PRICEWATERHOUSECOOPERS

14 November 2006

The Minister for Treasury, the Right Honourable Sir Rabbie Namaliu, CSM, KCMG, MP today handed down the 2007 National Budget.

Executive summary

The theme of the 2007 National Budget 'Investing in the Future of Papua New Guinea' continues the 'Improving People's Lives Through Strong Economic Leadership' policies underpinning the 2006 National Budget. The Budget, in part, seeks to allocate the "windfall gains" derived from higher commodity prices to areas of continuing and future development for Papua New Guinea.

Key components include:

- In a continuation of recent Budgets, it is expected that this Budget will result in a deficit of 0.2% of GDP in 2007 (2006 revised budget was a balanced budget following the handing down of supplementary budgets in 2006).
- No new taxes or increases in existing taxes while continuing with the scheduled reductions in both personal income tax rates and the mining levy.
- The proportion of budgeted expenditure allocated to the Medium Term Development Strategy priority areas is projected to increase to 52% in 2007 (2006 estimated allocation was 50%).
- Continued exercise of tight fiscal controls by closely monitoring all expenditure and by enhancing revenue collection.

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	2002 actual	2003 actual	2004 actual	2005 actual	2006 proj.	2007 proj.	Average (2002 - 2006)
Real GDP Growth (%)	(1.0)	2.2	2.7	3.3	3.7	**4.5**	2.2
Non-mining GDP Growth (%)	1.5	2.1	3.1	3.1	4.1	**4.2**	2.8
Inflation (year average) (%)	11.8	14.7	2.1	1.7	1.7	**1.5**	6.4
Oil Price (US$ per barrel)	24.0	27.4	42.1	53.4	65.0	**65.0**	42.4
Gold Price (US$ per ounce)	311	363	409	445	600	**600**	425.6
Copper Price (US$ per pound)	0.71	0.81	1.30	1.67	2.99	**2.49**	1.66
Interest rates % (yearly average 182 day T-Bill)	13.3	18.3	9.0	4.5	5.0	**6.0**	10.0

Source: National Statistical Office, IMF, Department of Treasury, BPNG

Investing the benefits from higher revenue collection

The 2007 Budget has been delivered in the context of seeking to capture the benefits of higher revenue collections, largely derived from higher commodity prices. The 2007 Budget seeks to translate these current benefits into continuing and future benefits for the people of Papua New Guinea.

Consistent with recent years, the government sees the 2007 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 an 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.

Financing the budget

The following table summarises the financing requirements arising as a result of the estimated Budget deficit for 2007 and also includes historic information for reference purposes.

Financing the budget (K millions)	2004 (actual)	2005 (actual)	2006 (revised)	2007 (projection)
Total revenue and grants	4,350	5,327	6,162	5,422
Total expenditure and net lending	4,148	5,319	6,162	5,457
Budget surplus / (deficit)	**202**	**8**	**-**	**(35)**
Budget surplus / (deficit) as a % of GDP	**1.5%**	**(0.6%)**	**0.0%**	**(0.2%)**
Net External Financing				
Concessional	(147)	(84)	(139)	(4)
Commercial	(10)	(18)	(18)	(18)
Extraordinary	(168)	(61)	(67)	(61)
	(325)	**(163)**	**(224)**	**(84)**
Net Domestic Financing				
Domestic borrowing	154	269	124	119
Asset sales	25	-	-	-
Other	(56)	(32)	-	-
	124	**236**	**124**	**119**
TOTAL	**(202)**	**73**	**(100)**	**35**

Source: Department of Finance and Treasury

The Government's total domestic financing requirement for 2007 is expected to be K119 million. This consists of the deficit of K35 million and net external financing repayments of K84 million. The key points in relation to financing the 2007 budget are:

- New concessional external borrowings in the amount of K163 million will be undertaken in 2007, however there will also be repayments of existing, concessional, commercial and extraordinary loans in the amount of K247 million in 2007.
- K2,115 million of new debt is to be raised domestically via the continuation of the Inscribed Stock program. Of the new debt raised, K1,996 million is required for the repayment of existing debt.
- It is not expected that the new borrowings will have an appreciable impact on interest rates.
- No receipts from asset sales or any new external debt are included in the financing for the 2007 Budget.

Recurrent and development expenditure

The total appropriation for 2007 of K5,456.6 million comprises:

- Recurrent budget of K3,370.0 million (2006 estimate = K3,824.6 million)
- Development budget of K1,636.6 million (2006 estimate = K1,687.2 million)
- Additional priority expenditure budget of K450.0 million (2006 estimate = K650 million)

The recurrent budget

From the recurrent budget, National Departments will receive K1,929.1 million of which 42.3% represents employee costs (including superannuation contributions and retirement payments) and 57.7% represents the purchase of goods and services. Provincial Governments will receive K277.0 million of which 56.5% represents salary and wages and 43.5% represents the purchase of goods and services. Interest payments and fees will account for K475.9 million or 14.1% of the recurrent budget.

The portion of the National Departmental and Provincial Governmental allocations represented by salary and wages has decreased compared to the 2006 Budget, particularly at the Provincial Governmental level, as has the anticipated interest payments and fees. While the costs of running the National Departments are expected to increase in 2007, the running costs of Provincial Governments are expected to decrease by a lower amount in 2007 resulting in a net increase in the running costs of the National and Provincial Governments compared to 2006. Transfers to statutory institutions are expected to remain relatively constant into 2007.

The development budget

K879.1 million or 53.7% of the development budget is in the form of project grants. This proportion was closer to 59.0% in the 2006 development budget and the decline is largely reflective of the Government's increased funding of the ongoing development budget in 2007. However, it is noted that the overall development budget has decreased over the last several years with the Government's increase in funding not offsetting the reduction in project grant funding.

Australia continues to be the largest contributor of project grants providing over 78.3% (in the 2006 development budget this was 71.5%), with the EU, New Zealand, the United Nations, China and Japan being the most significant other donors. This will see an increase in Australia's relative contribution to the development budget with a decline in the relative contributions of the EU and Japan.

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 2006 Budget allocated 50% of expenditure allocations. The K2,181.8 million allocation of expenditure to these priority areas is expected to increase to 52% in 2007 and is estimated to increase to 55% by 2010. These areas and the budgeted allocation each area in 2007 are:

1. Basic education	23.8%
2. Rehabilitation and maintenance of transport infrastructure	22.2%
3. Primary and preventative health care	19.7%
4. Law and justice	17.7%
5. Generation of income-earning opportunities.	8.5%
6. Development oriented adult education	1.1%
7. HIV/AIDS prevention	0.8%
Other expenditure	6.2%
	100.0%

Source: Department of Treasury

Additional priority expenditure

The additional priority expenditure has not featured in previous Budgets and represents allocations for spending the revenue collected due to higher commodity prices in 2006 and the higher prices that are expected to continue into 2007. It appears separately to avoid the risk of these "windfall gains" being built into the ongoing recurrent and development expenditure.

Whilst the Budget papers do not provide detailed information on the exact projects upon which these allocations will be utilised between now and 31 December 2007, the following table summarises the budgeted allocation of the K1,100 million additional priority expenditure over 2006 and 2007.

Allocation of 2006 and 2007 "Windfall Gains" (K million)

Rehabilitation of essential public infrastructure		
Rehabilitation of Education infrastructure	200	
Rehabilitation of Transport Sector infrastructure	120	
Rehabilitation of Health Sector infrastructure	110	
Rehabilitation of Law and Justice Sector infrastructure	75	
District Finance Office roll out (10 new offices)	30	
Rehabilitation of NBC infrastructure	21	
Rehabilitation of Bougainville infrastructure	20	
Rehabilitation of Strategic District Markets infrastructure	20	
Major Maintenance of National Parliament	10	
Feasibility Studies for EU Water Projects	9	
		615
Direct investment in economic projects		
Equity injection into State owned enterprises	130	
Gas Project Equity	100	
Government contribution to major Agricultural Projects	40	
		270
Repayment of debt and other one-off obligations		
Repayment of expensive debt	100	
Phasing of elections	30	
Public service sign-on bonus	25	
Outstanding PBBS payments (teachers)	20	
Resettlement of volcano victims	20	
Parliament: election related one-off items	20	
		215
		1,100

Source: Department of Treasury

Taxation developments and amendments – Income Tax

Corporate tax rates

There has been no change to the general corporate income tax rate of 30%.

Personal tax rates

As announced in the 2006 Budget personal tax rates were to be reduced over two years and the first reductions came into effect from 1 January 2006. The second reductions remain effective from 1 January 2007 and the rates from this date are set out below.

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

Taxable income	Tax thereon (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 thereon (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

Tourism incentives

The 2006 Budget included income tax amendments targeted at benefiting the tourism industry. This theme has been continued in 2007 with further income tax incentives to promote tourism:

(i) A double deduction will be allowed for payments for tourism staff training costs. This applies to expenditure incurred from 1 January 2007.

(ii) In 2006 the definition of “eligible property” was amended to include plant used by hotels or other short-stay accommodation facilities. This enabled tourism plant to qualify for initial year depreciation of 20% of the cost of the property. For tourism plant installed ready for use on or after 1 January 2007 the depreciation allowed in the year of acquisition has been increased to a maximum of 55%.

(iii) The taxation rate applicable to the income derived by a taxpayer solely from a new large scale tourism facility or a substantially improved tourist accommodation facility will be 20% for the 1st year in which such income is derived and for a maximum of 9 years thereafter. It should be noted that there appears to be a drafting error in the proposed new section giving rise to the 20% tax rate. It is expected that this error will be corrected prior to the passing of the related bill.

To qualify the taxpayer must register with the Commissioner General, the expenditure must be US$10 million or more on a hotel, motel, ship, inn or other short term accommodation in Papua New Guinea that provides 150 or more rooms for accommodation and construction of the facility must commence between 1 January 2007 and 31 December 2011.

(iv) The infrastructure tax credit scheme will be extended to large scale tourism investors (i.e., those who meet the qualification as described above). The maximum amount of the tax credit will be limited to 1.5% of assessable income derived during the year ended 31 December 2007 and subsequent years.

(v) The supply of accommodation and travel within PNG to a person who purchases the supply while they are outside PNG will be zero-rated for goods and services tax purposes.

30th Independence Day Celebrations and Pacific Islands Forum

The Income Tax Act has been amended to confirm a double deduction was available for donations made to the 30th Independence Day and Pacific Islands Forum held in 2005. The double deduction is only available in respect of gifts made in the period 1 January 2005 to 30 September 2005. As the deduction is available in respect of a period covered by an income tax return previously lodged by most taxpayers they should review their entitlement to this double deduction and if not already claimed, a request to amend the return should be lodged.

Expert advisors to Commissions of Inquiry

The existing exemption of income paid by the State to a non-resident Commissioner under the Commissions of Inquiry Act has been extended to include income paid to non-resident counsel or technical or professional experts to assist a Commission of Inquiry.

Agriculture incentives

The Budget did not introduce any new incentives for agriculture. However, the Government indicated its satisfaction with industry response to the incentives introduced over the last three years.

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 2007 Budget contains several amendments which impact these industries. The changes are:

(i) The Income Tax Act has been amended to provide an exemption from income tax for the participants in the Ramu Nickel Project for the period of a “tax holiday” agreed to by the Government in the mining development contract. Similarly the Stamp Duties Act has been amended to exempt from stamp duty the transfers of interests in exploration licences and related licences necessarily arising from entering into the Joint Venture Agreement and certain subsequent transfers. The Goods and Services Tax Act has been amended to provide for the zero rating of certain imports during the construction phase of the Ramu Nickel Project. Finally, the Customs Tariff Act and the Excise Tariff Act will both be amended to provide exemptions from these duties for the acquisition of certain items for the Ramu Nickel Project (including an exemption from duty on hydrocarbon products for use as fuel in the Project’s powerhouse for the life of the Project).

(ii) In 2006 Section 155L of the Income Tax Act was 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. There was a technical flaw in the final legislation and an amendment has been made to clarify that credit for exploration can be transferred to the new owner when an exploration licence is transferred. The amendment included in the Budget legislation is identical to the amendment proposed by PricewaterhouseCoopers and the Resource Industry.

(iii) In the 2006 Budget, Regulation 10G which deals with the taxation “ring fence” around the Kutubu and South East Mananda petroleum projects was reintroduced. There was a technical flaw in the final Regulation and an amendment has been made to address these anomalies. The amendment included in the Budget legislation is identical to the amendment proposed by PricewaterhouseCoopers and the Resource Industry.

(iv) The 2006 Budget included an amendment to the Goods and Services Tax Act which intended that the supply of crude oil by resource projects to a refiner in PNG will be zero-rated for GST purposes. The amendment did not achieve the intended result and an amendment has been made so that the sale of unprocessed oil from sources in PNG is zero-rated for GST purposes.

(v) The Notional Tax rules have been amended to extend their application to non-mining income of a company which has an interest in a resource development licence but does not derive any income from mining operations. According to the Budget papers this amendment is “to make Bougainville Copper Limited subject to the requirement to pay company tax in advance as intended”.

Taxation developments and amendments – Forestry

The existing royalty of K10 per cubic metre payable to landowners has not changed since 1996. The Government considers there is a compelling case to increase the benefits to landowners. From 1 January 2007 timber permit, timber authority and timber licence holders will be required to pay a new levy called ”Log Export Development Levy” of K8 per cubic metre in respect of the export of natural unprocessed logs and flitches. This levy will be administered using similar arrangements as currently apply for development levies paid in relation to petroleum projects. The cost of this levy is being offset by a reduction in log export tax.

Taxation developments and amendments – Goods & Services Tax

The Government considers the current formula for allocating GST Revenue to Provincial Governments is not sustainable. The Government is developing a new system which is designed to provide a stable source of funding that will grow in proportion to the National Government’s revenue that will equalize over time the capacity of provinces to provide the services maintained by them. The first step in this process will occur in 2007 by changing the basis for determining the GST revenue to be distributed to the provinces and the NCD. The current method is based on an estimate of GST to be received in the forthcoming year. The new system will be based on actual GST received in the most recent year adjusted for inflation.

For 2007 a comparison will be made between the GST collections in each province in 2005 and their actual amount of GST distribution received by the province in 2006. The amount the province will receive will be the greater of these amounts indexed by the expected level of inflation for 2007.

The GST Act has also been amended to ensure that trusts set up by aid providers to administer aid funds are treated for GST purposes in the same way as the aid provider.

Taxation developments and amendments – Stamp Duties

There were several amendments to the Stamp Duties Act:

(i) To repeal the exemption from stamp duty for long term bonds.

(ii) To remove a loophole which allows an agreement for the sale of shares to escape stamp duty on the transfer of shares subject to the agreement.

(iii) Division 10A which deals with the acquisition of interests in private corporations, referred to as “land-rich provisions”, has been repealed and replaced with a new Division 10A. The purpose of the new Division 10A is to ensure the land rich rules apply to the transfer of shares in a holding company whose subsidiary or subsidiaries own land in PNG.

(iv) To include within the company reconstruction relief provisions the transfer of property from a parent company to a subsidiary company

Taxation developments and amendments – Customs, Excise and Indirect Taxes

Excise duty - alcohol and tobacco

There have been no changes to the excise duty on alcohol and tobacco products. However, an amendment has been made to correct the description of the new tobacco competing product to enable utilization of the lower excise rate.

Excise tariff rates

The excise duty on aviation gasoline has been reduced from 2 toea per litre to Nil to assist operators of light aircraft who use this fuel.

To reflect the impact of world oil prices on gasoline-oil fuel used to fuel "banana boats" used by the coastal population a special excise rate of 30 toea per litre will apply to pre-mixed gasoline-oil fuel. This change will apply from 1 January 2007 and will apply for a trial period of one year.

Excise Regulations

The Excise Regulation and Excise (Beer) Regulation has been amended to remove redundant references to pre-independence descriptions of PNG in respect of labelling of excisable products and to increase penalties.

Customs tariff rates

The Government has responded to pressure from domestic industries processing and canning of some food and drinks. As a result temporary increases will be made with effect from 1 January 2007:

- Canned dark-meat tuna from 15% to 20%
- Carbonated soft drinks from 15% to 25%
- Canned baked beans from nil to 25%

The Government's undertaking to maintain an import tariff of 20% on canned mackerel has been extended to 31 December 2011.

Customs Act

Amendments are being made to the Customs Act:

- To facilitate PNG's adherence to its international obligations arising from its accession to the Revised Kyoto Convention.

- To introduce cyber crime legislation as a measure to protect the Custom's electronic entry processing system known as ASYCUDA ++.

- To introduce more stringent reporting requirements for travellers and goods entering and leaving PNG.

- To amend drafting errors and other anomalies identified in the 2006 Budget amendments to the Customs Act.

- The Customs Act is also being amended to allow taxpayers to make an application to the Commissioner General for a ruling in respect of the tariff classification of goods, the availability of customs duty concessions for a particular good and the country of origin of goods. Such rulings will be binding on the Commissioner General.

- Amendments to the Customs Act clarify the procedure for the resolution of customs related disputes with the Commissioner General and provide for the establishment of a Customs Review Tribunal and also allow taxpayers to refer matters to the National Court if they are dissatisfied with a decision of the Customs Review Tribunal. Previously the Commissioner General ruled on all customs disputes.

Log Export Tax

The existing log export duty operates on a progressive scale based on the log export price per cubic metre. As there were concerns the current progressive scale disadvantages production and investment, the log export tax will be changed to a flat rate so that the same rate of tax applies across the price range.

The new flat rate of log export tax will be 28.5%. This is intended to offset the “Log Export Development Levy” and the impact of the increase in the average rate of tax since the scales were last reviewed.

Bookmaking Act

Amendments have been introduced to the bookmaking Act to facilitate electronic betting by providing for the purchase of betting tickets from persons approved by the Commissioner General.

Gaming Machine Tax

There have been no changes to the Gaming Machine Tax.

Further information required?

Further information in relation to the 2007 National Budget can be obtained from David Caradus or Jason Ellis at PricewaterhouseCoopers in Port Moresby.