated Revenue Fund.
- To prevent future salary expenditure over-runs by strictly enforcing agency salary appropriations at the national and sub-national level and complete the one person, one position and one pay principle.
- Department of Finance should prepare a detailed list of possible assets sales over the period of 2014 to 2018 as well as a process for undertaking the sales for NEC consideration and approval.
- The amalgamation of government agencies that have been approved by the NEC be implemented from January 1, 2014 and be reflected in the 2014 Budget Appropriations.

J.8 Increased focus on compliance

The Internal Revenue Commission (IRC) and PNG Customs Services have been working hard to identify and address taxpayer non-compliance. The problem of non-compliance by many taxpayers is attributed to their registration, lodgment, correct reporting, and payment obligations and this has reduced revenue collections for the Government.

IRC has developed new strategies to enhance taxpayer compliance and these include implementation of new tax administration computer system and associated processes, integration and matching data with relevant agencies such as the Investment Promotion Authority (IPA) and simplifying the tax administrative system.

The PNG Customs Services has also put in place Compliance Assurance Strategy to enhance revenue collection to the support the national budget. This strategy includes improving industry compliance with cargo and trade related customs legislation, collection of correct revenue and ensure compliance with customs policies and guidelines.

In addition to identifying potential sources of additional revenue through the 2013/14 Tax Review, the Government is considering additional revenue raising measures by outsourcing some audit and compliance activities to an external party via normal procurement processes. This project will operate in conjunction with IRC and PNG Customs. This will increase the Governments revenue collections as they are not currently being collected but owed to the Government.

Capacity constraint is an issue to be addressed by the Government for both the major revenue collecting agencies. Increasing the staff levels to its required staff ceiling and providing training to enhance their skills and retaining these skilled employees are big issues faced by these two organizations.

K. CONCLUSION

The above set of policies has the specific endorsement and approval of the Cabinet and will guide and direct central agencies and departments in the preparation of the 2014 Budget.