

Budget Policy Statement 2019

1. Statement of Responsibility

The 2019 Budget Policy Statement is developed and finalised in line with the Public Finance and Economic Management (PFEM) Act (CAP 244). It incorporates Government's strategic priorities that are in line with the National Sustainable Development Plan and satisfies the legal conditions set out in section 9 and 10 of the Public Finance and Economic Management Act.

Section 9 requires the Government to:

- specify its economic and financial policies, including those relating to key economic and fiscal variables; and
- state the discipline it will adhere to in its economic and financial dealings.

Section 10 requires the Government to:

- state its long term objectives for fiscal policy in terms of major economic and fiscal variables;
- specify the main strategic priorities guiding the preparation of the budget;
- indicate Government's targets for fiscal and economic variables; and
- provide an assurance that the long term objectives outlined in the statement are:
 - a. consistent with the Principles of Responsible Fiscal Management laid down in section 22 of the PFEM Act; and
 - b. Consistent with previous year's Budget Policy Statement – that is, policies have remained consistent over time or, otherwise, justifications have been made for their departure.

The 2019 Budget Policy Statement confirms that the Government will continue to enhance economic growth and at the same time boost revenue, manage state debt and improve expenditure in both productive and social sectors in order to enhance service delivery and improve well-being for all the people in Vanuatu. On this note, Donor support for new and ongoing projects will continue to be implemented.

As the Minister and Director General responsible for deciding and implementing the economic, financial and fiscal policy of the Government, it is our honour to confirm that 2019 Budget Policy Statement is in line with section 9 and 10 of the Public Finance and Economic Management (PFEM) ACT (CAP 244).



Hon. Gaetan PIKIOUNE (MP)

Minister of Finance & Economic Management
Ministry of Finance & Economic Management



Letlet August
Director General
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2. Economic and Financial Policies

The Government will continue to put more emphasis in formulating and implementing economic, financial and fiscal policies that are in line with the principles of responsible fiscal management outlined in section 22 of the PFEM ACT. The economic, financial and fiscal policies, objectives and targets are crucial for optimum allocation of financial resources to achieve priority outcomes that are stated in the 2019 budget policy priorities and at the same time assist Vanuatu to withstand and manage financial crises as well as manage the economic and fiscal risks. Similarly, the Government will continue to undertake reforms, improve service delivery and promote investment and business friendly environment that will enhance economic growth and at the same time promote service delivery, in a way that is financially sustainable and does not jeopardize future economic growth.

The implementation and achievement of Government's policies, objectives and fiscal target will be guided by the principles of responsible fiscal management in section 22 of the PFEM Act. The principles of responsible fiscal management require the Government to pursue its budget policy objectives that:

- Maintain Government borrowings at manageable levels;
- Maintain public assets in good condition;
- Manage fiscal risks prudently;
- Maintain stable and predictable tax rates.

Principles of Responsible Fiscal Management

1. Managing, total State debt at prudent levels so as to provide a buffer against factors that may impact adversely on the level of total State debt in the future, by ensuring that, unless such levels have been achieved, the total overall expenditures of the State in each financial year are less than its total overall receipts in the same financial year;
2. Achieving and maintaining levels of State net worth that provide a buffer against factors that may impact adversely on the State's net worth in the future;
3. Managing prudently the fiscal risks facing the State; and
4. Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

3. Budget Policies

The formulation and the implementation of the 2019 budget policies is consistent with Public Finance and Economic Management Act (CAP 244). The Budget policies, objectives and targets are crucial in the process of developing and finalising the 2019 budget. The 2019 Budget policies consist of:

1. Budget Priorities for 2019;
2. Economic and Fiscal Targets for 2019; and
3. Long Term Fiscal Objectives

a) Budget Priorities for 2019

The 2019 Budget Policy priorities is prepared in line with the PFEM ACT (CAP 244) capturing the essence of the National Sustainable Development Plan or the People's plan 2030.

The 2019 budget policy priorities will guide the allocation of Government's fiscal space and it continues to put emphasis on the Government to allocate greater financial resources to both the productive and social sector in order to enhance economic growth, improve service delivery and all round well-being for citizens of Vanuatu.

The current government reaffirms its position on policy priorities 2019 that it will remain committed to the reforms it is currently undertaking. These reforms are essential as the country prepares itself for graduation from Least Developed Country (LDC) status in 2020.

The core strategic policy priorities for 2019 are set out in the following six expenditure priority outcomes:

Priority Outcome 1: Improved business opportunities and investment environment

The Government of Vanuatu remains committed to support the Productive Sector in 2019 as the country prepares to ratify the PACER Plus trade agreement, and as Vanuatu works towards graduation from LDC status. Support to the productive sector is aimed at increasing production and promoting value addition. For primary products that have comparative advantage in both the domestic and export markets. This will lead to greater employment opportunities in the islands, increase investment and boost tax revenue to support the domestic economy.

Land issues such as disputes have been an obstacle for investments in the past, the current government is embarking on land reform and dealings (acquisition) to boost public investments in 2019. The government wants to continue to create an enabling environment to encourage more Public Private Partnerships and Joint Ventures in order to spread economic development and benefits throughout Vanuatu.

- **Increase rural production** – through improving farming practices with rural extension officers; by increasing farming skills through training and knowledge sharing; by facilitating access to mechanised farm equipment; and by supporting Ni-Vanuatu to embrace commercial approaches to farming and fishing for ensuring food security and providing income to improve socio-economic livelihoods,
- **Increase tourist development** – through improving facilities (seafronts, wharves, airports and roads) in key tourist destinations; by attracting local and foreign investment in the sector; and by developing skills of Ni-Vanuatu to develop tourist attractions, products and services in the islands.
- **Promote Trade, Industry, and Cooperatives** – through promoting a business-friendly environment for trade and investment; by supporting local and foreign investment in industry and manufacturing of Value added products; by promoting the cooperative movement in Vanuatu; and by increasing financial literacy to enable access to finance.
- **Expand revenue base** - through compulsory acquisition of land in Provinces to boost investment and business opportunities; by enacting income tax legislation; and by developing the capabilities needed to deliver it, through review and desegregating of business licences categories for all economic sectors to promote local and foreign investments through acquisition of land for public investments in infrastructures to support economic growth and expand the revenue base.

Target Results:

- Increased participation of Ni-Vanuatu in the formal cash economy, particularly in agricultural production, fishing, transport, retail and products and services for tourists.
- Increase participation and support to the Cooperative movement in Vanuatu.
- Increased local and foreign investment in the agricultural value chain; in hotels and tourism services; and in manufacturing.
- Increased tourist arrivals and visitors, while looking into new emerging markets, and greater distribution of tourist revenues across the provinces
- Increase tax base revenue by the end of 2019, over a more diverse and equitable tax base
- Strengthened land management systems particularly in reducing backlog of cases involving land disputes and compulsory land acquisition for investment and development opportunities

Priority Outcome 2: Improved Infrastructure

Infrastructure is among other government core priority in 2019, roads, wharf and airports, including energy and telecommunication infrastructure will continue to strengthen connectivity between essential government services, agriculture, value addition, tourism and markets in the future through:

- **Improved Airport infrastructure-** continuing through developing of Code E terminal at Bauerfield International Airports, acquiring lands for airport development, upgrading major key airfield, sealing existing air space agreement.
- **Rehabilitation and improved maintenance of high priority rural infrastructure-** through partnership with private sectors, development partners and local communities to improve rural (including feeder) roads, upgrading of wharfs and jetties, building of warehouses infrastructures, and completing transport infrastructure maintenance fund strategies.
- **Expand access, and reduced costs of telecommunication and energy-**through promoting alternative sources of energy in rural areas such as solar energy , hydropower, and other renewable sources of energy, improving accessibility and affordability of telecommunication in rural areas,

Target Results:

- To continue support the implementation and completion of on-going infrastructure project with required standards.
- Improved trade and transportation within and between islands
- Continue to effectively implement the new office and structure of the Office of the Maritime Regulator to effectively regulate the Maritime Sector.
- Improved access to energy and electricity in rural areas, and to continue to support the National Green Energy Fund.

Priority Outcome 3: Improved education quality, accessibility and Training outcomes for children and young people

In 2019 the Government will continue to support increased access and quality of education for boys and girls, equip them with relevant skills and knowledge and continue the development of the national human resource to contribute to the country's economic growth through:

- Expanding greater access to education- through accelerating progress made in universal early child care and primary education from year 7 to year 10

- Improving the quality of education-through ensuring teachers are paid and trained, reforming the curriculum in line with NSDP, and upgrading school facilities and resources including those affected by TC PAM,
- Increasing higher education opportunities- through completing revised Vanuatu Education Strategy, developing national human resource development plan, and formalising early childhood education and life-long learning opportunities within the education system
- Improving opportunities for employability and entrepreneurial skills development-through technical and vocational skills training and increased support for out of school youth

Target Results:

- Increased budget support to cater for ECCE and tuition fees for yr7- yr10
- Improved teaching and learning
- Increased budget support for training programmes targeting out-of school youth

Priority Outcome 4: Improved Quality Health Care

The Government will continue to strengthen health services and accelerate progress towards health targets in the SDGs and NSDP through:

- **Strengthened health service management and information system** to track NSDP indicators and support evidence-based decision making
- **Improving population access to health services through integrated planning and fair allocation of resources**-through strengthening of financial management and process and efficiency use of resources.
- **Reduced the incidence of communicable and non-communicable diseases**-through better health promoting interventions and strengthening of outreach services.
- **Strengthen Collaborative action across sectors and within the health sector** - to create a healthier environment and address major health issues.

Target Results:

- 50% of Corporate positions within MOH filled on permanent basis

- 50% of Government owned Health Facilities are compliant with Role Delineation and essential health service minimum standards for human resourcing, infrastructure functional space and equipment requirements
- Vanuatu to have a density of 24 HWs per 10,000 population
- The national mortality ratio is reduced to less than 80 per 100,000 live births
- Reduce incidence of communicable and non-communicable diseases
- TB incidence in Vanuatu is reduced by 20%
- Annual parasitic incidence rate (API) for all cases of malaria is no more than 1 per 1,000 population
- 95% of population of children aged between 12/23 months received three doses of combined diphtheria, tetanus toxoid & pertussis vaccine in a given year, administered by a trained health professional
- Prevalence of obesity among the adult population is <32.9%
- Under-5 mortality rate is reduced to at least as low as 29 per 1,000 live births

Priority Outcome 5: Improved Service Delivery

The Government will continue to target improvements in the Public Service and continue to support the Decentralization policy that it is currently embarking on, as to ensure that the essential services reach people in remote areas of Vanuatu through strengthening local authorities and municipal institutions.

Foreign policy plays a critical role in terms of attracting aid and investment into the country to complement government priorities. The government also aims to further strengthen the coordination of donor resources in line with national objectives.

- **Improved delivery mechanisms**, particularly reviewing the decentralisation Act to empower area council, establishing a governance accountability mechanism, and developing and rolling out a sub-national work and training manuals on planning and budgeting
- **Enhanced partnership with donors**, community based organisations and non-government organisations-through reviewing existing NGOs arrangement and institutions, developing accountability mechanism with kastom authority, and developing memorandum of understanding with key service providers.

- **Strengthened institutions** at the head of the executive to continue to drive and implement reforms including the National Sustainable Development Plan;
- **Improved national security services-** through strengthening of the security services, institutions and correctional facilities.

Target Results:

- Commence the process of reviewing the Government Machinery to improve government services delivery
- Enhanced devolution process with systematic improvements in the framework and mechanism for Service Delivery at Sub-National level
- Developed structure for Malvatumauri, provincial, area, tribe and village councils,
- Complete area council governance mechanism
- Strengthen new VANGO establishment /signed MOU with Government
- Greater integration of donor programmes into ministry work plans and the annual budget

Priority Outcome 6: Improved Resilience and Natural Resource Management

The government will continue to ensure the protection of the natural environment on land and at sea, upon which much of our social and economic wellbeing depends, as well as continuing to build our resilience to climate change and natural hazards through:

- Improved climate change adaptation and disaster risk management governance- to mitigate the effects and impacts of climate change;
- Increased equitable, accessible and affordable water supply and sanitation- to increase the access of safe drinking water sources for the communities;
- Stronger institutions and governance that protect our environment and natural resources; to have a strong legislation and governance framework that protect our natural resources;
- Increase resilience in the productive sector- to improve resilience to the agriculture and fisheries produce.

Target Results:

Ensure a higher profile of Climate Change & Disaster risk governance in the Government Planning and Budgeting process to manage Disaster and Climate Change Impacts.

- Scaling up the implementation of Water Coverage- prioritize Water from 2018-2020 as a basic human right for the people and societies of Vanuatu.
- Fully support the implementation of resilience of the Agricultural & Fisheries Sector- including activities/programmes aimed to safeguard rural population's livelihoods/food source and production.
- Support to implementation of National environmental policies and programs to promote sustainable development with a focus on decision to 'Ban Plastic Bags' Implementation.

Priority Outcome 7: SOC 4 & SOC 5: Social Inclusion, Security, Peace and Justice

The Government will continue to ensure that our society is inclusive which upholds human dignity and where the rights of all Ni- Vanuatu including women, youth, and the elderly and vulnerable groups are supported, protected and promoted and also to enhanced a society where the rule of law is upheld and access timely justice to everyone through;

- **Build the institution capacity of national security forces** and ensure they are adequately resourced to meet performance targets- to have a strong national security and police forces
- **Implement gender responsive planning and budgeting processes-** to include gender in the process of planning and budgeting for all Ministries;
- **Promote traditional governance and Christian principles** for a peaceful society; to have a peaceful society that is based on our Melanesian values.

Target Results:

- Develop a national security framework to enhance inter agency coordination
- Increase capacity of Police security forces through proper trainings and resources
- Gender responsive planning and budgeting
- Provide resources to strengthen the coordination of the Human right activities
- Continue to promote a just and peaceful society based on Melanesian values.

- Implement the National Legislation governing youth development

Allocation of Fiscal Space to Priority Outcomes

It is proposed that the overall fiscal space, once determined through analysis by the Department of Finance and Treasury, should be allocated by MBC to resemble as closely as possible the following allocation between the seven Priority Outcomes above:

- Priority Outcome 1: Improved Business Opportunities and Investment Environment - 20%
- Priority Outcome 2: Improved Infrastructure - 20%
- Priority Outcome 3: Improved Education Quality and Accessibility - 15%
- Priority Outcome 4: Improved Quality Health Care - 10%
- Priority Outcome 5: Improved Service Delivery -10%
- Priority Outcome 6: Improved Resilience and Natural Resource Management - 15%
- Priority Outcome 7: SOC 4 & SOC 5: Social Inclusion, Security, Peace and Justice- 10%

Ongoing programs from the development partners

The government and its development partners will jointly implement programs in 2019. In 2018, the government held several dialogue with development partners that have existing programs in Vanuatu and discussions on how the partners could align their programs with those of the government in 2019 through stronger working relationships and coordination at the national and at the sector level.

TC Pam Recovery needs

The government's TC Pam Recovery program will continue in 2019 rolling over unfinished work from 2018 and the recovery programs that are yet to be carried out if any. The priority needs under the recovery are the productive sector, infrastructure and public buildings, water and Sanitation, Health and Education. The economic strengthening program is expected to continue in 2019 as some of the recovery programs will still be implemented due to delay in the implementation in 2018. These programs under the recovery will be implemented in parallel and complement those of development partners and government recurrent programs.

(b) Fiscal Policies

The implementation of Government's fiscal policies continues to be guided by the principles of responsible fiscal management. Together with Government's reforms and sound financial management, the implementation of fiscal policies will continue to put more emphasis in growing the economy, increasing Government revenue to meet its expanding expenditure programs and activities to enhance service delivery and improve well-being for all the people in Vanuatu. On this note, the Government will continue to develop and implement new revenue initiatives, allocate more financial resources to both the productive and social sector and create a business friendly environment that will also boost private investment.

C) Economic Update in 2018

World Economic Outlook (WEO)

According to the April 2018 World Economic Outlook (WEO), the International Monetary Fund (IMF) reported that the global economic activities is projected to pick up by 0.1 percentage point in 2017 to 3.8 per cent from 3.7 per cent in January 2018 WEO. Growth in 2018 and 2019 is expected to propel by 3.9 per cent in accordance with the IMF April WEO revision. Growth in the US expanded as firms regain confidence following developments in tax policy reform while growth lag is expected in the UK economy building up from developments surrounding BREXIT, dragging behind growth in other Euro Areas in 2018 as inflationary pressure expects to hamper investment prospect on the region over the medium term. Nonetheless, growth across major Advanced Economies (AEs), including the UK remains balanced with records of strong export growth emerging; driven by strong external demand conditions.

In the Developing and Emerging Markets (DEMs), growth forecasts remain mixed with a rebalancing in China after a one off peak in export in 2017 while geopolitical factors continue to affect growth momentum in the Middle East. Generally across the ASEAN economies, growth is expected to maintain momentum with expectations of keeping pace over the medium term sourcing from improved supply conditions of major commodities including fuel. For importing countries, this is crucial as they rebalance the fiscal burden of importation costs and for exporting countries, rising exports will bolster fiscal revenues and at the same time stabilize the country's current account balance. Growth in both the Indian and the Chinese economy is anticipated to remain strong at 7.4 percent and 6.6 per cent in 2018 reflecting anticipated stable commodity exports. Despite these recent developments, continued monitoring and assessment of key macroeconomic fundamentals remains the global agenda for economic policy in order to anchor global demand.

Even with stable global commodity and currency prices, headline inflation rates are picking up due to excess demand over the supply of major commodities. This will add pressure on commodity prices and expectations of wage rise due to tighter global labour markets. In both AEs and emerging markets, inflation is projected at 2.0 per cent in 2018 and 4.6 per cent compared to a 1.7 per cent and a 4.0 per cent growth in 2017.

Vanuatu Economic Outlook (VEO)

Vanuatu's economic growth in 2017 was revised upwards by 0.2 percentage point from 4.3 per cent in budget to 4.5 per cent in April 2018. In April meeting, the economy is estimated to expand by 3.4 per cent in 2018 followed with a further 3.2 per cent growth in 2019 before normalising to 2.6 per cent growth in 2020.

The current projection showed that 2018 growth will be driven by services sector with a contribution to growth of 2.0 per cent followed by a 0.8 per cent growth contribution from the industry sector while agriculture sector is expected to contribute around 0.5 per cent to 2018

projected Gross Domestic Product (GDP). Following few years of tranquillity, real estate and finance and insurance activities have shown signs of activity owing to the growing confidence in the economy. This is supported through continuous marketing in major tourist destination and news of the Bauerfield International Airport upgrade that is associated with the current political stability.

Expectations for copra and kava to maintain production momentum after surge in 2016 due to supply shocks and improved demand conditions driving prices higher. Recently, copra prices have weakened due to improved global supply conditions having direct feed into the domestic supply chain. Despite decline in global copra prices, closely traded commodities such as cocoa, coffee, kava and beef production are expected to partially offset possible loss of foreign earning inflows. Given the increasing and unpredictable impact of natural disasters in the country, domestic production is likely to be very volatile thereby imposing strains on policy making especially on the productive sector. While the Government has shifted attention towards the productive sector where majority of Vanuatu population are subsistence farmers, there must be innovative policy to assist farmers to produce disaster resilient crops. This is where the Government should focus as envisaged in its direction in *Policy Priority number 6*.

Vanuatu experienced a construction boom since 2016 which has contributed in sustaining the economy. The overwhelming support from development partners combined with stability in the Government has restored confidence and at the same time reinforced implementation of infrastructure development projects. This has created much needed employment in the industry sector; with spill over effects felt throughout the economy. This is very important as the Government continues to embark on infrastructure development policy to facilitate trade and at the same time safeguard Government policy on inclusive and sustainable infrastructure development. As expected, pursuing this objective will be maintained over the medium term with Government's intention to allocate approximately 20 per cent of its 2019 planned financial resources towards this objective. Meanwhile, the expected approach is be coherent with careful sequencing to avoid possible overheating of the economy; with possible short-term macroeconomic implications.

The services sector has recovered after the impact of TC Pam. Tourism arrivals have been driven by day arrivals with persistent challenges with air arrivals. The gradual increase in air arrivals is however inconsistent with the occupancy rates at Vanuatu's hotels and accommodations. A noticeable trend is slowly emerging with more air arrivals visiting friends while others returning home, especially foreigners with properties in Vanuatu. Anecdotal facts suggest that more visitors travelling by air are visitors at the lower income brackets; which explains the increasing number of air arrivals as evidenced by fully sold out flights on Vanuatu's national carrier Air Vanuatu and increasing passenger fees to Airports Vanuatu Limited but was not consistent with development in the hotel and accommodation sector. Furthermore, increase in Foreign Direct Investment has been noted boosting growth in the real estate and finance and insurance sector. With all these developments, the sector is

projected to expand by 3.1 per cent in 2018 before normalising at an average 2.3 per cent over the 2019-20 period.

Monetary update

The Reserve Bank of Vanuatu gradually tightened its monetary policy stance in May 2018. The Bank's policy rate was increased from 2.85 per cent to 2.90 per cent and its Statutory Reserve Deposits ratio increased from 5.00 percent to 5.25 percent. The Liquid Asset Ratio continued to be maintained at 5.0 per cent. The gradual tightening in monetary policy stance was necessary given the accumulation of excess liquidity in the banking system and the expected built up in inflationary pressures.

Macroeconomic stability was achieved in 2017 through to the first three months of 2018, as the two main objectives of monetary policy; foreign reserves and inflation remained within targets. Foreign reserves is currently sitting at over 8 months of projected import were well above the minimum threshold of 4 months of import cover,. Similarly, annual inflation though recorded 3.2 percent in the December quarter of 2017, is still within the RBV's target range of 0-4 percent. The banking system's liquidity continued to remain at elevated levels reflecting the continuous built up in excess reserves. The accumulation of excess reserves was associated with easing monetary policy stances, subdued economic conditions as portrayed by the persistent weak growth in private sector credit and net inflows of foreign reserves to the RBV. The two credit facilities; the Import Substitution and Export Financing Facility (ISEFF)¹ and the Natural Disaster Reconstruction Credit Facility (DRCF) ²remained active.

Money growth was steady throughout 2017 up to the first three months of 2018, driven mainly by net foreign assets (NFA's) and slight pickup in domestic credit. The slight pickup in domestic credit reflected to a large extent liquidity injection created by the fiscal authority, increase in domestic credit and to a lesser extent, the pick-up in credit extended to individual and households. Loans for commercial purposes remained subdued, reflecting the lack of demand triggered by uncertainties with the government tax policies and other structural issues. Growth in NFA remained robust in 2017 until March 2018, owing mainly to inflows recorded by both the RBV and Other Depository Corporations reflecting much needed reconstruction related funds. Money supply growth is expected to remain steady in 2018 attributed mainly to upward movement in NFA as foreign reserves is expected to remain sufficient and within the RBV threshold at the end of 2018. Private sector credit is expected to improve but at a slower pace throughout the year owing still to uncertainties in the economy.

Balance of payments

¹ ISEFF is a back-to-back lending facility to businesses offered through commercial banks.

² DRCF is offered to businesses for the purpose of rehabilitation and reconstruction post TC Pam disaster.

Vanuatu's balance of payments (BOP) posted a deficit of VT 620 million at end of December 2017. This implies a net outflow of foreign exchange. The Current Account deficit (CAD) expanded by 16 percent over the quarter and by 17 percent over the year reflecting net outflows of Vanuatu's International trade of goods and a reduction in official grants. With most public capital projects in completion stage, external financing reduced significantly at the end of December 2017. The financial account had also reported a huge reduction in deposit taking corporation's placements abroad. Nonetheless, the official reserves continued to sit comfortably above the threshold level of 4 months at 11.2 months of import cover at the end of December 2017.

Over the years up to March 2018, the Official Reserves stood approximately at VT 42 billion which is sufficient to finance a projected 10 months of import of goods cover, but with recent developments, this is likely to be affected but comfortably strong. Current account deficit is forecasted to worsen slightly in 2018, as the US dollar denominated goods value are expected to appreciate and external debt servicing elevated. Foreign reserves is expected to remain above the threshold in the short term supported by expected inflows of foreign exchange from government services and transfers. There is expectation of pressures on the level of official foreign reserves in the medium term with Government debt servicing and imports demand rise.

Inflation

Headline inflation remained well within RBV target 0-4 percent target range in December quarter 2017. An increase in domestic food prices specifically fruits and vegetables led to increased food prices, and the slightly stronger fuel prices contributed to increased prices of transport and utilities (although weakened in the last quarter) with year-on-year inflation recording 3.5 percent in the September quarter and 3.2 percent in the December quarter of 2017. Year-on-year headline inflation is forecasted to increase in 2018 above the target band of 0 - 4 percent, pushing beyond 5.0 per cent for the March quarter of 2018 before receding to above 4 percent by December quarter 2018 and lower in 2019. Inflation is primarily driven by the one-off effect of the increase in VAT (from 12.5% to 15%) effective beginning of 2018 and the impact of increase in public salaries and wages on demand. On the downside, the expected weakening in demand-driven construction activities related to on-going donor-funded infrastructure projects has reduced the output gap (positive output gap is narrowing). The recent increase in import commodity prices (specifically of rice) and slightly higher fuel prices are upside risks to inflation forecast. Over the medium-term, the preliminary year-ended headline CPI inflation is projected above 4 percent in 2018, and 2 and a half percent in 2019.

(d) Budget Management

The finalisation and implementation of Budget 2019 will be in line with the Public Finance and Economic Management Act (Amendment) Act [CAP 244]. In 2019, the Government will continue to support the revenue generating agencies in collecting the existing revenues and new revenue initiatives as well as improve the administration, compliance and enforcement

of taxes and fees so that there is enough cash to meet Government expenditure programs and activities. However, the Government will continue to borrow at prudent level in the event that there is insufficient revenue to meet Government expenditures. In managing the Government budget and cash flow, the Government will continue to implement some revenue and expenditure control measures as well as managing state debt at prudent level to achieve Government's fiscal policy objectives and targets, including a balance budget in 2019.

(e) Government Debt and Borrowing

Both 2017 and 2018 has seen a few major infrastructure projects completed or nearing completion. There have been no major changes to total debt forecasts since 2015 so debt stock is still in line with World Bank & IMF Debt Sustainability Analysis (DSA). However, this debt level is set to decline this year as the Government is currently embarking on a momentous debt reduction plan.

Vanuatu Reducing Debt (Advance repayment) - a Debt Policy milestone for the Government

Great efforts have been undertaken this year to reduce Government's debt levels. Domestic debt for example, was reduced by VT 1.1 billion in February 2018 alone. This is the first time ever that such a huge amount has been paid off completely, reducing domestic debt stock total to VT 6.8 billion.

For External Debt, the Government is currently making arrangements to reduce external debt burden by VT 1.5 billion by end of 2018. This will result in many external loans being completely repaid. The selected loans to be repaid are from ADB, World Bank and EXIM Bank of China. The advance repayment of loans is a big achievement compared to other countries regionally and is set to continue in the short term.y. The reduction of debt will create borrowing space in future for priority Government projects that would have bigger economic impact and increase Government revenue.

There is a new DSA Framework to be released in July and our moderate risk level of debt can be assessed thereafter. The Government's Present Value of External Debt to GDP is expected to peak in 2022 at around 32 per cent from the current level of around 20 per cent - the threshold for moderate strength in debt management policies and Least Developing Countries (LDC) is 40 per cent.

A call for better discipline in choosing new, responsible infrastructure financing and adhering to debt strategies is strongly recommended.

A full consideration of risks should be made while choosing new infrastructure financing to highlight the nature and diversity of debt vulnerabilities in our current debt moderate risk level. If not careful, debt servicing priorities would result in decreased Government social services (Education & Health) in the near future if revenue levels do not rise from its current levels.

Fiscal space must be assessed with appropriate measures taken and we must adhere to our debt management strategy – debt limit policy in the near term of having a 30 per cent only baseline threshold for example.

As such new revenue initiatives must be implemented to prepare for the debt repayment obligations in the near future when principal payments begin. All new borrowings must be on concessional terms only (35 per cent grant element). The debt management strategy in place recommends for the Government to pursue prudent fiscal policies and recommends for spending reprioritization, including tax reform implementation, and continue to seek grant financing for infrastructure investments.

Given Vanuatu's vulnerability and risks to natural disasters, the Vanuatu Government is likely to adopt a strategy to internalising the risks to growth associated with natural disasters and boosting the readiness to respond and manage their destructive forces. Nonetheless, the Government has embarked on instituting ex-ante measures that would require different layers of preparedness including but not limited to strengthening risk assessment and planning, building domestic fiscal buffers, ensuring external buffers and promoting and adopting resilient infrastructure and adequate maintenance. This now forms an integral part of the 2019 Budget Policy Statement to help guide budget discussions in order to identify and disclose fiscal risks including natural disaster and climate change³.

Publicly Guaranteed Debt

The Government from time to time is called to guarantee debt on behalf of a State Owned Enterprise. The present level of Guaranteed Debt is around VT 2.8 Billion – 93% of which is held by Air Vanuatu (Operations Limited). The Government has embarked also on a major review of State Owned Enterprises and will have major reforms from new SOE bills that will assist in overhauling the current SOE environment for the Government and have a better platform targeting improved financial sustainability & performance, customer service, good governance and transparency.

(f) Revenue and Taxes

The need for more revenue to fund essential services has been a priority for the national government. Subsequently, we have seen more efforts by the Government to raise sufficient revenue.

In 2017, revenue collections which were 22.2 per cent of GDP, exceeded budget target by 22.3 per cent. The Ministry of Finance and Economic Management (MFEM), Ministry of Internal Affairs (MIA) and the Citizenship Office recorded higher than budgeted revenue target in 2017.

³ Refer to Economic and Fiscal Targets 2019 Table

The Citizenship office has shown positive recovery from their transition to the new Vanuatu Development Support Program (VDSP) and the Vanuatu Contribution Program (VCP). Revenue collected exceeded budget target by 108.3 per cent.

MFEM has also witnessed strong growth in the collection from VAT which has exceeded its budgeted target by 7.1 per cent in 2017. Implementation of the new Department of Customs and Inland Revenue (DCIR) functional model in terms of its new operational design is seen to be making progress. Improvement in compliance has also contributed to their revenue performance. The strong revenue performance from this Ministry is also attributed to higher than budget revenue collection from import duties and related excises taxes.

MIA has also recorded a higher revenue from related immigration and border control activities. This trend is anticipated to continue in 2018.

Several ministries were not able to meet their revenue target for 2017 and therefore more effective monitoring is needed to ensure budgeted revenue collections from these Ministries in 2018. Revenue collected from these sectors are largely fees and charges imposed for services provided.

On taxation matters, the Government is committed to meeting the requirements of Global Forum on Transparency and Exchange of Information for Tax purposes (G-20). Major upcoming activities for Vanuatu in 2018 will be the second peer review to be undertaken by the Organisation for Economic Co-operation and Development (OECD) secretariat and Vanuatu's commitment to join the Convention on Multilateral Administrative assistance in Tax matters. Such undertakings are vital and Vanuatu needs to ensure important elements are in place before the peer review is done.

Vanuatu has enacted the International Tax Corporation Act in June 2016 which is the necessary legislation required to implement exchange of information for tax purposes with the possible implementation start date being June 2018. *With the effective exchange of information, Vanuatu will no longer be regarded as a tax haven by the OECD*, since one of its criteria of being a tax haven is listed as having laws or practices in place that prevent the effective exchange of relevant information with other governments on tax payers benefiting from the low or no tax jurisdiction. These are significant progresses made by the Government to ensure it fulfils its international obligations in the area of taxation.

Possible New Revenue Initiatives

The Government is still not in a position to make a decision on timing of implementation of income tax. The potential revenue from this revenue package, which also includes reduction in import duties and removal of costly fees and charges, is expected to be in excess of **VT 3 billion**. This revenue policy initiative will still be an agenda for the Government to decide in the near future.

Modernisation and Non-Tax Revenue Review

The priority for MFEM in 2018 would be to ensure an effective and efficient revenue administration and review non-tax revenue to eliminate inefficient fees and charges.

Modernising the Department of Customs and Inland Revenue (DCIR) operations is key feature of the revenue reforms and its effort in building capacity and operational strength has been done over recent years. Some features of the DCIR modernisation includes service based model where taxpayers are helped to meet their obligations, electronic lodgement and payments, risk based compliance management, client charter, code of conduct and performance standards, introduction of annual reporting against key performance indicators, modernised electronic services, enhanced customs procedures aimed at improving trade facilitation, and modern appeal and review procedures. It has also been recommended that tax and revenue laws be modernised to be prepared to implement the tax and revenue reform.

The Government is also working on reviewing all non-tax fees and charges with the objective that all fees and charges are well managed, efficiently collected and aligned to the Government's strategic objectives.

Outstanding Revenue

The Council of Ministers (COM) in their Decision in June 2017 instructed DCIR to recover outstanding VAT debt from State Owned Enterprises and Businesses and implement strategies to ensure their future compliance.

Revenue Policy and Implementation Unit is recommending to write off all outstanding VAT debt of wholly owned Government SOE's and municipalities to free up valuable DCIR resources to focus on improving lodgement and payment of current tax debts as they fall due. With the establishment of the new Revenue Governance Committee in April 2018, the Revenue Policy and Implementation Unit (RPU) is provided the responsibility to work together with the Ministries concerned in their outstanding revenue recovery efforts. If all goes according to plan then the Government can hope to recover up to over VT 200 million worth of outstanding debt. Also, clearing the backlogs will help improve current collections. The Ministry of Lands and the Ministry of Infrastructure and Public Utilities recorded the largest amount of revenue that is yet to be collected. This comprises 80% of the VT 1.6 million outstanding revenue (excluding VAT).

As always the case, the implementation of all approved Government expenditure programmes and activities for the budget year depends on its revenue collection. The Government will continue to boost its revenue collection through strengthening the administration, compliance and enforcement of its existing taxes as well as newly introduced fees and charges.

(g) Expenditure Programme and Policies

In 2019 the Government's expenditure program, activities and policies will be in line with the 2019 Budget Policies. Therefore, the allocation of Government's fiscal space for New Policy Proposals (NPPs) will resemble as closely as possible following the seven expenditure

priority outcomes outlined in the Government's strategic priorities. Government will continue to adopt sound financial management and fiscal discipline to ensure that there is sufficient cash to implement Government's expenditure program and policies as well as its expenditure priority outcomes.

4. New Policy Proposals (NPPs)

The 2019 budget will comprise of NPPs that resemble as closely as possible the Government's expenditure priority outcomes. However, the allocation of Government's fiscal space towards the NPP will be strictly considered for funding in 2019 if they have been approved by the head of the agency and submitted in the Government financial management systems. In addition, they are:

- able to be accommodated within the overall aggregate fiscal envelope;
- well researched and detailed proposals to reinforce Government's key policies, programs and activities;
- within the capacity of the Ministry to implement over the suggested time frame;
- able to expand and develop the economic capacity and growth rate of the country; and
- Must be financially sustainable if it is to become a recurrent activity.

The 2019 budget will also include donor funded NPPs. Therefore, the Government will continue to emphasise the importance of using the Government Financial Systems to fund expenditure programmes and policies that are in line with the Government priorities.

5. Economic and Fiscal Targets for 2019

The economic, financial and fiscal policies will continue to be implemented in line with the Public Finance and Economic Management Act (CAP 244) in order to achieve the following objectives and targets:

2019 Economic and Fiscal Targets	Long term fiscal objectives
Budget balance Balanced Budget	Recurrent balance is positive over the medium-term
Revenue Recurrent revenue is forecast to be at least 21.0 per cent of GDP	There is a broad revenue base with sufficient revenue to meet the budget balance objective. Recurrent revenue growth rate to be higher than expenditure growth rate
Expenditure Recurrent expenditure is forecast to be at least 21.0 per cent of GDP	Expenditures are consistent with the budget balance objective

Debt Maintain Net Present Value (NPV) of external debt at a maximum of 30 per cent of GDP.	Nominal Public and Publicly Guaranteed Debt-to-GDP ratio to remain below 60 per cent of GDP associated with disaster and climate change related risks
Economic Growth Growth forecast at 3.2 per cent	Annual economic growth rate averages at least more than population growth rate (2.3 per cent)
Inflation Inflation forecast at 2.5 per cent	Annual inflation rate remains below 4.0 per cent

6. Conclusion

The 2019 Budget Policy Statement is finalised and consistent with the legal conditions specified in the PFEM Act [CAP 244]. This will form the basic guiding principles of finalising 2019 Budget before parliamentary appropriation. Therefore, the Government will continue to make sure that agencies adhere to this Budget Policy statement in the process of finalising the 2019 budget.