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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR 106.8 MILLION (US$150 MILLION EQUIVALENT) TO

THE INDEPENDENT STATE OF PAPUA NEW GUINEA

FOR THE

FIRST ECONOMIC AND FISCAL RESILIENCE DEVELOPMENT POLICY OPERATION

September 26, 2018

Macroeconomics, Trade and Investment Global Practice
Governance Global Practice
East Asia and Pacific Region

INDEPENDENT STATE OF PAPUA NEW GUINEA – GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of July 31, 2018)

Currency Unit = Papua New Guinea Kina (K)
US$1.00 = K3.26
US$1.00 = SDR0.71

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
APEC	Asia-Pacific Economic Cooperation
BPNG	Bank of Papua New Guinea
CEFI	Centre for Excellence in Financial Inclusion
CEPA	Conservation, Environment and Protection Authority
CPF	Country Partnership Framework
CPI	Consumer Price Index
CPS	Country Partnership Strategy
DFAT	Department of Foreign Affairs and Trade
DoF	Department of Finance
DoT	Department of Treasury
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
EIA	Environmental Impact Assessment
FMIS	Financial Management Information System
FRA	Fiscal Responsibility Act
GBV	Gender-Based Violence
GDP	Gross Domestic Product
GoPNG	Government of Papua New Guinea
GRS	Grievance Redress Service
GST	Goods and Services Tax
IDA	International Development Association
IFMS	Integrated Financial Management System
IMF	International Monetary Fund
IRC	Internal Revenue Commission
K	Kina
KFR	Kina Facility Rate
LNG	Liquefied Natural Gas
LTO	Large Taxpayer Office
MSME	Micro, Small and Medium Enterprises
MTDS	Medium-Term Debt Strategy
MTFS	Medium-Term Fiscal Strategy
MTRS	Medium-Term Revenue Strategy
NCDC	National Capital District Commission
NRPB	Non-Resource Primary Balance
PDO	Program Development Objective
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PLR	Performance and Learning Review
PNG	Papua New Guinea
PPP	Public Private Partnership
REER	Real Effective Exchange Rate
SDR	Special Drawing Rights
SME	Small and Medium Enterprises
T-bills	Treasury Bills
TIN	Taxpayer Identification Number
US$	United States Dollar
WPA	Waigani Public Account

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INDEPENDENT STATE OF PAPUA NEW GUINEA
FIRST ECONOMIC AND FISCAL RESILIENCE DEVELOPMENT POLICY OPERATION

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SUMMARY OF PROPOSED CREDIT AND PROGRAM

INDEPENDENT STATE OF PAPUA NEW GUINEA

FIRST ECONOMIC AND FISCAL RESILIENCE DEVELOPMENT POLICY OPERATION

Recipient	Independent State of Papua New Guinea
Implementation Agency	Department of Treasury
Financing Data	IDA Credit; IDA terms; amount of SDR 106.8 million (US$150 million equivalent)
Operation Type	Programmatic (1 of 2); single-tranche Development Policy Operation
Pillars of the Operation and Program Development Objective	The Program Development Objective is to: (i) strengthen fiscal management and revenue performance; and (ii) strengthen key building blocks for public financial management and financial inclusion.
Result Indicators	<u>Strengthening fiscal management and revenue performance:</u> 1. The non-resource primary fiscal balance as a percentage of non-resource GDP improves: Baseline: -4.7 (2016); Target: -0.9 (2020). 2. Tax buoyancy (i.e. tax revenue as a share of GDP) increases: Baseline: 14.2 percent (2016); Target: 14.6 percent (2020). <u>Strengthening key building blocks for public financial management and financial inclusion:</u> 3. Accountability and transparency in the use of public funds is improved through timely submission of the annual financial statements to the Auditor General's Office: Baseline: 2014-2016 statements submitted at least 12 months after the end of each fiscal year; Target: 2018-2020 statements submitted within three months of the end of each fiscal year. 4. Financial inclusion increases, as indicated by the percentage of adults with an account at a formal financial institution: Baseline: 36.96 percent (June 2016); Target: ≥ 50 percent (June 2020). 5. The gender gap in new bank account establishment declines: Baseline: 26 percent of the new bank accounts established 2013-2016 were by women (2016); Target: ≥ 35 percent of the new bank accounts established 2016-2020 are by women (2020).
Overall Risk Rating	High
Climate and Disaster Risks	(i) Are there short and long-term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes ☒ No ☐ If yes, (ii) summarize briefly in the risk section.
Operation ID	P165717

IDA PROGRAM DOCUMENT FOR A PROPOSED CREDIT TO THE INDEPENDENT STATE OF PAPUA NEW GUINEA

1. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **The proposed operation is the first in a programmatic series of development policy operations (DPOs), designed to support economic and fiscal resilience in Papua New Guinea (PNG).** The proposed operation aims to strengthen PNG's fiscal framework and economic resilience (including by strengthening revenue collection), and strengthen key building blocks for public financial management and financial inclusion. The policy and institutional actions supported under the proposed series are measures that have been prioritized by the Government of PNG (GoPNG) in its Medium-Term Development Plan II 2016-2017,[1] Medium-Term Fiscal Strategy 2018-2022, Medium-Term Revenue Strategy 2018-2022, and Public Expenditure and Financial Accountability (PEFA) Road Map 2015-2018. The proposed DPO series is aligned with the World Bank's overall engagement with GoPNG, as laid out in the Country Partnership Strategy (CPS) FY2013-FY2018 (Report #74424) discussed by the Board on December 11, 2012.[2] It is the first DPO engagement with PNG for many years, and the request for budget support from the GoPNG is an illustration of the stronger country relationship that the Bank and GoPNG have built up over the past decade. The series will initially consist of two operations. The first operation in the series is an IDA Credit of SDR 106.8 million (US$150 million equivalent), which represents 75 percent of the financing envisaged for the series (if the series consists of two operations). The front-loading of the resources available for the programmatic series is in response to the magnitude 7.5 earthquake that struck the Highlands region of PNG in February 2018, which has imposed significant unforeseen additional financing obligations on GoPNG (see below). Front-loading the DPO series represents an efficient way of delivering resources when they are most needed.

2. **PNG is highly abundant in natural resources and the extractive resource sector has risen to almost define the PNG economy today**.[3] Discoveries of gold and copper resources in the 1970s, followed by natural gas and crude oil in the 1980s, saw the extractive sector increase from a negligible share of the economy around the time of independence to about 26 percent of GDP and 81 percent of exports today.[4] The sector is an important source of economic growth, foreign direct investment and foreign exchange but has limited linkages with the rest of the economy and is a significant source of macroeconomic challenges when global commodity prices decline. In particular, the sensitivity of the country's GDP growth and fiscal performance to developments in global commodities prices has been the basis of periodic boom and bust economic cycles. This pattern is compounded by the fact that the non-extractive resource sector (agriculture, forestry and fishing), which represents 20 percent of GDP and 19 percent of total exports, is also sensitive to global commodity price swings and natural hazard shocks. In the absence of strong macroeconomic institutions, this volatility has been frequently transferred to the domestic economy, placing considerable stress on fiscal outcomes, public spending, service provision and governing institutions. In any case, the significant benefits that the extractive sector has delivered have not filtered

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[1] GoPNG is currently in the process of preparing Medium-Term Development Plan III.

[2] The CPS originally covered the period FY2013-2016, but was extended for a further two years as a result of the Performance and Learning Review (PLR) in 2016 (Report #105698).

[3] Strictly, the resource sector consists of two groups of resources – extractives (mineral and petroleum) and non-extractives (agricultural, forestry and fishing). However, for the purpose of this DPO, the 'resource sector' is defined as the mineral and petroleum sector while the non-resource sector will include all the other remaining sectors of the economy.

[4] PNG LNG, a large LNG plant, alone accounts for 16 percent of GDP and 40 percent of exports. Its construction in 2010-2014 required US$19 billion of foreign direct investment.

through to many in PNG and, despite several decades of major extraction activities, long-term growth is relatively low (due to its volatility) and the country may arguably have limited development results to show for it.

3. **Despite its impressive bio-diversity, PNG remains highly vulnerable to the adverse effects from climate change and natural hazards including earthquakes, floods, droughts, landslides and sea-level rise.** The country's coastal and marine resources, fertile lands, dense wide-ranging forests, and enormous fresh water reserves, and their corresponding ecosystem services, are essential to the millions of local livelihoods that are based in agriculture, forestry, fisheries and tourism. However, a growing population, urbanization, resource extraction, poor agricultural practices and an expanding economic footprint are all placing increasing pressure on the environment and, in some cases, there is evidence of degradation.[5] PNG faces a range of environmentally-driven risks with potential for far-reaching impact. In 2016, the country ranked 10th out of 171 countries in terms of risks associated with its exposure and vulnerability to natural hazards.[6] Most prominently, the country must contend with the impacts of floods, droughts, landslides, earthquakes and sea-level rise. The severe earthquake that struck PNG in February 2018 is an illustration of the country's exposure and vulnerability to natural hazards (see below).

4. **From global as well as regional perspectives, prevalence of extreme poverty in PNG is high.** About 38 percent of the population in PNG in 2010 lived under the internationally recognized extreme poverty line of $1.90 per day (PPP US$ 2011). This incidence of poverty is by far one of the highest rates in East Asia and the Pacific region. It is also higher than in many of PNG's lower middle-income, resource-rich peer countries. Broadly consistent with the high proportion (87 percent) of the population living in rural areas, almost 90 percent of the country's poor are located in rural PNG and are more likely to be engaged in agricultural activities.

5. **Inequality is high in PNG and women face large economic and social disadvantages.** PNG's income-inequality remains high and is expected to have evolved little since 2010 when the national Gini coefficient stood at 0.42 with little difference between urban and rural areas. While households headed by women are not more likely to be living in poverty than households headed by men in PNG, women earn significantly less than men and face a number of other economic and social disadvantages. The inadequate quality and reach of health services contribute to relatively high rates of maternal mortality, inadequate access to reproductive health care, and malnutrition among women and children. Fertility and teenage pregnancy rates are high, and personal safety risks are a factor in decisions about accessing health services for women and girls. Primary and secondary school enrolment and completion rates are lower for girls than boys, and women constitute only 39 percent of university enrolments, with personal safety risks again a significant factor in educational decisions for girls and women. Women typically have less access to financial services than men, and in many areas of PNG have limited control over land. Women's political representation is extremely low, and they also have limited representation at senior levels in the public and private sectors. Finally, reported rates of gender-based violence (GBV) are very high.[7]

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[5] The clearest examples relate to deforestation and forest degradation, which are largely driven by commercial logging and the conversion of forest into other land types such as cleared land for agriculture. Over 4 percent of PNG's closed canopy forests were cleared or logged during 2002-14: approximately 3,752km^2 of rainforest completely cleared and a further 7,705km^2 of previously unlogged forest degraded through logging. (Bryan and Shearman, 2015).

[6] United Nations University Institute for Environment and Human Security, Bündnis Entwicklung Hilft and University of Stuttgart (2016).

[7] This assessment draws on the Bank's *PNG Country Gender Assessment* (2012, Report #75580), IFC's *PNG Gender and Investment Climate Reform Assessment* (2010), and the Bank's *PNG Country Gender Analysis* (2017) for the SCD.

6. **With exports and growth dependent on commodities, as well as other socio-economic vulnerabilities, PNG has been hit hard by a series of shocks in recent years.** First, the sharp decline in the oil price in 2014-2016. This was compounded by El Niño related drought conditions in 2015, which led to the temporary closure of Ok Tedi's mining operations and adversely affected agricultural production. The combination of shocks strongly dampened the boost to growth triggered by the commencement of production at PNG LNG in 2014 and led to a sharp slowdown in economic growth from 15.4 percent in 2014 to 5.3 percent in 2015, and to a mere 1.6 percent in 2016. The country's fiscal accounts were also severely hit, with the fiscal deficit rising to 6.3 percent in 2014. PNG's very large current account surplus did not prevent a foreign exchange shortage owing to the large capital outflows associated with the PNG LNG project and the limited depreciation of the currency. Finally, as the government entered 2018 with a focus on continued reforms to recover from previous shocks and safeguard against future fiscal challenges, the Highlands region of PNG was hit by a severe 7.5 magnitude earthquake in February 2018 followed by a series of strong aftershocks in March and April.

7. **In response to the commodity price and El Niño shocks, the government took decisive fiscal consolidation measures in 2015-2017 to adjust and maintain fiscal stability**. Between 2014 and 2017, the government reduced total public spending sharply from 27.2 percent of GDP to 20.9 percent of GDP. As a result, the budget deficit declined from 6.3 percent to 2.8 percent of GDP in that period, while the non-resource primary balance improved from -8.7 percent to -1.9 percent of non-resource GDP. To further support fiscal resilience, the government initiated a Medium-Term Fiscal Strategy 2018-2022, a Medium-Term Revenue Strategy 2018-2022, and a Public Expenditure and Financial Accountability (PEFA) Road Map 2015-2018. The implementation of these strategies and roadmap is considered crucial to strengthen PNG's fiscal framework, reduce public finance's vulnerability to commodity price swings and sustain public service delivery. The policy adjustment to recent shocks has occurred however mostly through a compression of government spending and of domestic demand. The managed crawling-band exchange rate regime has yielded only a moderate depreciation of the kina. The nominal effective exchange rate depreciated at an annual average rate of 4.5 percent between end-2014 and end-2016, then slowed to 3.1 percent between end-2016 and end-2017. However, PNG's real effective exchange rate (REER) remained broadly constant between end-2014 and end-2016, and marginally appreciated (0.3 percent) by end-2017.

8. **The recent earthquake has led to significant damages and losses with the cost of reconstruction and recovery estimated at about US$200m over three years (1.0 percent of GDP).** The epicenter of the earthquake was located in Hela Province, but damages were incurred in many provinces. The most severe impacts were in Hela and Southern Highlands provinces – while extensive damage was also sustained in Enga, Western and Gulf provinces. The devastating earthquakes led to disruptions to roads, highways, bridges, water, power supply and telecommunications and have perturbed supply chains, adding to the immediate economic costs. Combined, the series of earthquakes is estimated to have claimed over 100 lives and to have caused widespread damage to schools, health clinics, crops and gardens, roads, airports and district administration buildings. Around 8,000 homes were destroyed or severely damaged, while another 46,000 homes were damaged to a lesser degree, forcing over 43,000 displaced people to seek emergency shelter in care centers and with host families. Overall, the disaster is estimated to have affected over half a million people across the five most affected provinces, with over 270,000 people requiring humanitarian assistance, including 125,000 children. With the support of development partners, the reconstruction and recovery was assessed[8] to cost at least K640 million (US$200 million, 1.0

[8] To facilitate coordination and partnership with GoPNG, subnational authorities and non-state actors, development partners have formed the Highlands Earthquake Disaster Management Team, which is being led by the United Nations Resident Coordinator's Office and the Coordination and Assessment Team.

percent of GDP).[9]

9. **In response to the earthquake, the GoPNG announced a State of Emergency in the affected provinces and established a dedicated Restoration Authority to oversee the disaster response, recovery and reconstruction effort.** In the weeks following the earthquakes, the GoPNG established the Western, Enga, Southern Highlands, and Hela Restoration Authority[10] to manage the implementation of the long-term reconstruction and recovery of economic and social infrastructure and services in the affected provinces, as well as the resettling of people displaced by the earthquake. Prime Minister O'Neill announced K450 million (about US$138 million or 0.7 percent of GDP) for the recovery and reconstruction effort.[11] During the announcement, the Prime Minister stated that K100 million would be released immediately and the remaining K350 million allocated over the next three years. Additionally, as of 30 April, over US$61 million has been mobilized from the private sector and international donors for earthquake response and recovery, with the government announcing it had already committed about one third of these funds to humanitarian aid and road reconstruction.[12]

10. **The proposed operation supports objectives that are considered critical to strengthening fiscal and economic resilience. The Program Development Objective is to: (i) strengthen fiscal management and revenue performance; and (ii) strengthen key building blocks for public financial management and financial inclusion.** The adoption of a new fiscal anchor and measures to achieve structural improvements in revenue mobilization contribute to the first objective. The implementation of a new Integrated Financial Management System (IFMS) and measures to increase financial inclusion – particularly for women – contribute to the second objective. The reforms supported by this operation complement and are well-coordinated with IMF's technical support towards the implementation of the Medium-Term Revenue Strategy 2018-2022 and of the central bank's plan to strengthen monetary and exchange rate policies.

11. **The key risks to the proposed operation come from PNG's political and governance context, macroeconomic situation, fiduciary environment, and vulnerability to natural disasters.** Other significant risks arise from institutional capacity, environment and social factors, and stakeholders. Political and governance risks to the operation are accentuated by the relatively recent nature of the Bank's stronger economic policy dialogue with GoPNG. Another key source of risk is that another major natural disaster leads budget execution and policy priorities to go off-track due to the immediate requirements of disaster recovery. These risks are being mitigated by the selection of policy and institutional actions that the government has already made significant investments in and indicated strong support for in the policy dialogue with the Bank. They will be further mitigated through the implementation support and monitoring accompanying the programmatic series. The key macroeconomic risks to the operation arise from the resource-dependency of the economy, with the risk that a downturn in commodity prices indirectly reduces activity in the non-resource economy, threatening the achievement of the result under the first pillar, or that prolonged political violence and civil disturbances in the Highlands or worsening foreign exchange market imbalances affect oil and LNG production and macroeconomic stability. The supported actions on the fiscal framework and revenue

[9] These estimates excluded a range of key economic infrastructure sectors, did not incorporate damages to private property, and excluded around 15 facilities in Hela that could not be accessed due to security issues. Consequently, the total needs for recovery and reconstruction are expected to be higher.
[10] The authority will also cover parts of West Sepik and Gulf provinces.
[11] Section 2.2 discusses the fiscal impact of the earthquake.
[12] The majority of contributions have come from the private sector (approximately US$43 million), with large commitments from Bank South Pacific Group, ExxonMobil, Oil Search and Porgera Joint Venture. A further US$18 million has been received from Australia, Canada, China, France, Israel, Japan, New Zealand, the United States and the European Union.

performance and the parallel reforms the government is undertaking to its monetary and exchange rate policies with the support of the IMF will help to mitigate these risks. The fiduciary risk of the proposed operation is being mitigated by the adoption of specific disbursement and auditing measures.

2. MACROECONOMIC POLICY FRAMEWORK[13]

2.1 RECENT ECONOMIC DEVELOPMENTS

12. **Between 2014 and 2016, the PNG economy faced internal and external developments that had countervailing impacts on GDP growth.** The commencement of LNG production in April 2014[14] had a dramatic positive impact on growth, partly offset by a decline in commodity prices. Low commodity prices were compounded by El Niño related drought conditions in 2015, which led to the temporary closure of Ok Tedi mining operations and adversely affected agricultural production. Additionally, a contraction in the construction sector (down 13.1 percent) due to fiscal consolidation and lower commodity prices contributed to the contraction in GDP in the non-resource sector in 2015. However, overall growth in 2015 remained robust (5.3 percent) as PNG LNG reached its first full calendar year of production. In 2016, the ongoing impact of the El Niño phenomenon contributed to a contraction in the non-resource sector and, with lower commodity prices also weighing down on petroleum sector production, overall GDP growth was moderate (1.6 percent).[15]

13. **In 2017, real GDP growth rebounded on the back of robust growth in the resource sector and a modest pickup in the non-resource sector.** Overall GDP growth rebounded to 2.5 percent growth in 2017, with petroleum, gas and mining contributing to nearly half of the increase. In the *petroleum and gas sector*, a 21 percent increase in realized gas prices, coupled with lower production costs for the PNG LNG project, led to higher value addition and a robust 8.2 percent growth in the export volumes of liquified natural gas.[16] In the *mining sector,* production of copper, gold, cobalt and nickel all expanded in 2017.[17] The agriculture, forestry and fisheries sector recorded 1.0 percent growth, driven primarily by a significant increase in palm oil production, while the production and export of coffee and cocoa were constrained by adverse weather conditions, especially a prolonged dry spell in the Highlands in 2017. Although growth in the non-resource sector picked up in 2017 (1.9 percent, against -0.1 percent in 2016), it remains lackluster owing to the shortage of foreign currency, the slowdown in government spending and delays in payment of government bills to the private sector. Consistent with the sectoral pattern of growth, formal sector employment in the resource sector increased while the non-resource sector continues to

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[13] The analysis was conducted on information as of June 15, 2018.

[14] The commencement of LNG production at PNG LNG in April 2014 resulted in resource GDP more than doubling in a few months. Output in the oil and gas sector increased from K1.5 billion in 2013 to K10 billion in 2015, and is now larger than PNG's exports of gold, copper, nickel, wood and palm oil combined.

[15] See Table 1.

[16] The average realized gas price increased by nearly 21 percent in 2017 to US$7.67 (per mmBTU) after declining by 33 percent over the previous year.

[17] The higher gold production was due to increased output at Lihir Mine and Porgera Mine. The former was able to boost production with the installation of two new cyclone clusters during the year while the latter was able to return to full production after interruptions (landslide) in production in the previous year. The primary reason for the increase in cobalt and nickel production is an improvement in the maintenance of production equipment at the Ramu NiCo Mine. The return to full production at the Ok Tedi mines in 2017 after the interruption to operations in 2015 and 2016 has boosted production of copper exports by 40 percent. Moreover, across PNG's mining sector, higher global metal prices have spurred production in 2017.

show job losses (especially in construction).[18]

14. **The shortage in foreign currency has continued to adversely affect economic activity, investment, and business sentiment**. Through import compression, the foreign exchange shortage has increased net exports.[19] However, this is largely offset by the shortage's impact on private investment and consumption. The IMF Article IV (2017) reports that the shortage of foreign exchange has adversely affected trading activities as well as activities dependent on imported inputs. It is the non-export sectors of the economy – which include all sectors except the resource sector, and the commercial agriculture and fisheries sectors – that are hardest hit by the shortage of foreign exchange. The 2017 Survey of Businesses in Papua New Guinea by the Institute of National Affairs highlights that access to foreign currency and uncertainty regarding future exchange rate policy are two of the key concerns for private businesses. Large firms as well as small-and-medium enterprises report that foreign exchange is a major concern. However, with the concurrent decline in government spending necessitated by lower-than-expected revenue receipts, it is difficult to disentangle the impact of the foreign exchange shortage on overall growth.

15. **Headline inflation eased thanks to the recovery in agriculture and a slowdown in credit growth.** Headline inflation reached 6.7 percent in 2016 and eased to 5.4 percent in 2017 on the back of a sharp decline in food inflation to 2.8 percent in 2017 (from 5.1 percent in 2016) following a recovery in agriculture.[20] The lower inflation rate also reflects a slowdown in credit growth. Due to the weak growth in the non-resource sector, commercial bank lending to the private sector dropped by 5.1 percent in nominal terms in December 2017 (year on year), contributing to a 3.6 percent contraction in overall credit growth to the private sector.

16. **Additionally, there is persistent excess liquidity in the banking system, which is an indication of the limited effectiveness of monetary policy,[21] which the central bank is addressing.[22]** The excess liquidity stems from large capital inflows associated with the resource sector (especially the construction of PNG LNG) in the lead up to 2014 coupled with unsterilized purchases of foreign exchange by BPNG since 2009. The excess liquidity was exacerbated by some public agencies' deposits of public funds in trust accounts held by the commercial banks, instead of placing them at BPNG. As a result, the banking sector has remained highly liquid, with 28 percent of their total deposits and other liabilities held as cash at the central bank at the end of 2016, well above the Cash Reserve Requirement (CRR) of 10 percent. The high level of cash in the banking sector implies that there is limited trading between banks in the interbank market. Therefore, the Kina Facility Rate (KFR), which is typically used by commercial banks as a reference rate for trades in the interbank market, is inconsequential and an ineffective monetary policy instrument to manage inflation. Nevertheless, the IMF reports that financial stability indicators suggest a generally sound banking system, with commercial banks remaining well-capitalized, profitable and liquid, with a relatively low proportion of non-performing loans (at 2.8 percent) and a high return on assets (3.4 percent).

17. **Fiscal policy has been responsive to economic conditions and broadly supportive of fiscal**

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[18] Formal sector employment increased by 7.1 percent in the resource sector in 2017 and declined by 2.3 percent in the non-resource sector. The construction sector experienced the steepest contraction (24 percent) in formal employment.

[19] The shortfall is estimated at US$800 million. See paragraph 22.

[20] Core inflation increased slightly to 3 percent in 2017 from 2.6 percent in 2016, driven mainly by high transport costs.

[21] Excess liquidity means money held at BPNG by banks, above the required Cash Reserve Ratio on unremunerated Exchange Settlement Accounts (ESAs).

[22] See paragraph 24.

sustainability and macroeconomic stability. As described above, the combination of commodity price and El Niño shocks led to an 86 percent decline in mining and petroleum tax receipts, bringing government revenues (excluding grants) down to 15.8 percent of GDP in 2017, from 19.4 percent of GDP in 2014. In response, the government reduced total public spending sharply from 27.2 percent of GDP to 20.9 percent of GDP in that period. As a result, the budget deficit declined from 6.3 percent to 2.8 percent of GDP, while the non-resource primary balance improved from -8.7 percent to -1.9 percent of non-resource GDP. Much of the burden of the adjustment fell on capital spending, which was reduced by 75 percent, whereas compensation of employees and interest payments increased by 116 percent and 63 percent, respectively. The significant increase in the public sector wage bill, at both central government and provincial government levels, reflects limited effectiveness of payroll monitoring and control. Rising interest payments are a result of the increasing level and cost of domestic debt. Domestic debt-to GDP rose from 20.8 percent in 2014 to 27.7 percent in 2016 while the 365-day Treasury bill rate increased over this period from 3.76 percent to 7.77 percent (see Table 2 and below).

18. **In 2017, disappointing revenue collection and an inability to contain spending growth in the first half of the year prompted a decisive Budget revision in August.** At 6.8 percent, the revenue growth in January-June 2017 fell short of the 10 percent forecast in the budget. On the spending side, the government was unable to keep spending on target for specific categories of expenditure. Spending on personnel emoluments (salaries) was 8.4 percent higher than in the first six months of 2016, and 54 percent of the original 2017 Budget allocation of K3.9 billion. Similarly, interest expenditure increased by 33 percent in the first six months of 2017 compared to the same period in 2016. Similarly, net acquisition of non-financial assets (capital spending) in the first half of 2017, whilst being well below budget, showed a 19 percent year-on-year increase. In response, in August 2017, following the elections, the O'Neill-Abel Government announced the 100-Day Economic Stimulus Plan which introduced a supplementary budget to collect more revenues and reduce spending, with a focus on minimizing unproductive spending.

19. **The supplementary budget successfully helped the government achieve its fiscal consolidation objectives.** Owing to major compliance efforts undertaken by both PNG Customs and the Internal Revenue Commission (IRC), revenue collection ended up being higher in 2017 than expected in the Supplementary Budget.[23] The Final Budget Outcome (2017) reports that revenue (excluding grants) grew by 11.4 percent in 2017, higher than the 10.6 percent growth forecast in the 2017 Supplementary Budget but lower than the 15.2 percent growth projected in the 2017 Budget.[24] On the expenditure side, total spending in 2017 was 20.9 percent of GDP, 2 percentage points lower than in 2016. On wage bill control, the Supplementary Budget efforts included: commencement of physical audit into the payroll; a freeze on new recruitments; cessation of use of the parallel payroll system, and migration of all government employees onto the centralized government payroll; and to have a national identification card, as well as, identifying list of offices and agencies for amalgamation in 2018.[25] These actions contributed to lower spending on salaries and wages (by K90 million) over the previous year. Similarly, transfers ('grants') to provincial and local governments declined by K540 million. Additionally, the government, as in previous years of fiscal consolidation, focused its efforts on minimizing non-productive expenditure such as foreign

[23] One such effort is related to improving collection of GST on imported goods.

[24] Strong performers in 2017 included GST revenue, which increased by 29.5 percent, and personal income tax which rose by 8.8 percent. Similar to 2016, company tax continued to decline (down 14.3 percent) in 2017.

[25] The Department of Education has undertaken a number of steps to control teacher payroll. For instance, the recent IMF Staff Visit discovered that the Department has begun an auditing exercise, matching teacher salaries against registered teachers and placing on hold salary payments for all teachers who are not registered. The Department is now in the process of investigating the mismatches to obtain a final list of teachers to eliminate the existence of "ghost" workers.

travel, hotel accommodation and car hire. In contrast, interest expenditure has increased by 22 percent (K277 million) between 2016 and 2017. Overall, actions taken through the 2017 Supplementary Budget helped reduce the fiscal deficit to 2.8 percent of GDP in 2017, lower than the 2017 Budget forecast (3.0 percent) and 2.4 percentage points below the deficit recorded in 2016 (5.2 percent of GDP). The overall primary balance also improved significantly to -0.4 percent from -3.1 percent of GDP in 2016 while the non-resource primary balance (as a percent of non-resource GDP) improved to -1.9 percent in 2017 from -4.7 in 2016.

20. **The government has demonstrated a commitment to prudent debt management in recent years and the debt ratio declined marginally in 2017**. Government debt increased significantly from 27.1 percent of GDP in 2014 to 37.0 percent of GDP in 2016. In 2017, the debt-to-GDP ratio decreased marginally to 36.9 percent. In response, the Medium-Term Debt Strategy 2018-2022 (MTDS) recognizes that the debt-to-GDP ratio has increased in recent years and focuses on maintaining the debt-to-GDP ratio between 30-35 percent, whilst gradually reducing this ratio towards the 30 percent lower bound. The MTDS also aims to engineer a portfolio shift from expensive domestic debt securities to cheaper foreign currency debt. Domestic debt decreased to 26.9 percent of GDP (from 27.7 percent in 2016) while external debt increased to 10.0 percent of GDP (from 9.3 percent of GDP in 2016). The latter was driven in large part by the authorities' resort to external commercial borrowing via a US$280 million loan from Credit Suisse, of which US$190 million has been drawn down. The drop in the share of domestic debt in PNG's total debt is consistent with the government's strategy to reduce expensive domestic borrowing. Indeed, the average interest rate on one-year Treasury bills (T-bills) has risen from 5.0 percent in 2013 to 7.1 percent in 2017. Much of the increase occurred between 2013 and 2015 while, post-2015, the domestic interest rate has increased marginally. This reflects the fact that interest rates are not entirely market determined. In recent years, undersubscriptions of T-bills auctions have been matched not by a rise in interest rates but by the central bank intervening to purchase the surplus government papers. The net stock of government debt held by the central bank increased in 2016 before declining significantly in 2017 as the central bank reduced its purchase of Treasury bills.[26]

21. **PNG's current account surplus has remained large since the commencement of LNG exports in 2014 but it is matched by equally large capital outflows.** Prior to the production of LNG, the current account was broadly in balance from year to year. The construction phase of the PNG LNG plant[27] led to a large current account deficit as materials and services were imported, financed by foreign direct investment inflows on the financial account. Since the commencement of LNG exports in April 2014, the current account has shifted strongly into surplus, rising to 24.0 percent of GDP in 2017 from 1.3 percent of GDP in 2014.[28] On the surface this looks very healthy for PNG, showing that the country now exports significantly more goods and services than it imports. However, part of the current account surplus reflects import compression (see below). Moreover, the surplus is matched by a deficit on the capital and financial accounts, as the bulk of the proceeds from exports of LNG flow out to the foreign owners of PNG LNG to service their debt and other obligations. The generous tax concessions offered to the project imply that little additional tax revenue can be anticipated in at least the first 10 years of production, further limiting foreign currency inflows.

[26] The central bank's net claims on central government declined by 17.1 percent between December 2016 and December 2017, to K 2.37 billion.

[27] Total construction costs were US$19 billion (compared to PNG's 2010 GDP of US$14 billion).

[28] Annual output was planned at 6.6 million tons of gas and condensate per year. As of 2017, actual output is running at over 8 million tons per year, with the excess output being sold on the spot market. There is a potential for expansion for the project to include the Elk Antelope gas field, adding 7.6 to 10.6 million tons output per year.

22. **The sharp decline in capital inflows since 2014 as the construction phase of PNG LNG ended; the outflow of export proceeds from the PNG LNG project to service debt obligations; a steep decline in oil prices; and an insufficiently flexible exchange rate, have all contributed to a shortage of foreign exchange.** Long queues of unmet foreign exchange orders (approximately US$800 million) have been reported by commercial banks. This shortage of foreign currency has led to import compression. This is reflected in a decline in the ratio of non-resource imports to non-resource GDP from 15.3 percent to 7.9 percent between 2014 and 2016. The authorities have maintained a crawling-band exchange rate regime yielding only a moderate depreciation of the kina, contributing to the decline in foreign exchange reserves to US$1.7 billion in 2017, from US$2.3 billion in 2014. The nominal effective exchange rate depreciated at an annual average rate of 4.5 percent between end-2014 and end-2016, after which the central bank slowed depreciation of the kina to 3.1 percent between end-2016 and end-2017. However, PNG's real effective exchange rate (REER) remained broadly constant between end-2014 and end-2016, and marginally appreciated (0.3 percent) by end-2017.

23. **The IMF Article IV (2017) argues for a gradual depreciation of the kina over the medium-term, coupled with a gradual path of fiscal consolidation, supported by immediate foreign exchange inflows to reduce the foreign exchange backlog.** Such a strategy would lead to a temporary reduction in real GDP growth, higher but still moderate inflation, a significant narrowing of the fiscal deficit, and stronger current account and international reserves positions. A gradual depreciation is intended to ensure an orderly exit from the current crawling-band exchange rate regime by following a multi-pronged approach to dealing with both the foreign exchange rate backlog and create a more flexible exchange rate system**.** In practice, an effective monetary policy framework would be required to counteract any inflationary pressures that may emanate during the transition to a more flexible exchange rate regime. For such a framework to be developed, the following steps should be undertaken: (i) remove excess liquidity;[29] (ii) establish an interest rate corridor; (iii) improve coordination between Treasury and BPNG on Treasury cash management; and (iv) closer coordination between Treasury and BPNG on fiscal and monetary policy whilst maintaining central bank independence. This will support a gradual orderly exit from the crawling-band exchange rate regime to a free-floating exchange rate regime. Additionally, in the near term, in the transition to a more flexible exchange rate regime and to prevent a run on the currency, BPNG could consider support from external sources, such as a swap facility or an external sovereign bond.

24. **To strengthen monetary policy, the central bank has devised a strategy to address the following key issues:** (i) the current excess liquidity in the banking system; (ii) the lack of transmission of monetary policy; and (iii) the need to enhance the communication with market players. In this regard, the reforms include: (a) strengthening the repurchasing agreement facility with IMF review and support (to this end the central bank has recently revised its arrangements on liquidity management and the changes have been circulated to the commercial banks for review); (b) determining the possibility of raising the cash reserve requirement either on all deposits or only on public sector deposits; (c) setting the Kina Facility Rate on a market-based interest rate to signal monetary policy stance; (d) communicating the new monetary policy framework to market players and potential investors; and (e) reviewing the central bank's financial programming model with technical assistance (TA) from the IMF, which has recently commenced.

[29] According to the IMF Article IV (2017), active measures to absorb excess liquidity include: (i) moving more government trust funds from the banks to the BPNG (some of this has been done, but many accounts remain with banks); (ii) increasing reserve requirements; and (iii) reducing BPNG holdings of government securities. Reducing excess liquidity will be needed to ensure that movements in the policy interest rate have a direct impact on market interest rates.

25. **With regards to foreign exchange (FX) policy, the central bank's recent strategy paper seeks to resolve the following key issues:** (i) the significant shortage of foreign exchange in the FX market, which led to a build-up of unserved orders; (ii) the non-functioning inter-bank foreign exchange (spot) market; (iii) a lack of monitoring tools to ensure compliance to the foreign exchange and gold regulation and the central bank's directives and; (iv) lack of transparency and limited competition in the foreign exchange market. To resolve these issues the central bank has recently: (a) issued a directive to commercial banks to cease approving onshore foreign currency account applications and move the approval back to the central bank; (b) issued a directive to commercial banks to stop undertaking trade financing; and (c) commenced the effective utilization of the new SWIFT Scope reporting software to monitor international transactions of commercial banks. The upcoming IMF TA will inform the central bank on further actions to address the other foreign exchange market issues highlighted above.

2.2 ECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

26. **Before the earthquake, PNG's macroeconomic indicators were expected to improve in 2018 and over the medium term.** Economic growth was expected to pick up further in 2018 and converge to trend (around 3 percent) over the medium term. The current account surplus was forecast to increase significantly in 2018 to 26.5 percent of GDP, owing to higher global commodity prices and the recovery in agriculture, mining and petroleum sectors. On the fiscal side, actions undertaken by the government were anticipated to yield positive results such that the deficit was expected to shrink significantly to 1.9 percent. Improvements in domestic resource mobilization were also anticipated based on deliberate steps taken by government, with the tax-to-GDP ratio increasing from 14.2 percent in 2016 to 15.0 percent in 2020. The non-resource primary balance as a share of non-resource GDP was expected to improve to -0.9 percent in 2020 from -1.9 percent in 2017. This would be consistent with the fiscal anchor moving into balance by 2022, as required under the MTFS. (See Tables, 1, 2 and 3)

27. **The earthquake that struck PNG in February 2018 has significantly altered the near-term macroeconomic outlook, principally through its impact on mining and petroleum production and export.** Although the precise impact will depend on possible offsetting measures taken by firms, production of the mining and petroleum sector is expected to be particularly affected. Three major mining and petroleum projects have had to significantly scale back production. In particular: (i) the disaster forced the PNG LNG project to temporarily suspend production at the Hides gas conditioning plant and the Hides Well Pad in Hela Province. This led to the shutdown of the two LNG trains for an average of eight weeks. Given that PNG LNG accounts for 40 percent of PNG's goods exports and 16 percent of GDP, this will have a significant negative impact on growth; (ii) initial indications are that Porgera, a gold and silver mine, is expected to reduce output by 50 percent in 2018 due to energy supply shortages caused by damage to gas and electricity infrastructure; and (iii) Ok Tedi, a copper, gold and silver mine, which is one of the country's largest foreign exchange earners, was shut for two weeks as landslides cut the copper slurry pipeline and blocked the access road to the mine. Additionally, depending on the field, oil production may be suspended for between two to four months. Combined, these disruptions are expected to have caused substantial reductions in first and second quarter commodity production and exports, and therefore, to have negatively affected economic growth for 2018.

28. **The earthquake will have a substantial effect on the near-term outlook for economic growth, fiscal outcomes and the balance of payments (see Table 4 and Table 5):**[30]

[30] The impact of the earthquake was estimated in collaboration with IMF.

i. ***GDP impact:* The earthquake is expected to shave off 4.0 percentage points from GDP growth (equivalent to K2.5 billion or US$750 million) in 2018.** The total impact on the resource sector is a reduction in output in the mining sector by 10 percent, and in the oil and gas sector by 17 percent. Consequently**,** 2018 GDP growth has been revised downward from 2.4 to -1.6 percent. However, the impact of the earthquake on the resource sector is expected to be temporary. Over the medium term, the outlook for growth in this sector is relatively sanguine, with the announced establishment of new resource projects such the second LNG project (Papua LNG) and the Wafi Golpu gold mine in the 2020s.[31]

ii. ***Fiscal impact:* The fiscal deficit is expected at 2.2 percent of GDP (K1.5 billion) in 2018, 0.3 percentage points (K153 million) higher than the initial (pre-earthquake) baseline estimate.** The increase in the deficit is attributed to expected decreases in revenue due to lower dividend payments from the resource sector. Revenue is expected to decrease by 1.2 percent, primarily due to a decline in dividend receipts of K153 million owing to the closure of the PNG LNG project which will cancel dividend payments to the government in March. This will reduce by half the K300 million from Kumul Petroleum expected in the 2018 Budget. Additionally, mining taxes from the Ok Tedi mine could decline by K3 million owing to the two-week closure. However, revenue-to-GDP is expected to increase to 19.5 percent of GDP as the percentage decline in nominal GDP was larger than that in revenue. It is unclear whether the K450 million allocated for post-earthquake reconstruction and development will be appropriated in the central budget. For instance, it has not yet been established whether expenditure towards reconstruction efforts will amount to an increase in total public expenditure or if funds will be reallocated from other capital expenditure. Additionally, there has also been some indication that state-owned enterprises will be funding some of the increased expenditure. For instance, Kumul Petroleum[32] and Ok Tedi Mining Limited (a state-owned mine) have already provided a significant contribution to the relief effort. It is also unclear to what extent development partners will finance the additional expenditure and whether such expenditure will be channeled through the budget. For this reason, the forecasts do not assume any reconstruction expenditure by central government from 2018 onwards. Therefore, the estimated increase in the deficit in 2018 is driven primarily by anticipated lower revenue receipts owing to lower dividend payments. This increase in the deficit coupled with lower nominal GDP would raise the debt-to-GDP ratio to 36.2 percent, 0.5 percentage points higher than under the no-earthquake scenario.

iii. ***Balance of payments impact*: The earthquake is estimated to reduce the current account balance to 22.7 percent of GDP in 2018 from the no-earthquake scenario estimate of 26.5 percent.** The decline in the current account balance is primarily due to the adverse impact of the earthquake on mineral and petroleum exports. Export earnings from the resource sector (particularly PNG LNG) are expected to be US$7.9 billion in 2018 against US$8.4 billion under the no-earthquake scenario. The earthquake will shave off 6.5 percent (US$0.5 billion or 2.5 percent of GDP) from petroleum and mineral exports. However, the impact of the earthquake on the current account will be nearly offset by reduced financial outflows.[33] As a result, foreign exchange reserves will be reduced by US$192 million, bringing the import cover ratio to 7.0 months, from 7.5 months under the no-earthquake scenario.

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[31] As experienced with the first LNG project, the construction phase of these types of projects (4-6 years before actual production) is characterized by massive foreign direct investments and currency appreciation pressures.

[32] For instance, Kumul Petroleum will be providing K50 million towards reconstruction efforts by the government.

[33] The profits associated with PNG LNG are kept in an offshore account and are recorded as a residual item in the balance of payments.

29. **The earthquake has imposed additional financing obligations on GoPNG.** Pre-earthquake, the expected deficit for 2018 was K1,337 million. Post-earthquake, the deficit is expected to increase to K1,490 million, driven by lower revenue receipts of K153 million (see discussion above and Table 5). It is expected that the total required financing of K11,805 million will be met through domestic financing of K8,026 million and foreign financing of K3,626 million. This will result in a financing gap of K153 million (US$50 million). This financing gap is expected to be covered by the front-loading of an additional US$50 million of the resources available for this programmatic series of DPOs, taking total foreign financing to K3,779 million. Amortization of domestic loans and foreign loans is expected to be K10,015 million and K300 million respectively. The primary reason for the relatively high amortization expense for domestic loans is because the GoPNG is expected to retire domestic debt in favor of foreign debt due to the relatively high cost of domestic debt coupled with roll-over risk associated with short-term domestic debt. Planned foreign financing comprises the expected sovereign bond issuance of K1,530 million (US$500 million) and other loans of K2,249 million (US$735 million) – the latter including the US$150 million now planned for the World Bank DPO (prior to the front-loading, other loans were expected to be K2,096 million (US$685 million)).

30. Notwithstanding the economic impact of the earthquake, PNG's macroeconomic medium-term macroeconomic outlook is expected to improve (see Table 1 and Table 2).

i. ***Economic growth*** is expected to rebound strongly to 3.5 percent in 2019, underpinned by a return to undisrupted activity and calculated off a reduced level of GDP in 2018, and subsequently converge to trend (around 4 percent) over the medium term. Production from PNG LNG is expected to increase significantly due to maintenance work undertaken during the shutdown which increased production capacity, while Porgera is expected to have a full year of gold production after a 50 percent decline in production due to the earthquake. Growth in the non-resource sector is also expected to pick up, supported by a number of commercial operations in agriculture[34] and an expected increase in the demand for copra oil, in response to the growing demand for lauric acid (copra oil) by the food, chemical and beauty industries, particularly in Asia.

ii. ***Inflation*** is not expected to be affected by the earthquake. Inflation in 2018 is forecast at 4.2 percent. Higher tariffs on imported goods coupled with a higher excise tax on diesel, tabled together with the 2018 Budget, are expected to place upward pressure on the inflation rate, while restraint in government spending as per the 2018 Budget will constrain domestic demand and place downward pressure on inflation. Additionally, if the nominal effective exchange rate depreciates marginally (as it did between 2016 and 2017), then core inflation is expected to remain moderate at 2.5 percent. On the other hand, continuing central bank financing of the budget deficit presents an adverse (upside) risk to the inflation outlook.

iii. On the ***fiscal side***, the actions undertaken by the government should yield positive results. In particular, it is expected that the non-resource primary balance as a ratio of non-resource GDP will improve to -0.9 percent in 2020 from -1.9 percent in 2017. This is in line with ensuring that this fiscal anchor moves into balance by 2022, as required under the MTFS. Further, the actions undertaken to improve revenue are expected to also yield positive results, with the tax-to-GDP ratio increasing from 14.2 percent in 2016 to 14.6 percent in 2020.[35] This is primarily driven by rising corporate tax-to-GDP as actions such as the establishment of the large taxpayer office in

[34] For example, two new palm oil plantations have begun processing and exporting palm oil.
[35] The actions taken in the MTRS are expected to yield higher revenue receipts as they gain momentum with the tax-GDP ratio rising to 15.0 percent by 2023.

2017 begin to generate increased revenue. A one-off increase in revenue in 2018 is also anticipated in 2018 owing to the sweeping of funds kept by statutory authorities into the single Treasury account[36] coupled with off-shore funds from Ok Tedi supporting non-tax revenue. A shift in the debt portfolio is expected with the first tranche of the Asian Development Bank budget support operation and as the government intends to issue an external sovereign bond (expected at US$500 million at an interest rate of 7.5 percent). The government intends to use some of the proceeds of the external loans to retire a proportion of its domestic debt obligations while the remaining will be used to clear the foreign exchange backlog. The overall debt-to-GDP ratio is expected to decline to 36.2 percent in 2018 and fall further over the medium term. As discussed below, the risk of debt distress remains moderate for PNG.

iv. The ***current account*** surplus is forecast to increase in 2019 with the recovery in the resource sector post-earthquake. The expected supply of foreign exchange by the central bank using the proceeds of the sovereign bond and concessional financing will lead to an increase in imports. The confluence of these two events will lead only to a *moderate* improvement in the current account balance to 22.8 percent in 2019.

31. **The risk of debt distress is moderate but has increased.** The 2017 WB-IMF Debt Sustainability Analysis[37] (DSA) raised the risk of debt distress from low to moderate. This reflects a *marginal* breach of the debt-to-exports ratio in response to an export shock. The increase in the debt distress classification arises from the increasingly short-term profile of government debt which increases rollover risks. However, this assessment crucially depends on whether public finances can be brought under control. The DSA projects that the primary balance will improve from a deficit of 2.6 percent in 2016 to balance by 2022. However, the calculated public debt burden understates the true level of debt, as the debt figures do not fully capture the debt and guarantees of many statutory authorities and state-owned enterprises on which limited information is available. Additionally, the recent build-up in expenditure arrears (now at 4.5 percent of GDP) adds to the stock of public debt and can create serious fiscal risks if left unchecked.[38] The government is in the process of issuing a domestic bond specifically to cover some of the arrears to the pension fund.

32. **Macroeconomic outcomes remain subject to further risks following the earthquake.** These include: (i) a softening of commodity prices which could dampen exports and GDP growth and increase pressure on the exchange rate; (ii) other natural disasters, which are frequent in PNG and can devastate the local economy and create considerable fiscal pressure; and (iii) prolonged political violence and civil disturbances in the Highlands, which could adversely affect oil and LNG production. Nevertheless, while not all of these risks can be completely mitigated, most of them are mitigated and managed by the government's ongoing efforts to boost revenue collection and consolidate public finances, its adoption of the non-resource primary fiscal balance as a fiscal anchor, and the enacting of legislation to establish a sovereign wealth fund. These measures, along with the implementation of the PEFA Road Map 2015-2018, constitute important efforts to strengthen fiscal resilience. The support provided by development partners through financial and technical assistance is also a key mitigating factor, expected for instance

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[36] This action is in line with the Public Money Management Regularisation Bill passed in December 2017.

[37] The 2017 WB-IMF DSA (published in December 2017) does not take into account the Final Budget Outcome for 2017 (published in February 2018), the 2018 Budget (passed in December 2017) or the revised 2014 and 2015 GDP estimates (published in March 2018).

[38] The IMF estimates arrears to the pension fund at 3.9 percent of GDP and arrears to state-owned enterprises at 0.6 percent of GDP.

to help the government alleviate the impacts of natural disasters such as the recent earthquake.

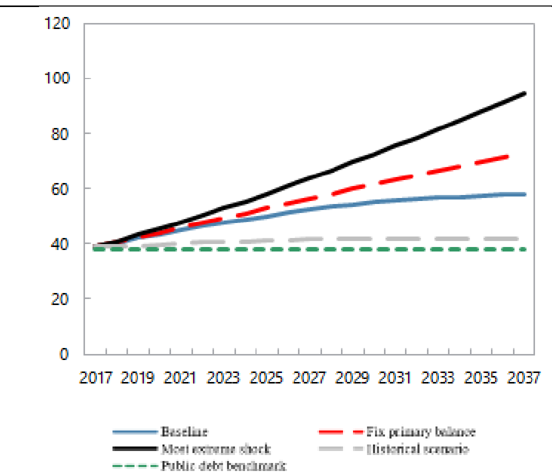
33. **Despite risks to the outlook, the macroeconomic policy framework is deemed adequate for this operation, based on the policy commitments provided by the authorities.** The government's fiscal consolidation and reforms, and ongoing discussions and implementation of the central bank's new plan to strengthen the monetary and exchange rate policy framework with the support of the IMF, underpin the Bank's assessment of the macroeconomic policy framework. PNG has taken decisive fiscal consolidation measures over the past two years and fiscal policy continues to be consistent with the prevailing economic conditions. The adoption of the non-resource primary balance as the new fiscal anchor is expected to help better manage the volatility of resource revenues and contribute to a more sustainable fiscal policy framework. Going forward, the government is strongly committed to pursuing fiscal reform efforts over the medium term consistent with its Medium-Term Fiscal Strategy 2018-2022 whose implementation is being supported by this operation and technical assistance from the IMF. The central bank has devised a strategy to strengthen monetary and foreign exchange policy frameworks to address the existing situation in the foreign exchange market.[39] The effective implementation of this strategy is crucial in strengthening PNG's overall macroeconomic framework.

34. **Over the medium-term greater exchange rate flexibility will be needed.** So far, the economy's adjustment to shocks has been solely shouldered by fiscal policy, while the lack of monetary and exchange rate adjustment has led to a shortage of foreign exchange and rationing. Going forward, ensuring that monetary and exchange rate policies can also adjust to changes in economic conditions will be important. In particular, strengthening the Kina Facility Rate as a credible benchmark for monetary policy operations to combat the inflationary consequences of a more flexible exchange rate system will be important, alongside creating the conditions for greater competition among authorized foreign exchange dealers. The IMF is assisting PNG in this policy area, with the objective of achieving a gradual, properly sequenced process of transition to a more market-driven exchange rate mechanism.

Figure 1: DSA Summary Charts

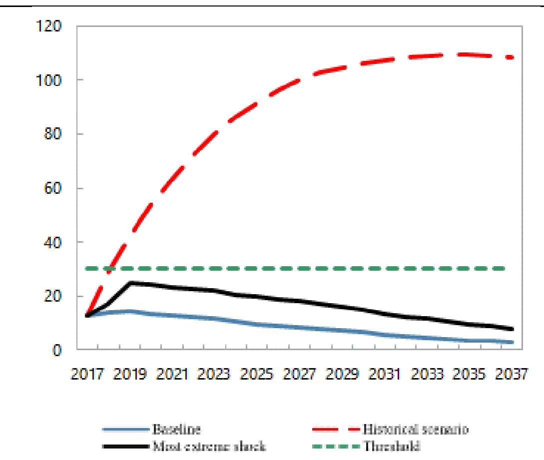
Present value of debt (% of GDP)

Public Debt Sustainability Analysis



Note: Most extreme shock is 'Growth LT shock'

External Debt Sustainability Analysis



Note: Most extreme shock is 'Export shock'

[39] See Section 3 which discusses the government's program.

Table 1: Key Macroeconomic Indicators[40]

Papua New Guinea: Selected Economic and Financial Indicatiors (2014-2021)*

	2014	2015	2016	2017	2018	2019	2020	2021
					Est		Proj**	
Output and inflation	*(Percentage change, unless otherwise stated)*							
Real GDP growth	15.4	5.3	1.6	2.5	-1.6	3.5	3.1	3.4
Of which contribution to real GDP growth (percentage points): Resource sector	*9.4*	*7.8*	*1.7*	*1.2*	*-2.6*	*2.1*	*1.3*	*1.4*
Non-resource sector	*6.0*	*-2.5*	*-0.1*	*1.4*	*1.0*	*1.4*	*1.7*	*2.0*
Change in CPI	5.2	6.0	6.7	5.4	4.2	3.8	3.8	3.8
Fiscal	*(Percent of GDP, unless otherwise stated)*							
Revenue and grants	20.9	19.2	17.7	18.1	19.5	17.1	17.3	17.5
Expenditure and net lending	27.2	23.6	22.9	20.9	21.6	19.5	19.4	19.2
Overall balance	-6.3	-4.4	-5.2	-2.8	-2.2	-2.3	-2.1	-1.8
Non-resource primary balance (% non-resource GDP)	-8.7	-4.7	-4.7	-1.9	-0.3	-1.1	-0.9	-0.6
Public debt	27.1	32.3	37.0	36.9	36.2	36.0	35.8	35.6
Domestic	*20.8*	*24.4*	*27.7*	*26.9*	*22.3*	*22.0*	*21.8*	*21.5*
External	*6.2*	*7.9*	*9.3*	*10.0*	*13.8*	*14.0*	*13.9*	*14.1*
Money and credit	*(Percentage change)*							
Domestic credit	23.5	15.8	24.6	-0.2	-8.8	4.3	5.2	6.0
Credit to the private sector	3.5	3.4	7.2	-3.6	-4.3	3.7	4.8	5.8
Broad money	3.4	8.0	10.9	1.7	10.0	-5.8	6.8	5.5
Interest rate (182-day T-bills; period average)	5.3	7.1	7.4	7.1	6.7	7.3	7.8	7.8
Balance of payments	*(In millions of U.S. dollars)*							
Exports, f.o.b.	8758	7802	8685	9595	9248	10452	10217	10298
Of which: Resource	*7082*	*6619*	*7106*	*8019*	*7993*	*9013*	*8728*	*8823*
Imports, c.i.f.	-4510	-2650	-1968	-2507	-2628	-3560	-3673	-3747
Current account	303	2481	4572	4760	4679	4855	4400	4411
(In percent of GDP)	1.3	12.0	24.1	24.0	22.7	22.8	20.0	19.2
Overall balance	-520	-440	446	54	1249	-745	96	-35
Gross official reserves (in millions of U.S. dollars)	2305	1865	1681	1736	2984	2240	2336	2301
(In months of goods and services imports, c.i.f.)	5.9	6.0	4.6	5.1	7.0	5.1	5.2	5.0
(In months of non-resource imports of good and services, c.i.f.)	11.2	11.3	8.6	10.5	12.2	8.6	8.7	8.4
Exchange rates								
US$/kina (end-period)	0.39	0.33	0.32	0.31	-	-	-	-
NEER (2005=100, end-period)	114.2	116.4	104.2	101.0	-	-	-	-
REER (2005=100, end-period)	123.6	131.4	123.6	124.0	-	-	-	-
Terms of trade (2010=100, end-period)	97.4	102.1	93.4	83.6	-	-	-	-

Sources: Department of Treasury; IMF estimates and projections in collaboration with the World Bank

** Post-2015, GDP is estimated as GDP data is available only until 2015 from the NSO*

*** The projection includes the MTRS projections for revenue*

[40] The analysis was conducted on information as of June 15, 2018.

Table 2: Key Fiscal Indicators[41]

Papua New Guinea: Selected Economic and Financial Indicatiors (2014-2021)*

	2014	2015	2016	2017	2018	2019	2020	2021
					Est		Proj**	
Revenue and Grants	**20.9**	**19.2**	**17.7**	**18.1**	**19.5**	**17.1**	**17.3**	**17.5**
Taxes	18.0	15.4	14.2	14.3	14.2	14.4	14.6	14.7
Taxes on income, profits, and capital gains	11.9	10.3	8.9	8.3	8.2	8.3	8.4	8.5
of which: Personal income tax	*5.6*	*5.3*	*4.8*	*4.8*	*4.8*	*4.8*	*4.8*	*4.8*
of which: Company tax	*4.4*	*4.2*	*3.5*	*2.8*	*2.9*	*3.0*	*3.1*	*3.2*
Taxes on payroll and workforce	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on goods and services	5.1	4.1	4.4	5.1	5.1	5.2	5.3	5.4
of which: GST	*2.9*	*2.1*	*2.4*	*2.9*	*2.9*	*3.0*	*3.1*	*3.2*
Taxes on international trade and transactions	1.0	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Grants	1.5	1.4	2.4	2.3	1.5	1.3	1.2	1.2
Other Revenue	1.4	1.8	1.1	1.5	3.8	1.5	1.5	1.5
Expenditure	**27.2**	**23.6**	**22.9**	**20.9**	**21.6**	**19.5**	**19.4**	**19.2**
Expense	21.9	21.1	21.7	19.7	20.3	18.2	18.2	18.0
Compensation of employees	3.6	7.0	7.5	6.9	6.1	5.9	5.8	5.6
Use of goods and services	4.4	5.2	4.7	5.0	5.7	4.9	4.9	4.8
Interest	1.6	1.9	2.1	2.4	2.6	2.0	1.9	1.8
Grants 1/	12.1	6.9	7.3	5.3	5.6	5.1	5.3	5.6
Social benefits	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Other expenses	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Out of scope for GFS coding purposes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net acquisition of non-financial assets	5.3	2.5	1.1	1.2	1.4	1.3	1.3	1.2
Net lending (+)/borrowing (-)	**-6.3**	**-4.4**	**-5.2**	**-2.8**	**-2.2**	**-2.3**	**-2.1**	**-1.8**
Primary balance	-4.7	-2.6	-3.1	-0.4	0.5	-0.3	-0.2	0.1
Non-resource balance (% of non-resource GDP)	-10.8	-7.1	-7.4	-4.9	-3.7	-3.6	-3.3	-2.9
Non-resource primary balance (% of non-resource GDP)	-8.7	-4.7	-4.7	-1.9	-0.3	-1.1	-0.9	-0.6

Sources: Department of Treasury; IMF estimates and projections in collaboration with the World Bank
** Post-2015, GDP is estimated as GDP data isavailable only until 2015 from the NSO*
*** The projection includes the MTRS projections for revenue*
1/ Grants include spending on wages and salaries, goods and services, and capital expenditure

[41] The analysis was conducted on information as of June 15, 2018.

Table 3: Balance of Payments financing requirements and sources[42]

Balance of Payments financing requirements and Sources

US$ millions *(Outflows negative, inflows positive)*	**2017**	**2018** **Est**	**2019**	**2020** **Projections**	**2021**
Financing requirements	**-1159**	**-1255**	**-2136**	**-2060**	**-2090**
Current account balance	4760	4679	4855	4400	4411
Debt amortization	-1533	-1490	-1531	-1609	-1586
Other capital outflows	-4386	-4443	-5460	-4851	-4916
Financing sources	**-1159**	**-1255**	**-2136**	**-2060**	**-2090**
FDI (net)	591	606	621	637	653
Portfolio investments (net)	308	288	225	281	264
Debt disbursements*	315	1609	546	1238	1138
IMF credit	0	0	0	0	0
Change in reserves (increase -)**	-55	-1248	744	-96	35

Sources: Department of Treasury, IMF/World Bank estimates

** Debt disbursement estimated to increase significantly in 2018 with the anticipated USD 500 million sovereign bond issuance, and the first tranche of World Bank and ADB budget support loans. It is assumed that proceeds of the debt issuance will be used to reduce the foreign exchange backlog at the end of 2018/early 2019.*

*** Change in reserves: "-" denotes an accumulation; "+" denotes a reduction.*

[42] The analysis was conducted on information as of June 15, 2018.

Table 4: Economic Impact of the Earthquake

Economic Impact of the Earthquake	2017	2018 No Earthquake	2018 Earthquake
Output and inflation	**(Percentage change)**		
Real GDP growth	2.5	2.4	-1.6
Of which: Resource GDP growth	*1.2*	*1.4*	*-2.6*
Non-resource GDP growth	*1.4*	*1.0*	*1.0*
	(Percent of GDP, unless otherwise stated)		
Fiscal			
Revenue and grants	18.1	19.1	19.5
Expenditure and net lending	20.9	21.0	21.6
Overall balance	-2.8	*-1.9*	-2.2
Public debt	36.9	35.7	36.2
Of which: Domestic	*26.9*	*21.9*	*22.3*
External	*10.0*	*13.8*	*13.8*
	(In millions of U.S. dollars)		
Balance of payments			
Exports, f.o.b.	9595	9894	9248
Of which: Resource	8019	8448	7993
Imports, c.i.f.	-2507	-2600	-2628
Current account	4760	5324	4679
(In percent of GDP)	24.0	*26.5*	22.7
Overall balance	54	1424	1249
Gross official reserves (in millions of U.S. dollars)	1736	3160	2984
(In months of goods and services imports, c.i.f.)	5.1	*7.5*	7.0
(In months of nonmining imports, c.i.f.)	10.5	*13.0*	12.2

Sources: Department of Treasury; IMF estimates and projections in collaboration with the World Bank

Table 5: Additional financing requirements due to the Earthquake

K millions (nominal)	2018	
	Pre-earthquake	*Post-earthquake*
Revenue and Grants	**13,381**	**13,228**
Expenditure	**14,718**	**14,718**
Net lending (+)/borrowing (-)	**-1,337**	**-1,490**
Amortization		
Domestic loan amortisation	10,015	10,015
External loan amortisation	*300.3*	*300.3*
Total required financing	**11,652**	**11,805**
Financing	**11,652**	**11,652**
Net acquisition of financial assets	0	0
Net acquisition of financial liabilities	11,652	11,652
Domestic	8,026	8,026
External	3,626	3,626
Debt securities (sovereign bond)	1,530	1,530
Loans	2,096	2,096
Financing gap (K millions)	**0**	**153**
or		
Financing gap (US$ millions)	**0**	**50**

2.3 IMF RELATIONS

35. **The government of PNG is working closely with the IMF on strengthening the monetary and exchange rate policy framework.** At the request of the government, the IMF has recently completed a fact-finding mission to support the government on possible actions to strengthen the monetary and exchange rate policy framework. The central bank has also requested IMF technical assistance on several areas, including strengthening the monetary policy framework, assisting in improving and recording balance of payment statistics, reviewing of the foreign exchange regulation, reviewing the operations of the foreign exchange interbank market and subsequently assisting PNG in developing an appropriate policy framework for the foreign exchange market. In recent years, the IMF has provided TA on sovereign wealth fund management; reform of the extractive industries fiscal regime, and non-tax revenue reforms; drafting of a tax administration law; assistance to the central bank on supervision and regulation; and technical support on government finance statistics.

3. THE GOVERNMENT'S PROGRAM

36. **The GoPNG has undertaken a number of steps to improve the fiscal policy framework and prospects for inclusive growth in PNG**. Post-2017 elections, the GoPNG announced its 100-Day Economic Stimulus Plan to reinforce macroeconomic resilience and support inclusive growth. The Plan establishes an ambitious set of 25 priority objectives, aimed at strengthening confidence in the medium-term

sustainability of the economy and public finances, and supporting inclusive growth. The growth-enhancing initiatives are focused on energy sector development and infrastructure investments to enhance service delivery. The Plan serves as a strong signal of the incoming administration's likely policy orientation over the coming years. Additionally, the GoPNG has published its MTFS (2018-2022) and MTRS (2018-2022). The former undertakes to improve fiscal resilience by adhering to fiscal anchors which mitigate the impact of commodity price volatility on the fiscal situation. The latter outlines various measures the incoming administration plans to implement, to update revenue policy and legislation and strengthen revenue administration, with the aim to reduce compliance costs and increase collections.

37. **The Bank of Papua New Guinea has devised a strategy to strengthen monetary and foreign exchange policy frameworks to address the existing situation in the foreign exchange market.** Specific measures were identified to address the key issues on the monetary and foreign exchange policy sides. They fit within the broader context of government policy to stabilize and diversify the economy, build resilience (buffers) and are designed to complement ongoing fiscal and public financial management reforms supported by this DPO. The strategy took into account discussions from the IMF's Article IV consultations and on the proposed DPO. As highlighted below, some of the measures will be devised and implemented with technical support from the IMF in the coming months.

38. **More generally, the recently elected O'Neill-Abel Government adopted the Alotau Accord II, which focuses on economic and fiscal resilience.** The Accord prioritizes economic growth, infrastructure development, law and order, education and health sectors. There are specific provisions on support for non-mineral sectors of the economy, access to finance and support for SMEs and informal sector enterprises, renewable energy development, and rural electrification. The Accord recognizes the importance of increasing economic participation, empowerment and private sector development to boost the country's growth prospects. In support of these priority areas, the government is undertaking key reforms to strengthen systems and processes of service delivery and accountability. One such reform is the implementation of the PEFA Road Map 2015-2018 to ensure the efficient delivery of the Free Education Policy and provision of basic health care. Furthermore, using the Alotau Accord II as a foundation, the government is currently preparing the Medium-Term Development Plan III.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

39. **The proposed operation supports four key components of the government's development program, as articulated in the Alotau Accord II, MTFS, MTRS and the existing Medium-Term Development Plan II 2016-2017.** The first component is fiscal management, where the government aims to improve fiscal resilience to resource-based volatility by establishing the non-resource primary balance as a medium-term fiscal anchor. The second is revenue mobilization, where the government aims to reverse the recent declining trend in tax revenue to GDP by broadening the tax base, providing clear revenue administration legislation, and operating a fair and efficient revenue administration. The third is public financial management (PFM) reform, where the government aims to continue the implementation of the PEFA Road Map 2015-2018, within which the rollout of the IFMS is among the highest priorities. The fourth is gender equality, where the government aims to support the economic empowerment of women.

40. **The design of this operation has incorporated some of the key lessons learned from the last**

policy-based engagement in PNG. The Governance Promotion Adjustment Loan approved by the Board in May 2000 was a particularly challenging operation, and this proposed operation would be the first policy-based engagement in PNG since then. There are three lessons from the Implementation, Completion and Results Report from the earlier adjustment loan that are particularly pertinent to the current engagement. The first is the importance of a stable social and political environment and strong country ownership and commitment to support macroeconomic and structural reforms. The history of governing coalitions in PNG suggests that the policy environment can be unpredictable. Given the relatively recent strengthening of the Bank's economic policy dialogue with GoPNG, the team has focused on policy actions that the government has already made significant investments in or that have the support of both the government and the opposition, so as to mitigate the possibility of policy reversal even if there is a change in the political environment. The second lesson is the importance of the Bank and country counterparts having common expectations on all key components of the engagement, including the specific requirements of the triggers and the likely timeframes for subsequent operations, to avoid a situation where differences in expectations lead to triggers being missed and subsequent operations delayed. The team has worked and will continue to work with GoPNG counterparts to make the specific requirements of all key components of the DPO series as clear as possible. The third lesson is the value of establishing a team in government that includes the policymakers who are responsible for the implementation of each of the prior actions and indicative triggers – so they can work collectively to help keep the program on track. This mechanism has been established under the leadership of the Department of Treasury (DoT), comprising the heads of all of the departments covered by the policy matrix.

41. **Consistent with government priorities and the above lessons, the Program Development Objective (PDO) of the proposed operation is to: (i) strengthen fiscal management and revenue performance; and (ii) strengthen key building blocks for public financial management and financial inclusion.** Under the first part of the PDO, the operation supports the adoption of the non-resource primary balance as a fiscal anchor, measures to improve tax administration and compliance, the preparation of a tax expenditure statement, and an increase in diesel excises (with climate co-benefits). These reforms are directly aligned with the fiscal management, revenue mobilization, and climate resilience/disaster preparedness components of the government's program. The second part of the PDO, under which the operation supports the IFMS institutional reform and measures to increase financial inclusion – particularly for women – is directly aligned with the PFM reform and gender equality components of the government's program. The first and second parts of the PDO are expected to contribute to poverty reduction and shared prosperity by improving medium-term fiscal stability, the sustainability of public expenditures, and the execution of the annual budget – crucial foundations for the delivery of public education, health, infrastructure and disaster preparedness which are all of critical importance to the poor – and by improving the policy environment for women's access to finance. All six actions in the proposed policy matrix for the operation have been completed.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Strengthening fiscal management and revenue performance

42. **GoPNG has made strengthening its medium-term fiscal framework and reversing the recent decline in tax revenue as a share of GDP top priorities.** It recognizes that without a fiscal policy framework that adequately reduces the volatility of the public resource envelop and strengthens and stabilizes revenues, its ability to implement its program for economic development and poverty reduction will remain elusive. In recent years, the fiscal policy framework has not adequately delinked government

spending from resource-based revenue volatility, with spending rising and falling in line with fluctuations in global commodity prices, resulting in insufficient fiscal buffers being built in upswings and disruptions to public spending and service delivery in downswings. The government's procyclical fiscal policy has also put upward pressure on wages and prices in good times, and has accentuated aggregate demand compression and unemployment in bad times. Against this backdrop, unfortunately, revenue collection agencies face significant structural challenges to improve tax compliance. The first pillar of the proposed operation supports measures to address these issues.

Prior Action 1: In order to establish a medium-term fiscal anchor: (i) the Recipient's Parliament has amended its Fiscal Responsibility Act to require the fiscal strategy to target a zero average annual non-resource primary fiscal balance over the medium term; (ii) the Recipient's National Executive Council has approved a Medium Term Fiscal Strategy for 2018-2022 that is consistent with a zero average annual non-resource primary fiscal balance over the medium term; and (iii) the 2018 Budget presented to the Recipient's Parliament is consistent with the MTFS for 2018-2022. [Completed]

43. **In September 2017, PNG amended the Fiscal Responsibility Act (FRA) to provide for the non-resource primary balance (NRPB) as a share of non-resource GDP to serve as a medium-term fiscal anchor – requiring it to average zero over the medium term.** The 2018 Budget was approved in early December 2017. The consistency of the 2018 Budget with the amended FRA is demonstrated through the Medium-Term Fiscal Strategy 2018-2022 (MTFS). The latter sets out a NRPB that moves into balance in 2022. This target is feasible as the NRPB has been improving steadily since 2014 (see Table 1).

44. **By delinking expenditure from commodity price fluctuations, the use of the non-resource primary balance as a fiscal anchor will help ensure that resources collected from the non-resource economy will be the basis for constructing the budget every year**. Growth in the non-resource economy is more stable and less at risk of sharp accelerations and downturns, and hence should lower the likelihood of large fiscal adjustments in the future. The NRPB rule can thus contribute to a more sustainable fiscal policy framework and more stable public spending. Complementing the use of NRPB as a new fiscal anchor, the government is working on the establishment of a sovereign wealth fund (SWF) to absorb volatile resource flows and provide a predictable stream of financing to the annual budget. The legislation to establish the SWF is now in place.[43] The country's SWF is expected to support macroeconomic stability, intergenerational equity, and a better management of assets accrued from mineral and petroleum revenue. Steps should be taken to prepare for the operationalization of the SWF to coincide with expected inflows into the fund. This would also strengthen the government's fiscal buffer to better respond to natural disasters and climate change shocks. The IMF and the World Bank have been supporting the government efforts to operationalize the SWF through technical assistance.

45. **An indicative trigger for the second operation in the series is that the 2019 Budget should be consistent with the MTFS 2018-2022, which targets a zero average annual non-resource primary fiscal balance over the medium term.**

46. **<u>Expected results</u>: The expected result from this action is an improvement in the non-resource primary balance.** This will be measured by an improvement in the non-resource primary balance from -4.7 percent in 2016 to -0.9 percent of non-resource GDP in 2020.

47. **In response to the large revenue shortfalls in recent years, GoPNG has also developed a Medium-Term Revenue Strategy (MTRS) for the period 2018-2022**. The MTRS contains policy, legislative

[43] A law establishing a SWF was enacted and certified by Parliament in 2016.

and administrative reforms aimed at increasing revenue as a share of GDP by broadening the tax base to ensure everyone makes a fair contribution, providing clear revenue administration legislation, and promoting voluntary compliance by operating a fair and efficient revenue administration that provides high quality services to taxpayers. The strategy draws substantially on the findings and recommendations of recent IMF technical assistance.

Prior Action 2: To improve revenue administration and enhance compliance: (i) the Recipient's Parliament has voted its approval of the Tax Administration Bill; (ii) the Recipient's Parliament has amended the Income Tax Act to make Taxpayer Identification Numbers mandatory; and (iii) the Recipient's Internal Revenue Commission has approved the establishment of a new Large Taxpayer Office. [Completed]

48. **Improving revenue administration and enhancing compliance is a key objective of the MTRS.** The new Tax Administration Bill that Parliament voted its approval of in December 2017 is a key component of GoPNG's strategy to achieve this objective. The Bill aims to modernize and simplify tax administration, making it easier to administer and comply with. The Bill removes tax administration provisions from individual pieces of legislation for different tax measures (like income tax, GST, and so forth), and brings these administrative provisions together in a single piece of legislation. At the same time, the Bill harmonizes and simplifies these administrative provisions. The Bill covers the entire tax administration process, including taxpayer registration, records, tax returns, tax assessments, decisions, objections and appeals, collection and recovery, information collection, tax clearance, communications, forms, notices, penalties and tax offences. By providing more certainty on taxpayer rights and obligations and streamlined administration processes, the Bill is expected to reduce the costs of compliance for taxpayers. It is also expected to significantly reduce the cost of tax administration for the IRC, so enabling it to better prioritize its administrative and compliance resources. Both effects should contribute to increased revenue collection over the medium term. The Bill is now in the process of being certified by the Speaker of Parliament. It will then require gazetting to come into effect. It is expected to be brought into effect on January 1, 2020, to allow the IRC to reform its systems, procedures, forms, filing and payment mechanisms, and so forth during 2018 and 2019, ready for implementation on January 1, 2020. In this and its other reform efforts, IRC has been supported by GoPNG's decision to dedicate significant additional resources to tax administration, enabling the IRC to recruit 50 new staff in the last year or so.

49. **A further key component of GoPNG's strategy to improve revenue administration and enhance compliance is the Income Tax Act amendment of December 2017 that makes Taxpayer Identification Numbers (TINs) mandatory for all taxpayers.** Until now, the IRC has had to rely on stop gap measures to increase the coverage of TINs (for example, directives from BPNG making TINs mandatory for new business accounts, as requested by the IRC). With the legislative amendment making TINs mandatory, the IRC is now in a stronger position to persuade taxpayers to register for TINs through public awareness campaigns, and – where taxpayers fail to do so – to force register them. Ensuring TINs are mandatory strengthens enforcement of tax policy as it is a necessary initial step towards improving audit capabilities. There is a particular concern that the largest revenue leakages due to the absence of TINs are in the resources sector, including sub-contractors. Ensuring that TINs are mandatory should therefore improve domestic revenue mobilization, because the reform is a critical foundation for enhancing tax enforcement and, consequently, compliance. At the current juncture, the IRC has obtained information from commercial banks which it is now using to match with information held by the IRC, to identify taxpayers that operate bank accounts but do not have TINs, as a basis for force registering those that have not obtained TINs voluntarily. Once the backlog of unregistered taxpayers is dealt with, this data sharing and matching arrangement is expected to become part of normal business processes at IRC. The profiling of

taxpayers that is possible through the matching of information on different tax types for unique TINs will significantly enhance the effectiveness of the IRC's compliance efforts, potentially reducing tax evasion.

50. **A third key component of GoPNG's strategy to improve revenue administration and enhance compliance is the establishment of a Large Taxpayer Office (LTO) as part of IRC's adoption of a risk-based approach to compliance.** Approximately 80 percent of tax revenue in PNG is derived from 20 percent of taxpayers, making efficient taxpayer services for, and compliance efforts targeted to, those large taxpayers of overarching importance to tax revenue. The LTO will provide a single point of engagement for large taxpayers – a 'one-stop shop' service – and facilitate the tailoring of training, competencies and experience of IRC staff to this taxpayer group. Critically, the LTO will facilitate the better prioritization of the IRC's administrative resources, by aligning them with revenue potential. Over time, as its capacity is built, its remit is expected to be expanded (for instance, to include a debt collection function). At present, following the Commissioner for Taxation's approval of the structure of the LTO, the Assistant Commissioner in charge of the LTO has been appointed and the establishment of the LTO is progressing.

51. **Going forward, GoPNG is expected to take further key steps to improve revenue administration and enhance compliance.** The indicative trigger for the second operation in the series is: (i) passage of the first phase of consequential amendments to existing tax legislation, in preparation for the entry into force of the Tax Administration Act; (ii) completion of the first phase of the compliance strategy for data matching between banking data and income tax records to identify business accounts with and without TINs; and (iii) development and implementation of the Standard Operational Procedural Manual for the IRC's new risk-based audit referral tool.

Prior Action 3: The Recipient, through the Department of Treasury and the Internal Revenue Commission, has prepared a tax expenditure statement and made it publicly available as part of the 2018 Budget. [Completed]

52. **As a first step in a process aimed at broadening the tax base, GoPNG has prepared a tax expenditure statement and included it as a chapter of the 2018 Budget Volume 1: Economic and Development Policies.** Recent analytical work by the Bank argued that the use of tax incentives has contributed to the erosion of the tax base and, consequently, to declines in revenue as a share of GDP. GoPNG has recognized the problem and, as a first step in the process of quantifying the extent of the problem and increasing transparency on it, the Department of Treasury (DoT) and IRC prepared a tax expenditure statement, which was included as a dedicated chapter in Volume 1 of the 2018 Budget. Both the preparation and the publication of this tax expenditure statement are important steps. The preparation of the statement involved the analysis of data captured in the information system of IRC, in order to identify and quantify tax expenditure categories applying to the main tax groups. The tax expenditure statement published in the 2018 Budget covered tax incentives schemes, tax credit schemes, and GST zero-rating and exemptions. This is a reasonable start, given that these comprise many of the tax expenditure categories in the three main tax groups. The tax expenditure statement overstated the revenue foregone, insofar as it included as revenue foregone the GST zero-rating of exports (whereas this is a key principle of the GST and should not be considered foregone revenue).[44] This will be corrected in the tax expenditure statement in the 2019 Budget, which will also include for the first time duties and GST

[44] A rough correction for this suggests that the revenue foregone through the tax expenditure categories covered in the tax expenditure statement was approximately 7.5 percent of total tax revenue in 2016. Since the GST zero-rating for mineral exports may have been extended back to suppliers of mineral exporters (an extension now prohibited by a legislative amendment), this estimate is likely to represent the minimum value of the foregone revenue.

on exempted imports, which IRC has now been able to quantify. The publication of the tax expenditure statement and its detailed accompanying tables is critical to improving transparency on tax expenditures. By making information on the magnitude of these losses publicly available – hence also making transparent the magnitude of the higher taxation borne by others to compensate for these tax expenditures, or the lower public spending that can be afforded as a result of them – the tax expenditure statement should add to pressure over time to reduce revenue foregone through tax expenditures. From a climate change perspective, these tax expenditures cover direct and indirect climate-related expenditures for fossil fuels. Disclosing them publicly in annual tax expenditure statements is a critical step in the process of being able to transparently monitor and eventually reduce revenue foregone through tax expenditures.

53. **While an important first step in the process, considerable further work is required for this process to have an impact on tax revenue performance.** Firstly, it is important to recognize that the coverage of the tax expenditure statement does not yet extend to revenue foregone from large entities sitting outside the tax system because they have individual tax exemptions in specific project agreements. DoT has requested technical assistance from the World Bank with the methodology and analysis required to quantify this additional foregone revenue, which is not captured in the information system of IRC – as part of a comprehensive review of tax incentives. This technical assistance has now commenced, and GoPNG is in the process of gathering all such specific project agreements as a basis for testing alternative methodologies and quantifying the revenue foregone through specific project agreements. This will enable even more comprehensive information on tax expenditure to be included in the 2019 Budget. The technical assistance will also attempt to estimate the benefits accruing from these tax expenditures, to provide a cost-benefit analysis that DoT plans to use as a basis for rationalizing current incentive structures. Such a rationalization would of course depend on GoPNG taking action to repeal or narrow the coverage of tax expenditure provisions, and to reduce the extent of tax exemptions offered in specific project agreements going forward. There are certainly indications of GoPNG willingness to take such actions, including the repeal of double deduction provisions for exploration expenditures in 2017, and clarification that the scope of GST zero-rating for mining companies applies narrowly to the mining companies themselves not their supply chains (as the provisions had been being applied in practice), in legislative amendments accompanying the 2018 Budget.[45] More broadly, GoPNG has commenced the validation process under the Extractive Industries Transparency Initiative, which is expected to inform overall tax policy considerations through transparency on the revenues that are accruing to GoPNG from the resource sector tax base.[46]

54. **As a trigger for the second operation in the series, GoPNG will complete the review of tax incentives that has commenced in 2018, and the recommendations of the review will be tabled at the National Executive Council.** As mentioned above, at the request of the DoT, the Bank is providing technical assistance for this review.

Prior Action 4: The Recipient has increased the excise on diesel in the 2018 Budget, in order to raise revenue, reduce the distortion between diesel and petrol taxes, and reduce environmental pollution. [Completed]

55. **Emissions from diesel combustion have been found to have severe negative local**

[45] GoPNG has also requested specific assistance from the Bank to assess the effectiveness of the Infrastructure Tax Credit Scheme, with a view to formulating recommendations for its improvement by August 2018.

[46] GoPNG has also officially requested Bank support with the establishment of a Petroleum Resources Authority, modelled on the Mineral Resources Authority that the Bank previously assisted PNG to establish.

environmental impacts, and significantly more so than those from petroleum. Diesel emissions include nitrogen and sulfur dioxides, and particulate matter, which are harmful to human health and have been linked to respiratory illnesses. Reflecting this, many countries and subnational jurisdictions have imposed stricter diesel standards, such as restrictions on the sulfur content of diesel (e.g. Australia) and the nitrous oxide content of emissions from certain vehicle classes (e.g. USA), mandating the use of diesel particulate filters and newer engines in certain vehicle classes (e.g. California), and imposing fees for the use of older engines in central city areas (e.g. London). While mitigating technologies such as particulate filters, exhaust gas recirculation and selective catalytic reduction do exist, these require maintenance, tend to be absent from older vehicles, and have seen significant efficiency increases in recent years. Consequently, in a low-income country such as Papua New Guinea, where the vehicle fleet is old and poorly maintained, and where commercial diesel generators are unlikely to include newer mitigation technologies, shifting the composition of fuel use in favor of petroleum is expected to yield significant benefits for air quality and human health.

56. **To reduce the distortion between petrol and diesel taxes and encourage the consumption of less diesel, the government has increased the excise tax on diesel.** Currently, the excise tax on petrol is at 61 toea per liter and diesel is at 10 toea per liter. This indicates that there is a preferential treatment of fuel excise based on end-use despite the fact that both diesel and petrol vehicles are contributing to the overall wear and tear of the road network. The government in the 2018 Budget increased the diesel excise to 23 toea from 10 toea to align rates more with petrol excises. Moreover, the government will increase the excise for diesel by 13 toea every two years starting in 2018 until the gap between petrol and diesel excise tax is closed. For this reason, there is no trigger following from this action in 2019, as the next increase in the diesel price to close the gap is expected in 2020.[47]

57. **This action is expected to contribute to higher excise tax.** The increase in the excise tax on diesel is expected to raise an additional K67 million in 2018. This will be measured by the tax revenue to GDP indicator, outlined below.

58. **<u>Expected results:</u> Taken together, these reforms under prior actions 2 to 4 are expected to increase tax compliance and tax revenue as a share of GDP.** This will be measured by the tax revenue to GDP ratio, with a baseline of 14.2 percent in 2016 and a target of 14.6 percent in 2020.

Pillar 2: Strengthening key building blocks for public financial management and financial inclusion

59. **To complement stronger fiscal management in the context of PNG's commodity-dependent economy – as supported by the first pillar of this operation – it is critical that GoPNG strengthen public financial management and also strengthen prospects for inclusive growth in the non-resource sector of the economy.** Good public financial management is essential to the implementation of the government's program for economic development and poverty reduction, because it underpins effective allocation, control, accountability and transparency in the use of public funds. It is a key complement to fiscal consolidation, because the ability to maintain service delivery while rationalizing expenditure depends critically on effective allocation and control mechanisms. PFM reforms are thus one of the focus areas of this pillar of the operation. Measures to strengthen prospects for inclusive growth in the non-resource sector of the economy are also a key complement to the reforms supported under the first pillar, as GoPNG attempts to de-link public expenditure from commodity-price fluctuations. In the non-resource sector of the economy, economic inclusion requires a focus on the informal economy and SMEs, where

[47] The 2020 excise increase could be captured in a third operation in the series, if it occurs.

the vast majority of Papua New Guineans are employed.[48] One of the top constraints to the growth of informal enterprises and SMEs in PNG is access to finance, with the constraints particularly severe for women. Measures to increase financial inclusion – particularly for women – are the other focus area of this pillar of the operation.

Prior Action 5: The Recipient's Department of Finance has implemented the Integrated Financial Management System in national government departments, such that it is being used to record all expenditures other than trust fund expenditures. [Completed]

60. **In 2015, GoPNG formulated the PEFA Road Map 2015-2018, a PFM reform plan informed by the findings of the PEFA self-assessment and the independent PEFA assessment undertaken in 2014 and 2015.** The PEFA Road Map 2015-2018 identified as the three highest priority PFM reforms: (i) the completion of the rollout of the IFMS, development of interfaces with payroll and other PFM systems, and implementation of associated checks and controls; (ii) accounts reconciliation and improved cash management; and (iii) revision of the legal framework for PFM and better alignment of PFM practices with the capabilities of the IFMS.[49] The DPO series supports implementation of the first of these three top priority PFM reforms. (With respect to the second, in 2017 GoPNG made key reforms to cash management with the passage of the Public Money Management Regularisation Act. With respect to the third, in 2016 GoPNG revised the legal framework for PFM, with the passage of amendments to the Public Finances (Management) Act 1995. A revised Finance Management Manual, reflecting these amendments, IFMS capabilities and other developments, is expected to be issued shortly.)

61. **The 2015 PEFA assessment highlighted how the absence of a functioning IFMS undermined PNG's ability to perform an array of PFM functions effectively.** A functioning IFMS was considered a critical institutional requirement for improving GoPNG's ability to carry out 15 of the 22 dimensions of the PEFA with a D/D+ rating. These 15 dimensions spanned six of the seven pillars of the PEFA and included the credibility of the budget composition (outturn versus approved budget), public access to key fiscal information, all asset and liability management and reporting dimensions, effectiveness of payroll controls and internal controls for non-salary expenditure, all accounting, recording and reporting dimensions, and external audit of annual financial statements. By implementing the IFMS, initially in national government departments, GoPNG has the key building block that it needs to improve these other dimensions of PFM. As GoPNG clearly acknowledges in its PEFA Road Map 2015-2018, the IFMS rollout will not in itself result in those improvements, but it does provide a necessary foundation for them.

62. **The Department of Finance (DoF) has now implemented the IFMS in all national government departments.** An institutional reform of this magnitude is a major achievement. For many years, the IFMS was operational in only DoF, DoT and the Department of National Planning and Monitoring. That changed with the PEFA Road Map 2015-2018, when DoF management prioritized the roll-out and dedicated significant budgetary and personnel resources to it (with some technical advisor positions funded by development partners), resulting in considerable reform momentum that has been sustained since. By the end of 2015, 22 departments were using the IFMS; by the end of 2017 all 43 departments were using it (with the final department added in December 2017).[50] To date, while the regular budgets of departments have been moved onto the IFMS, the movement of their trust funds onto the IFMS is still

[48] In PNG, 84 percent of people who are employed are employed in the informal sector.
[49] In the second half of 2018, GoPNG plans to review the implementation of the PEFA Road Map 2015-2018 and issue an updated version covering 2019 onwards.
[50] While the IFMS now operates in all national departments, the provincial offices of some of these departments are not yet on the IFMS, so their data has to be manually transferred from the old financial management system as a transitional measure.

in progress (with movement of the remaining trust funds pending the due establishment of the requisite instruments for these trust funds). The share of expenditure that national departments represent is about 59 percent (with 32 percent by provinces, and 9 percent by statutory authorities).[51]

63. **The IFMS consists of integrated planning, budgeting and accounting modules, and provides real time visibility for public finances and a full audit trail.** The IFMS provides a platform for the application of commitment controls (warrant ceilings and purchase orders/authorities to pre-commit expenditure for procurement), and for precluding cheque issuance outside the IFMS. The IFMS has management reporting functions allowing departments to plan and track their expenditure, which they could use in conjunction with indicators of performance/outcomes to inform improvements in service delivery (though DoF's focus in this first phase of this institutional reform has been on the accounting and control functions). Budget reports and financial statements for the recurrent and development budgets of national departments can now be generated from the IFMS – the first time this was possible for all national departments was for the 2017 annual financial statements. The 2017 annual financial statements have already been submitted for audit – a major break with the extensive delays of the past. These previous delays had, in turn, delayed the submission of the audited financial statements to Parliament. In a clear indication of one of the critical impacts of the IMFS rollout, in parallel DoF has been working to clear the backlog of annual financial statements. In 2017, the audited financial statements for 2010-2014 were submitted to Parliament, and the annual financial statements for 2015-2016 were submitted to the Auditor General's Office for audit.

64. **Going forward, DoF plans to continue the rollout of the IFMS to statutory authorities and other levels of government, and to strengthen key components of PFM using the foundation the IFMS now provides.** The IFMS has so far been rolled out to seven statutory authorities, and DoF has also commenced the rollout at the provincial level, where infrastructure and capacity challenges are far more pronounced than at the national level. Given that weaknesses in expenditure control at sub-national levels have significant implications for the aggregate budget, DoF's focus on the sub-national rollout is understandable. Arguably, however, the priority placed on the sub-national rollout may be premature, given that significant capacity building and support is still required to enable national departments to comply with financial management processes surrounding the IFMS, and to fully leverage the potential of the IFMS (for instance, by completing the interface of the IFMS with the payroll system to enable effective payroll controls – work which is underway). Among the most immediate PFM challenges for GoPNG is to bring bank reconciliations up to date. Bank reconciliations – a critical financial control – have in the past required a considerable amount of tedious manual work that has been treated as a low priority by many departments. In combination with the electronic submission of bank records, the IFMS can automate bank reconciliations, facilitating a focus on the causes of discrepancies. However, bank reconciliations are yet to be brought up to date in a significant number of departments – including some of the bigger spending ones – since the implementation of the IFMS. DoF has now created a bank reconciliation support team, which has the potential to raise the priority that departments place on bank reconciliations and assist their capacity in this area, if DoF prioritizes this work. As a trigger for the second operation, and building on the prior action for the first operation, bank reconciliations in national government departments representing at least 85 percent of the total expenditure of national government departments on the IFMS – will be brought up to date.[52] DoF also plans to have the integrity of the control systems under the new IFMS verified, once the statutory authority and provincial rollout is also complete.

[51] In 2017, a maximum of 13.5 percent of expenditure by national departments was funded by government trust funds, which are progressively being moved to the IFMS but which have not all been moved yet. Given the significant reduction in the number and value of government trust funds over the last 6-9 months, this share could be expected to be lower in 2018.

[52] The explanation of what up to date means in GoPNG's bank reconciliations monitoring platform is provided in Annex 1.

This could serve as a trigger for a subsequent operation in the series.

65. **The implementation of the new IFMS and the PFM reforms related to it are complemented by a series of reforms to improve cash management.** The earlier PEFA assessment highlighted a number of significant weaknesses in cash management that systematically undermine budget execution and increase public borrowing costs. In addition to the lack of timely bank reconciliations already discussed above, these included: (i) inadequate attention to cash forecasting; (ii) revenue-raising entities not remitting revenues to the Consolidated Revenue Fund (CRF) in a timely manner; (iii) public funds being held in trust accounts outside the Waigani Public Account (WPA) system; and (iv) the absence of a whole-of-government banking arrangement that would permit the use of idle cash in accounts outside the WPA system. As a consequence of these weaknesses, and exacerbated by recent declines in revenue, GoPNG has experienced significant cash flow problems. Weaknesses in predicting cash balances have meant that warrants have not been released in a reliable fashion, and even that released warrants have been retracted, impeding the ability of departments, statutory authorities and sub-national tiers of government to implement their planned activities and deliver public services. Shortages of cash have meant that GoPNG has been reliant on costly short-term borrowing to meet immediate obligations, in turn further exacerbating its fiscal constraints.

66. **Since the new government took office in August 2017, it has been addressing identified key weaknesses in cash management.** One aspect of these reforms has been a review of trust accounts. To date, approximately 400 redundant or non-compliant trust accounts out of an initial total of some 500 trust accounts have been closed and their balances transferred to the CRF. For the remaining trust accounts, DoF is working through a process to ensure the requisite instruments have been established for the operation of each, at which point each trust account is being brought onto the IFMS. DoF is also seeking to ensure that new trust accounts are only created if they comply with the relevant provisions of the PFM Act and Finance Management Manual. Another aspect of these reforms has been bringing non-tax revenues raised by statutory authorities onto the budget, via the changes instituted under the Public Money Management Regularisation Act. By January 1, 2020, non-tax revenues will be paid directly into the CRF and recorded in the budget, and statutory authorities will be funded by budget appropriations (rather than partially statutory authorities raising non-tax revenues and funding their operations from them, with neither the revenues nor the expenditures captured in the budget. These reforms also give DoF the authority to retrieve public funds that have been accumulated by statutory authorities in the past. That one-off correction is budgeted to contribute nearly 4.5 percent of total revenue in 2018.

67. **<u>Expected results</u>: Among the many improvements in PFM that the IFMS has the potential to underpin, is greater accountability and transparency in the use of public funds.** Timely submission of the annual financial statements for audit is critical to the potential effectiveness of external oversight institutions. Thus, the results indicator chosen for this reform area is that the annual financial statements are submitted to the Auditor General's Office within three months of the end of each fiscal year.

Prior Action 6: (i) To support increased financial inclusion, the Recipient's National Executive Council has approved the Financial Sector Development Strategy and the National Financial Inclusion Policy; and (ii) to increase women's financial inclusion, the Recipient, through the Bank of Papua New Guinea, has launched the Gender Equity and Social Inclusion (GESI) Policy for Microfinance Institutions. [Completed]

68. **Supporting prospects for inclusive growth in the non-resource sector of the economy is critical to improving the wellbeing of poor and vulnerable groups, including women, as well as to broader social and economic equity.** Access to finance is a key constraint to the growth of informal enterprises and

SMEs in PNG, where the vast majority of people are employed. Constraints on access to finance for women are particularly severe, and tackling them is important to improving women's economic empowerment. It is also an area where GoPNG is showing considerable and sustained policy leadership and commitment. To quote the World Bank's 2012 World Development Report (Report #64782), increasing gender equality is not only the right thing to do, but also smart economics.

69. **PNG has made significant progress on financial inclusion in recent years, but there remains considerable work to improve access to financial services – particularly for women in rural areas.** In June 2013, 20 percent of adults had an account at a regulated financial institution; by June 2016, this figure had nearly doubled to 37 percent. Moreover, recent advances in, and expansion of, mobile banking have been game changing, particularly to those outside urban centers and rural towns who have long been disconnected from financial sector infrastructure. Nonetheless, finance is not readily available to businesses in PNG, and PNG falls behind the average experience in developing East Asia and Pacific and lower-middle income countries. SMEs report that improved access to finance would be the foremost way to help them grow their business, while almost 50 percent of informal sector business held the view that better access to finance was the best way to stimulate people to open more businesses. And it remains the case that about two thirds of the population continues to lack access to any form of formal financial service – with the unbanked concentrated in rural areas and among women.

70. **Continued increases in financial inclusion in PNG will be critical to inclusive growth, and this has been clearly recognized in GoPNG's SME Policy 2016.** The accompanying SME Master Plan 2016-2030 targets a reduction in the proportion of the population who are unbanked, and includes as a key strategy the development of a holistic financial inclusion and access framework for SMEs. To support further increases in financial inclusion going forward, GoPNG has recently adopted two important strategy and policy documents. The first is the Financial Sector Development Strategy. This supports the innovative use of technology for scaling-up access to financial services and financial literacy; strengthens consumer protection by developing new prudential guidelines and monitoring frameworks for various national regulators and industry networks; develops a means of collecting data for monitoring and to inform policymaking; and enhances dialogue and knowledge sharing between stakeholders (including development partners) and PNG's Center for Excellence in Financial Inclusion. The second is the National Financial Inclusion Policy. This lays out a set of programs to advance financial inclusion through digital financial services, inclusive insurance, financial literacy, consumer protection, and specific programs tailored to the informal economy and agricultural sector, SMEs and the resources sector. Together, these strategy and policy documents will enable financial inclusion to move to the next level in PNG, by supporting the necessary financial sector developments and their application to financial products and services for the unbanked.

71. **Even with the significant improvements in financial inclusion in PNG in recent years, however, it remains the case that financial exclusion affects specific groups more than others: it is more prevalent among women, in rural communities, and for micro, small and medium enterprises – especially those working within the informal economy and in agriculture.** Women have significantly lower levels of financial inclusion than men (holding just over one third of bank accounts). This is true even where financial services are available in urban communities (38 percent of urban women have some form of savings account, versus 68 percent of urban men), *and* where women hold jobs in the formal sector (where women's access to financial products still lags that of men). That is, women face additional barriers to accessing finance, unrelated to the barriers arising from their location and their employment status. Financial exclusion is particularly pronounced in rural areas, with only 9 percent of women and 21 percent of men having some form of savings account. The findings from the study *The Financial*

Competence of Low Income Households in Papua New Guinea were that women in low income households are significantly less financially empowered than men, a gap that may be related to lower levels of confidence in their ability to communicate in English (in which most financial documents are written), lower levels of mobile phone ownership and access, and culturally-conditioned gender power asymmetries with respect to financial matters. Closing the gap between women and men on access to finance is important as a contributor to women's economic empowerment, to women's ability to engage in self-employment and other private enterprise, to women's capacity to budget and save for bulky expenditures associated with schooling for children and health care for family members, and to a reduction in the vulnerability of women to predatory practices among informal moneylenders. It is also recognized as an important intervention to help prevent GBV in PNG's National Strategy to Prevent and Respond to Gender Based Violence 2016–2025. Indeed, PNG's first National Financial Inclusion and Financial Literacy Strategy noted that GBV within households is often related to struggles over money – with any money that women hold in cash (as opposed to in an account) highly vulnerable.[53]

72. **To tackle entrenched sources of constraint to women's financial inclusion, BPNG has recently adopted a Gender Equity and Social Inclusion (GESI) Policy for Microfinance Institutions.** The GESI Policy takes, as its starting point, the implementation experience of the first National Financial Inclusion and Financial Literacy Strategy. The overarching goal of that strategy was to bank 1 million more unbanked low-income people, 50 percent of whom were to be women. By the end of the strategy period, 1.2 million new deposit accounts had been opened – an impressive achievement – but only 26 percent of those were by women. The aforementioned *Financial Competence of Low Income Households* study argued that without substantive change to financial inclusion products, services and programs to bring women into the formal financial system, gender equity would not be achieved. The GESI Policy responds to that finding, by laying out a strategy to address gender equity and social inclusion within microfinance institutions. It includes strategies to: (i) remove barriers to the employment and promotion of women within microfinance institutions, to change their institutional cultures as well as their customer interfaces; (ii) reformulate the design and delivery of products and services to fit the needs of women customers; (iii) change the way microfinance institutions communicate and engage with women customers, including their provision of physical access to services that accommodates personal security factors for women; and (iv) monitor, evaluate and publish indicators of the impact of these reforms. Financial literacy training will also be expanded, with a new target of 60 percent female participation. BPNG will provide overall leadership and support for the implementation of the GESI Policy by microfinance institutions, supporting and monitoring the preparation and implementation of GESI Action Plans. The GESI Policy aims to complement existing policy and institutional developments that GoPNG has already made to support financial inclusion for women. These include its passage of the Personal Property Security Act, which created the legal authority for an asset registry for moveable assets. Because women typically have very limited control over land, the expansion of the types of collateral that can be used for loans is of disproportionately high importance to women's access to credit. These measures also include the earlier GoPNG-supported establishment of a women's microfinance institution, which is now expanding beyond Port Moresby to smaller urban centers.

73. **Over the next year, BPNG will implement a new National Switch platform, enabling all regulated financial institutions – including microfinance institutions – to offer digital financial services and products which have proven effective in overcoming barriers to women's financial inclusion.** This will serve as a trigger for the second operation in the series. BPNG will work specifically with microfinance institutions to connect them to the National Switch, thereby facilitating their ability to offer new digital

[53] This recognition was based on Banthia *et al* (2013) *Deepening Financial Inclusion for Women in the Pacific Islands*.

financial products and service innovations tailored to women customers.

74. **<u>Expected results</u>: The implementation of these strategies and policies is expected to support the monetization of rural economies and facilitate access to finance to support growth of micro and small enterprises, particularly amongst women entrepreneurs.** They are expected to provide the means to expand access to financial services to both the formal and informal sectors of the economy by utilizing technology to overcome physical barriers. GoPNG's objective is to bank two million more unbanked people across the country by the end of 2020, 50 percent of whom will be women. Given that the bulk of unbanked people in PNG are low-income earners, the expansion of micro-finance is expected to make the largest contribution to this overall objective. Since only 26 percent of new accounts were opened by women in the previous strategy period, this is ambitious however. The first results indicator for the prior action and trigger supported by this series will be the increase in the aggregate level of financial inclusion in PNG. The second results indicator will focus on closing the gap between women and men in new bank account establishment, as indicated by increasing the percentage of new bank account-holders who are women from the 26 percent baseline.

Table 6: DPO Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar 1: Strengthening fiscal management and revenue	
1. In order to establish a medium-term fiscal anchor: (i) the Recipient's Parliament has amended its Fiscal Responsibility Act to require the fiscal strategy to target a zero average annual non-resource primary fiscal balance over the medium term; (ii) the Recipient's National Executive Council has approved a Medium Term Fiscal Strategy for 2018-2022 that is consistent with a zero average annual non-resource primary fiscal balance over the medium term; and (iii) the 2018 Budget presented to the Recipient's Parliament is consistent with the MTFS for 2018-2022.	IMF Article IV (2017) and the World Bank's Systematic Country Diagnostic and Economic Update (December 2017, Report #126776): recommendations on focusing on the non-resource primary balance as a fiscal anchor.
2. To improve revenue administration and enhance compliance: (i) the Recipient's Parliament has voted its approval of the Tax Administration Bill; (ii) the Recipient's Parliament has amended the Income Tax Act to make Taxpayer Identification Numbers mandatory; and (iii) the Recipient's Internal Revenue Commission has approved the establishment of a new Large Taxpayer Office.	The Tax Review Committee Report (2015), including several IMF technical assistance missions, IMF Article IV (2017), and World Bank's Systematic Country Diagnostic and Economic Update Part B: Towards and Integrated Macroeconomic Policy Framework (December 2017, Report #126776): recommendations on improving revenue administration and tax compliance, and reversing the erosion of the tax base.
3. The Recipient, through the Department of Treasury and the Internal Revenue Commission, has prepared a tax expenditure statement and made it publicly available as part of the 2018 Budget.	
4. The Recipient has increased the excise on diesel in the 2018 Budget, in order to raise revenue, reduce the distortion between diesel and petrol taxes, and reduce environmental pollution.	Increasing the excise tax on diesel is an efficient way to generate additional revenue and reduce environmental pollution.
Pillar 2: Strengthening key building blocks for public financial management and financial inclusion	
5. The Recipient's Department of Finance has implemented the Integrated Financial Management System in national government departments, such that it is being used to record all expenditures other than trust fund expenditures.	2015 PEFA Assessment; PEFA Road Map 2015-2018, 'IFMS Expansion' priority.

6. (i) To support increased financial inclusion, the Recipient's National Executive Council has approved the Financial Sector Development Strategy and the National Financial Inclusion Policy; and (ii) to increase women's financial inclusion, the Recipient, through the Bank of Papua New Guinea, has launched the Gender Equity and Social Inclusion (GESI) Policy for Microfinance Institutions.	World Bank (2014) PNG Financial Sector Development Strategy; IMF Article IV (2015) selected issues paper titled "Financial sector development and access: Supporting inclusive growth".

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

75. **The proposed DPO series is aligned with the World Bank Group's overall engagement with PNG, as laid out in the CPS FY2013-FY2018.** The third pillar of the CPS is 'Increasingly prudent management of revenues and benefits', with macroeconomic management one of the key components of that pillar. The milestones under that component include the announcement of new debt and fiscal strategies that continue prudent a-cyclical policy and expenditure rules. The two pillars of the DPO are closely aligned with this CPS component and milestone, and are expected to support poverty reduction and shared prosperity through improved medium-term fiscal stability, expenditure sustainability and budget execution – critical foundations for the delivery of public services of most importance to the poor. The first pillar of the CPS is 'Increased and more gender equitable access to inclusive physical and financial infrastructure', with the financial sector one of the key components of that pillar. The results indicators under that component include increased access to finance for SMEs and increased access to finance for women, particularly in rural areas. The measures to increase financial inclusion – especially for women – under the second pillar of the DPO are closely aligned with this CPS component and outcomes, and are expected to support poverty reduction and shared prosperity through improving the policy environment for women's access to finance. A new Country Partnership Framework (CPF) covering the period FY2019-FY2023 is currently under preparation.

76. **The DPO series is complemented by a set of other World Bank Group operations.** These include the Rural Service Delivery Project II, Urban Youth Employment Project, a set of engagements in the transport, agriculture, water and sanitation, communications, health, energy, tourism and finance sectors, and technical assistance engagements in the areas of tax policy and administration, and extractive industries. In addition to these engagements, the International Finance Corporation also has a significant engagement with the PNG Business Coalition for Women.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

77. **Consultations.** The government is currently preparing the MTDP III in PNG, which will cover the years 2018 to 2022. The government has undertaken an extensive consultation process with a wide range of civil society stakeholders and the general public. In this vein, the government kicked-off the discussions on the MTDP III by inviting all relevant stakeholders to a week-long workshop in March 2018. At the workshop, stakeholders presented their views on key areas of development in PNG. For the proposed operation, the Treasury established a working group headed by a first assistant secretary and chaired by the Secretary of the Treasury. The working group consulted broadly across sectors in the process of building the joint policy matrix.

78. **Collaboration with other development partners.** The Asian Development Bank (ADB) is currently preparing linked policy-based lending and investment operations for PNG, focused on the health sector. The two pillars of the Bank's DPO are consistent with the fiscal framework and PFM reform components of the ADB's policy-based lending operation, and its other components (on budget allocations to priority

sectors and on strengthening health sector legal framework, institutional arrangements, human resources, procurement, planning, budgeting, funds flows, accounting and reporting), complement the Bank's DPO by supporting service delivery in this key sector for the poor. The IMF is providing technical assistance to GoPNG in several areas of relevance to the Bank's DPO, particularly in support of monetary and exchange rate policy reforms and improved revenue performance. Australia's Department of Foreign Affairs and Trade (DFAT), through the PNG Governance Facility (PGF), also provides technical assistance to GoPNG in areas of relevance to the World Bank's DPO, particularly in support of the implementation of the PEFA Road Map 2015-2018.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

79. **The prior actions supported under the first pillar are likely to have an indirect, positive effect on poverty reduction, including on women.** Prior action 1 focuses on improving the management of volatile resource revenue by designing a fiscal policy framework that aims at reducing the procyclicality of government spending. Previously, procyclical government spending, correlated with resource revenue receipts, has typically led to inefficient spending, higher wages and higher inflation in good times and sharp compressions of public spending and rising unemployment in bad times, which has generally led to negative impact on the poverty profile. The targeting of the non-resource primary balance fiscal anchor, would support a more stable public expenditure profile which will help to insulate public expenditure from the vagaries of the commodity price cycle and contribute to a more stable public expenditure profile in support of the delivery of public services. Given the strong correlation between delivery of key services and poverty, ensuring the delivery of public services will have an indirect impact on reducing poverty. As the crisis in health services in PNG in recent years has shown, delivery of key public services can be disproportionately important to women and children (with primary care and health outreach in all geographic areas critical to maternal, reproductive and child health, in particular). Raising revenue via the actions supported under this pillar, will allow for continued capital expenditure, which has been bearing the brunt of the fiscal consolidation efforts in the face of lower revenue receipts. Capital expenditure is generally productive, as it is investment into future growth which is expected to support poverty reduction. Moreover, since the revenue actions focus on boosting compliance and reducing tax expenditure to generate revenue, these actions are unlikely to adversely affect the poor or poor women, in particular. These actions are intended to boost revenue so that government has increased funds for public service delivery, again of disproportionate importance to the poor, women and children.

80. **The policy action on increasing diesel taxation is expected to have a small negative impact on poverty, all else constant**. Studies reveal that the impact of diesel price increase on the poor are varied across countries depending on the magnitude of the increase and the country specific circumstances such as the weight of diesel in the CPI basket; the proportion of diesel consumed by the bottom quintiles of the income distribution; the possibility of substitution away from diesel to other fuels; and the existence and effectiveness of countervailing targeted policies and actions to mitigate the impact of the higher price on the poor. Even though the poorest quintiles are expected to have a higher dependence on diesel-based public transport, there are a number of reasons for the expected small negative impact on poverty. Firstly, the increase in the diesel tax is both moderate and gradual. To align rates more with petrol excises. the diesel excise will increase marginally by only 13 toea (US$ 0.04). Moreover, the government will very gradually increase the excise for diesel by 13 toea every two years starting in 2018 until the gap between petrol and diesel excise tax is closed. Secondly, given that the National Statistics Office estimates diesel

to account for only 0.5 percent of the CPI basket and transport (as a whole) accounts for 12 percent of the CPI basket, the share of household expenditure on diesel (as a component of transport expenditure) is expected to be relatively small.

81. **The prior actions supported under the second pillar of the operation are expected to have either indirect or direct positive poverty and social effects, including a direct effect on closing the gender gap in the area of financial inclusion.** Over the medium term, the rollout of the IFMS is expected to lead to better budget execution – by ensuring that budgeted resources are available and actually used to support the service delivery activities they were approved for, and that accurate reports can be generated and published in a timely way to enable both policymakers and the public to verify this. Given that poorer quintiles are typically more dependent on the availability of public services like primary schools and health clinics than richer quintiles – and that women have a particular reliance on these services in areas of maternal and reproductive health, access to education, and personal security/law and order – reforms that improve budget execution can be expected to be of disproportionate benefit to the poor and women– albeit an indirect benefit of the reforms. The measures to support increased financial inclusion – particularly for women – are expected to have positive poverty and social impacts and a specific positive impact on financial inclusion for women, through increasing access to finance for the poor and, particularly, for women.

82. **PNG has limited systems available to mitigate negative poverty impacts but has set up some mechanisms to enhance the poverty-reducing effects associated with the specific policies supported by the DPO.** By mitigating the impact of volatile commodity prices on public expenditure by adhering to a fiscal anchor, supporting revenue-enhancing measures and strengthening PFM, the government is building a framework to support more effective service delivery, and, by extension reduce poverty. For instance, improved access to education facilities is supported by the mechanism set up through the provision of fee-free education, which provides a basis to increase service delivery in the education sector and thus enhances the poverty-reducing impact associated with the actions that provide the foundation for improving service delivery. Another example is PNG's Center for Excellence in Financial Inclusion, an institution which enhances the financial inclusion agenda supported by the respective prior policy action. However, in PNG, there do not exist institutions or systems to mitigate even the expected small adverse impact on poverty of prior action on increasing the excise tax on diesel marginally by US$ 0.04.

5.2 ENVIRONMENTAL ASPECTS

83. **Most of the prior actions supported under this operation are not expected to have significant effects on PNG's environment, forests or natural resources.** These prior actions concern establishing a medium-term fiscal anchor, strengthening revenue administration and enhancing revenue compliance, preparing a tax expenditure statement, implementing the IFMS, and adopting new financial sector and financial inclusion strategies, which in the team's judgement will not have significant environmental effects.

84. **The action on diesel taxation supported under the first pillar of the operation is expected to have significant positive environmental effects.** Emissions from diesel combustion have been found to have severe negative local environmental impacts, significantly more so than those from petroleum. Diesel emissions include nitrogen and sulfur dioxides, and particulate matter, which are harmful to human health and have been linked to respiratory illnesses. Reflecting this, many jurisdictions have imposed stricter diesel standards, such as restrictions on the sulfur content of diesel (e.g. Australia) and the nitrous oxide content of emissions from certain vehicle classes (e.g. USA), have mandated the use of diesel

particulate filters and newer engines in certain vehicle classes (e.g. California), or have imposed fees for the use of older engines in central city areas (e.g. London). While mitigating technologies such as particulate filters, exhaust gas recirculation and selective catalytic reduction do exist, these require maintenance, tend to be absent from older vehicles, and have seen significant efficiency increases in recent years. Consequently, in a low-income country such as Papua New Guinea, where the vehicle fleet is old and poorly maintained, and where commercial diesel generators are unlikely to include newer mitigation technologies, shifting the composition of fuel use in favor of petroleum is expected to yield significant benefits for air quality and human health. Annex 4 summarizes the expected poverty and social and environmental effects of the operation.

85. **While there are policies governing environmental impact assessment in PNG, implementation of these policies is limited.** The Conservation, Environment and Protection Authority (CEPA) is mandated and responsible for environmental impact assessment. Four levels of assessment are defined with the regulation, approval for projects commences with the Notification of project to CEPA who will determine whether the project is assessed as level 1 requiring no approval, level 2A and 2B requiring an application or level 3 requiring an application and being submitted to full Environmental Impact Assessment (EIA). Other relevant institutions include; Agriculture, Forestry, Fisheries, Lands, National Planning and Monitoring, Mining and Petroleum, Health, Education, City Authorities such as the NCDC, Local Level Government and Landowner groups. However, coordination is weak between these different agencies and government departments is weak resulting in poor implementation of policies and standards. Moreover, limited capacity due to a shortage of skills and funding, limit CEPA's ability to process and review EIAs, particularly for the more complex proposals with more comprehensive EIA requirements. There may be opportunities to strengthen capacity through the Bank's infrastructure project pipeline.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

86. **The 2015 PEFA reports mixed but generally weak PFM performance.** With PEFA ratings of only 1 A and 4 Bs, but 4 Cs and 21 Ds, PNG's PFM performance has considerable scope for improvement in many areas. PNG scores relatively well on credibility of the fiscal strategy and budget at a total level, although high variances between budgets and actual spending at individual appropriation heads indicate underlying issues. PNG also scores reasonably well on policy based planning and budgeting, and on comprehensiveness and transparency. PNG's general government budget is made publicly available in printed form and online. However, PNG's performance on the other aspects of PFM is weaker, with considerable scope for improvement in accountability – one of the cornerstones of good PFM; the management of public assets and liabilities and associated fiscal risk; and the quality, availability, comprehensiveness and timeliness of bank reconciliations and public accounts. On accountability, the PEFA notes an absence of effective accountability mechanisms stemming from non-compliance with internal controls, numerous reallocations and little evidence of systematic follow up of findings of the Auditor General's Office (AGO) and Public Accounts Committee (PAC) reports.

87. **The PEFA Road Map 2015-2018 recognizes the weaknesses in the PFM systems identified in the PEFA and prioritizes important actions that must be taken to remedy the major identified weaknesses.** While key PFM reforms are planned under the PEFA roadmap, the implementation and internalizing of these is constrained by limitations in capacity at all levels in the Department of Finance and in the line departments, as well as by weak institutions and poor financial integrity. The implementation of the prioritized actions is ongoing, and some of the key actions such as the roll out of the IFMS and improved cash management are included in the policy matrix of this first operation in the DPO series. Other key actions will likely become prior actions in a second operation. However, verification of these and other

actions is in progress. The PEFA Road Map 2015-2018 recognizes the important linkages among the various parts of the PFM system and the many interlinked processes that would need to change to improve PFM. The rollout of the new IFMS system is a fundamental platform for many improvements, however by itself, it will not necessarily achieve the overall strengthening in PFM. A number of development partners are providing substantial assistance with the implementation of the PEFA Road Map 2015-2018, and PNG's broader Financial Management Improvement Program. With the amendment of the PFM Act in 2016, the EU completed an earlier round of PFM reform support, and is in the process of designing the next round. DFAT also provides significant support, including through in-line PFM reform advisers.

88. **A review of the control environment for foreign exchange management was conducted based on available information.** BPNG is currently not subject to the IMF Safeguards Assessments policy.[54] A review by the Bank team of the publicly available annual reports and audited financial statements of BPNG for 2001-2009 and 2012-2016[55] showed: (i) unqualified audit reports in all years reviewed; (ii) since 2012, a "going concern" note regarding significant valuation losses in its foreign currency assets as a result of changes in the kina valuation against other major currencies resulting in net asset deficiency positions of K1,201 million in 2012, K593 million in 2013, K555 million in 2014, K35 million in 2015 and K377 million in 2016; (iii) no commentary on internal controls; and (iv) no published detailed management reports or findings. With respect to the net asset deficiency positions, the annual reports state, "… the Central Banking Act 2000 (CBA) provides that where the BPNG incurs a loss due to change in the value of assets or liabilities, the Minister shall cause to be paid to the BPNG such an amount out of the Consolidated Revenue Fund as necessary to avoid the loss, or may create and issue non-interest bearing non-negotiable notes for an amount not exceeding any payment made by the Minister. The above provisions of the CBA effectively require the Government to provide financial support to the BPNG." As such, a Promissory Note to the value of K1.2 billion was issued in December 2014.

89. **The fiduciary risk rating for the operation is "High" due to the weaknesses noted above in PNG's PFM performance and control environment for foreign exchange management.** PFM weaknesses have resulted in: (i) variations in the composition of budget outcomes (and hence poor predictably of funds for implementation); (ii) delayed financial reports; (iii) concerns about compliance with the internal control environment; (iv) numerous reallocations; and (v) limited audit oversight and follow up arrangements, which impact on the ability to prevent or detect irregularities, misuse and inefficient use of funds. Reviews to date indicate that while the IFMS has been rolled out to national departments, required improvements to the PFM system have not yet materialized as: (i) IFMS rollout only covers recurrent and development funds, not trust funds, so not all government funds are captured under the new IFMS yet; (ii) the available features and controls of the IFMS are not being fully implemented and used, such as bank reconciliations and reporting; (iii) other parts and processes of the PFM system have not yet been changed. Also, given the delays in preparation and submission of financial statements for audit, there has been no audit of the government financial statements since the majority of national departments have been on the new IFMS. Additionally, as reported in the earlier PEFA: (i) numerous reallocations appear to continue; and (ii) lack of systematic follow up of AGO and PAC reports continues to hamper compliance, enforcement and remedial actions.

90. **IDA financing will be disbursed according to IDA disbursement procedures for development**

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[54] PNG was subject to a transitional assessment applicable to countries with IMF arrangements in effect prior to June 30, 2000. In the case of a transitional assessment, the central bank is subject to assessment in only one of the areas of the safeguards framework, namely the external audit mechanism, and normally there is no on-site assessment.
[55] Annual reports and audited financial statements for 2010 and 2011 were not reviewed, since they are not publicly available.

policy operations. The full amount of the credit will be disbursed against satisfactory completion of the specified policy actions and the government agreement as summarized in the Letter of the Development Policy, and adequacy of the macroeconomic policy framework, and is not tied to any specific purchases. Once the credit is approved by the Board and becomes effective, the proceeds of the credit will be deposited by IDA, at the request of the Recipient, into a dedicated Foreign Currency Deposit Account that forms part of the official foreign exchange reserves. As a due diligence measure, within 30 days of receipt the Recipient will provide a written confirmation to IDA when an equivalent amount is accounted for in the government's budget management system. Disbursements would not be linked to specific purchases. The proceeds of the operation would not be used to finance expenditures excluded under the General Conditions for IDA Financing: Development Policy Financing (General Conditions). If, after being deposited in a government deposit account, the proceeds of the operation are used for excluded expenditures as defined in the General Conditions, IDA will require the Recipient to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled.

91. **The Bank will require an audit of the transactions of the dedicated Foreign Currency Deposit Account, including receipt of the disbursement in the dedicated account and transfer into the budget management system of the Recipient**. The report on the audit of the dedicated account should be furnished to the Bank within six (6) months from the end of the Recipient's fiscal year. The audit opinion will cover: (i) the accuracy of the summary of transactions of the dedicated account, including the accuracy of exchange rate conversions; (ii) confirmation that the dedicated account was used only for the purposes of the operation, including that no other amounts were deposited into the dedicated account; (iii) confirmation that all payments out of the dedicated account were not made for any excluded expenditures as defined in the General Conditions; and (iv) for the amounts received into the dedicated account, confirmation that an equivalent amount was accounted for in the Recipient's budget management system.

92. **The closing date for the proposed operation will be March 31, 2020.**

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

93. **The Treasury is responsible for coordinating the monitoring and evaluation of the result indicators for this operation.** The Treasury has set up a high-level team at First Assistant Secretary level to monitor and evaluate the progress of the proposed operation. This team has the capacity to monitor and evaluate the results of the budget support operation. The Treasury will coordinate with the relevant government departments on the indicators for revenue, payment systems and cash management. The Treasury will also coordinate with the Bank of PNG on financial inclusion indicators.

94. **The results indicators chosen for the operation have been selected with a view to the ready availability of data of reasonable timeliness and quality.** Capacity constraints in such a small public administration affect the array, timeliness and quality of available data. Where possible, results indicators have been selected from those that already exist, rather than requiring new data to be produced, diverting scarce capacity from core data collection and analysis functions.

95. **Grievance redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns.

Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

96. **The overall risk rating for the proposed operation is high.**

97. **Political and governance risks to the proposed operation are rated as high**. Even though PNG is a relatively stable democracy, with scheduled elections carried out without fail since 1975 and transitions of power taking place without major disruption, frequent votes of no-confidence occur in parliament. There is thus a risk that the current government may change during the course of the DPO series, possibly entailing policy reprioritization.[56] The history of governing coalitions in PNG also suggests that the policy environment can be unpredictable during the tenure of a coalition. These factors pose political and governance risks to the operation, which are accentuated by the relatively recent nature of the Bank's stronger economic policy dialogue with GoPNG. This risk is being mitigated by the selection of policy and institutional actions that the government has already made significant investments in and indicated strong support for in the policy dialogue with the Bank, or where there is broad political support by both government and opposition (for instance, on strengthening fiscal resilience to commodity price fluctuations). It is also being mitigated by the adoption of a programmatic approach to budget support, to better facilitate implementation support and monitoring.

98. **Macroeconomic risks to the proposed operation are rated as high, with a number of downside risks which could adversely affect the achievement of its results.** A downturn in commodity prices could indirectly reduce activity in the non-resource economy. Consequently, this would limit revenue receipts from the non-resource economy and increase the risk of a deterioration in the non-resource primary balance, hurting the achievement of the result under the first pillar. There is also a risk that political violence and civil disturbances in the Highlands may be prolonged, adversely affecting oil and LNG production. Moreover, the risk of the foreign exchange market imbalance worsening would have subsequent impacts on macroeconomic stability and investor confidence, and could possibly harm the likelihood of future investment. Both could adversely affect achievement of results under Pillars 1 and 2. There is a risk that future resource projects could be provided with large tax incentives, which would increase the revenue forgone through tax expenditures and therefore negatively affect the achievement of the result under the first pillar. There is a government-wide effort to avoid providing generous tax terms given the lessons learnt from resource sector project agreements. Focused analyses of the impact of such resource project agreements on government revenues by the World Bank and IMF have informed the debate within Government, and the review of tax incentives that the Bank is providing technical assistance for will further inform this debate.

99. **The third area of high risk to the proposed operation arises from the fiduciary environment.** The fiduciary risk rating for the proposed operation is high due to the weaknesses in PNG's PFM

[56] Given that elections were held in July 2017, the earliest possible date for such a vote to occur is after December 2018, since there is a moratorium on holding votes of no-confidence for the first 18 months post-election.

performance and control environment for foreign exchange management noted in Section 5.3. Mitigation measures include the adoption of specific disbursement and auditing measures.

100. **The fourth area of high risk to the proposed operation arises from PNG's vulnerability to natural disasters.** PNG experiences frequent and significant natural disasters including earthquakes, volcanic eruptions, tsunamis, cyclones, river and coastal flooding, landslides, and droughts. With the highlands – home to some 2.5 million people in many thousands of small villages – vulnerable to weather extremes of heavy rainfall and drought, and the low-lying coastal areas and coral atolls – home to some half a million people in 2,000 villages – vulnerable to weather extremes and inundation, significant disaster events can badly stretch the capacity of GoPNG. In such instances, budget execution is likely to be destabilized and policy effort is likely to be diverted away from the actions in the policy matrix, potentially undermining the achievement of the PDOs. The selection of policy and institutional actions for which GoPNG has indicated strong support in the policy dialogue mitigates this risk to some extent, as does complementary work by other development partners to strengthen PNG's capacity to prepare for and respond to natural disasters, but in the face of a major disaster, it remains likely – and desirable – that policy priorities will change.

101. **Institutional capacity for implementation and sustainability poses a substantial risk to the proposed operation.** While there are pockets of very strong capacity in particular institutions in GoPNG, capacity is relatively thin across the board, which poses a specific risk to policy and institutional reforms that depend on widely distributed capacity – like the rollout and sustained use of the IFMS. This risk is mitigated by the top priority that DoF places on the IFMS rollout, and by its access to long-term and just-in-time technical assistance from development partners to support this and related aspects of PFM reforms.

102. **Environment and social risks represent a substantial risk to the proposed operation.** The policy action on increasing diesel taxation entails the risk that the relatively small potential adverse impact on poverty expected may prove larger than anticipated. This risk is mitigated by the empirical evidence in support of the expected impact, and by the absence of feedback to the contrary in the first six months of implementation.

103. **Stakeholder risks represent a substantial risk to the proposed operation.** A number of the measures supported by the proposed operation challenge the interests of very powerful stakeholders – including those benefiting or potentially benefiting from overly generous tax incentives, and those benefiting from holding public funds outside the WPA. The key mitigating factor here is the high-level commitment GoPNG appears to have to these reforms – in the first case as a result of lessons learned from PNG LNG, and in the second case because the holding of public funds outside the WPA forces GoPNG to pay to borrow funds that it in fact already has, exacerbating already severe fiscal constraints.

Table 7: Summary Risk Ratings

Risk Categories	**Rating (H, S, M or L)**
1. Political and governance	H
2. Macroeconomic	H
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	S
6. Fiduciary	H
7. Environment and social	S
8. Stakeholders	S
9. Other: vulnerability to natural disasters	H
Overall	**H**

ANNEX 1: POLICY AND RESULTS MATRIX

<table>
<tr><th colspan="2">Prior Actions and Indicative Triggers</th><th>Results</th></tr>
<tr><th>DPO 1: Prior Actions</th><th>DPO 2: Indicative Triggers</th><th></th></tr>
<tr><td colspan="3">Pillar 1: Strengthening fiscal management and revenue performance</td></tr>
<tr><td>1. In order to establish a medium-term fiscal anchor: (i) the Recipient’s Parliament has amended its Fiscal Responsibility Act to require the fiscal strategy to target a zero average annual non-resource primary fiscal balance over the medium term; (ii) the Recipient’s National Executive Council has approved a Medium Term Fiscal Strategy for 2018-2022 that is consistent with a zero average annual non-resource primary fiscal balance over the medium term; and (iii) the 2018 Budget presented to the Recipient’s Parliament is consistent with the MTFS for 2018-2022.
[Completed]</td><td>1. The 2019 Budget is consistent with the MTFS 2018-2022, which targets a zero average annual non-resource primary fiscal balance over the medium term.</td><td>1. The non-resource primary fiscal balance as a percentage of non-resource GDP improves:
Baseline: -4.7 percent (2016)
Target: -0.9 percent (2020)
Source: Department of Treasury, World Bank and IMF</td></tr>
<tr><td>2. To improve revenue administration and enhance compliance: (i) the Recipient’s Parliament has voted its approval of the Tax Administration Bill; (ii) the Recipient’s Parliament has amended the Income Tax Act to make Taxpayer Identification Numbers mandatory; and (iii) the Recipient’s Internal Revenue Commission has approved the establishment of a new Large Taxpayer Office.
[Completed]</td><td>2. The Recipient has: (i) passed the first phase of consequential amendments to existing tax legislation, in preparation for the entry into force of the Tax Administration Act; (ii) completed the first phase of the compliance strategy for data matching between banking data and income tax records to identify business accounts with and without Tax Identification Numbers; and (iii) developed and implemented the Standard Operational Procedural Manual for the IRC’s new risk-based audit referral tool.</td><td rowspan="3">2. Tax buoyancy (i.e. tax revenue as a share of GDP) increases:
Baseline: 14.2 percent (2016)
Target: 14.6 percent (2020)
Source: Department of Treasury, World Bank and IMF</td></tr>
<tr><td>3. The Recipient, through the Department of Treasury and the Internal Revenue Commission, has prepared a tax expenditure statement and made it publicly available as part of the 2018 Budget.
[Completed]</td><td>3. The Recipient’s Department of Treasury will complete the review of tax incentives and the recommendations of the review will be tabled at the Recipient’s National Executive Council.</td></tr>
<tr><td>4. The Recipient has increased the excise on diesel in the 2018 Budget, in order to raise revenue, reduce the distortion between diesel and petrol taxes, and reduce environmental pollution.
[Completed]</td><td></td></tr>
</table>

Pillar 2: Strengthening key building blocks for public financial management and financial inclusion		
5. The Recipient's Department of Finance has implemented the Integrated Financial Management System in national government departments, such that it is being used to record all expenditures other than trust fund expenditures. [Completed]	4. The Recipient has brought bank reconciliations in national government departments representing at least 85 percent of the total expenditure of national government departments up to date.*	3. Accountability and transparency in the use of public funds is improved through timely submission of the annual financial statements to the Auditor General's Office: Baseline: 2014-2016 statements submitted at least 12 months after the end of each fiscal year; Target: 2018-2020 statements submitted within three months of the end of each fiscal year. *Source: Auditor General's Office*
6. (i) To support increase financial inclusion, the Recipient's National Executive Council has approved the Financial Sector Development Strategy and the National Financial Inclusion Policy; and (ii) to increase women's financial inclusion, the Recipient, through the Bank of Papua New Guinea, has launched the Gender Equity and Social Inclusion (GESI) Policy for Microfinance Institutions. [Completed]	5. The Bank of Papua New Guinea will implement a new National Switch platform, available to all regulated financial institutions – including microfinance institutions.	4. Financial inclusion increases, as indicated by the percentage of adults with an account at a formal financial institution: Baseline: 36.96 percent (June 2016) Target: ≥ 50 percent (June 2020) 5. The gender gap in new bank account establishment declines: Baseline: 26 percent of the new bank accounts established 2013-2016 were by women (2016) Target: ≥ 35 percent of the new bank accounts established 2016-2020 are by women (2020) *Source: Centre for Excellence in Financial Inclusion (CEFI) and BPNG*

* For this trigger, 'up to date' means that the latest monthly bank reconciliation to be completed is less than 3 months old – which aligns with the 'green' categorization of DoF's bank reconciliation monitoring platform.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

Papua New Guinea

PRIME MINISTER
PORT MORESBY

20th June 2018

His Excellency Jim Yong Kim
President of the World Bank Group

Dear Excellency,

SUBJECT: LETTER OF DEVELOPMENT POLICY

I am writing, on behalf of the Government of Papua New Guinea, to request a budget support program of USD300 million to support our country's strategy which aims to confront the current set of challenging fiscal and economic conditions.

Following the rapid growth brought about by the commodities boom and the construction of the PNG LNG project, the PNG economy has endured a series of economic shocks. These shocks include falling commodity prices, from which the economy has been slow to recover, and a severe drought in 2015, which affected our agricultural production and the general welfare of our population.

A foreign exchange imbalance has developed, a legacy of the significant investments in the extractive industry construction phase, further constraining economic growth, and there have been reductions in fiscal expenditures to confront rising debt levels and domestic financing constraints. Specifically my Government has had to respond to these shocks by cutting discretionary spending, mostly from the capital budget, which has further suppressed economic activity.

We have been trying to capture the positive momentum in the recent global recovery but, earlier this year, we experienced a 7.5 magnitude earthquake, which will erode much of the gains that we were expecting in 2018.

This Letter of Development Policy sets out the key actions that our Government is committed to undertake to ensure strong, sustainable and inclusive growth in the future. We have formulated a strategy that will combat the current adverse trends and get the economy moving forward again with some momentum.

The strategy will pursue four parallel paths: (i) strengthening fiscal management and revenue performance; (ii) continuing with public finance management reforms; (iii) supporting prospects for inclusive and sustainable growth; and (iv) strengthen monetary and exchange rate policy management.

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Country Development Goals

Our broader priorities and development objectives are guided by the *Vision 2010-2030* and the *Medium Term Development Plans and National Strategy for Responsible Sustainable Development (StaRS)*.

These essentially aim to grow the economy and empower the people by protecting social spending priorities to improve the opportunities and the standard of living through investments in education, health, infrastructure, law and justice, and growing the economy. We are supported by our Development Partners' alignment through country strategies with PNG's development priorities, which include assistance in funding PNG's Sustainable Development Goals, in cross cutting areas such as gender equity and participation, capacity building, climate change and environmental support.

Recent Economic Developments

Our economy has grown by an average of 6 per cent over the last decade. Preliminary analysis shows that in 2017, the economy is anticipated to have grown by 3.0 per cent with the main driver being record natural gas production which more than offset a weakening in the non-mining sector.

While it is still too early to quantify the eventual production and export losses of the earthquake experienced earlier this year, the economy in real terms is expected to contract by around 1.3 per cent in 2018. However, some of the lost production may made up by bringing forward programmed maintenance and optimization activities that will improve technical efficiencies of the PNG LNG project and the Porgera Gold Mine.

What has been most positive however has been the reaction from the local and international community in assisting the Government's relief efforts. In these situations, this help is most welcome and most appreciated.

The inflation outcome (in annualized average terms) for 2017 is 5.4 per cent compared with 6.7 per cent in 2016 which reflects a modest depreciation of the Kina exchange rate over the year offset by subdued aggregate demand and lower spending by the Government. In 2018 and over the medium term, inflation is expected to be contained at 4 percent.

PNG's trade position with the rest of world continues to benefit from the resurgence in commodity prices and we have recorded a substantial current account surplus in 2017 which has been driven by higher commodity prices and increased gas, copper and copra production. However, despite the large current account surplus, the impact of large capital account repatriations due to LNG project debt repayments and the holding of foreign currency accounts offshore by resource companies has meant that the balance of payments and foreign exchange reserve levels have been under some stress.

Given the impact of the earthquake on the resource sector production in 2018, the current account is expected to be adversely affected, although higher commodity prices may mitigate the impact to some extent. Importantly, the disconnection between the current account surpluses and foreign exchange inflows is expected to continue for some time which reflects both the holding of export receipts in foreign currency accounts under the provisions of respective project development agreements and tax concessions particularly related to accelerated depreciation that income tax receipts.

Outlook and Macroeconomic Policies to Support Stability and Growth

Despite the immediate challenges, the outlook for growth remains broadly positive when considering the recovering global economy, the ongoing proactive reforms the government is implementing and the potential mining and gas projects on line for development in the immediate term.

We fully appreciate the importance of macroeconomic stability for our development agenda and in this regard, the fiscal, financial, monetary and exchange rate policies will aim to achieve sustainable inclusive economic growth, low inflation and prudent debt levels, as well as address the foreign exchange imbalance faced by the country.

Strengthening Fiscal Management and Revenue Performance

Fiscal policy aims to consolidate fiscal trends, notably, through strengthening the ongoing efforts and reforms aimed at achieving improved revenue trends, whilst engineering sustainable and efficient public spending. The strategy also deliberately cushions the effects of fiscal adjustments on the vulnerable in a manner that creates opportunities for employment creation, productivity and inclusiveness.

The fiscal framework itself has also been refined to cushion procyclical characteristics associated with fluctuations in global commodity prices and to reinforce macroeconomic resilience and strengthen fiscal management. Specific actions implemented to date include:

(i.) Amendments to the Fiscal Responsibility Act to require the Medium-Term Fiscal Strategy (MTFS) to target a zero average annual non-resource primary fiscal balance over the medium term;

(ii.) Publishing of a Medium Term Revenue Strategy (MTRS) 2018-2022 aimed at improving tax administration and building and broadening a revenue base that is able to finance the Government's expenditure plans on a sustainable basis through tax revenues generated in an efficient and fair manner and through improving the collection of non-tax revenues; and

(iii.) Adherence to PNG's debt management strategy that ensures funding is available to meet the fiscal needs of the Budget when it is required and at the lowest cost within a manageable risk framework where a 30 per cent debt to GDP ratio is targeted over the term of the debt strategy. The strategy also focuses on efficient management of both public financial assets and liabilities,

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(iv.) the development of the domestic financial sector, recognition of impacts of the Kina exchange rate and the development of the market for PNG external debt.

Other specific reforms include Parliament passing; (i) a Tax Administration Act; (ii) an amended Income Tax Act to make taxpayer identification numbers mandatory; and (iii) legislation to increase the excise tax on diesel. Furthermore, the Internal Revenue Commission (IRC) has commenced the establishment of a new Large Taxpayer Office and published a tax expenditure statement in consultation with Department of Treasury and going forward we envisage completing all ongoing revenue reforms to improve revenue performance.

Continuing with Public Financial Management Reforms

My Government also remains committed to expediting a number of public finance management reforms in accordance with the Public Expenditure and Financial Accountability (PEFA) Roadmap 2016. Comprehensive amendments were made to the Public Finance Management Act and the Government is currently in the process of finalizing the revised Finance Manual.

The Government is addressing identified structural issues preventing transparent and effective use of public monies including accelerating reforms around the management of the public service and in particular the associated wage bill. The Government through the establishment of the Public Sector Reform Working Group (PSRWG) and the Organisational, Staffing and Personnel Emolument Audit Committee (OSPEAC) is continuing with efforts to improve institutional and administrative systems that will nurture and encourage proper management of public resources, improve fiscal management and transparency in budgeting.

Our medium term fiscal strategy is aimed at reducing the relative allocations between recurrent spending in favour of a greater allocation towards public investment, whilst maintaining spending on the Government's key priorities and economic enablers particularly in education and health.

This is supported by reforms in a number of other areas including legislative amendments, optimisation of procurement processes, management of arrears and better management of contract and capital projects.

Specific reforms in situ and implemented to date include:- (i) the installation of the Integrated Financial Management System public accounting software in all national government departments; (ii) Parliament passing the Public Money Management Regularisation Act which requires public revenues held by all revenue collecting agencies to be remitted to the Consolidated Public Account in a timely manner; and (iii) the adoption of a two-stage sector–level budgeting process.

Going forward, we plan to continue to implement reforms to strengthen the budget process and we expect to contribute to improvements in the quality of spending through better expenditure prioritization and better expenditure planning.

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Supporting Prospects for Inclusive Growth

In relation to the structural policy landscape, my Government will continue to pursue a comprehensive national reform agenda to support greater private sector participation at the micro-level aimed at creating an enabling and conducive environment for the growth and development of small to medium sized enterprises. As part of this reform agenda, the Government will partner with key stakeholders in removing barriers to doing business and investment in PNG.

In this regard, we have gazetted the Public Private Partnerships (PPPs) Act (2014) to encourage a more coordinated approach to PPP programs. This new Act creates a transparent, predictable and robust process for PPP project development to reduce the risks associated with project development.

Specifically, the PPP Act: (i) establishes a Public–Private Partnership Center to assist the government in developing, tendering and implementing PPPs; (ii) establishes a PPP Forum and Steering Group; and (iii) specifies the powers of key public bodies to enter into PPP arrangements.

In addition, we are also pursuing a *Gender-Equitable Financial Inclusion Strategy* for micro-finance aimed at providing access to micro-finance for both men and women, to promote inclusive growth and reduce poverty.

My Government is also focused on improving access to electricity through the recently adopted *National Energy Policy (NEP)* which provides some guidance on clear and measurable outcomes for the energy sector, including initiatives to increase the use of renewable energy, with specific initiatives around the rural population. Furthermore, we are developing a separate Natural Gas Policy for the use of locally extracted natural gas to provide electricity.

Monetary and exchange rate policies

Monetary and exchange rate policies also fit within the broader policy framework to stabilize and diversify the economy. We have devised a strategy to strengthen our monetary and foreign exchange policy frameworks.

In respect of monetary policy, the key issues that need to be resolved are: (i) the current excess liquidity in the banking system; (ii) the transmission mechanism for monetary policy; and (iii) the need to enhance the communication with market players. In this regard, the government's reforms include:

(i.) *Strengthening the Repo facility with IMF review and support.* Currently there is no intra-day repo, and the overnight repo is not secure (not securitized or collateralized). Going forward, the central bank will establish an intra-day repo and all repos will be securitized with government security bills.

A Master Repurchase Agreement has been drafted and circulated to the commercial banks for review. These measures should help improve liquidity management.

(ii.) *Raising the cash reserve requirement (CRR) either on all deposits or only on public sector deposits.* The central bank will decide on whether to increase the CRR on all deposits or only on public sector deposits after an assessment of the recently passed Public Money Management Regularisation Act on commercial banks' liquidity.

The Act requires public funds held in various trust accounts in the commercial banks to be transferred to the main Treasury consolidated revenue account. To date, approximately 90 redundant or non-compliant trust accounts out of a total of 340 trust accounts have been closed and their balances transferred to the WPA.

(iii.) *Setting the Kina Facility Rate (KFR) on a market-based interest rate to signal the monetary policy stance announced each month.* This aims to transform the KFR into a reference policy rate signaling and transmitting the monetary policy stance of the Central Bank by linking the KFR to a relevant money market interest rate, such as the 28-day central bank bill rate (set at the auctions) or the 28-day commercial bank deposit rate.

(iv.) *Communicating the new monetary policy framework to market players and potential investors.* The targeted audience to communicate the new strategy and reforms therein include commercial banks, the Department of Treasury and the Chamber of Commerce.

(v.) *Review of the central bank's financial programming model.* IMF's PFTAC support of this measure is confirmed to enhance consistency and linkages of policy measures between the four macroeconomic accounts – fiscal, monetary, real and external sectors. The review is expected to start within 6 months.

In respect of Foreign Exchange (FX) Policy, the key issues to be resolved are: (i) the shortage of foreign exchange in the FX market which has led to a build-up of unserved payment orders; (ii) the non-functioning inter-bank foreign exchange (spot) market which was inactive due to the imbalance between foreign exchange inflows and outflows; (iii) a lack of monitoring tools to ensure compliance with the Foreign Exchange and Gold Regulations and the Central Bank's directives; and (iv) lack of transparency and limited competition in the foreign exchange market.

In solving these imbalances, actions already taken include:

(i.) *Issuing of a Directive to commercial banks to stop undertaking trade financing.* In recent years, commercial banks have intensified the use of trade financing: the foreign exchange currencies they received were not brought to the inter-bank foreign exchange (spot) market but, rather, loaned to their resident customers, with a repayment requested in foreign exchange, in violation of the Foreign Exchange and Gold Regulation. This practice has deprived the spot market of FX liquidity.

(ii.) *Issuing of a Directive to commercial banks to cease approving onshore foreign currency account (FCAs) applications and move the approval back to the*

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(iii.) *central bank.* Delegating the approval of onshore FCAs to commercial banks has led to some malpractices such as granting these accounts to those who do not have their own sources of foreign currency. Unlike exporters who have their own sources of foreign currency, many of the other beneficiaries, such as importers, individuals and some government agencies have accessed FX in the spot market to keep in their onshore FCAs.

In addition, the holders of all existing onshore FCAs were directed through their commercial banks to reapply to the Central Bank to justify why they should have an onshore FCAs. A good number of onshore FCAs were closed down following this exercise and it is expected that this measure will reduce the build-up of FX balances in individual and company accounts and will increase transactions in the FX spot market.

(iv.) *Effectively utilizing the new SWIFT Scope reporting software to monitor international transactions of commercial banks.* By using the SWIFT Scope software, the central bank will be able to more effectively monitor international financial transactions (e.g., inflows, outflows, currency used, sending and receiving countries). Furthermore, with the automation of reporting, there will be less errors in manual "typing" of the data in reports received from commercial banks.

The use of SWIFT Scope is thus expected to significantly improve the accuracy of reporting balance of payment transactions by providing a 'snapshot' of what could be expected in the future when the commercial banks submit their reporting forms.

The next set of actions to be pursued by the Central Bank include:

(i.) *Reforms to Central bank's intervention strategy in the FX market.* This comprises:

a. *Changing the allocation of foreign currency to commercial banks from targeted earmarks to wholesale allocation.* This measure is expected to reduce the inefficiencies and distortions involved in the targeted allocation which went to selected nationally strategic (critical) sectors such those involved in providing fuel, food, transportation and telecommunication services.

b. *Use of non-mineral import cover (with a prudent target) as a benchmark for the forex reserve buffer.* Currently, the central bank uses total imports against FX reserves as a guide for assessing the adequacy of the foreign exchange buffer. Given that the petroleum and mineral sector use their own offshore foreign currency accounts for their offshore payment obligations, non-mineral import cover will be used as a guide.

As in the past, a conservative, prudent, target will be used. This measure is expected to increase the central bank's supply of foreign exchange to the spot market.

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c. *Review of intervention strategy in the FX market with IMF support.*

(ii.) *Review of the operations in the FX interbank market including Foreign Exchange and Gold Regulations with IMF support.*

(iii.) *Increase the number of authorized FX dealers in the interbank market.* Currently, there are only 6 authorized dealers in the FX market; 4 commercial banks and 2 finance companies with a further two new finance company applications being processed. It is expected that a larger number of dealers in the market will increase competition and assist in the proper functioning of the FX market.

(iv.) *Automate the reporting and recording of trade flow data.* Currently, exporters and importers manually fill out forms which are sent by commercial banks to the central bank periodically. Thus, the capture of the trade data is fraught with errors such as misclassification and lengthy time lags.

Automation is expected to significantly increase the accuracy and timeliness of trade data and the current account balance.

(v.) *Auditing of mining, oil, logging and fishing companies' international transactions.* This measure has two objectives: (i) ensuring that mining and oil companies comply with approval conditions for holding an offshore foreign current account (FCA) and (ii) cross-checking international transaction data with other sources like Customs system.

(vi.) *Contribute to the review of all major project development agreements (PDAs) with a view of better informing future contracts for resource project development.* This is to ensure the agreements are in line with the fiscal regulations, taxation arrangements, FX requirements and development objectives of the Government for sustainable growth.

Conclusion

In all, I am writing, on behalf of my Government, to request a Development Policy Operation of USD300 million to support our country's strategies.

Yours Sincerely

HON. PETER O'NEILL, CMG, MP
Prime Minister of Papua New Guinea

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ANNEX 3: FUND RELATIONS

Papua New Guinea—Assessment Letter for the World Bank
July 6, 2018

1. **In recent years, the Papua New Guinea (PNG) economy has been adversely affected by exogenous shocks and weak macroeconomic policies.** Adverse developments include the end of a major investment boom in the natural gas sector in 2014; falls in commodity export prices; a severe drought in 2015-16; and a large earthquake disrupting gas production and exports in 2018. The fiscal authorities were slow to adjust to lower long-term revenue prospects from gas and minerals production, leading to fiscal deficits that have become increasingly difficult to finance domestically.[57] In response to the worsened terms of trade and weakening of foreign exchange (FX) inflows, the Bank of PNG (BPNG) used administrative measures to slow depreciation of the Kina. This has led to severe compression of imports and a FX orders backlog of around $1 billion.[58] FX reserves declined only modestly, and at end-2017 amounted to $1.7 billion (slightly above 5 months of imports).

2. **Following a large earthquake in February, GDP is projected to fall by 1.6 percent in 2018 from estimated growth of 2.5 percent in 2017**. The earthquake disrupted production and exports of natural gas (LNG), oil, and minerals. Activity in the non-resource sector remains subdued, dampened by FX shortages. In 2019, a rebound in gas production is projected to boost growth to 3.5 percent, and from 2020 onwards, new investments in gas and minerals production are likely to support growth. CPI inflation declined to 4.7 percent at end-2017, and is expected to ease further to 4 percent during 2018.

3. **The new government, elected in 2017, has begun to address the main fiscal policy challenges.** A number of one-off revenue measures helped bring the deficit down from 5.2 percent in 2016 to an estimated 2.2 percent of GDP in 2018. The government has also developed a medium-term strategy for further fiscal consolidation and sustainability. The main measures include: (i) implementation of a medium-term revenue strategy, with IMF technical assistance, to reverse a trend decline in fiscal revenues; and (ii) strengthened monitoring and control of the government payroll.[59] In addition, IMF-supported improvements in the government's financial management information and control systems are continuing. Together, these measures should enable a further gradual consolidation and achievement of the government's medium-term debt/GDP target of 30 percent.

4. **The authorities are working to secure external funding to cover the fiscal deficit and address the FX shortage**. In May, they drew down the remaining $200 million of a $500 million Credit Suisse syndicated loan, and are now preparing the issuance of a $500 million

[57] Financial institutions' portfolios are mostly overweight on government securities, while corporates have little appetite for government debt.
[58] Estimates of the overvaluation of the Kina range from 10-30 percent (including the impact of FX controls). Although PNG has a current account surplus exceeding 20 percent of GDP (underpinned by large exports of LNG), it also has very large structural financial outflows, reflecting debt service and profit remittances associated with foreign financing of minerals sector development.
[59] The projected fall in government spending relative to GDP in 2019 partly reflects better payroll control and partly the rebound in GDP post-earthquake.

sovereign bond. These funds, together with the first tranches of ADB and World Bank budget support and identified funds from a few other sources, could largely clear the backlog of FX orders while reducing the government's domestic currency debt.

5. **The Bank of Papua New Guinea (BPNG) appears to be intent on addressing the FX shortage**. At the Spring Meetings, BPNG proposed a series of measures to increase the supply of FX, decrease excess liquidity, and overhaul its FX and monetary operations. In this context, BPNG has requested TA from the IMF to assist in formulating strategies for eliminating excess liquidity in the domestic financial market and re-establishing a functioning FX market. Eliminating the FX backlog and adjusting the exchange rate are essential to restoring the FX market. An IMF TA mission is scheduled to visit BPNG in August. BPNG staff have confirmed that they will no longer provide direct guidance to banks on how FX intervention should be allocated to different uses, which will remove a foreign exchange restriction under Article VIII of the IMF Articles of Agreement. BPNG has also initiated discussions of its reform strategy with banks.

6. **BPNG is also preparing to reduce excess liquidity in the financial system**.[60] The BPNG indicated that they will begin to reduce excess liquidity in the system by increasing reserve requirements and/or reducing rollover of maturing short-term government debt. A major government objective in the use of the FX borrowing is to facilitate lengthening the maturity structure of government debt.

7. **Outlook and risks**. Implementation of the fiscal and monetary and exchange rate policy strategies outlined above would substantially address PNG's current macroeconomic challenges and position it well to benefit from the next resource boom, while limiting the risks of Dutch disease.[61] The main downside risk is that the authorities may move too gradually in adjusting the exchange rate, clearing the FX orders backlog, and reducing excess liquidity. This would continue to hamper growth in the short term as well as dampen investment and future growth of the non-resource sector.

8. **IMF relations.** PNG is an IMF surveillance country. The 2017 Article IV consultation was concluded by the IMF Executive Board on December 29, 2017, and IMF staff visits took place in March and June 2018. The next Article IV mission is planned for September 2018. PNG is a substantial contributor to the financing of the Pacific Financial Technical Assistance Center and makes extensive use of IMF technical assistance. The IMF is providing PNG with a resident advisor to assist with implementation of the Medium-Term Revenue Strategy.

[60] Despite excess liquidity, credit growth is very weak, reflecting lack of demand for credit. Cutting excess liquidity is needed to restore effectiveness of monetary policy instruments.
[61] The projections in Table 1 do not incorporate an exchange rate adjustment and its macroeconomic effects.

Table 1. Papua New Guinea: Selected Economic and Financial Indicators, 2014–22

Nominal GDP (2016):	US$21.1 billion 1/
Population (2016):	7.9 million
GDP per capita (2016):	US$2,342
Quota:	SDR 131.6 million (14th Review: SDR 263.2 million)

	2014	2015	2016	2017	2018	2019	2020	2021	2022
			Est.	Est.	Proj.				
			(Percentage change)						
Real sector									
Real GDP growth	15.4	5.3	1.6	2.5	-1.6	3.5	3.1	3.4	3.5
Resource 2/	69.2	39.0	6.3	4.3	-9.4	8.3	5.0	5.0	5.0
Non-resource	7.0	-3.1	-0.1	1.9	1.4	1.9	2.3	2.8	2.9
Agriculture, forestry and fishing (share)	17.8	18.4	19.2	19.0	18.9	19.1	19.4	19.6	19.9
Mining and quarrying (share)	9.1	7.7	8.8	9.2	8.4	8.6	8.8	9.0	9.1
Oil and gas extraction (share)	11.3	14.1	11.4	11.2	12.7	12.3	11.2	11.0	10.8
CPI (annual average)	5.2	6.0	6.7	5.4	4.2	3.8	3.8	3.8	3.8
CPI (end-period)	6.7	6.3	6.6	4.7	4.2	3.8	3.8	3.8	3.8
			(In percent of GDP)						
Central government operations									
Revenue and grants	20.9	19.2	17.7	18.1	19.5	17.1	17.3	17.5	17.6
Expenditure and net lending	27.2	23.6	22.9	20.9	21.6	19.5	19.4	19.2	19.2
Net lending(+)/borrowing(-)	-6.3	-4.4	-5.2	-2.8	-2.2	-2.3	-2.1	-1.8	-1.6
Non-resource net lending(+)/borrowing(-)	-8.6	-5.6	-5.9	-3.9	-2.9	-2.9	-2.7	-2.3	-2.2
			(Percentage change)						
Money and credit (percentage change)									
Domestic credit	23.5	15.8	24.6	-0.2	-8.8	4.3	5.2	6.0	4.9
Credit to the private sector	3.5	3.4	7.2	-3.6	-4.3	3.7	4.8	5.8	6.9
Broad money	3.4	8.0	10.9	1.7	10.0	-5.8	6.8	5.5	4.3
Interest rate (182-day T-bills; period average)	5.3	7.1	7.4	7.1	6.7	7.3	7.8	7.8	7.4
			(In billions of U.S. dollars)						
Balance of payments									
Exports, f.o.b.	8.8	7.8	8.7	9.6	9.2	10.5	10.2	10.3	10.4
Of which: Resource sector	7.1	6.6	7.1	8.0	8.0	9.0	8.7	8.8	8.9
Imports, c.i.f.	-4.5	-2.7	-2.0	-2.5	-2.6	-3.6	-3.7	-3.7	-3.8
Current account (including grants)	0.3	2.5	4.6	4.8	4.7	4.9	4.4	4.4	4.4
(In percent of GDP)	1.3	12.0	24.1	24.0	22.7	22.8	20.0	19.2	18.3
Gross official international reserves	2.3	1.9	1.7	1.7	3.0	2.2	2.3	2.3	2.2
(In months of goods and services imports)	5.9	6.0	4.6	5.1	7.0	5.1	5.2	5.0	4.8
			(In percent of GDP)						
Government debt									
Government gross debt	27.1	32.2	36.9	36.9	36.1	36.0	35.8	35.5	35.2
External debt-to-GDP ratio (in percent) 3/	6.2	7.9	9.3	10.0	11.4	11.7	11.7	11.9	12.6
External debt-service ratio (percent of exports) 3/	1.1	1.0	1.2	1.3	1.6	1.8	3.2	3.2	4.6
Exchange rates									
US$/kina (end-period)	0.3855	0.3325	0.3150	0.3060	...	...	...	...	...
NEER (2005=100, end-period)	114.2	116.4	104.2	101.0	...	...	...	...	...
REER (2005=100, end-period)	123.6	131.4	123.6	124.0	...	...	...	...	...
Terms of trade (2010=100, end-period)	97.4	102.1	93.4	83.6	87.6	85.4	85.1	87.4	88.4
Nominal GDP (in billions of kina)	56.8	57.1	59.3	63.8	68.0	71.7	75.5	80.5	85.9
Non-resource nominal GDP (in billions of kina)	45.2	44.7	47.3	51.0	54.2	57.5	61.2	65.3	69.8

Sources: Department of Treasury; Bank of Papua New Guinea; and IMF staff estimates and projections.

1/ Based on period average exchange rate.

2/ Resource sector includes production of mineral, petroleum, and gas and directly-related activities such as but excludes indirectly-related activities such as transportation and construction.

3/ Public external debt includes external debt of the central government, the central bank, and statutory

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects, positive or negative (yes/no/to be determined)
Pillar 1: Strengthening fiscal management and revenue performance		
1. In order to establish a medium-term fiscal anchor: (i) the Recipient's Parliament has amended its Fiscal Responsibility Act to require the fiscal strategy to target a zero average annual non-resource primary fiscal balance over the medium term; (ii) the Recipient's National Executive Council has approved a Medium Term Fiscal Strategy for 2018-2022 that is consistent with a zero average annual non-resource primary fiscal balance over the medium term; and (iii) the 2018 Budget presented to the Recipient's Parliament is consistent with the MTFS for 2018-2022.	No	Yes – positive
2. To improve revenue administration and enhance compliance: (i) the Recipient's Parliament has voted its approval of the Tax Administration Bill; (ii) the Recipient's Parliament has amended the Income Tax Act to make Taxpayer Identification Numbers mandatory; and (iii) the Recipient's Internal Revenue Commission has approved the establishment of a new Large Taxpayer Office.	No	Yes – positive
3. The Recipient, through the Department of Treasury and the Internal Revenue Commission, has prepared a tax expenditure statement and made it publicly available as part of the 2018 Budget.	No	Yes – positive
4. The Recipient has increased the excise on diesel in the 2018 Budget, in order to raise revenue, reduce the distortion between diesel and petrol taxes, and reduce environmental pollution.	Yes – positive	Yes – negative
Pillar 2: Strengthening key building blocks for public financial management and financial inclusion		
5. The Recipient's Department of Finance has implemented the Integrated Financial Management System in national government departments, such that it is being used to record all expenditures other than trust fund expenditures.	No	Yes – positive
6. (i) To support increased financial inclusion, the Recipient's National Executive Council has approved the Financial Sector Development Strategy and the National Financial Inclusion Policy; and (ii) to increase women's financial inclusion, the Recipient, through the Bank of Papua New Guinea, has launched the Gender Equity and Social Inclusion (GESI) Policy for Microfinance Institutions.	No	Yes – positive