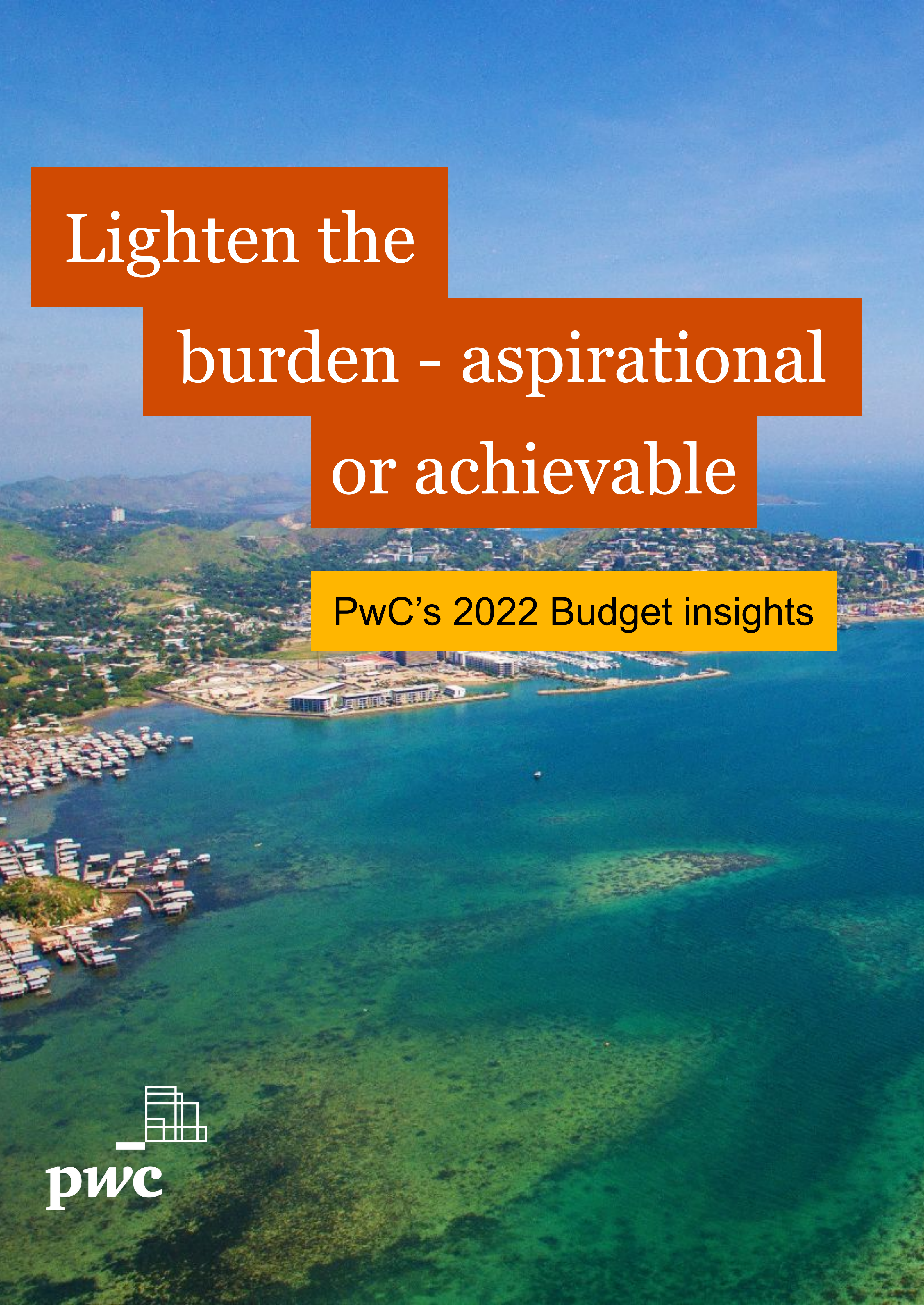
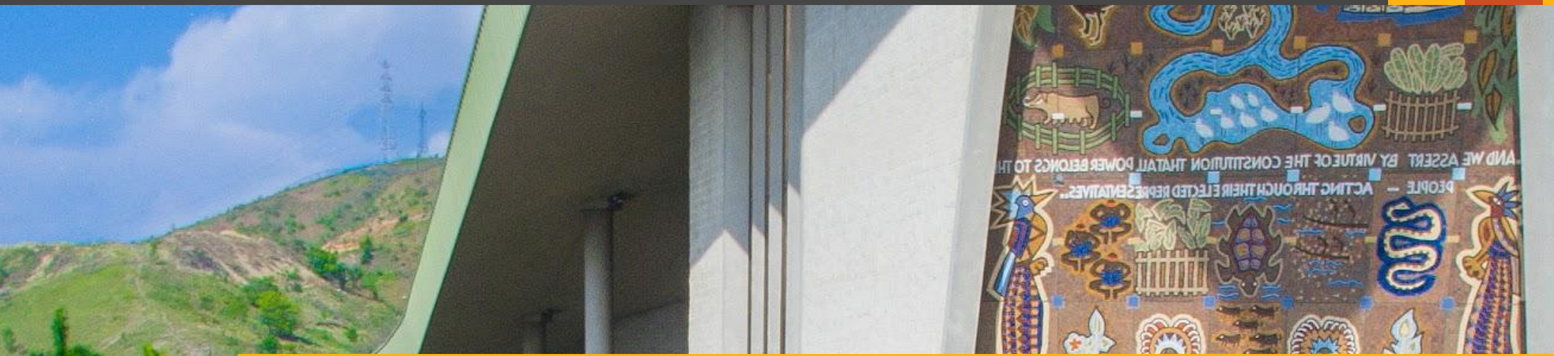
Lighten the burden - aspirational or achievable

PwC's 2022 Budget insights



Executive summary



There is no denying that 2021 was not a conducive environment for being able to create a budget for 2022. The distractions of a global pandemic, the ongoing challenges of the continued shutdown of Porgera and a generally lacklustre foreign investment climate have all taken their toll.

Nonetheless, the 2022 Budget as delivered appears replete with contradictions. The budget is themed as ‘Lighten the Burden’ and yet it describes itself as a further step in budget repair efforts with a strong focus on putting the country on a path where revenue raising will outstrip the growth in costs for the medium term. The country sits within the lowest quintile globally when measuring the percentage of the population that are vaccinated against COVID-19, and yet the potential for further significant economic damage through ongoing outbreaks is barely referenced and the recent focus on meeting enhanced health needs appears as no longer critical.

Unfortunately, the budget also suffers the scars of its difficult creation. The cyber attack on the IFMS system has highlighted the difficulties in creating the document and may be the cause of a number of the inconsistencies. Nevertheless, the challenge in analysing this Budget is to examine and embrace these contradictions, and to draw from the document whether it rises to the challenge of providing a platform for the development of the country.

So what should be our conclusion? Does the Budget meet expectations?

This is a Budget in which the largest revenue raising initiative is the implementation of levies on single participants within the banking and telecommunication sectors with the rationale described as clawing back super normal profits based on market concentration. Will this enhance the willingness of the private sector to invest, compete and thrive? It is a budget which predicts that the growth in GST revenue in 2022 will be double that of economic growth. How is this possible? It is a budget that assumes the year on year growth in dividends from state owned entities will be almost 50%. Is this feasible in the current environment? But it is also the budget that sticks to the purity of an economic planning theory and does not recognise any upside from resource projects that have not yet reached FID. It is also the budget that quite rightly identifies the critical nature of investment in infrastructure, education and health as the key to a country’s long term development. Will Connect PNG, GTFS and HELP be implemented well enough to deliver on their promise?

A budget can be an aspirational document, it can signal where you want to go and how you want to get there. The age old question is whether those delivering the budget will hold implementing agencies to account for its delivery.

Contents

Introduction

Papua New Guinea (PNG) is used to having its national Budgets prepared in the face of external shocks, whether they be earthquakes, enormous swings in major export commodities, and so on. Not much can be done to manage the scale of these shocks, and so the emphasis has been on dealing with their aftermath.

This year's Budget is framed in the shadow of a shock that is different to the shocks described above because its scale of impact is addressable, and the consequences are manageable: COVID-19

While COVID-19 has significant economic and fiscal implications, at its heart it is a health issue. The key issue going forward is the pace and rate of vaccinations. Here the people of PNG have their health, economic and fiscal destiny in their own hands:

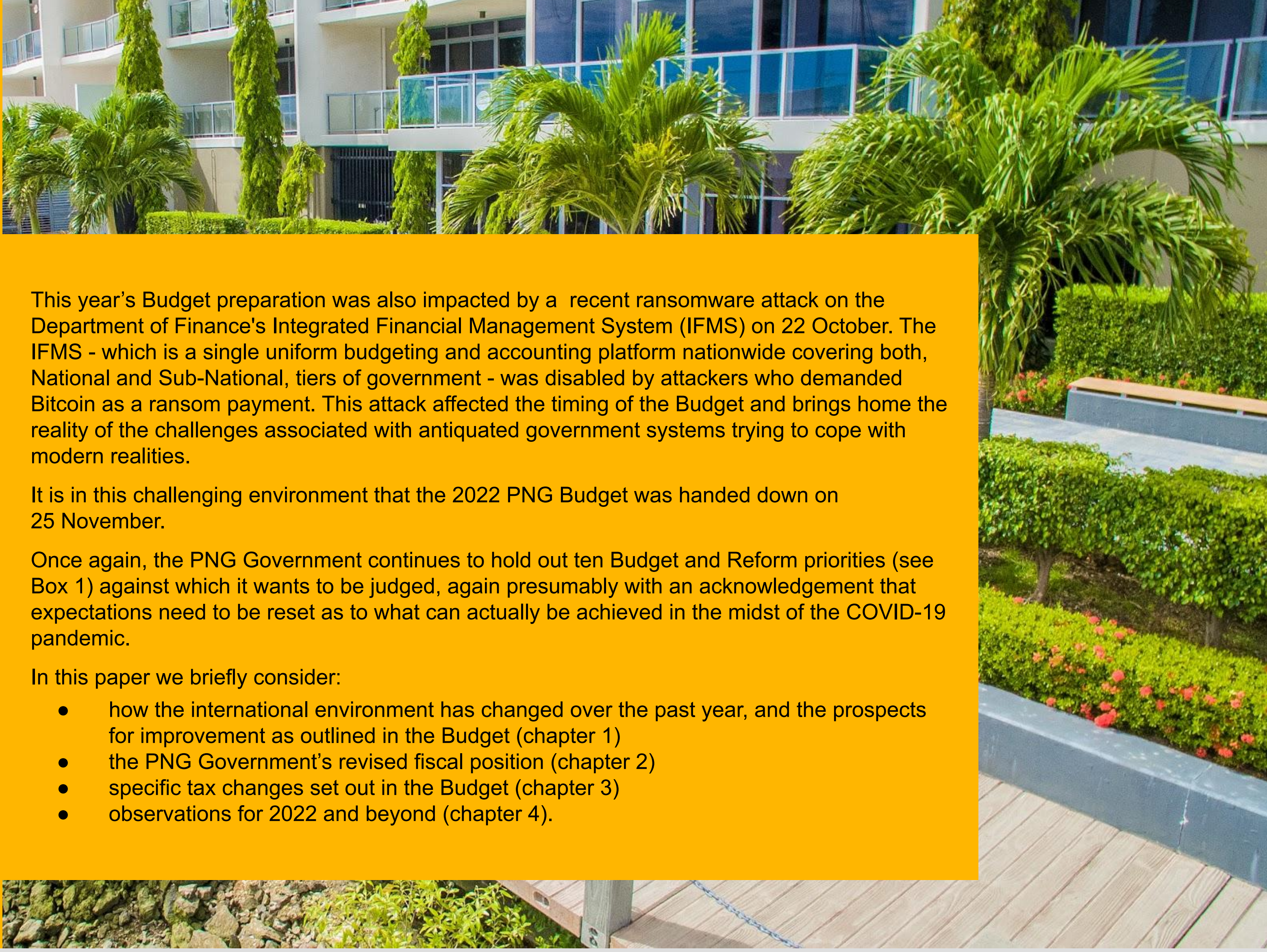
- On the upside, drastically improving the meagre penetration of the COVID-19 vaccines will reduce the need for additional spending on the health system and lead to a stronger recovery as restrictions are lifted and economic activity resumes.
- Downside risks stem from slower vaccine rollouts. Continued outbreaks risk the emergence of further COVID-19 variants that could be more resistant to current vaccines. Delayed vaccine delivery would further impede reopening, weakening economic activity over a longer period.

Until COVID-19 vaccination rates in PNG increase dramatically, COVID-19 will continue to be a handbrake on PNG's economic growth prospects and a likely driver of further economic inequality. Worryingly, therefore:

> *Others – notably Papua New Guinea … – are on track to be amongst the last in the world to reach high levels of vaccination. In these countries the challenges of health sector capacity and vaccine demand are so great that when the model concludes in August 2026 Vanuatu is expected to have vaccinated 86% of its adult population and Papua New Guinea only 35%.*[1]

1 Alexandre Dayant, *Vaccinating the Pacific*, available at https://pacificvaccination.lowyinstitute.org/

2 For more information on the scope and importance of the IFMS see https://www.finance.gov.pg/projects/ifms/



This year's Budget preparation was also impacted by a recent ransomware attack on the Department of Finance's Integrated Financial Management System (IFMS) on 22 October. The IFMS - which is a single uniform budgeting and accounting platform nationwide covering both, National and Sub-National, tiers of government - was disabled by attackers who demanded Bitcoin as a ransom payment. This attack affected the timing of the Budget and brings home the reality of the challenges associated with antiquated government systems trying to cope with modern realities.

It is in this challenging environment that the 2022 PNG Budget was handed down on 25 November.

Once again, the PNG Government continues to hold out ten Budget and Reform priorities (see Box 1) against which it wants to be judged, again presumably with an acknowledgement that expectations need to be reset as to what can actually be achieved in the midst of the COVID-19 pandemic.

In this paper we briefly consider:

- how the international environment has changed over the past year, and the prospects for improvement as outlined in the Budget (chapter 1)
- the PNG Government's revised fiscal position (chapter 2)
- specific tax changes set out in the Budget (chapter 3)
- observations for 2022 and beyond (chapter 4).

Box 1 - Ten principles underpinning the National Government's 2021 Budget and Reform priorities

1 Spend the money we have more wisely

2 Raise the revenues more fairly

3 Finance the debt more cheaply

4 Leverage friendly international support more intelligently

5 Focus on growth in the agriculture, forestry and fishing sector, SMEs and the informal economy

6 Distribute resource benefits more equitably

7 Stimulate non-resource growth back to at least 5% annually

8 Comprehensive Government state owned enterprise (SOE) reform program for cheaper energy, internet and water

9 Getting foreign exchange flowing more freely

10 Create at least 10,000 jobs annually

1. The PNG Economy

In this chapter we discuss the global economic environment (section 1.1) and its possible shaping of local outcomes, and then specifically consider the economic outlook as presented in the 2022 Budget (section 1.2).

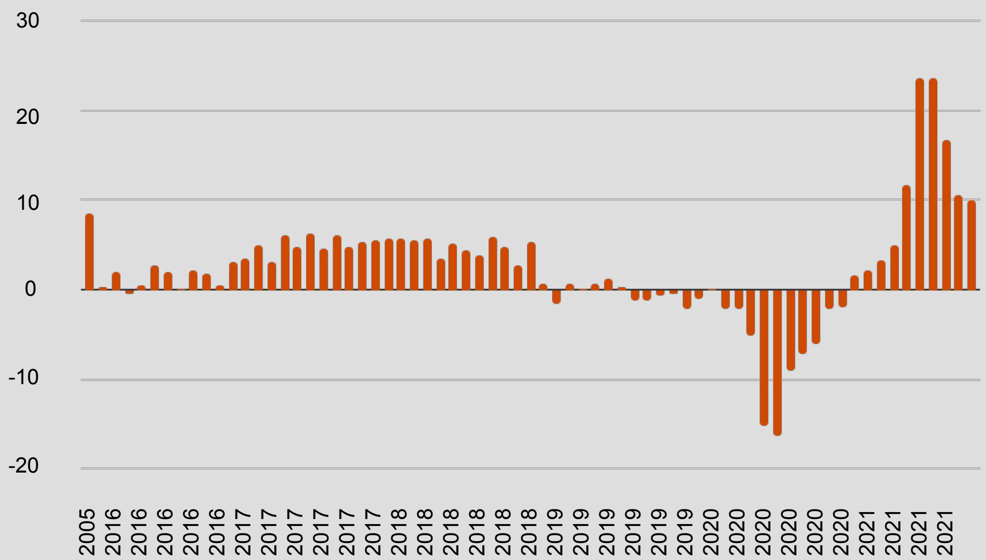
1.1 The global economic environment

We noted last year that history tells us that recovery from a pandemic recession traditionally happens faster than from a 'traditional' recession, and so a relatively quick return to global growth was plausible (even though growth may be uneven across countries).

This has been borne out - the global economic recovery remains on track (even though slightly delayed by the recent Delta variant of COVID-19).

The global recovery can be seen in how global trade sprang back from the initial contraction in the first two quarters of 2020 (after stagnant world trade in the preceding two years).

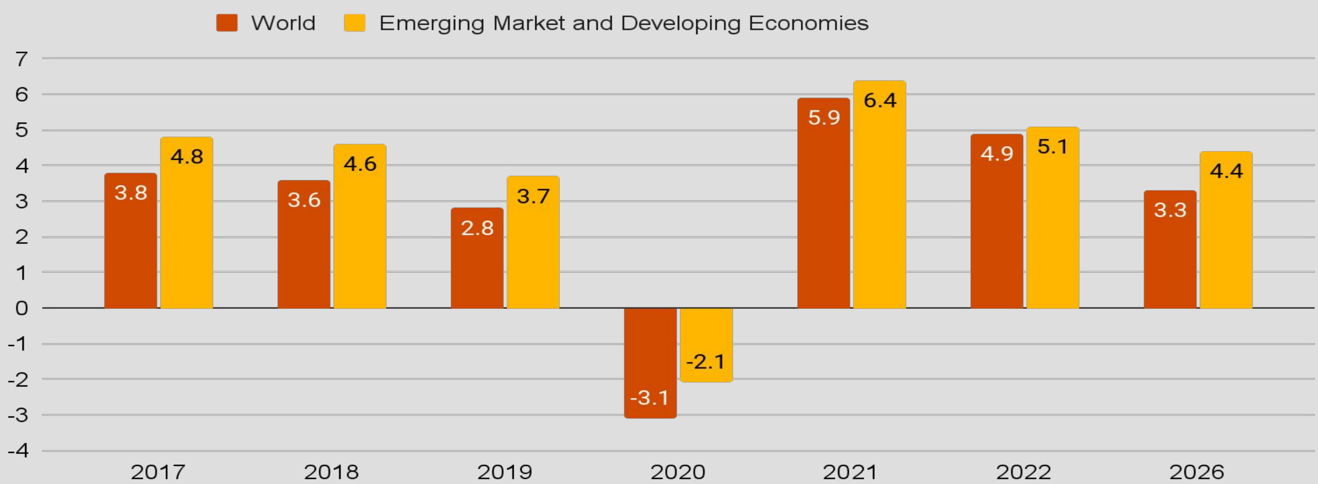
Figure 1: Growth in the Volume of World Trade (%)



Source: Netherlands Bureau of Economic Policy Analysis

Correspondingly, global economic growth is assumed by the International Monetary Fund (IMF) in their November 2021 *World Economic Outlook* update to be 5.9% in 2021 and 4.9% in 2022, after falling by 3.1% in 2020 (Figure 2). Rapid progress in vaccinating eligible populations and very high levels of fiscal and monetary support from governments (discussed more in section 2.2) has meant that the global recession of 2020 was short-lived.

Figure 2: IMF real GDP growth forecasts (%)



Source: IMF

In emerging and developing economies, economic growth has been revised down slightly since earlier in 2021 to 6.4%. This downward revision follows renewed outbreaks of COVID-19 in emerging Asia, especially India and Indonesia, and reflects the economic impact of containment measures implemented to control the spread of the virus and relatively lower vaccination rates.

Growth in emerging and developing economies is assumed to be 5.1% in 2022, driven by a surge in activity as vaccination programs become more widespread and economic activity resumes. It is assumed that vaccination rates will increase over 2022 as vaccines are redirected away from advanced economies towards emerging and developing economies.

In advanced economies, economic growth assumptions have been revised up compared with those published in the June and September quarters. Growth in 2021 has been revised upwards to 5.9%. These revisions reflect better progress with vaccination programs in economies that have reopened sooner than previously assumed, such as those in the eurozone and the United States.

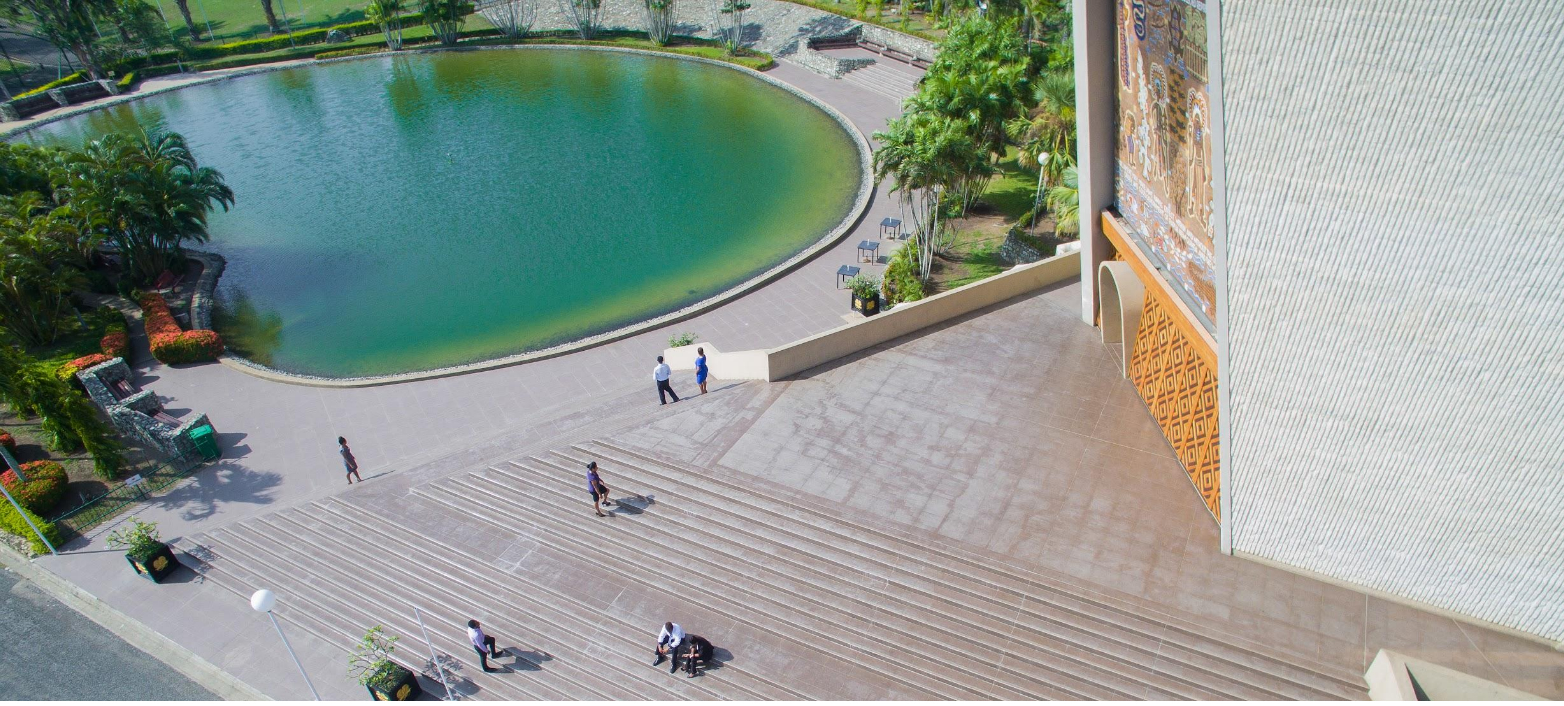
The global recovery is not without its challenges.

COVID-19 continues to be the key risk to economic recovery, with the highly infectious Delta variant challenging global health systems. Vaccine deployment has so far been concentrated on advanced economies where the economic recovery from the COVID-19 caused recession has been strongest. Limited access to vaccines in emerging and developing economies is delaying their economic recovery and constraining growth in that group. Hence, risks to global economic recovery continue to depend on the pace of vaccine rollout:

- on the upside, earlier access to vaccines and a faster uptake than currently assumed will lead to a stronger recovery as movement restrictions are lifted and economic activity resumes
- downside risks stem from slower vaccine rollouts, especially in emerging and developing economies. Continued outbreaks risk the emergence of further COVID-19 variants that could be more resistant to current vaccines. Delayed vaccine delivery would further impede reopening.

Additionally, inflation has climbed in some economies over recent months, notably in the United States. Inflation has been driven higher by increased oil prices and COVID-19 related disruptions to supply chains. Elevated inflation is assumed to be temporary because a large part of the increase is driven by lower prices in 2020 (known as the 'base effect'). Underlying measures of inflation (which exclude volatile items such as oil and food prices) remain below central bank targets in most major economies.

However, sustained high inflation is a risk to the outlook in a continued low wage growth environment. If the temporary factors that are contributing to high inflation do not weaken, inflation could slow the global economic recovery. Furthermore, prolonged higher inflation would also encourage central banks to start raising interest rates sooner to slow inflation. Raising interest rates would slow economic activity as the cost of borrowing and servicing debt increases. This would also lead to falling consumption and investment.



1.2 The domestic economy

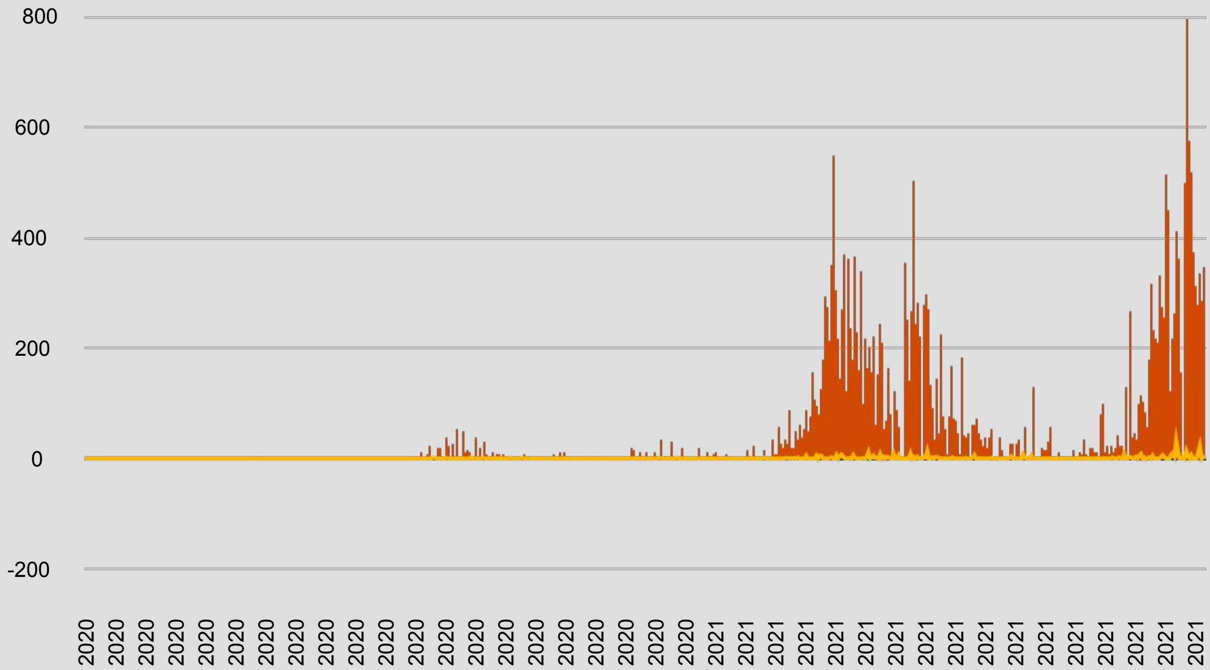
Even before considering both the global and local economic environments, and the future fiscal position of the PNG Government it is necessary to appreciate the impact of COVID-19.

As noted in section 1.1, the global economic environment has been disrupted by the COVID-19 pandemic. Not surprisingly, PNG has not been immune to this in a health, economic and fiscal context.

As shown in Figure 3, with the benefit of restricted international movements, PNG remained relatively unaffected by COVID-19 till 2021 and exposure to the most recent Delta variant.

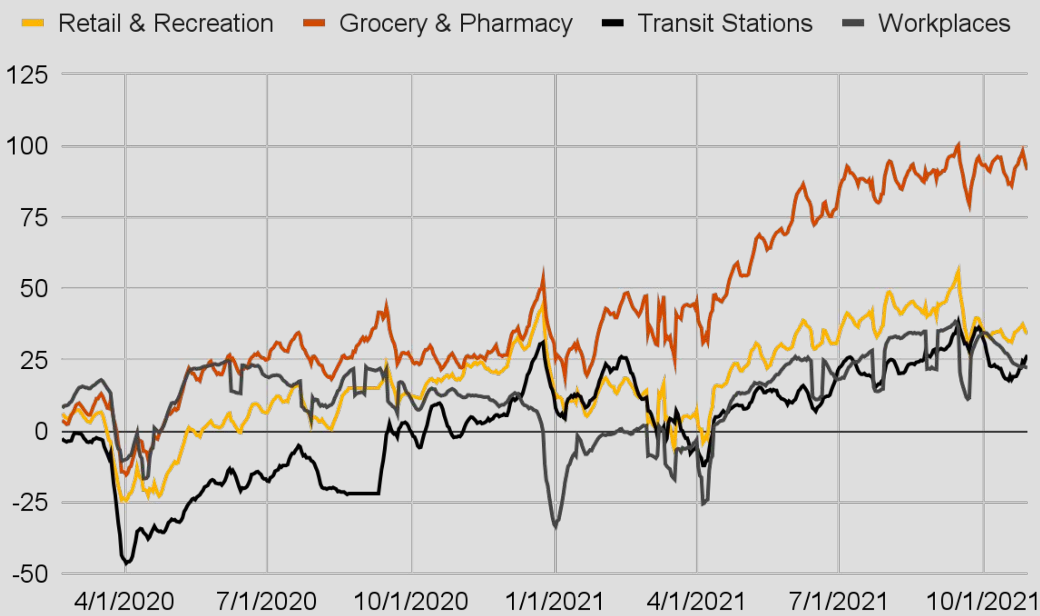
Despite the rise in COVID-19 exposures over 2021, the PNG community has continued to be active (see Figure 4), minimising the broader economic impact of COVID-19 and the loss of revenue for government, but potentially increasing the call on future health expenditures.

Figure 3: COVID-19 Pandemic - Daily Confirmed PNG COVID-19 Cases and Deaths



Source: World Health Organization

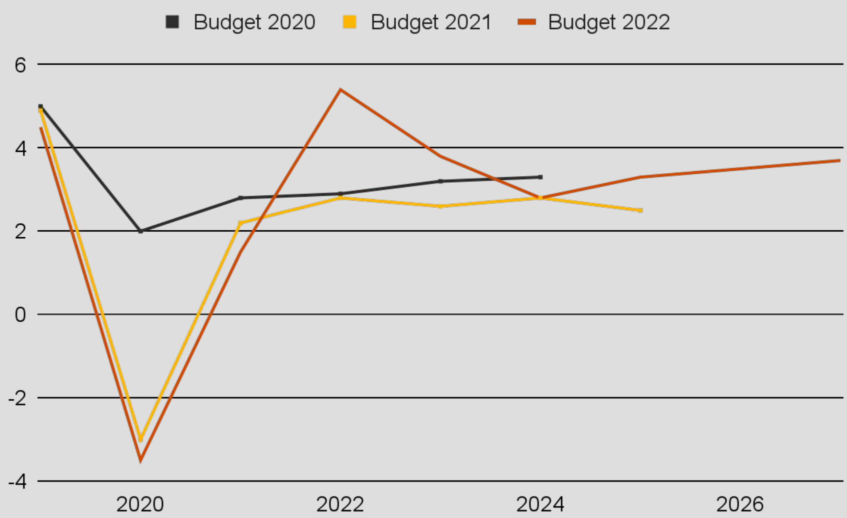
Figure 4: Mobility of the PNG Population by Site Compared to February 2020 Baseline



Source: Google

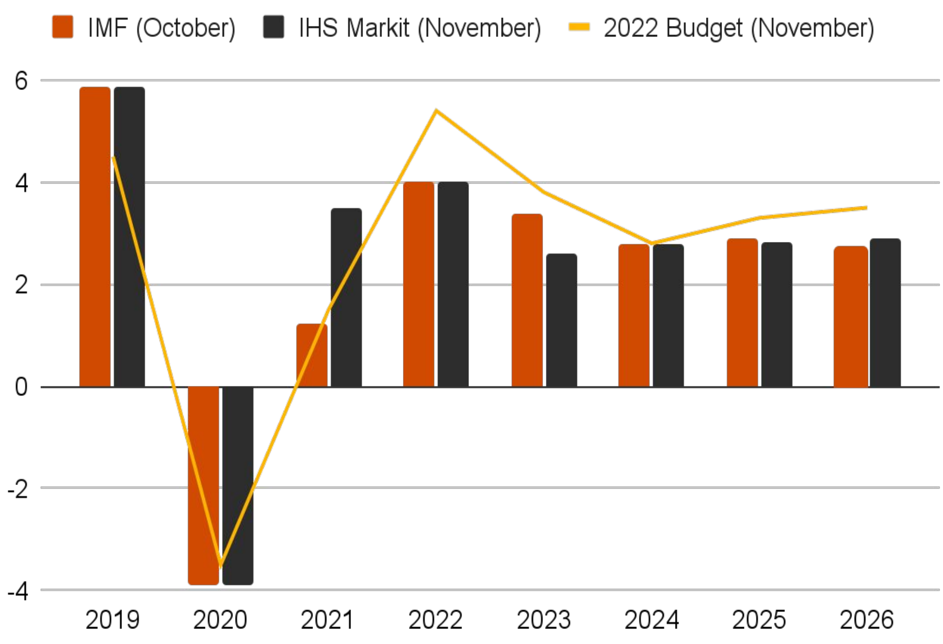
The delayed exposure to COVID-19 meant that economic activity over 2020 was relatively less affected than in many other countries, but that the delayed impact likely means that many of the negative economic and fiscal consequences are still to be experienced, and that consequently the PNG economy may experience a delayed recovery.

Figure 5: Real GDP growth (%)



Source: Budget 2020, 2021 & 2022

Figure 6: Comparison of real GDP growth forecasts



Source: Budget 2022, IMF, IHS Markit

Economic growth

Like other countries, and not unexpectedly, PNG took a significant hit to economic growth in 2020. due to COVID-19; PNG's forecast 2021 economic growth of -3.8% was well below the forecast provided in the 2020 Budget (2%), but marginally above the forecast presented in the 2021 Budget (see Figure 5).

The 2022 Budget now projects that the PNG economy to recover with growth of 1.5% in 2021 and then 5.4% in 2022 (see Figure 5). A large part of the projected growth is attributed to the commencement of Porgera in the 2nd Quarter, complemented by growth in non-resource sector and the support of the Connect PNG initiative.

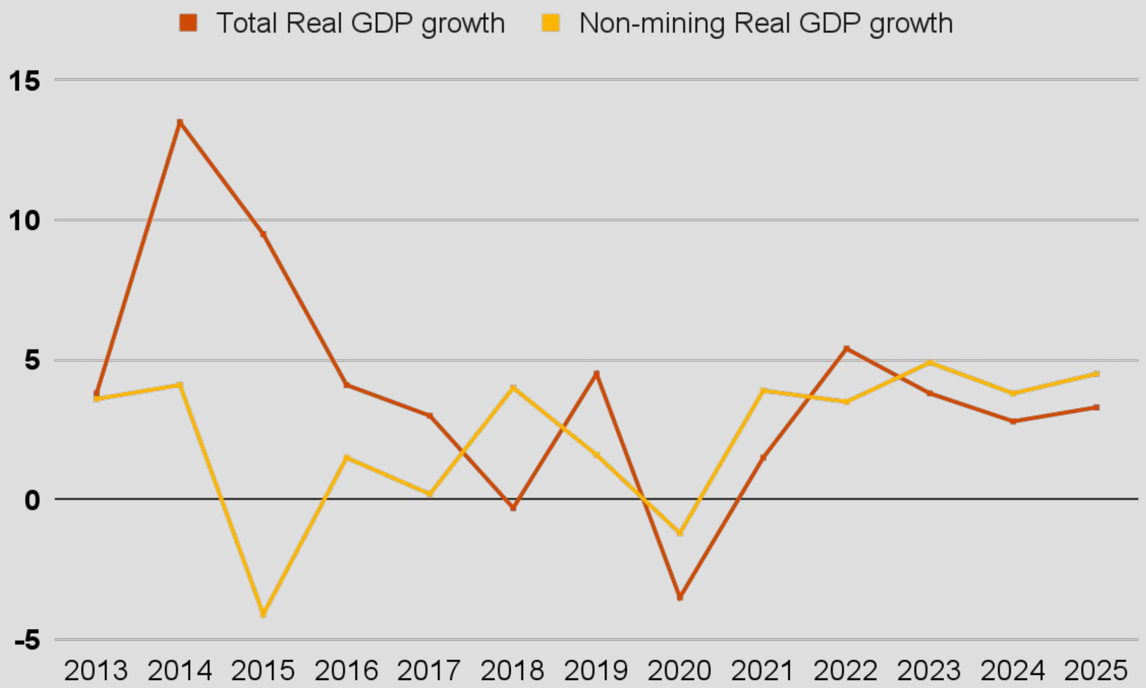
While forecasting is challenging at the best of times, we note that the Treasury growth forecast for 2022 is well out of line with other forecasters, including the IMF (i.e. 5.5% rather than 4%), and is also above other forecasts in 2023 (see Figure 6).

As noted above, the key driver of this projected increase in economic growth in 2022 is related to the extraction of natural resources (see Figure 7).

However, non-resource GDP is the best measure for economic activity in which most Papua New Guineans are involved, excluding output from the largely foreign-owned extractive sector. The non-resource sector is projected to recover and grow in real terms by 3.9% in 2022 (see Figure 8). This growth is a reflection of the strong recovery in the Agriculture, Forestry, and Fisheries sector as well as increased spending in health and social work activities to combat COVID-19.

The risk with these forecasts is that they potentially underplay the drag on economic growth that COVID-19 may have because of the impact of social distancing obligations and if it results in widespread illness that reduces the labour force.

Figure 7: Real GDP growth in the non-mining sector and the total economy (%)



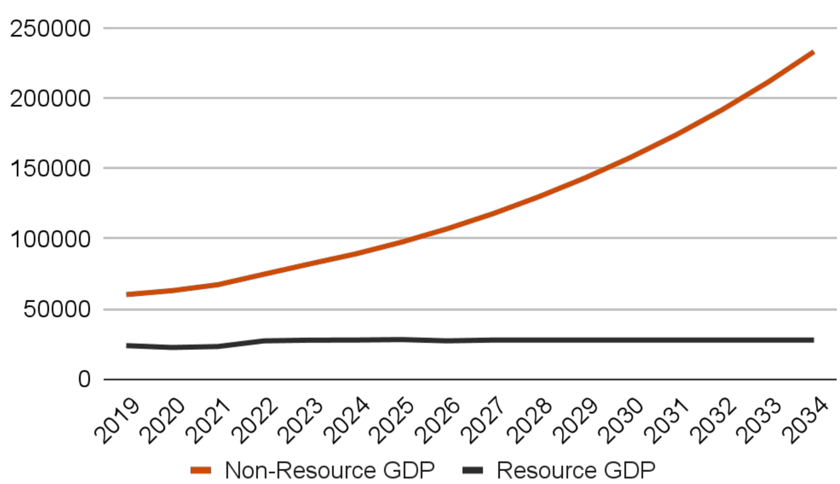
Source: Budget 2022

Like last year, the interesting element of the future projections (in aggregate in Figure 8) is that the Government is forecasting that from 2023 the non-mining sectors will grow faster than the mining sector.

While it has certainly been the ambition of governments to grow the non-mining sector faster, as can be seen in Figure 7, we have not seen this as a consistent outcome. Such an outcome, if achieved, would be welcomed as a step towards greater needed diversification of the economy.Indeed, the relative growth prospects of the two sectors are even starker over the longer term.

Despite it being a long-held ambition, we are dubious of the longer term Budget forecasts that show almost all economic growth coming solely from the non-mining sector (Figure 8). Indeed, the forecast appears overly optimistic in getting the Porgera mine back up to speed in 2022, but then shows almost no mining industry growth over the next 12 years.

Figure 8: Longer term projections for real GDP in the mining and non-mining sectors (Kina)



While this approach has been justified as being conservative - new resource projects are not included until a foreign investment decision (FID) is reached - and so provides 'upside'. However, this is a poor way to approach planning, particularly given the importance of the sector to the economy.

Note: 2019 and 2020 is from the FBO
Source: Budget 2022

Employment

The Bank of PNG's quarterly employment survey, as shown in Figure 9, clearly shows the significant hit to employment in the minerals sector in the September 2020 quarter, falling 28%. As documented in this year's MYEFO, this contraction was triggered by a 'significant reduction in the Ok Tedi Mine production due to COVID-19 impact and a fire at a mill in December 2020, the delayed operation of Porgera mine and the unexpected closure of Simberi mine'.[3]

In aggregate, and possibly not surprisingly given the impact of COVID-19, the Government's objective of creating at least 10,000 jobs annually (see Box 1) was not met in 2020. According to BPNG, total employment contracted by 4.1% from June 2020 to June 2021, mainly driven by the decline in the mining sector by 19.3%.

While the mining sector has declined, the non-mining sector recorded a strong growth of 9.7% (see Figure 9), driven by increased activity in manufacturing and wholesale sectors (see Figure 10).

We note that in last year's Budget the Government stated that the 'The negative impact of COVID-19 on formal employment is … implied to be concentrated on employees earning below the tax-free threshold'. That is, the concern is that informal employment has also been disproportionately hit, and this is likely to also be true as the impact of the Delta variant is fully drawn out over coming months (if not years).

Figure 9: Employment index (March 2002 = 100)

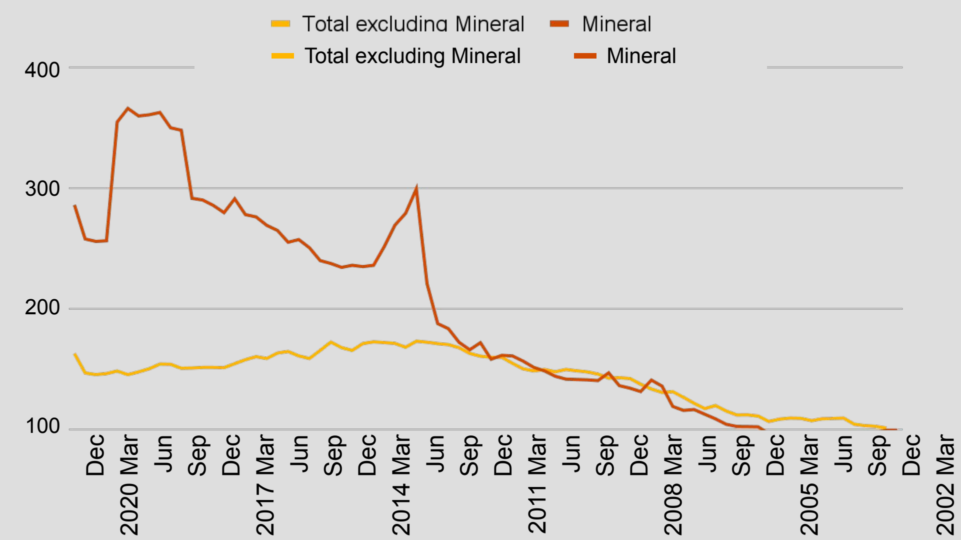
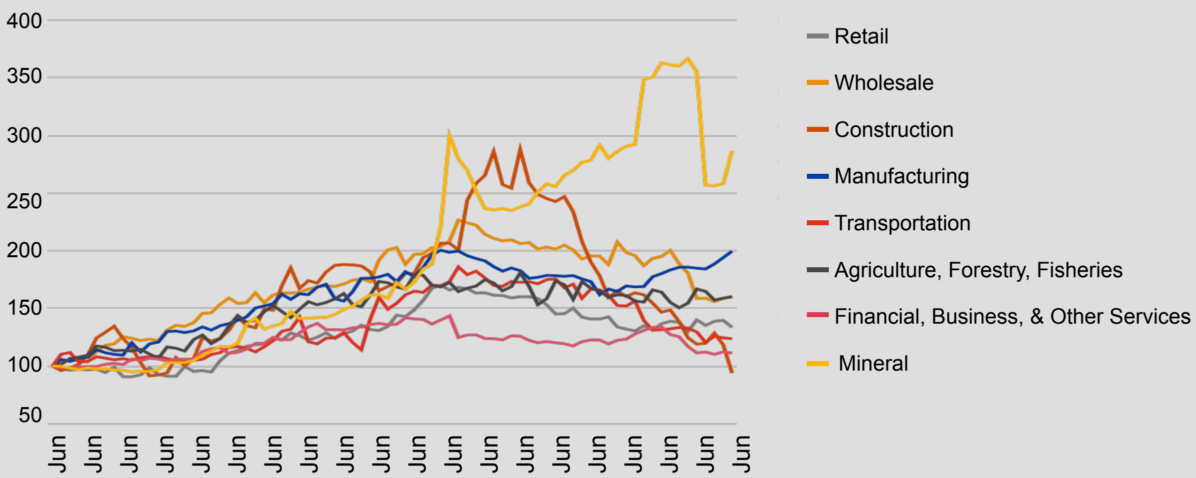


Figure 10: Employment index (March 2002 = 100)



[3] Treasury (2021), *Mid-Year Economic and Fiscal Outlook (MYEFO) Report*, p.4

[4] We note that while the Government has set itself a jobs target (see Box 1), the Budget papers do not actually specify the specific change in jobs achieved (instead referring to the indices shown in Figure 9)

Note: June 2020 Qtr data is provisional
Source: Budget 2021

Inflation

COVID-19 related disruptions have increased freight costs and transit times in both the global shipping and airfreight industries. PNG has not been immune to this:

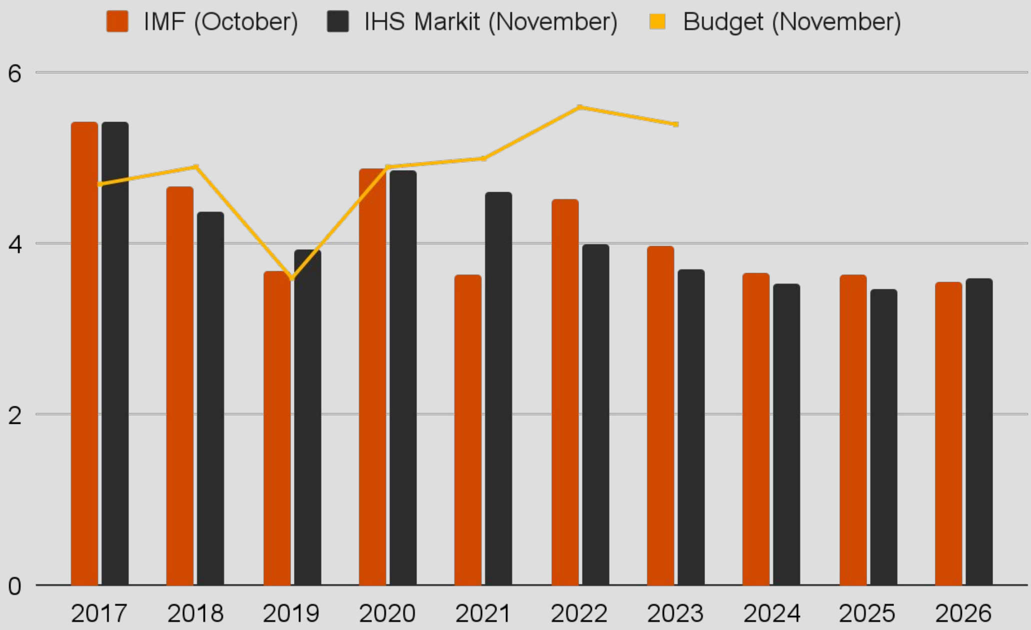
> *The pandemic has also disrupted the balance between air freight and shipping because of exponential increases in air freight charges. ... The same applies to PNG, where container prices are up from US$50 to US$70 per tonne on routes to Asia, and from US$170 to US$221 to the US. Again, this is less than the 50% rise in air freight prices reported. This is causing companies that used to air freight their products to divert to sea where possible to save costs.*[5]

Freight costs are assumed to remain elevated throughout 2021 and into 2022.

Despite rising commodity prices and the noted increased international freight costs, the inflation forecasts for PNG have only increased in this Budget from 5.0% to 5.6% as muted domestic demand is expected to persist longer than previously anticipated owing to the ongoing COVID-19 outbreaks.

Interestingly, the Budget forecasts for inflation are noticeably above the IMF and IHS Markit forecasts in the out years.

Figure 10: PNG inflation



Source: Budget 2022, IMF, IHS Markit

[5]Rachel Richardson & Rob Hitchins (2021), *Disruptions to global shipping: regional impacts*, available at https://devpolicy.org/disruptions-to-global-shipping-regional-impacts-20210622/

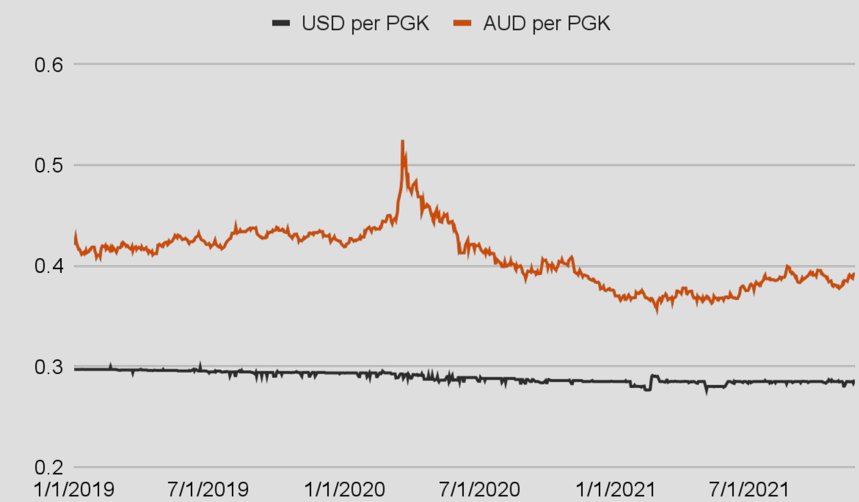
Foreign exchange

By and large, the Kina moves in line with major trading partners' currencies (Australia, New Zealand, Japan, etc).

Over 2021 (see Figure 11) we have seen an:

- a flat USD/PKG relationship as the Bank of PNG intervened in the foregn exchange market
- appreciation of the Kina against the Australian dollar. This reflects cross-currency movements; as the US dollar appreciated against the Australian dollar, so the Kina appreciated against the Australian dollar given the flat Kina/USD relationship.

Figure 11: Spot rates for the Kina (PGK) - 1 January 2019 to 19 November 2021



Source: Reserve Bank of Australia

It is reasonable to expect the kina to continue to appreciate against the Australian dollar as the Australian dollar is expected to weaken as the economic recovery in the US pushes up the strength of the US dollar.

Relatedly, an annual lament at Budget time is the issue of currency availability, and 'getting foreign exchange flowing more freely' is still one of the Government's stated principles underpinning the Budget and its reform agenda (see Box 1).

To cope with the shortages of foreign reserves, over the past six years there has been rationing of reserves being made available to the broader PNG economy. The rationing policy has focused on allowing for priority imports such as food, and has created significant backlogs in import funding and arrears on foreign payments by firms. Profit repatriation by any firms outside the extractive sectors is also significantly restricted, frustrating established foreign investors, and deterring new potential investors.

We have previously commented that the measures under last year's Budget would both assist and harm the availability of foreign exchange as:

- access to external financing will provide an injection into foreign exchange reserves that will facilitate the easing of the foreign exchange imbalance, but
- the fiscal deficit financing under a quantitative easing (QE) program run by BPNG will have the opposite impact on FX reserves.

Indeed, the 2021 Budget papers note that 'legacy issues such as foreign exchange shortages will continue to be impediments towards the improved growth of the business environment in the non-mineral sector'.

In this year's Budget the unavailability of foreign is identified as a macroeconomic risk, but with no strong emphasis on any new initiatives to reduce this risk other than announced in previous Budgets.

2. The Government's Fiscal position

2.1 Revenue

An objective of successive governments has been to raise the level of taxes collected to better be able to invest in physical and human capital to advance development.

The 2022 Budget projects tax revenue to grow 11.2%, with other revenue and grants also up massively (48.8%). These projected increases are driven by:

- in the resources sector:
  - higher commodity prices
  - the resumption of the operations of major mines (Porgera, Simberi and Ok Tedi Mining)
- in the non-resources sector
  - forecast strong domestic economic growth
  - election-related spending.

Figure 12: Revenue changes since the 2020 Budget (Kina, million)

	2019 Budget	2020 Budget	2021 Budget	2022 Budget	Difference
Tax Revenue	**10,918.10**	**11,307.80**	**11,109.7**	**12,511**	**1,401**
Grants	1775.6	932.1	1008.3	1,825	977
Other Revenue	986.8	1855.5	877	1,854	817
TOTAL	**13,680.50**	**14,095.40**	**12,995.00**	**16,190**	**3,195**

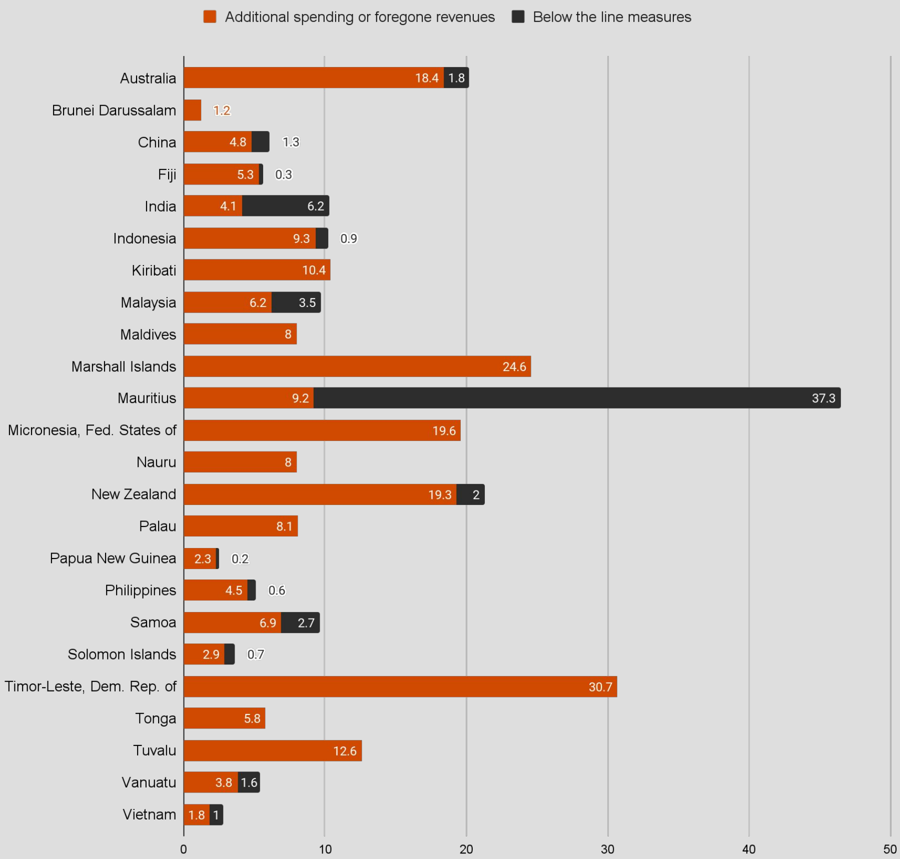
Source: Budget 2022

There is a lot that can go wrong with this forecast, with real concerns that the resumption of major mines will take longer than projected, and that the downside risks associated with COVID-19 have not been fully captured.

2.2 Expenditure

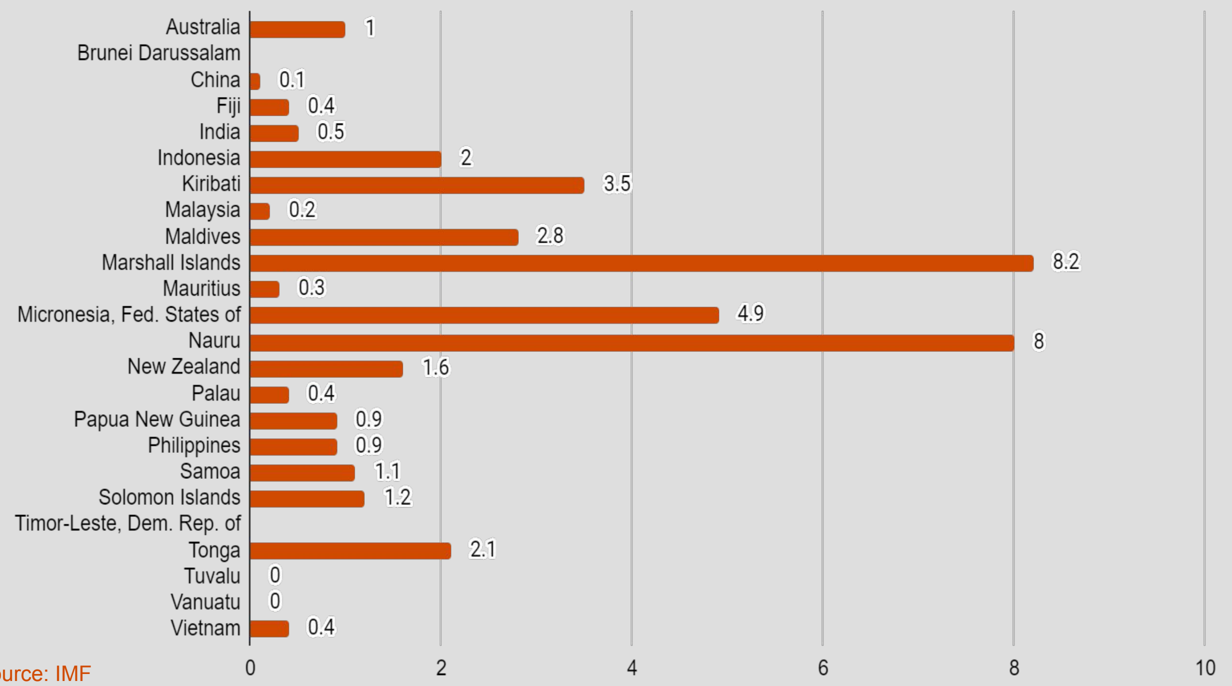
Reflecting the relatively low exposure to COVID-19 until early 2021, additional COVID-19 related expenditure by the PNG Government has been relatively lower than in other nearby countries (Figure 13) at 2.5% of GDP since January 2020, including additional health spending equivalent to 0.9% of GDP (Figure 14) over the same time.

Figure 13: Fiscal Measures in Select Countries in Response to the COVID-19 Pandemic since January 2020 (% of GDP)



Source: IMF
Note: As at October 2021

Figure 14 - Additional Health Spending in Select Countries in Response to the COVID-19 Pandemic since January 2020 (% of GDP)



Source: IMF
Note: As at October 2021

A number of other notable things stand out in Figure 15:

- Administration/Miscellaneous (26.8%)
- Provinces (20.0%)
- Debt Servicing (18.3%).

Figure 15: Expenditure by sector as a % of the total budget

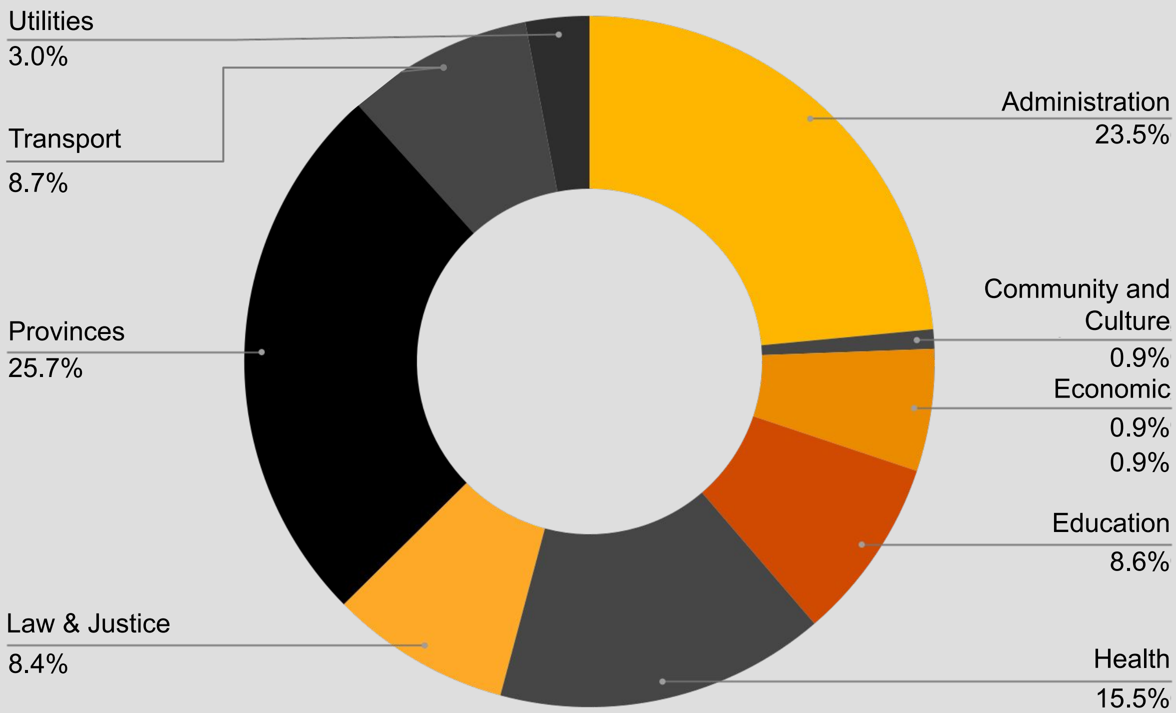
	Budget 2019	Budget 2020	Budget 2021	Budget 2022
Administration/Miscellaneous	25.2	21.5	27.3	30.2
Community and Culture	0.9	0.7	0.5	0.7
Debt Services	12.3	12.5	12.0	10.8
Economic	4.6	4.8	3.4	4.4
Education	8.5	9.0	5.6	6.6
Health	9.6	10.4	8.9	11.9
Law & Justice	8	9.7	6.5	6.5
Provinces	19	23.7	20.1	19.8
Transport	8	6.4	11.0	6.7
Utilities	3.8	1.2	2	2.3

Source: Budget 2019-2022

Not surprisingly in a pandemic, health expenditure is forecast to be 33.7% higher than in 2021.

Drawing on the data from Figure 12, a more down-to-earth perspective of the relative focus of spending can be discerned by excluding Debt Servicing and Miscellaneous, as shown in Figure 16.

Figure 16: Expenditure in 2021 by sector as a % of total expenditure (net of Debt Servicing and Miscellaneous spending)



Source: Budget 2022

2.3 Debt

Cost of debt is budgeted to decrease as the Government focuses on concessional loan agreements and bringing down costs of domestic borrowing with a falling yield curve at longer end maturities.

In 2021, with total revenue of K12,995.0 million and total expenditure of K19,607.8 million, the resulting fiscal deficit is K6612.8 million (7.3% of GDP).

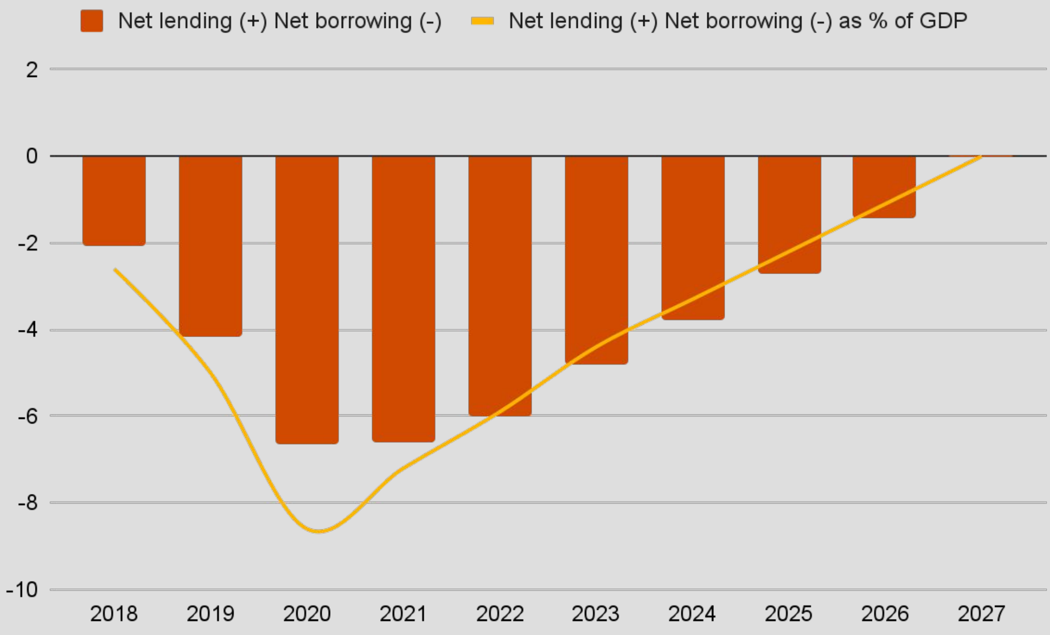
Figure 14 shows the projected deficits in millions of Kina and as a percentage of GDP. The pandemic put back the path to getting the Budget into surplus (the 2023 forecast of a deficit of 1.8% is now 3.2%).

Indeed, we are sceptical that the level of spending constraint and/or tax collections required to achieve the consistent reduction in deficits shown in Figure 14 can be maintained.

This K6612.8 million shortfall will be financed through external (K3744.7 million, down from K4612.8 million in 2021 million) and domestic (K2010.2 million, down from K2000 million in 2021) borrowings to meet the total funding requirement for the 2022 Budget appropriation.

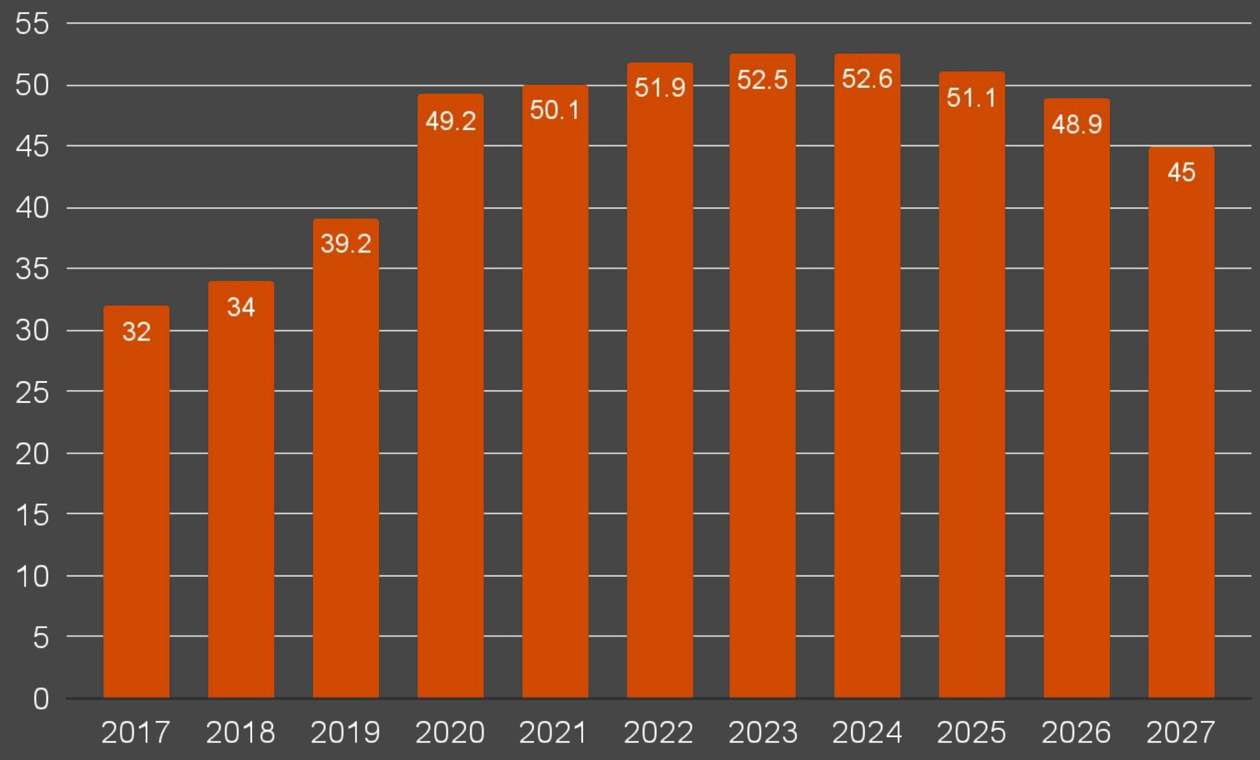
The Fiscal Responsibility Act put a fiscal constraint on the Government in that it limited debt levels to 45% of GDP. Despite this legislative barrier, the deficit this year will increase the level of public debt, excluding valuation changes, to K42,766.3 million, or 51.9% of GDP (excluding outstanding arrears). As shown in Figure 17, debt is not projected to fall below the 45% threshold till 2027.

Figure 17: Net borrowing (Kina, million and % of GDP)



Source: Budget 2022

Figure 18: Debt as a percentage of GDP



Note: 2020 are actuals and 2021 refers to the supplementary budget
Source: Budget 2022

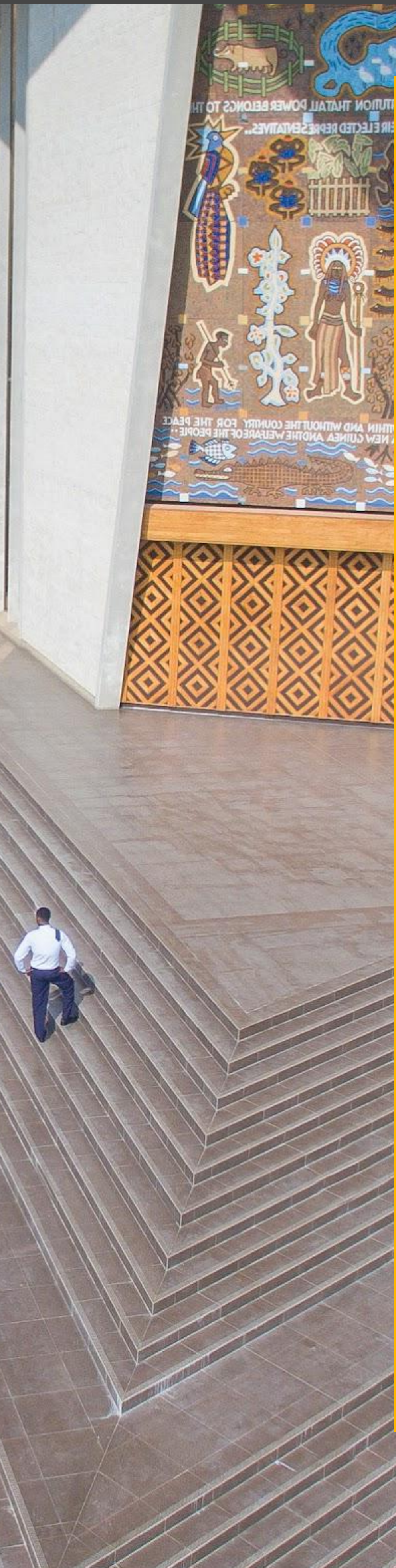
Even though in a lower interest rate environment, debt servicing costs are projected to increase in absolute terms and as a percentage of total expenditure (see Figure 18).

Figure 19: Debt servicing costs

	2020	2021	2022	2023	2024	2025	2026	2027
Debt servicing (Kina million)	2064.4	2270.8	2,324.0	2,431.3	2535.9	2587.9	2566.9	2491.0
Debt servicing as a % of total	11.5%	11.6%	10.5%	10.8%	10.9%	10.5%	9.9%	9%

Note: 2020 refers to the 2020 Supplementary Budget
Source: Budget 2022

3. Taxation developments and amendments



The 2022 Budget has been framed in the context of the Medium Term Fiscal Strategy, which itself has evolved during recent years. The MTFS 2018-2022 which would have been coming to its conclusion in this budget cycle was subject to revision to become the MTFS 2020-2024 which arose from the Loloata Commitment of the current government. The document has been updated to a MTFS 2022-2027 which further reflects the fiscal plans of the government. Throughout these documents the commitment to tax reform has remained consistent.

The reform agenda continues to aim at enhancing revenue collection and this is set to continue as the government maintains the aim of budget repair for the medium term. Reform has focussed on core areas such as:

- enhanced financing and capacity at the IRC for more robust revenue collection and administration
- broadening the tax base
- the review of GST
- the introduction of capital gains tax
- consideration of new taxes/levies on the banking and telecommunication sectors

Within each of these elements, the focus has generally been on revenue enhancement.

It had further been expected that this budget cycle would see the completion of the most significant piece of tax legislative reform in more than half a century with the introduction of the new Income Tax Act (the new Act) to replace the Income Tax Act 1959 (the 1959 Act) and to bring into effect the accompanying new Tax Administration Act which is to act in tandem with the new Act.

The new Act would have introduced capital gains tax, altered the incidence of taxation for the resource sector, overhauled the taxation of non-residents, and eliminated many of the current concessions and exemptions for the agriculture sector. However, despite renewed fleeting consultation in September 2021, the new Act has not been presented. Presumably the significant gaps and high levels of remaining uncertainty with the most recent draft have caused the legislation to be again deferred.

The pathway to the drafting of the new Act commenced in 2019 and exemplifies the challenge of significant tax reform in any jurisdiction. However, an examination of its progress also highlights some of the general shortcomings that have been evident through the entirety of the recent tax reform process. Consultation with stakeholders has been very limited given the ambition of the reform. Attempting a combination of simplification and reform simultaneously has also led to challenges. Unfortunately, without a significant rethink of the consultation and drafting process, the mere delay of the new tax Act will not address these challenges and shortcomings. Nevertheless, in deferring the presentation of the current draft, there is an opportunity to improve the process during the next year.

3.1 Legislative amendments

Despite the deferral of the new income tax Act, the budget has seen the introduction of a substantial number of legislative amendments. The principal amendments and their respective implications are outlined below:

Market Concentration Levy

The Income Tax Act has been amended by including a new Division 11A that imposes a fixed value levy on a market concentration taxpayer within the banking and telecommunications sectors.

The levy is imposed on taxpayers that hold a more than 40% market share within the respective industry sector. The concept of measuring market share is proposed to rely on information from the regulator of the relevant sector (NICTA or Bank of PNG).

The fee is an annual levy/tax collected in instalments and appears to be aligned with the collection of provisional tax. The levy is imposed at PGK 95 million for the telecommunications sector and PGK 190 million for the banking sector.

The potential for banking and telecom levies has been part of the budget discussion for a number of years, with references in budget papers that the levies were under consideration. However, the design of the levy as described in the draft legislation is a departure from similar levies in other jurisdictions. It is also the first time that such a design has been included in a PNG context as a revenue raising measure. The focus on market dominant players is another feature that has not been a traditional part of budget thinking.

Infrastructure tax credits

The provisions surrounding the ability to generate and then utilise infrastructure tax credits have been further refined. The impact of the amendments is to further limit the scope of the provisions that have been in place to allow taxpayers in the mining petroleum or gas operations, primary producers, or tourism operators to generate and apply tax credits from approved infrastructure spend. At the same time, the level of the taxpayer's liability that can be met with approved credits has been consolidated at 2% of assessable income for all eligible taxpayers.

The amendments limit the ability to carry forward the credits for more than seven years, and the amendments appear to be attempting to introduce further conditions for qualification for the scheme through a series of what are described as integrity measures. These involve the timing for accessing credits (once the project is signed off as complete), as well as allowing participation by "taxable" entities only - although it is unclear what this limitation means.

Infrastructure tax credits have been subject to a number of revisions over recent years as the Treasury has grown more concerned about the potential growth of tax expenditures as part of the budget process. However, infrastructure tax credits and the projects from which they are derived remain a very important element of most resource agreements and projects. The challenge over these credits also has been a source of conflict between the Ministry of Planning and Treasury in relation to the appropriate government body to administer the program.

Changes associated with the Tax Administration Act 2017

There are a significant number of amendments included in the budget legislation that are described as consequential changes necessary to enable the entry into force of the Tax Administration Act 2017. The Acts amended as a result of these include the Income Tax Act 1959, the Goods and Services Tax Act 2003, the Stamp Duties Act 1952, the Departure Tax Act 1980 and the Gaming Control Act 2007.

The Tax Administration Act was initially passed into law in 2017 however, it has yet to be made effective through gazettal. The move to pass these consequential changes could mean that the Tax Administration Act 2017 will be in operation by 1 January 2022, although this has not been referenced in any of the budget papers.

The Act is expected to promote efficiency, improve compliance and tax administration and in theory should have a neutral impact on taxpayers. However, at the time of passing the original bill, and in the years since, there have been no announcements by the IRC or Treasury in relation to programs for public awareness or consultation on the bill's potential impacts. While in principle the Tax Administration Act 2017 consolidates the tax administration process from taxpayer registration to tax appeals in the one law to be applied across the range of taxes, in substance the act contains a set of rules for tax administration almost entirely in favour of the Commissioner General. This includes provisions which ignore the principles of limited liability even after a company has been liquidated.

During the most recent interaction in relation to the new income tax act, it was understood that the Tax Administration Act would continue to be twinned with the new income tax act and as such there would be continued consultation to ensure alignment in terminology and meaning. Should the Tax Administration Act be brought into force in January 2022, this will be another lost opportunity for effective consultation.

Other income tax act changes

Among the multitude of amendments, the legislative support for the move to align the provisional tax instalments for all taxpayers (even those with a substituted accounting period) has been achieved - again. This change was raised in previous years and in fact this same amendment was already passed in 2021.

An amendment has also been included which allows even wider powers to the IRC when it comes to regulating group employers. The amendment provides a blanket right to the IRC to issue notices, instructions and orders with respect to any and all group employer duties. This is targeted at allowing the IRC greater authority to pursue what it believes are the incorrect application of salary and wages tax by any employer.

Customs Tariff changes

The budget bills contain a number of changes to the customs tariff schedule, including:

- the repeal of the 10 toea per litre tariff on imported diesel and petrol, which will be phased in over two years (5 toea each year). This effectively reverses a previous policy that imposed the tariff on imported products to support local producers. However, the view has changed and the tariff is now viewed as limiting competition in the market for fuel.
- the removal of any tariff on imported ultra high temperature (UHT) milk. Again, a tariff had been imposed with the view of supporting local producers, however, the government acknowledges that the increase was not imposed through an administrative practice. This change aligns the law with the current practice.

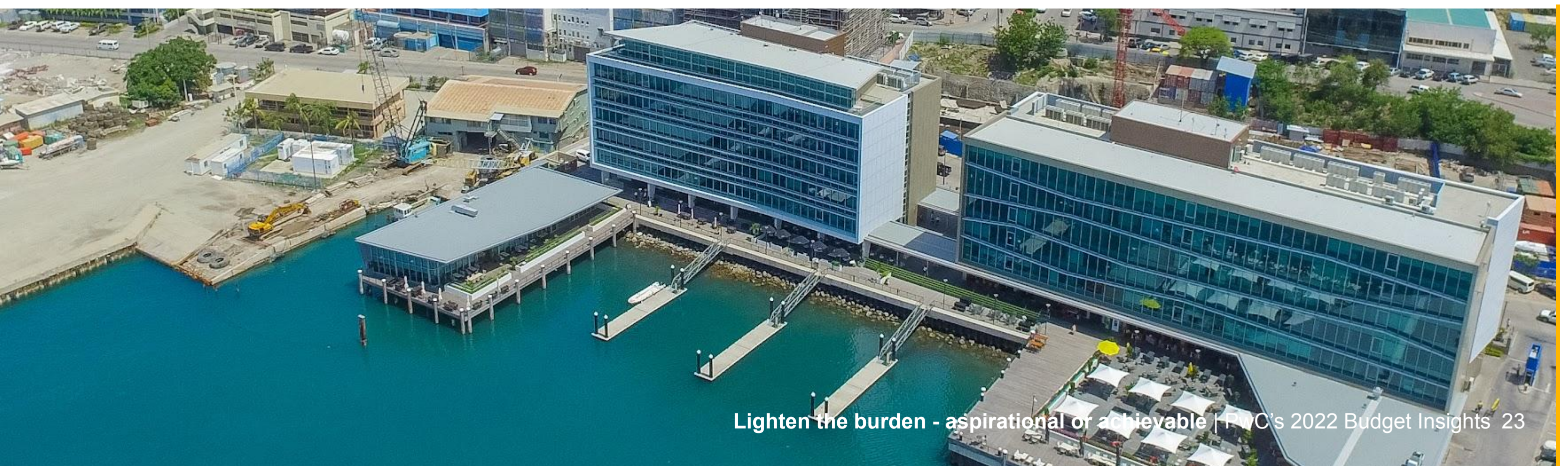
Excise Tariff changes

For a number of years, government policy has been a six-monthly increase in the excise rate for tobacco and alcohol, with the increment being set at 5%. The rate increase was suspended in December 2020 as the impact of continuous increases led to an overall reduction in excise collection as demand for locally produced products plateaued and the pressure from illegal imports increased. However, the suspension was reversed in September 2021 and the rate increase was applied retrospectively from December 2020. In the current budget, while the automatic indexation is retained, the increment will be reduced from 5% to 2.5%, resulting in the moderation of the anticipated growth in excise collections from the tobacco and alcohol industry.

Further adjustments within the alcohol sector comes in the form of an increase in the excise rate for anti-social drinks (being those with a strength greater than 10.0% of alcohol content) by a further K100 per litre of alcohol increasing the current rate from K689.66 to K789.66 per litre. This is expected to reduce the consumption of high alcoholic products which lead to social and health issues. Both reforms will come into effect on 1st December 2021.

Also in relation to the tobacco industry is reform to extend the tobacco second excise tier to counter illicit tobacco. The Government will continue to apply the second-tier tobacco excise for the next two years. Treasury and PNG Customs will continue to monitor its performance and advise the Government on the next policy action. The reform will come into effect on 1st December 2021.

The final proposed amendment to the Excise Tariff Act is to remove the import taxes on electric vehicles. The world is moving towards electric cars. This is due to concerns on global climate change as well as improving technologies. The government encourages the uptake of electric cars in PNG by repealing the import tariff on fully kitted electric vehicles to support the green economy. The reform is revenue neutral and will come into effect on 1st January 2022.



4. Observations for 2022 and beyond

As noted in the introduction (Box 1), the Budget continues to be built around a set of principles that are indisputably positive and aspirational. However, when examining the results of recent tax reforms including those in the current budget, it is important to consider the outcomes and what this may mean for business into 2022 and beyond.

The objective of focusing spending on core areas that are proven to support development - human capital (i.e. education), health and infrastructure[6] - is eminently sensible, and so too is the aspiration to improve the fiscal position of the government.

The challenge is whether the plan - to grow the non-resources sector, increase the collection of taxes, get the Budget to surplus in 5 years, and eradicate sovereign debt in 13 years - is plausible.

As noted in Chapter 2, there exist questions about at least some of the economic projections upon which the plan is built. For example:

- the 2022 growth forecast looks wildly optimistic (see Figure 6), particularly in light of the likely drag on the PNG economy caused by COVID-19
- all economic growth after 2022 is projected to come solely from the non-resources sector of the economy (Figure 8). This implies a stagnation in the resources sector that is difficult to understand

The Government espouses that it wants to raise revenues more fairly. However, introducing significant specific levies on individual “market concentration taxpayers” in the banking and telecommunications industries arguably fails this principle. Imposing significant additional cost burdens or barriers to investment based on market share would ordinarily be associated with antitrust actions rather than taxation. It is possible that the nature of this new collection mechanism will leave many taxpayers wondering whether their industry may be the next target.

In the Budget for 2022 there is an expectation that revenue from Goods and Services Tax **(GST)** will increase in 2022 to just over K5 billion (from just over K4.1 billion in 2021). The growth in GST revenue in 2022 of about 22% substantially exceeds the expected growth in GDP for the same period. This makes interesting reading as GST is a tax on consumption and therefore it would be expected that any increase in GST collections would correlate with the increase in GDP. It is impossible to determine the expected source of the growth from the budget papers - however, you could speculate that such an increase in GST is likely to come from the way in which the application of section 65A is measured or even the non-payment of GST refunds.

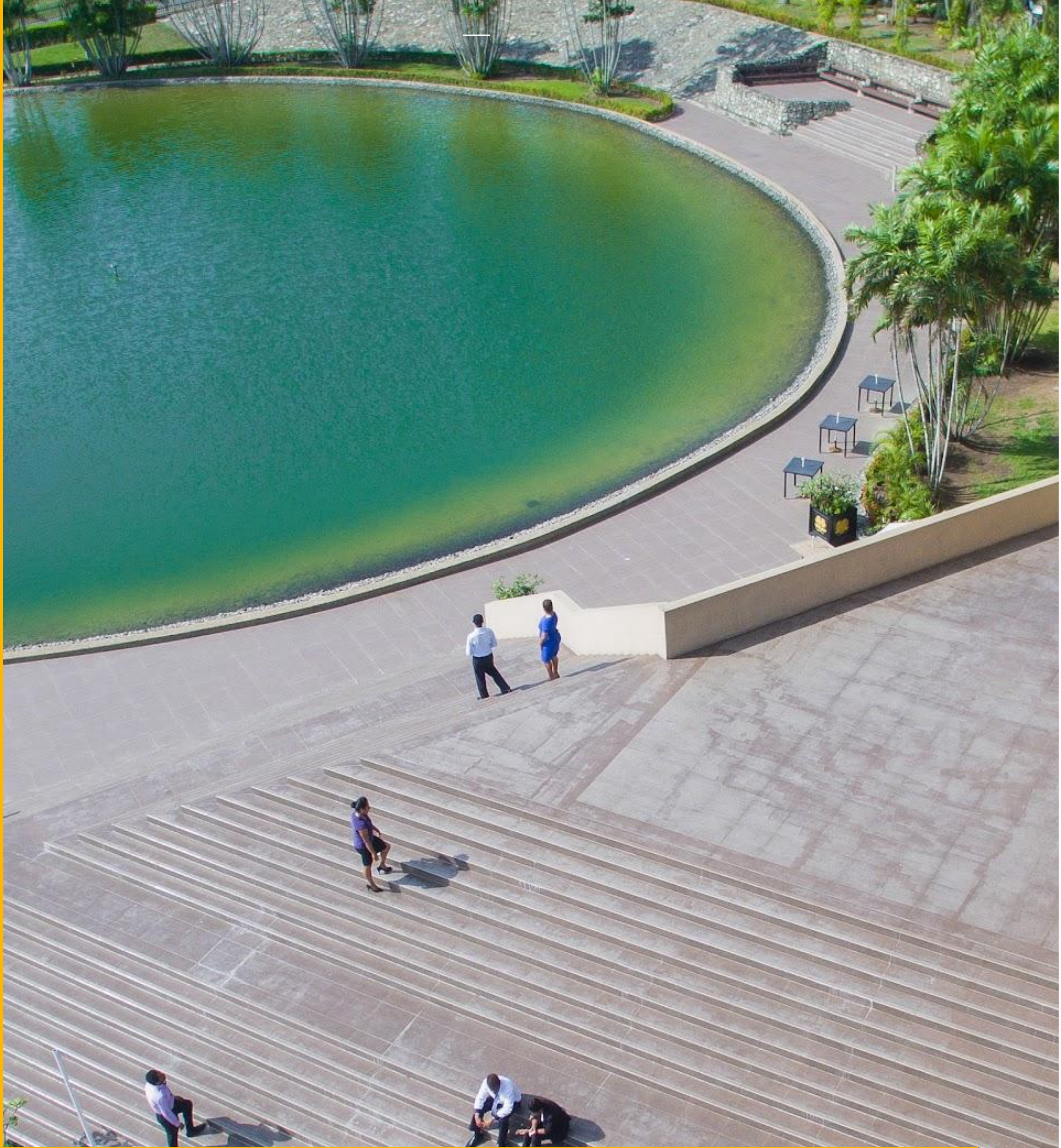
Section 65A is designed to encourage compliance with the GST system. The theory is that instead of the customer paying their supplier the GST component of their transaction, they pay the IRC directly. The IRC should then record this as a credit to the supplier's GST account. The supplier will in turn be encouraged to file their GST return and obtain the use of this GST input tax component they have incurred in making the course of their operations. Revenue collection from Section 65A should be neutral. The success of Section 65A should be judged on how many new taxpayers are filing GST returns to obtain their GST credits as opposed to how much revenue the IRC collects under Section 65A. It is unclear whether the GST revenue collected from Section 65A is included as part of the increase in GST revenues.

The non-payment of GST refunds is a challenge for businesses operating in PNG. The Business Council of PNG is reported as saying that businesses in PNG are owed K2 billion by the State in GST refunds. It is not evident how the GST refunds owed to PNG taxpayers have been accounted for in the Budget for 2022. The issues with the non-payment of historical GST refunds have adversely impacted the resource, agriculture and tourism sectors in particular as well as many PNG businesses that have struggled through the past two years.

Another of the key principles for the budget is to spend more wisely the money that has been received. During recent years, the IRC and Customs have been recipients of relatively significant additional funding. The goal of the funding is clear - to enable the development of more robust administrations for the collection and administration of the revenue agencies. It is acknowledged that a robust and efficient tax administration system is needed for PNG.

The challenge for the Government is how to measure the benefits. Initiatives aimed at broadening the tax base would be expected to be favoured, as would technological advances that would both facilitate taxpayer compliance as well as reduce the level of rework and errors arising from taxpayer records. Unfortunately, while identified as part of the tax reform agenda for the 2018-2022 MTFS, development of an enhanced upgrade of SIGTAS, the adoption of an online lodgement portal, and a focus on broadening the tax base have seen little progress in recent years. The current commitments will hopefully begin to take effect rapidly over the coming year.

During 2021, it was widely expected that 2022 would be a landmark year for tax reform in PNG with the introduction of a new act for the first time in more than a half century. While this type of reform has ultimately been deferred (again), 2022 will see taxpayers having to manage change and potentially significant change. The changes have again been introduced with little or no consultation, and little or no policy materials to support the basis for the changes. The budget calls for some very optimistic growth in tax revenues, while the resource sector is assumed to be flat. The ultimate takeaway is that taxpayers will need to continue to be ready for change and ready for the pressure of increased collections across much of the economy. It may be some time until taxpayers feel the result of a budget that desires to lighten the burden.



The PNG Budget commentary has been prepared to provide an overview of the general issues raised in the 2022 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.

Contact us for more information

Jonathan Seeto
Managing Partner
jonathan.seeto@pwc.com

Peter Buchholz
Partner
peter.l.buchholz@pwc.com

Peter Burnie
Partner
peter.burnie@pwc.com

Grant Burns
Partner
grant.burns@pwc.com

Jason Ellis
Partner
jason.b.ellis@pwc.com

Jonathan Grasso
Partner
jonathan.a.grasso@pwc.com

Teresa Kenny
Partner
teresa.x.kenny@pwc.com

Alison Judd
Partner
alison.judd@pwc.com

Stephen Beach
Principal
stephen.beach@pwc.com

Port Moresby office
PwC Haus, Level 6
Harbour City, Konedobu
T: (675) 305 3100 | 321 1500
F: (675) 321 1428

Lae office
BSP Commercial Centre, Level 1
Markham Road
T: (675) 472 2644

www.pwc.com/pg

About PwC and this publication

At PwC, our purpose is to build trust in society and solve important problems. We are a network of firms in 155 countries with more than 284,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com/pg