

Budget Policy Statement 2020

1. Statement of Responsibility

This statement of responsibility confirms that the Government's economic and financial policies have been included in this Budget Policy Statement which is in line with sections 9 and 10 of the Public Finance and Economic Management (PFEM) Act (CAP 244).

Section 9 requires the Government to:

- specify its economic and financial policies, including those relating to key economic and fiscal variables;
- 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 the 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 the previous year's Budget Policy Statement – that is, policies have remained consistent over time or, otherwise, justifications have been made for their departure.

The 2020 Budget Policy Statement incorporates the Government's economic and financial policies and 2020 Budget Policy Priorities which will guide the allocation of financial resources and finalisation of the 2020 Budget. These policies are in line with the National Sustainable Development Plan (NSDP) 2030 with the main objectives and intentions to increase investment, increase employment, boost revenue, manage state debt and at the same time enhance economic growth, improve service delivery and wellbeing for all the people in Vanuatu.

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 2020 Budget Policy Statement is in line with sections 9 and 10 of the Public Finance and Economic Management (PFEM) ACT (CAP 244).



Hon. Gaeton 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

Over the past years, the Government has undertaken several fiscal reforms while implementing economic and financial policies that enhance economic growth and improve the wellbeing of all people in Vanuatu. It has aimed to do so in a way that is financially sustainable and does not jeopardize future economic growth.

These reforms and policies will remain consistent in 2020 with the main objective and intention to achieve the 2020 budget policy priority outcomes, including the economic and fiscal targets outlined in this Budget Policy Statement.

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

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 2020 Budget policies are in line with the National Sustainable Development Plan and also comply with the legal requirements of the Public Finance and Economic Management Act (CAP 244). The Budget policies, objectives and targets are crucial in the process of developing and finalising the 2020 Budget. The 2020 Budget policies consist of:

1. Budget Policy Priorities for 2020;
2. Economic and Fiscal Targets for 2020; and
3. Long Term Fiscal Objectives

A. Budget Priorities for 2020

The 2020 Budget Policy priorities are 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 2020 budget policy priorities will guide the allocation of the Government's fiscal space. The Government continues to place great emphasis on allocating greater financial resources to both the productive and social sectors in order to enhance economic growth, while improving service delivery and all round well-being for citizens of Vanuatu.

As one of the major commitments in 2020, the Government of Vanuatu will hold the National General Election early next year for the new Government to execute and implement Budget 2020. Through the 2020 policy priorities the current government reaffirms its position 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 2020 are set out in the following seven budget policy priority outcomes:

Priority Outcome 1: Improved business opportunities and investment environment

The Government of Vanuatu remains committed to supporting the productive sector in 2020 as the country prepares to ratify the PACER Plus trade agreement and progress further in other trade agreements, while working towards graduation from LDC status. Support to the productive sector is aimed at increasing production and promoting value addition to primary products where there is comparative advantage in both the domestic and overseas markets. This will lead to greater employment opportunities in the islands, increase investment and boost tax revenue to support the domestic economy.

Land issues and disputes have been an obstacle for productive investments in the past, thus the current government is embarking on land acquisitions and land reform to boost public investment in 2020. 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 the country.

- **Increase rural production** – through improving production capacity practices with rural extension officers; by increasing technology and skills via training and knowledge sharing for farming, fishing, livestock, forestry and biosecurity; by facilitating access to mechanised farm and fishing equipment; by supporting Ni-Vanuatu to embrace commercial approaches to farming and fishing to ensure food and nutrition security and provide income to improve socio-economic livelihoods.
- **Increase investment opportunities** – through acquisition of land to boost productive investments and to increase public investments in infrastructure to support economic growth and expand the revenue base; and strengthening Private Sector Development.

- **Increase capacity for managing biosecurity and border control risks** – through efficiently staffing border control offices, proper training, equipment for monitoring, and standard equipment for destruction of confiscated or high risk imports.
- **Increase national tourist development** – through raising the standards of Ni-Vanuatu SMEs through investment in their products and services; investment in green infrastructure (energy efficiency, renewable energy, waste management and water conservation initiatives); encouragement of Ni-Vanuatu entrepreneurship and increased support to diverse, niche Ni-Vanuatu-owned tourism businesses and improvement of infrastructure (seafronts, wharves, airports, and roads).
- **Promote trade, industry, and cooperatives** – through promoting a business-friendly environment for trade and investment; by supporting local and foreign investment in industry and in manufacturing of value-added products; by promoting the co-operative movement in Vanuatu; and by increasing financial literacy to enable access to finance.
- **Create Economic Development Zones** – supporting the Government’s decentralization policy through a sound policy and regulatory framework; incentive packages to support establishment of both local and foreign investment in targeted economic sectors to help boost exports and generate additional income and employment opportunities for the rural population.
- **Expand revenue base** – by strengthening the Government Compliance System to collect revenue; by assessing income tax legislation as an option to increase the revenue base and by developing the capabilities needed to deliver it; through review and desegregation of business licence categories for all economic sectors to promote local and foreign investments.
- **Strengthen enforcement of lands legislative framework** – to address the backlog of land cases and strengthen compliance.

Target Outcomes:

- Improved participation rate of Ni-Vanuatu business in the formal cash economy, prioritizing the following sectors: agriculture, fishing, transport and tourism.
- Increased exports by improving Vanuatu’s capabilities to compete in niche markets with outstanding quality of products and services at premium prices in a sustainable and inclusive manner.
- Increased number of local entrepreneurship and increased support to the co-operative movement in Vanuatu including improved access to financial capital and financial literacy and through the Vanuatu Cooperative Business Network.
- Increased earnings and volume of trade due to new and existing trade agreements.

- Improved performance on ‘doing business’ indicators and greater competition in order to increase local and foreign investment in the agricultural value chain, in hotels and tourism services, and in manufacturing.
- Increased number of incineration systems to reduce the risk of environmental exposure to international waste and the associated risk of pests and diseases of biosecurity concern.
- Improved border control and biosecurity by ensuring: staffing and postings at all points of entry (borders); training of officers; equipment for screening, testing and monitoring; proper incineration facilities for the disposal and destruction of biosecurity risks.
- Increased number of tourist arrivals and visitors, assessment of new emerging markets and long haul markets, greater distribution of tourist revenues to rural communities, and strengthened border control measures and capacity.
- Larger, more diverse and more equitable tax revenue base by the end of 2020, with a strengthened Government Compliance System to collect revenue.
- Reduced backlog of cases involving land disputes and compulsory land acquisition for productive investments and development opportunities in both urban and rural areas.

Priority Outcome 2: Improved Resilient Infrastructure

Resilient infrastructure is a core government priority in 2020. Improved roads, wharves and airports, as well as energy and telecommunication infrastructure, will continue to strengthen connectivity between essential government services, agriculture, value addition, tourism and markets in the future.

- **Improved airport infrastructure** – through continuing the development of the Code E terminal at Bauerfield International Airport, acquiring land for airport development, upgrading major key airfields, and sealing the existing air space agreement. The regulatory arm of the industry must also be strengthened to keep up with operational demand.
- **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, upgrade wharves and jetties, build warehouses, and complete transport infrastructure maintenance fund strategies.
- **Expanded access to, 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, as well as improving the accessibility and affordability of telecommunication in rural areas.

Target Outcomes:

- Continued support to the implementation and completion of on-going infrastructure projects, while ensuring that these projects meet the required building standards.
- Strengthened regulatory arm of the aviation industry including an interactive website where clients can file applications and obtain standard information.
- Improved transport infrastructure facilities, including wharves, roads and airports to facilitate trade within and between islands.
- Establishment of the Maritime Affairs Commissioner's office, with the capacity development of personnel and Safer Marine approaches through increased installation of the Marine Aids to Navigation (AToNs) network at identified locations, and development of hydrographic surveys.
- Increased number of households with access to clean energy and electricity in rural areas, by continuing support of the National Green Energy Fund.

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

In 2020 the Government will continue to support increased access to 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.

- **Expanding greater access to education** – through accelerating progress made in universal early child care and primary education from year 7 to year 13.
- **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 the volcanic disasters in Ambae and Ambrym, and TC Hola.
- **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 Outcomes:

- Increased student net enrolment ratio for years 7 to 13.

- Improved support for ECCE.
- Improved training of teachers, and learning facilities.
- Improved teaching materials.
- Maintained student-teacher ratio.
- Improved support to National Tertiary Education.
- Improved support for training programmes through technical and vocational skills development.

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:

- **Strengthening 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 strengthened financial management and processes, and more efficient use of resources.
- **Reducing the incidence of communicable and non-communicable diseases** – through better health-promoting interventions and strengthened outreach services.
- **Strengthening collaborative action across sectors and within the health sector** – to create a healthier environment and address major health issues.
- **Improving health financing through mobilization and pooling of funds for health care** – to develop a National Health Insurance Policy to cater for financial support for Ni-Vanuatu people.

Target Outcomes:

- Increased proportion of managerial positions within MOH filled on a permanent basis.
- Compliance rate of 40% of Government-owned health facilities with the Role Delineation and Essential Health Service Minimum Standards for Human Resourcing, Infrastructure Functional Space and Equipment Requirements.
- Increased number of health workers per 10,000 population.
- Increased number of trained midwives, health facilities, transportation and medicines to reduce the maternal mortality ratio.

- Reduced incidence of communicable and non-communicable diseases, through appropriate measures e.g. review of existing excise tax.
- Reduced tuberculosis incidence in Vanuatu.
- Reduced Annual Parasitic Incidence rate for all cases of malaria.
- Increased vaccination coverage of children aged between 12 to 23 months (three doses of combined diphtheria, tetanus toxoid & pertussis vaccine in a given year, administered by a trained health professional).
- Reduced under-five mortality rate.
- Developed National Health Insurance policy.

Priority Outcome 5: Improved Service Delivery

The Government will continue to target improvements in the Public Service and support the on-going decentralization policy, to ensure that 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, ensuring that they are in line with national objectives.

- **Improved delivery of services** – by reviewing the government machinery and implementing the Decentralisation Act to empower area councils, establish a governance accountability mechanism, and develop and roll out sub-national work and training manuals on planning and budgeting.
- **Strengthened capacity to manage growing external relations** – to continue to expand Vanuatu's global interests.
- **Enhanced partnership with donors, community-based organisations and non-governmental organisations** – through reviewing existing NGO arrangements and institutions, developing accountability mechanisms with *kastom* authorities, and developing memorandums 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 security services, institutions and correctional facilities.

Target Outcomes:

- Completed Government Machinery review to improve government service delivery.
 - Enhanced devolution process with systematic improvements in the framework and mechanism for service delivery at the sub-national level.
 - Completed area council governance mechanism.
 - Developed structure for Malvatumauri, provincial, area, tribe and village councils.
- Established M&E focal points in all ministries.
- Completed National Foreign Policy Framework to complement the recently launched Aid Management Policy Framework.
- Improved labour mobility through strengthened administration of Temporary Labour Movement programs (RSE, SWP and Pacific Labour Scheme).
- Strengthened VANGO establishment.
- Enhanced regionalism through hosting the Pacific Islands Forum and 40th Independence Anniversary.

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, while 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 communities' access to safe and secure drinking water sources.
- **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 of production in agriculture, livestock, forestry and fisheries.
- **Improve Waste Management** services and operations to reduce pollution impacts.

Target Outcomes:

- Developed and implemented National Disaster Risk Management Framework to manage preparation, response and recovery.
- Strengthened National Advisory Board to ensure sustainability of facilitation and coordination of climate financing.
- Development and implementation of a marine spatial plan to meet goals under the National Oceans Policy.
- Improved environmental and climate services in all six provinces in accordance with the decentralization policy. Improved resilience of the agricultural & fisheries sector.
- Improved water safety and security for the entire population.
- Improved waste management and pollution control.

Priority Outcome 7: Social Inclusion, Security, Peace and Justice

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

- **Building the institutional capacity of national security forces and ensuring they are adequately resourced to meet performance targets** – to have strong national security and police forces.
- **Implementing gender-responsive planning and budgeting processes** – to include gender in the process of planning and budgeting for all ministries.
- **Promoting traditional governance and Christian principles for a peaceful society** – to have a peaceful society that is based on our Melanesian values.

Target Outcomes:

- Established National Security Council and National Security Framework.
- Reduced prevalence of crime considering all types of criminal offenses including violence against women and vulnerable groups, human trafficking, cyber-crime, drug trafficking and money laundering.
- Improved border control and protection through capacity building of human resources and the modernization of our border control systems.

- Demarcated maritime boundaries.
- Increased capacity of police security forces through proper training and resourcing, while ensuring that male and female officers are equally supported.
- Drafted guidance notes for gender-responsive planning and budgeting.
- Provided resources to improve coordination of Human Rights activities and Anticorruption Framework.
- Provided support to implement the National Youth Authority Act.

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 stated above:

- **Priority Outcome 1:** Improved Business Opportunities and Investment Environment - 20%
- **Priority Outcome 2:** Improved Resilient 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:** Social Inclusion, Security, Peace and Justice - 10%

Ongoing programs from the development partners

The Government and its development partners will implement programs jointly in 2020. In previous years, the government held several dialogues with development partners that have existing programs in Vanuatu. Discussions included how partners could align their programs with those of the Government in 2020 through stronger working relationships and coordination at the national and sector level. The dialogue will continue in 2020.

TC Pam Recovery needs

The government's TC Pam Recovery program will continue in 2020, rolling over unfinished work from 2019 and any recovery programs that are yet to be carried out. 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 until February 2020 as some of the recovery programs are yet to be implemented following a delay in 2018. These recovery programs will be implemented in parallel and complement those of development partners and government recurrent programs.

B. Fiscal Policies

The Government will continue to formulate and implement fiscal policies in order to achieve the economic and financial objectives and targets stated in this budget policy statement. The formulation and implementation of these policies will be guided by the principles of responsible fiscal management so that 1) state debt is managed at prudent levels and 2) there is sufficient revenue to meet expenditure programs and activities, to improve Government service delivery while enhancing economic growth.

C. Economic Update in 2019

World Economic Outlook (WEO)

The World Economic Outlook of July 2019 presented a global growth forecast of 3.2 per cent in 2019 and 3.5 per cent in 2020. These are downward revisions from the April forecast due to the continuous socio-economic challenges particularly in the Euro area and somewhat in the US, UK, Latin America, Australia and Canada. Whether growth will pick up thus greatly depends on the outcomes of the challenges experienced by these regions.

Growth in advanced economies is projected to be 1.9 per cent in 2019 and 1.7 percent in 2020. The 2019 projection made in July is 0.1 percentage point higher than in the April forecast, driven by the upward revision for the United States. Growth in the United States was expected to be 2.6 percent in 2019, a 0.3 percentage point increase from the April WEO forecast; US growth is expected to decrease to 1.9 percent in 2020 as the fiscal stimulus unwinds. Furthermore, growth forecasts for the Euro area remained at 1.3 per cent for 2019, with a slight increase from 1.5 per cent to 1.6 per cent for 2020. Growth in the emerging markets and developing economies has also been revised downward from 4.4 per cent to 4.1 per cent for 2019 and from 4.8 per cent to 4.7 per cent for 2020. The Chinese economy is projected to grow by 6.2 per cent this year, a slight increase on the previous forecast of 6.2 per cent. This upward revision was due to the implementation of both fiscal and monetary stimulus to offset the negative impact of trade tariffs with the US.

The global inflation forecast for 2019 remains muted due to low commodity prices according to the July forecast. Inflation in advanced economies is anticipated to be 1.6 per cent, keeping the same forecast as in the April WEO. The US economy is currently operating above potential output, as a result of strong domestic demand adding pressure on commodity prices; driving the US inflation forecast of 2.3 per cent. This is expected to be short-lived, after the planned unwind of the fiscal stimulus during the second half of 2019 easing inflationary pressure to normalise at 1.9 per cent in 2020. Core inflation in the Euro area is expected to be 1.3 per cent in 2019 and 1.5 per cent in 2020. Forecasts of inflation in emerging markets and developing economies have moved only slightly, due to relatively stable prices; inflation forecasts for 2019 in most regions have been revised down by 0.1 percentage points compared to the April outlook, to 4.8 per cent.

Despite positive economic growth projections for 2019, global headwinds remain moderately skewed to the downside with much of Asia exposed to cross winds, primarily due to China's effective rate of expansion and trade tensions with the United States. In addition, the existence of tail winds, including a 'No-Deal Brexit' presents much uncertainty over growth in the UK and across the Eurozone, particularly with the potential socio-economic impacts.

Vanuatu Economic Outlook (VEO)

The domestic economy has been driven mainly by the industrial sector for the past 3 years, overtaking the services sector which used to be the main growth driver. The industrial sector growth contribution mainly comes from public infrastructure projects through on-going construction activities. However, growth is expected to wind down this year and over the medium term as major infrastructure projects are now reaching the stages of completion. According to forecasts by the Macroeconomic Committee (MEC), economic growth is expected to be 2.8 per cent in 2019, before increasing to 3.4 per cent in 2020, supported mainly by tourism-related services and major upcoming construction activities; growth is then forecast to rise to 4.0 per cent in 2021.

Expansionary fiscal policies remain in place and continue to be supported by donor partners on publicly-funded projects over the post-Pam reconstruction period. The current expansionary fiscal policy stance is expected to raise domestic demand and boost growth going forward but could also drive up temporary inflationary pressure. With debt rising gradually to finance public investment, it is necessary for Vanuatu's authorities to start thinking deeply about the sustainability of increasing spending through expanding the current tax base in 2020. The government launched *Vanuatu 2030 – People's Plan* early in 2017 with the vision of a stable, sustainable and prosperous Vanuatu. With policies allocated under the three main pillars of this plan, Society, Environment and Economic, economic growth prospects should be diversified, resilient, sustainable and inclusive.

Growth in the agricultural sector is expected increase to 3.1 per cent in 2019, before accelerating up to 4.4 per cent in 2020 and then stabilising at 3.6 per cent in 2021. Major commodities such as copra and cocoa have been affected by recent cyclones and the current low copra price, despite the new government subsidy. Going forward, the current coconut rhinoceros beetle infestation of coconut tree plantations in North Efate poses a risk to the industry if not managed or eradicated. Cocoa production is expected to maintain growth over the medium term given a general increase in production supported by a stable export price. Animal and meat production on the other hand may face a slight reduction over the medium term due to the continuation of the cattle restocking around the country. On the upside, kava production has continued to maintain solid growth and is expected to remain robust over the medium term. Growth in the forestry and fishing sectors is expected to moderate over the medium term supported by various development partners' projects. EDF 11 funding is expected to drive growth in the agricultural sector over the medium term, so it is vital that implementing agencies coordinate and implement the program on schedule.

The industrial sector has been the driving force of the economy in recent years thanks to major government infrastructure projects. Growth in the sector is expected to remain robust at 11.7 per cent in 2019, 9.7 per cent in 2020 and 6.1 per cent in 2021. This solid growth forecast is supported by current ongoing infrastructure projects, including Phase II of the Tanna and Malekula Roads project, the Vanuatu Infrastructure Reconstruction & Improvement Project, Energy access project, Vanuatu Agriculture & Development Project, Vanuatu Agriculture & Development Project, Vanuatu PAM Road Reconstruction and School rebuilding project. These projects are funded through loans and grants, coming to a total of VT 79,752.3 million. Growth over the medium term will be also supported by the Pentecost road project (currently at the negotiation stage) and the Bauerfield air terminal as well as other private investment projects such the Havannah cruise tourism project.

The manufacturing sector in Vanuatu has the potential to achieve solid growth in the medium term, but this will require many policy initiatives to drive this sector forward, particularly given competition through recent trade agreements; the WTO and MSG agreements continue to put pressure on Vanuatu's local industries. Growth in electricity and water is expected to remain stable over the medium term supported by recent and ongoing infrastructure projects, as well as continuous efforts by the Utility Regulatory Authority (URA) on utility providers to meet consumer demand.

The service sector is expected to achieve strong growth of 2.5 per cent in 2019, 3.1 per cent in 2020 and 3.3 per cent in 2021. Recent increases to public sector wages have had positive spill over effects on the retail trade, other wholesale, transport, and finance and insurance as a result of greater demand in the domestic economy. Over the medium term, the government's *Shared Vision 2030* in the tourist industry will increase the aircraft fleet and boost tourism-related services over the medium term. Additional flight routes will be added, including new destinations, which should boost tourist arrivals in Vanuatu thereby increasing activity in accommodation and food services, air transport, finance and insurance, telecommunication and other tourism-related services. Major challenges include building the capacity to accommodate this influx of visitors and maintaining a high standard of services to ensure that Vanuatu is seen as one of the best destinations in the region.

Monetary update

The Reserve Bank of Vanuatu (RBV) continued to maintain an accommodative monetary policy stance throughout 2018 and up to June 2019. The Bank's policy rate remained at 2.90 per cent, while its Statutory Reserve Deposits ratio and the Liquid Asset Ratio continued to be maintained at 5.25 per cent and 5.0 per cent, respectively.

The macroeconomic fundamentals remained sound throughout the first four months of 2019: foreign reserves were at comfortable levels and inflation remained within the target range. At the end of April 2019, foreign reserves were sufficient to finance over 11.9 months of import cover. Similarly, annual inflation was under control. In Quarter 1, 2019, annual inflation was recorded at 2.1 per cent, well within the RBV's target range of 0-4 percent. The persistent build-up of excess liquidity in the banking system reflects 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)² remained active.

Money in circulation gradually expanded throughout the first four months of 2019, though at a slower rate than witnessed throughout the same period of 2018. Growth continues to be driven by net foreign assets (NFA), reflecting the ample level of foreign currency liquidity in the banking system. Domestic credit on the other hand, continued the downward trend since 2018, up to April 2019. In April the decline largely reflected the reduction in net claims on the central government vis-à-vis the banking system. Furthermore, the persistent weak growth in business loans partly attributed to this downward trend. Private sector growth over the year to April 2019 was driven by loans for household and personal consumption. Overall, the banking system remained well supportive of growth as evidenced by high liquidity holdings and sound capital position. Going forward, private sector credit is expected to grow but at a slower rate throughout the year, owing still to uncertainties in government policies on income and corporate tax, and weak domestic demand in the economy. Money supply growth is expected to remain steady throughout 2019 owing mainly to the movement in net foreign assets.

Balance of payments

Vanuatu's balance of payments (BOP) was in surplus during the first four months of 2019. This good performance reflected surpluses in the current account offsetting huge import bills and retained earnings of foreign enterprises. The further improvement in the current account reflected the significant contribution of Government export of services, which boosted the secondary account and the contribution of the seasonal workers programs in Australia and New Zealand leading to an improvement in the primary income account. Import financing continues, however at lower levels than in the previous two years, signifying the winding down of major infrastructure projects and related imports. As of April 2019, the official reserves stood at around VT48.9 billion and sufficient to finance 11.9 months of import of goods cover.

With current developments, foreign reserves are expected to remain above the threshold in the short and medium term mainly due to expected inflows of foreign exchange from major inflow sourced accounts particularly in the primary and secondary income account. Therefore a current account surplus is expected for 2019. On the downside, the value of US dollar-denominated goods is expected to appreciate and external debt servicing to be elevated. In addition, there is expectation of pressures on the level of foreign reserves in the medium term through Government debt servicing and import demands on proposed government projects.

Inflation

Headline inflation remained well within the RBV's 0 to 4 per cent target range in Quarter 1 2019. Annual headline inflation rose from 1.9 per cent in the fourth quarter of 2018 to 2.1 per cent in the first quarter of 2019. A lagged impact of increased fuel prices contributed to increased transport, and housing and utility prices, while a recent pickup in domestic prices of

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.

fruits and vegetables contributed to food price inflation. Inflation in 2018 was driven by the one-off effect of the increase in the Value Added Tax (from 12.5% to 15%) effective from January 2018, which was offset by reduced education prices, and despite increased public wages and salaries, demand pressures have remained subdued. In 2019, inflation is expected to remain low with the upside risk predominantly driven by domestic food prices. Imported food and fuel-related prices remain steadily low, which along with the narrowing output gap, reflecting the expected weakening demand-driven construction activities in the economy (as development projects wane down), present downside risks to inflation forecasts. International fuel prices declined 8.9 percent over the year to US\$67 per barrel in May 2019 and this is expected to have a lagged effect on domestic transport and utility prices. Further changes to the government policy decision on fees and charges and market conditions also remain a determinant factor of price movements in the medium term. Vanuatu's fixed exchange rate regime will continue to anchor inflation in the medium-term, as the year-on-year headline inflation is forecast to remain stable in 2019 and 2020. The year-end inflation forecast is expected to remain within the mid-range of the 0 to 4 percent target range in 2019 and 2020.

D. Budget Management

The finalisation and implementation of Budget 2020 will be in line with the Public Finance and Economic Management Act (CAP 244). In 2020, Vanuatu will be conducting the National General Election and will be graduating from the UN's Least Developed Countries (LDC) list. These are some of the major government commitments that will be included in the 2020 budget, including New Policy Proposals that fall in line with the 2020 Budget Policy Priorities. In 2020, the Government will also be placing more emphasis on supporting both the productive and social sectors in order to collect more revenue, improve Government service delivery and enhance economic growth. In addition, the Government will continue to formulate and implement revenue and expenditure control measures as well as managing state debt at prudent levels to achieve the Government's fiscal policy objectives and targets, including a balanced budget in 2020.

E. Government Debt and Borrowing

Vanuatu's recovery progress from Cyclone PAM is remarkable. Its young population is growing and stretching both the education & health budgets. In order for its future to be prosperous, Vanuatu must continue to invest in its infrastructure programs and other capital projects. In order to guide the country on being responsible sustainably and at the same time cater for its ambitious infrastructure programs; debt management is then key. It ensures that fiscal and debt dynamic risks are managed and strategies are in place to assist in preventing challenging situations.

Now in 2019, the major individual projects that were projected from 2015 will now be completing off or are nearing completion. In fact, from 2015 to 2019, there have been no

major changes to total public debt as per forecasts from 2015, when TC Pam occurred. However, this debt level is set to decline from last year 2018 to this year 2019 and onwards as the Government is currently embarking on a momentous debt reduction plan. Based on key initiatives of that plan, over VT 3 billion worth of domestic & external loans will be prepaid this year alone.

The Debt Sustainability Analysis completed by the IMF and DoFT in 2018 suggests that Vanuatu's debt-carrying capacity continues to be moderate. There are no breaches in the baseline scenario, however, the stress tests suggest that a one-off 30 percent depreciation shock and a consequential shock to financing terms would negatively affect debt dynamics. If this were to happen, this would cause a breach of the Net Present Value of the debt-to-GDP ratio threshold.

Every year, more and more developing nations are realising the impacts from poor decisions of taking on too much external debt. Many have faced fiscal pressures and have given up national resources (e.g. fishing rights) to offset loan repayments. Vanuatu must be vigilant due to its small economy and must take every possibility to improve its debt management. Ensuring that important services like education and health are not affected by the outflow of financial resources is crucial.

With Vanuatu's current debt carrying capacity assessed to be moderate, many key debt policies have been drafted. A new debt technical advisory committee will be established, while important rules, guidelines and improvements to the financial regulations and the PFEM Act are being drafted, among other innovative debt policies to assist the country with its debt portfolio and managing fiscal and debt dynamic risks.

The fiscal space must be assessed, appropriate measures taken and the Government must adhere to the debt management strategy, which includes a debt limit policy in the near term of 30 per cent baseline threshold. All new borrowing must be on concessional terms, with a minimum 35 per cent grant element. The Government's debt management strategy also includes guidelines to continue to seek grant financing for infrastructure investments.

Given Vanuatu's vulnerability to and risk of natural disasters, the Government places importance on internalising the risks to growth associated with natural disasters and boosting the country's readiness to respond. The Government has thus embarked on instituting ex-ante measures that require different layers of preparedness including strengthening risk assessment and planning, building domestic fiscal buffers, ensuring external buffers and building and maintaining resilient infrastructure. Identifying and disclosing fiscal risks including natural disasters and climate change now form an integral part of the 2020 Budget Policy Statement.

Debt Management Policy recommendations

- Given Vanuatu's vulnerability to natural disasters, the Government must be cautious with future major infrastructure projects in regards to rapid debt accumulation;

- Rebuild fiscal buffers over the medium term through strengthening public finance;
- Management, reprioritizing spending, and mobilizing new revenue resources (the government must continue to find new revenue sources to broaden the tax base and ensure that it is not relying too much on individual sources of revenue);
- Continuous prepayment of loans when fiscal conditions are favourable – prepayments totalling at least VT 2 billion should be executed in 2019.
- Economic growth is vital for debt management. Favourable fiscal and monetary policies targeting sustainable economic growth are key for debt management.
- Good governance is also crucial, including adhering to the debt policies of the day and making the necessary structural reforms in key government sectors.

F. Revenue and Taxes

With the need to fund essential services a priority, the Government continues in its efforts to raise sufficient revenue.

In 2018, revenue collections exceeded the budget target by 31.5 per cent. The Ministry of Finance and Economic Management (MFEM), Ministry of Internal Affairs (MoIA) and the Citizenship Office recorded higher than budgeted revenue targets in 2018.

The Citizenship Office has had success with its Vanuatu Development Support Program (VDSP) and Vanuatu Contribution Program (VCP). Total revenue collected by the programs in 2018 exceeded their budget by 371.5 per cent. Total revenue earned from these programs in 2018 outweighs the collections from VAT for the first time. This confirms that VDSP and VCP were the biggest revenue earners for the government in this financial year. In past decades VAT has always been the top revenue earner for the government but in 2018, revenue from VCP and VDSP overtook VAT revenue.

MFEM continues to see growth in revenue from taxes, fees and charges collected by the Department of Customs and Inland Revenue (DCIR). Although VAT revenue collection was more than in previous years due to the Government's decision to increase Value-Added Tax (VAT) from 12.5% to 15% from January 1 2018, VAT revenue collection was only 94.2 per cent of the 2018 budget target. The strong revenue collection by the DCIR is linked to the Department's implementation of its functional model in terms of its new operational design since 2017. This has improved DCIR's compliance and also seen strong revenue collection from import and export duties and related excise taxes. The Tax Administration Act passed by Parliament in 2018 is expected to further improve DCIR's way of doing business and is anticipated to improve revenue collections.

The MoIA has recorded higher revenue collections from related immigration and border control activities. This trend is anticipated to continue in 2019.

Several ministries did not meet their revenue targets in 2018. Revenue collected by these ministries are largely fees and charges imposed for services provided; more effective monitoring is needed to ensure revenue budget targets are met in 2019.

In the international arena, Vanuatu continues in its obligations to meet international standards in good tax practices. This includes those set by the OECD's Global Forum on Transparency and Exchange of Information for Tax purposes (Global Forum) and the European Union's Code of Conduct Group (EU CoCG).

Vanuatu has made good progress in meeting the OECD Global Forum's standards. The necessary legislations required to implement the exchange of information for tax purposes (International Tax Cooperation Act of 2016) have been put in place. Vanuatu signed the Multilateral Convention on Mutual Assistance in Tax Matters and Multilateral Competent Authority Agreement in June 2018, which then came into force on 1 December 2018. These instruments allow Vanuatu to exchange information automatically. ***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.

In February 2019, EU Finance Ministers updated the EU list of non-cooperative tax jurisdictions and concluded that Vanuatu has not taken sufficient steps to fulfil its commitments, thus Vanuatu was downgraded to 'black list' status. The Government is working on reforms that include amendments to the Vanuatu Financial Services Commissions' current legislations and gazettal of the Tax Administration Act that will help with the EU requirements.

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 on the agenda for the Government to decide in the near future.

Modernisation, Tax Administration Act and Non-Tax Revenue Review

The priority for MFEM in 2019 is to implement the recently passed Tax Administration Act (TAA) and 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. Great efforts have been made to build capacity and operational strength over recent years. The Tax Administration Act supports the Government's initiative to modernise the DCIR and provides for uniform procedural rules to taxes administered by DCIR. The TAA provides for DCIR's 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.

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) instructed DCIR to recover outstanding VAT debt from State Owned Enterprises and Businesses and implement strategies to ensure their future compliance in their Decision in June 2017. In responding to this COM Decision the DCIR embarked on an in-depth operation to recover the current VAT Outstanding. In relation to this, DCIR has made the following progress since 2018.

- Wholly owned SOE arrears have reduced by 98% throughout 2018 while in 2019 debt has reduced by 78% as at 31st March 2019. Overall, outstanding returns have reduced by 96%
- Not much has been done with partly owned SOEs due to their arguments that the government owned 100% shares in these entities. The advice from State Law Office in December 2018 confirms that these entities are not to be treated differently but are obliged to lodge VAT returns to the government. It is anticipated that actual compliance activities will commence in 2019.
- Core VAT owing is maintained at an average of VT1.5 million over the last twelve months indicating a good level of compliance.
- DCIR also confirmed that the number of non-filers was reduced drastically in October 2018
- So far DCIR has prosecuted four cases. Total outstanding is over VT100 million. The first case has been completed, in which the government recovered the total outstanding tax of VT 10 million. There are still no reported court cases for 2019 and five cases were yet to be registered for court hearing by the Public Prosecutors Office (PPO).

With regards to outstanding fees and charges (non-tax revenue) over VT 130 million worth of outstanding has been approved by the Ministry of Finance and Economic Management to be written off. The 'National Write-off Committee' has concluded that it is nowhere possible for the Government to recover these outstanding. The Ministry also confirms that a similar exercise will continue throughout the course of 2019 and the Committee will continue to work with each individual ministry to assess current outstanding and provide recommendations accordingly. It is anticipated that ongoing reduction will be seen in the amount of outstanding revenue recorded, over the medium term.

As is 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 by strengthening the administration, compliance and enforcement of its existing taxes through the implementation of modernised laws as well as newly introduced fees and charges.

G. Expenditure Programme and Policies

In 2020 the Government's expenditure program, activities and policies will be in line with the 2020 Budget Policy Priorities. Therefore, the allocation of Government fiscal space for New Policy Proposals (NPPs) will resemble as closely as possible following the seven budget policy priority outcomes outlined in the Government's strategic priorities. The Government will continue to adopt sound financial management and fiscal discipline to ensure that there is sufficient cash to implement the Government's expenditure program and policies as well as achieve its expenditure priority outcomes.

4. New Policy Proposals (NPPs)

The 2020 budget will comprise of NPPs that are in line with the Government's budget policy priority outcomes as much as possible. The allocation of Government fiscal space towards funding NPPs in 2020 will only be considered if they have been approved by the head of the agency and submitted in the Government financial management systems with supporting documents. In addition, NPPs must be:

- able to be accommodated within the overall aggregate fiscal envelope;
- accompanied by well-researched and detailed proposals to reinforce the 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
- financially sustainable (if the activity is to become recurrent).

The 2020 budget will also include donor-funded NPPs. Therefore, the Government will continue to emphasise the importance of using the Government Financial System to fund expenditure programmes and policies that are in line with the Government priorities.

5. Economic and Fiscal Targets for 2020

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:

2020 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 balanced budget objective. Recurrent revenue growth rate must be higher than the expenditure growth rate.
Expenditure Recurrent expenditure is forecast to be at least 21.0 per cent of GDP	Expenditures are consistent with the balanced budget objective.
Debt Maintain Net Present Value (NPV) of external debt at a maximum of 30 per cent of GDP.	The Nominal Public and Publicly Guaranteed Debt-to-GDP ratio remains below 60 per cent associated with disaster and climate change related risks.
Economic Growth Forecast Real GDP Growth rate of 3.7 per cent	The annual economic growth rate averages at least more than the population growth rate (2.3 per cent).
Inflation Inflation forecast to be in the middle of the target range of 0-4 per cent.	The annual inflation rate remains below 4.0 per cent.

6. Conclusion

The 2020 Budget Policy Statement is in line with the Public Finance and Economic Management Act (CAP 244). On this note, the 2020 budget policy priorities and the principles of responsible fiscal management will form the basic guiding principles of allocating, finalising and executing budget 2020. Therefore, the Government will continue to ensure that all line agencies adhere to this Budget Policy statement in order to achieve a balanced budget in 2020 and at the same time enhance economic growth and improve the wellbeing of all the people in Vanuatu.