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2011 Papua New Guinea

National Budget

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Contents

The Minister for Treasury and Finance, the Honourable Peter O'Neill, MP handed down the 2011 National Budget on 16 November 2010.

Executive summary

The theme of the 2011 Budget is "Building the Foundation for Economic Growth and Prosperity". This is a departure from the theme of the two previous budgets which referred to the empowerment and transformation of the rural economy. The Government acknowledges that PNG has been impacted by current global economic conditions which remain precarious at best. However, the Government considers PNG well positioned to continue its recent economic growth and predicts robust growth during the course of 2011.

Key components of the 2011 Budget include:

- It is expected this budget will deliver a balanced budget in 2011.
- It is expected that Government revenues and expenditure will both increase in 2011 when compared to 2010.
- Economic growth is forecast to be 8.0% in 2011 (the revised 2010 estimate is 7.1%), while inflation is forecast to rise to 8.2% in 2011.
- As with the prior year, the 2011 Budget continues to recognise the significance of the PNG LNG Project as a driver of economic growth.
- The Government has formally committed to the establishment of a sovereign wealth fund to address the downside macroeconomic risks associated with large scale projects such as the PNG LNG Project.

Key budget assumptions

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

Principal economic indicators	2005 actual	2006 actual	2007 actual	2008 est.	2009 est.	2010 proj.	2011 proj
Real GDP Growth (%)	3.6	2.3	7.2	6.6	5.5	7.1	8.0
Non-mining GDP Growth (%)	3.4	3.9	8.1	7.6	6..3	7.3	8.2
Inflation (year average) (%)	1.8	2.4	0.9	10.8	7.0	6.0	8.2
Oil price (US$ per barrel)	53	64	71	97	62	76	76
Gold price (US$ per ounce)	445	604	697	881	973	1150	1150
Copper Price (US$ per ton)	6731	6731	7132	6963	5100	7115	7115
Interest rates % (yearly average T-Bill)	4.5	5.0	5.0	5.9	7.3	5.5	7.0

Financing the budget

The following table summarises the financing requirements arising as a result of the estimated balanced budget for 2011 and also includes historic information for reference purposes.

Financing the budget (k millions)	2008 (actual)	2009 (actual)	2010 (revised)	2011 (projection)
Total revenue and grants	7,073.3	6,651.3	8,244.5	9,328
Total expenditure and net lending	7,551.8	6,687.5	8,244.5	9,328
Budget surplus/(deficit)	(478.5)	(36.2)	0.0	0.0
Budget surplus / (deficit) as a % of GDP	(2.2)	(0.2)	0.0	0.0

Revenue and grants

The total budgeted revenue and grants for 2011 are expected to be derived from the following sources:

Financing the budget (k millions)	2009 (actual)	2010 (revised)	2011 (projection)
Taxation revenue	4,974.5	6,481.0	7,331.0
Non-taxation revenue	765.8	409.6	411.1
Grants	877.5	1,293.9	1,526.1
Total revenue and grants	6,651.3	8,244.5	9,328.1

Total revenue is forecast to increase from K8,244.5 million to K9,328.1 million in 2011. The value of donor funding is expected to increased from K1,293.9 million to K1,526.1 million due in part to the appreciation of the Kina.

Of the K7,331.0 million expected to be derived in the form of taxation revenue, K5,292.5 million of this is forecast to be in the form of taxes on income and profits. The composition of the revenue may be summarised as follows:

Taxes on income and profits (K million)	2011 (projection)	%	2010 (revised)	2009 (actual)
Personal income tax	1,727.1	32.6%	1,497.4	1,241.8
Company tax	1,401.9	26.5%	1,219.7	1,121.4
Dividend withholding tax	298.0	5.6%	275.6	244.4
Mining and petroleum tax	1,594.7	30.1%	1,471.2	693.1
Interest withholding tax	42.4	0.8%	42.4	32.0
Other direct tax	119.7	2.3%	104.3	83.1
Gaming tax	108.6	2.1%	96.1	103.9
Total	5,292.5		4,706.7	3,519.7

Taxes on income and profits are forecast to increase by K585.8 million in 2011 which represents a 12.4% increase from 2010. This is a result of expected revenues flowing from the start-up of the PNG LNG Project and higher commodity prices for existing resource projects. Consistent with 2010, personal income taxes are forecast to be the largest contributor to all taxes in 2011. The growth in personal income tax (15.3%) and company tax (14.9%) are largely attributable to the forecasted impact of the PNG LNG Project and continued domestic economic growth.

Recurrent and development expenditure

The total appropriation for 2011 comprises:

Recurrent and development expenditure budget (K millions)	2009 (actual)	2010 (revised)	2011 (projection)
Recurrent expenditure	4,166.3	4,160.9	5,287.1
Development expenditure	2,348.7	3,430.3	4,041.0
Reappropriation into Trust Account	172.5	0.0	0.0
Supplementary budget	-	653.3	0.0
Total	6,687.5	8,244.5	9,328.1

Recurrent and development expenditure is forecast to increase during 2011 with total expenditure estimated to be K9,328.1. Increased funding is provided to support the Medium Term Development Plan which include key sectors such as infrastructure, health, education and law and order. It is specifically noted in the Budget papers that some of this additional expenditure will be directed towards agencies supporting the PNG LNG Project.

The recurrent budget

Total recurrent expenditures are forecast to increase from K4,160.9 million to K5,287.1 million in 2011. In addition to expenditure on wages and goods and services by government, the 2011 recurrent budget provides for funding for new spending decisions. This includes the following:

- **Universal access to primary and secondary education – additional funding of K149.1 million**

  Increased funding will be provided to the Department of Education, the Provinces and Universities to assist with the purchase of equipment and wage costs of additional teaching staff. This funding will also support the subsidy of school fees.

- **National transport corridors – additional funding of K46.7 million**

  Additional funding is set aside to connect rural populations to markets and services. This funding will be allocated to the Department of Works for National Road Maintenance, and for bridge maintenance. Part of this funding will be provided to the Provinces in the form of transport infrastructure grants.

- **Improving health outcomes – additional funding of K101.3 million**

  Additional funding will be provided for the purchase of drugs, and for increases in the remuneration of doctors. An extra 1,333 funded hospital beds will be funded together with the purchase of ten new ambulances and three new utilities. Part of this funding will be provided to the Provinces to support existing health programs.

- **Improving law and order – additional funding of K132.6 million**

  Additional funding will be provided to the Police, the Department of Correctional Services, the Department of Defence and the Judiciary. Of this total amount, K30 million alone will be provided to the Police for LNG support.

The development budget

The development budget for 2011 is K4,041 million.. All sources of funding for the development budget are expected to increase in 2011. The large increases reflects the Government's commitment to investing in projects that will further development opportunities for Papua New Guineans.

Funding source for the development budget (k millions)	2009 (actual)	2010 (revised)	2011 (projection
Direct government funding – 'ordinary'	1,382.1	1,867.5	2,126.6
Infrastructure tax credits	33.5	60.0	60.0
Concessional loans	89.1	268.9	388.4
Commercial loans	0.0	0.0	0.0
Project grants for donors	877.5	1,293.9	1,526.1
Total	2,348.7	3,430.3	4,041.1

The medium term development plan

The *'Medium Term Development Plan 2011 – 2015'* is a revision of the *Medium Term Development Strategy 2005 – 2010* that has informed the structure of past budgets. The revised development plan continues the theme of guiding the allocation of funds from both the recurrent and development budgets into seven priority areas. These priority areas, and the source and allocation of funding for 2011 may be summarised as follows:

Expenditure priority area	Government funding	Donor grant funding	Total
Transport	757.7	207.4	965.1
Law, order and justice	749.5	83.2	832.7
Health	841.0	124.8	965.8
Primary and secondary education	1,127.4	208.3	1,335.7
Higher and technical education	325.3	36.4	361.7
Utilities	242.9	32.6	275.5
Land	131.8	11.9	143.7
Total	4,175.6	704.6	4,880.2

A total of 53.4% of the development and recurrent budgets is directly targeted at the seven MTDP priority areas. The key areas of focus for donor grant funding in the expenditure priority areas relative to government funding are basic education, and health.

Establishment of a sovereign wealth fund

One of the key measures introduced in the 2011 Budget is the commitment by the Government to the establishment of a sovereign wealth fund.

It is apparent from the discussion in the Budget papers that this decision has been influenced by the desire of the Government to avoid the potentially damaging macroeconomic impacts of the PNG LNG Project and other large scale projects that are expected to commence over the short to medium term. Concern is expressed at the possible inflationary impact of an increase in liquidity in the domestic market. There is already evidence of price increases taking hold with inflation predicated to be 8.2% during 2011. This would be of particular disadvantage to low income earners who would potentially experience a decrease in their real earnings.

The second major consideration driving the desire to establish a sovereign wealth fund is an appreciation of the Kina caused by large inflows of foreign currency. This could have the effect of making exported goods relatively more expensive leading to reduced demand. In turn, this would have a compressive effect on sectors of the economy that are unrelated to large scale resource projects, setting the pretext for the so-called 'Dutch Disease'.

Proposed funds

The Government is proposing to establish an offshore sovereign wealth fund that will be comprised of three parts:

- A Stabilization Fund established from LNG tax revenue and other mineral and petroleum revenue. The purpose of this fund is to provide a ready source of funding that may be needed to counter the damaging effects of commodity price fluctuations and volatility;
- Future (Savings) Fund established from LNG and other resources tax revenues. The underlying rationale for the establishment of this fund is to promote longer terms savings, and to smooth projected Government spending; and
- An Infrastructure Fund that is to be established from LNG dividends. This will provide a pool of funds for strategic nation building projects to meet ongoing development needs.

Taxation developments and amendments

Unlike the prior year Budget, there were a number of amendments to existing tax law that will take effect on 1 January 2011. These are either technical in nature, or have been introduced to reflect the rising costs of doing business in PNG.

Corporate and personal tax rates

There has been no change to the general corporate income tax rates of 30% for residents and 48% for non-residents. There has also been no change to personal tax rates (these rates were last changed with effect from 1 January 2008).

From 1 January 2011 the rates for residents will continue to be as follows:

Taxable income	Tax thereon (k)	Rates on tax on excess (%)
7,000	Nil	22
18,000	2,420	30
33,000	6,920	35
70,000	19,870	40
250,000	91,870	42

From 1 January 2011 the rates for non- residents will continue to be as follows:

Taxable income	Tax thereon (k)	Rates on tax on excess (%)
Nil	Nil	22
18,000	3,960	30
33,000	8,460	35
70,000	21,410	40
250,000	93,410	42

Liability for unpaid salary or wages tax

Under the current provisions of the *Income Tax Act 1959*, an employer who fails to remit salary or wages tax in relation to its employees is liable to pay the amount of unpaid tax together with any additional penalties that may be imposed (refer Section 299J). Where the employer is a corporate entity, this recovery mechanism is only effective to the extent that an employer is sufficiently solvent to meet the total amounts outstanding.

The Government has estimated that approximately K200 million of unpaid salary or wages tax is outstanding. From 1 January 2011, a new Division 2AB will create personal liability for unpaid salary or wages tax for the directors of a company. This is intended as a further lever to ensure a higher standard of group tax compliance. Under Section 299AD on or before the due date of each group tax payment, the directors shall cause either the correct amount of tax to be paid, an arrangement to be made for deferred payment with the Commissioner General, or a corporate employer to be placed into liquidation. Where the required amount of group tax is not paid, each director of that company is jointly and severally liable to the extent of the shortfall.

Division 2AB prescribes the manner in which the Commissioner General may collect amounts from the directors of an employing company. Broadly, the Commissioner General must provide 30 days notice of the intention to recover the outstanding amounts. The penalty will not imposed on the director of the company if within this timeframe:

1. the liability of the employer is discharged;
2. a payment plan is agreed; or
3. the employer company has commenced the process of winding up.

The significance of this new measure cannot be underestimated. Under the *Companies Act 1997* and the applicable corporate law regimes of other countries, a company is generally prohibited from indemnifying a director for penalties that arise as a consequence of the discharge of their office. A penalty that is imposed under these new provisions will therefore truly be borne by the individual directors themselves.

Retirement savings accounts

The concessional taxation treatment of retirement savings accounts (“RSA”) has been amended. The maximum balance for an RSA has been increased from K100,000 to K250,000. In addition, where there is a withdrawal from an RSA in excess of the prescribed limits the tax exemption on earnings from the RSA will not be affected. Excess withdrawals will continue to be taxed at 30%.

Housing benefits

The taxable value of employer provided housing benefits have been increased across the board. The impact of these changes may be reduced in some circumstances by amendments to the thresholds that define the value of a housing benefit as either high, medium or low cost.

The current taxable value of housing benefits and the deemed values that will apply from 1 January 2011 may be summarised as follows:

Current taxable value:

Type of housing	Value of taxable benefits per fortnight		
	Area 1	Area 2	Area 3
High cost house or flat	K225	K156	K0
Medium cost house or flat	K131	K100	K0
Low cost house or flat	K55	K50	K0
Mess / Barracks accommodation	K45	K40	K0
Government Mess / Barracks	K5	K5	K0
Employees in approved low cost housing scheme	K0	K0	K0

Where:

- High cost housing means accommodation that would fetch K220,000 or more if sold on the open market or a weekly rental equal to or greater than K950.
- Medium cost housing means accommodation that would fetch between K95,000 and K220,000 if sold on the open market or a weekly rental between K300 and K950.
- Low cost housing means accommodation that would fetch less than K95,000 if sold on the open market or a weekly rental of less than K300.

Taxable value from 1 January 2011:

Type of housing	Value of taxable benefits per fortnight		
	Area 1	Area 2	Area 3
High cost house or flat	K700	K500	K0
Medium cost house or flat	K400	K300	K0
Low cost house or flat	K160	K150	K0
Mess / Barracks accommodation	K60	K50	K0
Government Mess / Barracks	K7	K7	K0
Employees in approved low cost housing scheme*	K0	K0	K0

Where:

- High cost housing means accommodation that would fetch K800,000 or more if sold on the open market or a weekly rental equal to or greater than K3,000.

- Medium cost housing means accommodation that would fetch between K400,000 and K800,000 if sold on the open market or a weekly rental between K1,000 and K3,000.

- Low cost housing means accommodation that would fetch less than K400,000 if sold on the open market or a weekly rental of less than K1,000.

Low cost housing

From 1 January 2011, the Low Cost Housing Scheme is to be replaced by a program referred to as the 'Citizen Employee First Time Home Buyer Scheme.' Under the current scheme, a low cost house is one with a value of K75,000 or less. This is being replaced by an upper value of K400,000.

An upwards adjustment has been made to the stamp duty concession that is available to first time home buyers. Under the revised concession, a first time citizen home buyer will only be subject to stamp duty on the portion of the purchase price that exceeds K500,000. This is a marked increase from the current concession which imposes a reduced rate of 2% where the value of the property purchased by a first time citizen is greater than K210,000 and less than K280,000, and 5% for amounts in excess of K280,000.

The policy intention between the K100,000 disparity between the upper limit of the Citizen Employee First Time Home Buyer Scheme and the concessional rate of stamp duty is not clear. In any case, these upward revisions are in line with the rapidly increasing cost of accommodation in Papua New Guinea.

Environmental protection and clean-up costs

One of the more substantive technical amendments to the *Income Tax Act 1959* is the introduction of two new provisions which operate to provide specific deductions for environmental protection and clean-up costs.

Section 72D

From 1 January 2011, Section 72D will operate to provide a deduction for expenses incurred for the purpose of 'environmental protection activities.' This is an exhaustively defined term, and refers to the prevention or clean-up of:

- pollution that has been caused (or is likely to be caused) by a taxpayer, or

- pollution that is present on a site that a taxpayer has or will be entitled to use;

This provision includes a number of specific exclusions, which are more in the nature of integrity measures than substantive limitations. Specifically excluded is expenditure of a capital nature that relates to the construction of a building, and expenditure that relates to the acquisition of land.

Arguably the specific exclusions set out by Section 72D(3) are already excluded by the wording of Section 72D(2) which refers to expenditure that is 'incurred for the 'sole or dominant purpose' of environmental protection activities. The inclusion of a sole or dominant purpose test should be carefully considered by a taxpayer embarking upon environmental protection activities. It will be important to ensure that this expenditure is separately documented rather than being incorporated within the costs associated with a more comprehensive project. For example, if a taxpayer wishes to construct a new building on a polluted site, it would be advisable for that taxpayer to separately document ground preparation costs that relate to the repatriation of the site rather than paying a single price for the project.

Where a taxpayer has deducted an amount under Section 72D, the subsequent recoupment of all or part of that expenditure will be assessable income. In addition, where a site is subsequently sold, the sale consideration will be deemed to be a recoupment of deductible environment protection costs to the extent that a deduction has or could be claimed.

Section 72E

A new Section 72E will be introduced that will permit an allowable deduction for the costs associated with preparing an environmental impact study. These costs will be deductible over the anticipated life of the project, or ten years. Like Section 72D, this deduction will only be available where costs are incurred for the sole or dominant purpose of preparing an environmental impact study. Amounts that represent a recoupment of prior expenditure will be assessable.

Amendment to Section 73

A minor technical amendment will be made to ensure that plant or equipment used in the course of environmental protection activities or conducting an environmental impact study is depreciable in accordance with Section 73 of the *Income Tax Act 1959*.

Taxation of resource projects

A number of changes have been made that are relevant for taxpayers carrying on resource operations.

GST amendment

The first such change is a technical amendment to the definition of 'resource company' contained in the *Goods and Services Tax Act 2003*. Under the current definition, reference is made to a taxpayer participating in a 'gas project' as this term is defined in the *Oil and Gas Act 1998*. From 1 January 2011, this definition will be replaced and will refer to a taxpayer participating in a 'designated gas project' as this term is defined in the *Income Tax Act 1959*.

More substantively, this revised definition now specifically includes the holders of a 'mining lease' as well as those taxpayers who hold either a special mining lease or an exploration licence. This expansion of the definition of 'resource company' will ensure that supplies made to taxpayers who only hold a mining lease will be zero-rated. Similarly, goods that are imported by the holder of only a mining lease will not be subject to import GST.

Pooling of exploration expenditure

Section 155N of the *Income Tax 1959* allows exploration expenditure incurred outside the area of a resource project to be pooled by a taxpayer. This expenditure may then be subsequently transferred to form part of a producing resource project and may then be subsequently deductible as allowable exploration expenditure. It is stated by Section 155N that a taxpayer must make an election to transfer exploration expenditure to a Section 155N pool, but the Act is currently silent as to the form of that election.

Under the newly introduced Section 155N(2A) a taxpayer is required to make an election in writing, signed either by or on behalf of the taxpayer and delivered to the Commissioner General no later than the due date of the income tax return for that period. The drafting of this new subsection is identical to the current Section 155F(4) which may be made in relation to depreciable plant that is classified as allowable capital expenditure.

It will be important to ensure that due regard is had to the operation of Section 155N(2A) going forward. Taxpayers who have been evidencing a Section 155N election through the preparation of their income tax return will need to be mindful of the obligation to make a separate filing. Of greater practical consequence is the pressure that this will place on taxpayers to ensure that their income tax returns are finalised prior to the due date, so that the correct amount of exploration expenditure is disclosed in the election notice. It is an open question how this new provision will work in circumstances where a taxpayer wishes to lodge an amended income tax return increasing the amount of exploration expenditure. One would hope that the Commissioner General will adopt a practical approach in these circumstances and exercise his discretion to extend the time in which the election may be made.

Customs exemption for the PNG LNG Project

As noted immediately below, the scope of the exemption from customs duty has been clarified in relation to the initial or subsequent phases of the PNG LNG Project.

Customs and excise amendments

The 2011 Budget contains a number of customs and excise amendments that will be effective from 1 January 2011. These may be summarised as follows:

- Currently, mixed alcohol beverages made from fruit sourced from within Papua New Guinea enjoy a concessional rate of excise of K33.73 per Lal. The Government has expressed concern that this lower rate of excise has created an indirect encouragement for the consumption of these relatively high alcohol beverages. This concessional rate of duty will now only apply to mixed alcoholic beverages that have been manufactured from fruit grown in Papua New Guinea and having an alcohol content of 10% or less by volume.

- A technical amendment will be made to clarify the scope of the exemption for goods and consumables that are used in the course of the first or subsequent phases of the PNG LNG Project. This amendment is described in the explanatory statement as clarifying any doubt about the import duty exemptions granted to the PNG LNG Project to ensure consistency with the intent of the PNG LNG Gas Project Agreement.

- A number of changes have been made to the rates of customs duty set out under Schedule 1 of the *Customs Tariff Act*. This is consistent with the long term intention of the Government to reduce the rates of customs tariffs applicable to goods imported into Papua New Guinea.

Administrative amendments

The 2011 Budget contains a number of administrative amendments. This includes the ability of the Commissioner General to use the last known place of business or abode of a person as a valid address for service. The power of the Commissioner General to share taxpayer information with other law enforcement agencies has also been clarified.

Areas of policy development

The 2011 Budget papers foreshadow the intention of the Government to direct tax policy into a number of key reform areas. These may be summarised as follows:

- PNG's export subsidy program is to be abolished. This is in line with the obligations of Papua New Guinea as a member of the World Trade Organisation.

- The taxation of unit property trusts is to be evaluated with a view to encouraging the formation of new investment vehicles and the investment by superannuation funds. It is hoped that this may provide greater scope for the diversification of property investments, and pave the way for larger developments than those that are currently taking place.

- The current practice of funding income tax refunds by annual appropriation is to be discontinued. This is to be achieved by changes to the administrative processes of the Internal Revenue Commission.

- The possible reinstatement of the Highlands Highway tax credit scheme. This was previously applicable for expenditure incurred in the 2002 and 2005 years of income.

- The Government will consider introducing a penalty regime to discourage the significant underestimation of mining and petroleum taxation instalments.

- The Government may consider a technical amendment to recognise a nil assessment as an assessment. This will put to rest any lingering uncertainty about the commencement of the limitation period and the consequent ability of the Internal Revenue Commission to issue an amended assessment. It is foreshadowed that returns which give rise to a nil assessment are likely to have a longer period of amendment.

The PNG Budget commentary has been prepared to provide an overview of the general issues raised in the 2011 Budget. It does not cover exhaustively the subjects discussed. When specific issues occur in practice it is necessary to refer to the laws and regulations and to obtain appropriate professional advice.

While every care has been taken in the preparation of this publication, no warranty is given as to the correctness of the information it contains and no liability is accepted for any statement or opinion, nor for any error or omission.

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