PRICEWATERHOUSECOOPERS

15 November 2005

The Minister for Finance and Treasury, the Honourable Bart Philemon, MP, today handed down the 2006 National Budget.

Executive summary

The theme of the 2006 National Budget 'Improving People's Lives through Strong Economic Leadership' continues the 'Building the Economy Through Sustained Reform' policies underpinning the 2005 National Budget. The Budget seeks to translate benefits derived from the stability in the economy into improvements in people's lives without compromising macroeconomic stability.

Key components include:

- A budget deficit path that continues to track downwards resulting in deficits of no more than 0.6% of GDP in 2006 (2005 revised budget was a deficit of 0.6% also) with a view to a balanced budget by 2008.
- No new taxes or increases in existing taxes while continuing with the scheduled reductions in the mining levy and continuation of the tariff reduction program.
- The proportion of budgeted expenditures allocated to the Medium Term Development Strategy priority areas is projected to increase to 50% in 2006 (2005 estimated allocation was 48%). The priority areas identified are transport infrastructure rehabilitation and maintenance, promotion of income-earning opportunities, basic education, development oriented informal adult education, primary health care, HIV/AIDS prevention and law and justice.
- Continuation of the public sector "rightsizing" program with the objective of controlling public sector salary costs.
- Introduction of a number of measures to address ongoing problems of inefficient telecommunications, poor service delivery from utility providers (particularly power and water), high transport costs and a range of issues around land.
- Continue to improve budget strategy and processes and public finance management.

Key budget assumptions

The major assumptions on which the budget has been based are summarised in the table below. Historic indicators are also included for reference purposes.

Principal economic indicators	2001 actual	2002 actual	2003 actual	2004 actual	2005 revised	2006 proj.	Average (2001 - 2005)
Real GDP Growth (%)	(2.3)	(1.0)	2.9	2.9	3.0	**3.5**	1.1
Non-mining GDP Growth (%)	(4.1)	1.5	1.9	3.5	3.5	**3.2**	1.3
Inflation (year average) (%)	9.3	11.8	14.7	2.1	1.0	**3.0**	7.8
Oil Price (US$ per barrel)	26.2	24.0	27.4	42.1	55.0	**58.0**	34.9
Gold Price (US$ per ounce)	283	311	363	409	420	**410**	357
Interest rates % (yearly average 182 day T-Bill)	12.6	13.3	18.3	9.0	4.5	**6.5**	11.5

Courtesy: National Statistical Office, IMF and Treasury Department

Delivering the benefits from fiscal management and economic reform

The 2006 Budget has been delivered in the context of seeking to capture the benefits of prudent fiscal management and sustained economic reform. Economic improvements have been realised on the back of a strong global resources sector and a solid global economy generally. The 2006 Budget seeks to translate these benefits into the lives of all Papua New Guineans by delivering real and sustainable improvements in living standards.

Consistent with the 2005 Budget, the government sees this Budget as being in line with the *'Medium Term Fiscal Framework'*, which requires responsible and sustainable fiscal management. Further, the budget is heavily guided by the *'Medium Term Development Strategy 2005 – 2010'* which has three main roles:

1. To provide overarching development strategy for Papua New Guinea;

2. To provide the policy and expenditure framework for the implementation of the Agenda for Recovery and Development; and

3. To help strengthen the public expenditure management framework in Papua New Guinea.

Continuing and sustained structural reform

In a manner similar to the 2005 Budget, the 2006 Budget focuses on the creation of an environment supportive of private sector growth in the 3 key areas of:

(i) creating a stable investment climate;
(ii) providing an efficient, effective and affordable public section; and
(iii) creating a competitive and dynamic private sector.

Financing the budget

The following table summarises the financing requirements arising as a result of estimated Budget deficit for 2006 and also includes historic information for reference purposes.

Financing the budget (Kina millions)	2003 (actual)	2004 (actual)	2005 (revised)	2006 (projection)
Total revenue and grants	3,650	4,350	5,054	4,739
Total expenditure and net lending	3,774	4,148	5,151	4,829
Budget surplus / (deficit)	**(124)**	**202**	**(97)**	**(90)**
Budget surplus / (deficit) as a % of GDP	**(1.0%)**	**1.5%**	**(0.6%)**	**(0.6%)**
Net External Financing				
Concessional	(136)	(83)	(155)	(40)
Commercial	11	-	-	(18)
Extraordinary	(182)	(73)	-	(66)
	(307)	**(156)**	**(155)**	**(124)**
Net Domestic Financing				
Domestic borrowing	361	169	252	214
Asset sales	40	-	-	-
Other	30	(215)	-	-
	431	**(46)**	**252**	**214**
TOTAL	**124**	**(202)**	**97**	**90**

Courtesy: Department of Finance and Treasury

The Government's total financing requirement for 2006 will be K214 million. This consists of the deficit of K90 million and net external repayments of K124 million. The key points in relation to financing the 2006 budget are:

- New concessional external borrowings in the amount of K163 million will be undertaken in 2006, however there will also be repayments of existing, concessional, commercial and extraordinary loans in the amount of K287 million in 2006.
- K1,220 million of new debt is to be raised domestically via a K420 million issue of new Treasury Bills and a K800 million issue of new Inscribed Stocks (K500 million of which will represent the switching of Treasury Bills to Inscribed Stock). Of the new debt raised, K1,006 million is required for the repayment of existing debt.
- It is not expected that the new borrowings will have a significant impact on interest rates.
- No receipts from asset sales are included in the financing for the 2006 Budget.

Recurrent and development expenditure

The total appropriation for 2006 of K4,829.3 million comprises:

- Recurrent budget of K3,142.1 million (2005 estimate = K2,889.2 million)
- Development budget of K1,687.2 million (2005 estimate = K1,888.3 million)

From the recurrent budget, National Departments will receive K1,692.1 million of which 43.7% represents salary and wages and 56.3% represents the purchase of goods and services. Provincial Governments will receive K269.9 million of which 64.8% represents salary and wages and only 35.2% represents the purchase of goods and services. Interest payments and fees will account for K497.0 million or 15.8 % of the recurrent budget.

The portion of the National Departmental and Provincial Governmental allocations represented by salary and wages has decreased compared to the 2005 Budget, as has the anticipated interest payments and fees.

K994.0 million or 58.9% of the development budget is in the form of project grants or donor assisted development programs. This proportion was closer to 68.0% in the 2005 development budget and the decline is largely reflective of the reduced scale of the police component of the Enhanced Cooperation Program. Australia is the largest contributor providing over 71.5% (in the 2005 development budget this was 82.1%), with the EU, Japan and China providing the balance. This indicates that Australia's relative contribution to the development budget is expected to decline slightly over 2006, with the relative contributions of Japan and China growing in importance.

The *'Medium Term Development Strategy 2005 – 2010'* provides the framework for the development budget. This strategy identifies and addresses 7 expenditure priorities to which the 2005 Budget allocated 48% of expenditure allocations. The K1,992.1 million allocation of expenditure to these priority areas is expected to increase to 50% in 2006 (and 80% of the development budget specifically) and is estimated to increase to 55% by 2010. These areas and the budgeted allocation each area in 2006 are:

1.	Basic education	25.4%
2.	Rehabilitation and maintenance of transport infrastructure	22.8%
3.	Primary and preventative health care	21.0%
4.	Law and justice	16.1%
5.	Generation of income-earning opportunities.	8.6%
6.	Development oriented adult education	1.0%
7.	HIV/AIDS prevention	0.4%
	Other expenditure	4.8%

Key 'Impact' Programs within the 2006 development budget are:

1. Transport Infrastructure Rehabilitation and Maintenance

    - Other roads and bridges maintenance and rehabilitation – K146.0 million
    - Highlands Highway (including infrastructure tax credit) – K103.5 million
    - Maritime Infrastructure Development – K66.2 million
    - District Roads Improvement Program – K35.6 million

2. Export Promotion and Income Earning Opportunities

    - Agricultural research – K15.0
    - Provincial Economic Impact Program – K14.5 million
    - Petroleum Industrial Park – K4.0 million
    - PNG Gas to Queensland Support – K3.0 million.

3. Public Sector Reform & Governance

    - Enhanced Cooperation Program – K116.1 million

4. Access to Basic Education and Health

    - National AIDS Council – K32.3 million
    - Curriculum reform – K24.5 million
    - Basic Education Development Program – K23.7 million

Taxation developments and amendments

Corporate tax rates

There has been no change to the general corporate income tax rate of 30%, however the rate of income tax on income from mining operations derived by a non-resident company has been reduced from 48% to 40%.

Personal tax rates

General personal income tax rates will be reduced over two years. The new rates for residents and non-residents are set out below.

From 1 January 2006 the rates for residents are as follows:

Taxable income	Tax there on (K)	Rates of tax on excess (%)
6,300	Nil	25
18,000	2,925	30
33,000	7,425	35
70,000	20,375	40
150,000	52,375	45

From 1 January 2006 the rates for non-residents are as follows:

Taxable income	Tax there on (K)	Rates of tax on excess (%)
Nil	Nil	25
18,000	4,500	30
33,000	9,000	35
70,000	21,590	40
150,000	53,950	45

From 1 January 2007 the rates for residents are as follows:

Taxable income	Tax there on (K)	Rates of tax on excess (%)
6,600	Nil	25
18,000	2,850	30
33,000	7,350	35
70,000	20,300	40
250,000	92,300	42

From 1 January 2007 the rates for non-residents are as follows:

Taxable income	Tax there on (K)	Rates of tax on excess (%)
Nil	Nil	25
18,000	4,500	30
33,000	9,000	35
70,000	21,590	40
250,000	93,590	42

Dividends - Exemption

Dividends derived by resident individuals and resident trust estates which have been subject to dividend withholding tax will be exempt from further taxation. This means dividend withholding tax will be a final tax for resident individuals and resident trust estates. The effect of this change is to reduce the impact of the double taxation of company profits for resident shareholders. Under the existing rules the maximum effective tax rate on distributed profits is 62.9%. Under the new rules the maximum effective tax rate on distributed profits in 41.9%. This reflects the top marginal income tax rate which is intended to apply from 1 January 2007.

Tourism incentives

There are three taxation amendments targeted at benefiting the tourism industry:

(i) The double deduction for expenditure incurred on export market development expenditure has been amended to included outgoings incurred primarily for the purpose of seeking opportunities, or creating and increasing demand for the development of tourism within PNG. This applies to expenditure incurred after 31 December 2005.

(ii) The definition of “eligible property” has been amended to include plant used by hotels or other short-stay accommodation facilities. Where a taxpayer acquires items of plant which qualify the depreciation allowed in the year of acquisition is increased by 20%.

(iii) According to the Budget papers to assist the tourism industry the rate of excise duty on photographic film will be reduced from 30% to nil. The rate of customs duty has been reduced to nil for other items including sheets, towels, ceramic tableware and glass tableware that will also benefit the tourism industry.

Agriculture incentives

There are three taxation amendments targeted at benefiting the agricultural sector:

(i) The infrastructure tax credit scheme available for primary producers has been increased from 1% to 1.5% of assessable income derived during the year ended 31 December 2006 and subsequent years.

(ii) The 2004 Budget included a concessional income tax rate of 20% to apply for ten years to new agricultural projects with an investment of more than K5 million. The rate applied to projects commencing construction between 1 January 2004 and 31 December 2006. The eligibility period has been extended to 31 December 2011 and the minimum investment has been reduced to K1 million.

(iii) The 2004 Budget announced that tractors for use in agricultural and forestry work would be exempt from the 10% excise duty on tractors. This required substantiation of the use of the tractor which increased costs for taxpayers and created administrative difficulties. The exemption has been amended so that it applies to all wheeled tractors with an engine capacity of 4 liters or less. This will allow the normal tractors used in agriculture to be imported free of excise duty but will retain duty on large tractors used in resource projects.

Amalgamation - Tax losses

A technical amendment has been included to bring the deductibility of tax losses of companies which have been amalgamated into line with the conditions which apply before the amalgamation. This amendment was sought by PricewaterhouseCoopers in a submission to Treasury which pointed out that the “same business test” for deduction of losses did not apply where there had been a greater than 50% change of ownership in a company which had tax loss prior to the amalgamation.

Charitable Bodies

The income of charitable bodies established to help the victim of or in the reconstruction efforts of those affected by the Manam Island volcanic disaster of 24th October 2004 and/or the Asian Tsunami disaster of 26th December 2004 is exempt from income tax. Donations to such charitable bodies will be allowable deductions.

Research and Development

The law has been amended to include a right of appeal to the Review Tribunal where a taxpayer is not satisfied with a decision of the Research and Development Approval Committee.

Taxation developments and amendments – mining, petroleum and gas

In prior years there have been a number of amendments relating to the Mining, Petroleum and Gas Industries. The 2006 Budget contains several amendments which impact these industries. The changes are:

(i) A new concept of “exploration expenditure” has been included in the Income Tax Act. This is defined as expenditure incurred on exploration in Papua New Guinea which would be allowable exploration expenditure had a resource development licence been issued immediately after the expenditure was incurred.

(ii) Section 155L of the Income Tax Act has been repealed and replaced with a new Section 155L. The new section provides for the transfer of exploration expenditure, allowable exploration expenditure and allowable capital expenditure. As the law is currently drafted it is arguable expenditure incurred on exploration could not be transferred to the purchaser of an interest in an exploration licence. PricewaterhouseCoopers and our Resource Industry clients were concerned the Internal Revenue Commission would apply a literal interpretation of the law and not allow a deduction for exploration costs transferred under a Section 155L Notice. After more than two years of lobbying and submissions the amendment was approved in principle. The amendment included in the budget legislation is identical to the final amendment proposed by PricewaterhouseCoopers and the Resource Industry.

(iii) The rate of income tax on income from mining operations derived by a non-resident company has been reduced from 48% to 40%. This change follows a submission lodged by PricewaterhouseCoopers requesting a reduction in the tax rate for non-resident mining companies to reflect the effective tax rate on distributed profits of resident mining companies which is 37%. In addition some other technical amendments were sought in relation to the provisions of the Rating Act which deals with the tax rate applicable to non-residents. However, these technical amendments have not been taken up in the 2006 Budget.

(iv) The supply of crude oil by resource projects to a refiner in PNG will be zero-rated for GST purposes. According to the Budget papers, this change arises due to the bonded store arrangements applying to the Napa Napa Refinery which provides a cash flow advantage when crude oil is imported because GST is not payable until the refined product leaves the refinery. This currently discriminates against crude oil from the Kumul Terminal.

(v) The former regulation 10G to the Income Tax Act was inadvertently deleted when the mining and petroleum provisions were revised in 2003. According to the Budget papers, regulation 10G which deals with the taxation “ring fence” around the Kutubu and South East Mananda petroleum projects will be reintroduced. A copy of the regulation was not made available with the Budget papers, however the new regulation has been sighted.

Taxation developments and amendments – Goods & Services Tax

The current formula for allocating GST Revenue to Provincial Governments will be continued, pending a further review of the current method. However, the current method may disadvantage some Provinces because it results in reduced distributions. Consequently, the law has been amended so that for 2005 and 2006 the distributions cannot go down in those years. This will result in some additional payments to disadvantaged provinces this year, as well as slightly higher distribution to some provinces next year.

Taxation developments and amendments – Stamp Duties

There were three minor technical amendments to the Stamp Duties Act:

(i) To allow the use of computers for betting and to provide that bookmakers who use that method will lodge weekly returns for payment of the Stamp Duty, instead of having to buy pre-paid betting books.

(ii) To clarify the tests which must be satisfied following a company reconstruction that is subject to stamp duty relief under the company reconstruction relief provisions.

(iii) To change the meaning of majority interest in a private corporation from more than 50% to "50% or more". This means if a person acquires a 50% interest in a private corporation the landholding private corporation stamp duty rules will apply.

Taxation developments and amendments – Customs, Excise and Indirect Taxes

Excise duty - alcohol and tobacco

Currently, excise tax on tobacco and alcohol is increased by 2.5% at six monthly intervals on 1 June and 1 December of each year. This is intended to allow excise tax rates to increase in line with inflation. However, inflation has been significantly lower. As a result, excise indexation for tobacco and alcohol will now be linked to actual movements in the Consumer Price Index. The rate of excise indexation will be capped at the current indexation rate of 2.5% every six months to ensure that any excessive future inflation will not produce excessive excise increases.

The informal tobacco sector is growing rapidly and no excise is paid on locally grown tobacco ("brus"). To enable the formal sector to release a new low-margin product that will be competitive with commercially produced brus tobacco, the rate of excise will initially be set at 60 per cent of the current excise rate on tobacco but will be reviewed after one year. The new rate will apply to locally manufactured "roll-your-own" tobacco.

Customs Tariff Rates

The Treasury has reviewed tariff rates, in conjunction with the Department of Trade and Industry and the private sector. This review has identified areas where tariffs are not protecting domestic production but are serving to increase costs for investors who import these goods. As a result the tariff rates on a number of items have been reduced to nil. These include items used in the tourism industry, fish processing, food processing and other general items.

Customs Act

Amendments are being made to the Customs Act to bring it into line with the requirements of the International Agreement on the Simplification and Harmonisation of Customs Procedures. The changes will reform customs administration, accelerate processing for importers and give the IRC more control over post-import audits. They will allow customs entries to be lodged by email directly into the ASYCUDA system which will facilitate the future complete automation of the customs import system. Customs will be able to review assessments for up to five years and the changes will allow cruise ships to visit ports outside those controlled by customs, under certain conditions.

Currently electrical items are not included in the K1,000 duty free personal allowance for passengers arriving in PNG. The Customs (Personal Effects) Regulation will be amended to include items of electronic equipment within the K1,000 duty free allowance.

Log Export tax

No changes have been made in respect of the log export tax.

Gaming machine tax

There have been no changes to the Gaming Machine Tax.

Further information required?

Further information in relation to the 2006 National Budget can be obtained from John Leahy or David Caradus at PricewaterhouseCoopers in Port Moresby.