

Budget Policy Statement 2016

1. Statement of Responsibility

The following Budget Policy Statement is made with reference to and in accordance with sections 9 and 10 of the Public Finance and Economic Management (PFEM) Act number 6 of 1998.

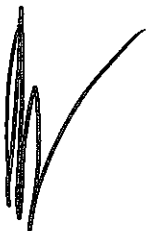
Section 9 requires the Government to:

- 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.

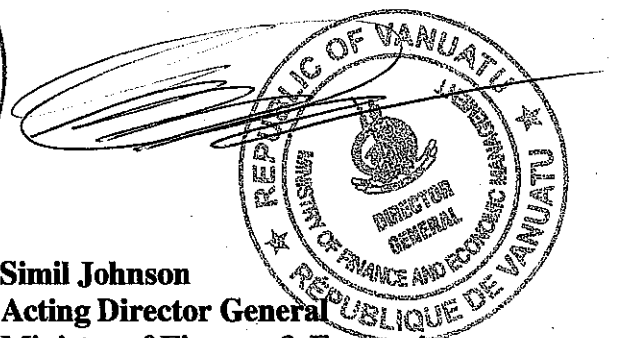
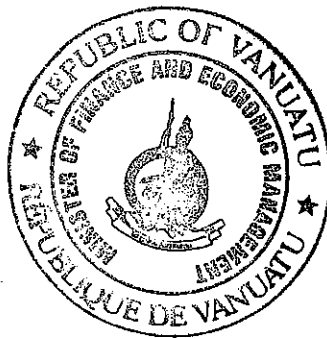
Section 10 requires the Government to:

- 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 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.

Pursuant to section 10, the Government confirms that the fiscal policy objectives, strategic priorities and intentions are consistent with the Principles of Responsible Fiscal Management specified in section 22 of the PFEM Act of 1998 and that there is broad consistency with the 2015 budget policy.



Hon. Bob Loughman (MP)
Acting Minister of Finance & Economic Management
Ministry of Finance & Economic Management



Simil Johnson
Acting Director General
Ministry of Finance & Economic
Management

2. Economic and Financial Policies

The PFEM Act of 1998 specifies the principles of responsible fiscal management. These require that the Government pursues budget policies that:

- Ensure that the Government's borrowing is kept at manageable levels;
- Maintain public assets in good condition;
- Manage fiscal risks prudently;
- Maintain stable and predictable tax rates.

The Government's highest priority for Budget 2016 is to boost Vanuatu's economic growth and improve the wellbeing of all Ni-Vanuatu, in a way that is financially sustainable and does not jeopardize future economic growth.

The Government will achieve this by sound management of public finances and by following fiscally responsible policies. Section 22 of the PFEM Act requires that the Government adheres to a set of defined principles of responsible fiscal management. These are set out in the box opposite.

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

Government's Budget Policies come from the application of the "Principles of Responsible Fiscal Management" Section 22 of the PFEM Act of 1998. The Budget Policies consist of:

1. Budget Priorities for 2016;
2. Economic and Fiscal Targets for 2016; and
3. Long Term Fiscal Objectives

a) Budget Priorities for 2016

The 2016 Budget priorities are strongly influenced by the recent experience of Cyclone Pam and the government plan for recovery and social and economic strengthening, as well as the longer term national plans. While partner funding will provide much of the capital needed for investment in recovery activities, the recurrent funded component

of the Budget needs to be aligned with and support these activities. In 2016 government will also continue to support economic and productive sector in order to continue to grow the economy. It is therefore crucial to invest into them so that in turn it gets more revenue to meet the growing social sector needs.

To the extent that additional funds can be made available, the allocation of resource in line with the recovery plan and MTEF will first see funding directed to supporting recovery plan implementation and then see 50 percent of fiscal space goes to the productive sector while 50 per cent is shared among other sectors. This also captured the essence of the national broad policy framework in the national planning documents (PAA and PLAS).

The core strategic policy/resource allocation priorities for 2016 are set out as follows:

Rehabilitation, Reconstruction and Economic and Social Strengthening

- ✓ Allocate funding required for Ministries to support the implementation of recovery activities, in accordance with principles of fiscal responsibility;
- ✓ Identification of administrative efficiencies and reallocation of funds in line with recovery and longer term priorities;
- ✓ Restructuring of the private sector through allocations of resources to projects which support the domestic private sector;
- ✓ Support re-development of the services industry and improve market opportunities for small holder primary producers.

Services sector

- ✓ Increase allocation to Department of Tourism, Cooperative & Ni Vanuatu Business, Industry sector, and also TBT & SPS in order to continue recover from TC PAM and boost activities in Tourism, Trade and Private Sector participation;
- ✓ Increase allocation of resources by having lands properly registered in compliance and enforcement of land laws (fair land dealing processes) throughout Vanuatu;

Productive Sectors

- ✓ Increase allocation to fisheries, agriculture and forestry, livestock and quarantine for their TC PAM recovery;

- ✓ Increase allocation to Department of Tourism, Cooperative & Ni Vanuatu Business, Industry sector, and also TBT & SPS in order to continue recover from TC PAM and boost activities in Tourism, Trade and Private Sector participation;
- ✓ Increase allocation of resources by having lands properly registered in compliance and enforcement of land laws (fair land dealing processes) throughout Vanuatu;

Complementary Sectors

- ✓ Strengthen support to foreign policy to continue enhance dialogue abroad and attract more aid in to the Country;
- ✓ Increase allocation to the Head of Executive to strengthen policy implementation and security and policing to improve governance and management within the force and at the same time address the massive debt burden;
- ✓ Strengthen government support to contributions on public projects, Ports and Harbour and increase support to civil aviation sector, for equitable, social and economic development;

Social Sectors

- ✓ Provide support to human rights and infrastructure to boost the law services to all citizens of Vanuatu;
- ✓ Provide support for gender mainstreaming across all ministries;
- ✓ Increase allocation and access to quality youth services and programmes at all levels throughout Vanuatu;
- ✓ Increase support to Climate change to strengthen management of disaster and risks;
- ✓ Maintain support to improve national health services as well as rebuilding of health facilities damaged by TC PAM;
- ✓ Maintain support to the development of the national human resource focused on maximising Vanuatu's economic growth. Support in 2016 will also be targeted to the rebuilding of classrooms.

(b) Fiscal Policies

The Government will continue to effectively manage its budget in 2016 in a way that is in line with the Public Finance and Economic Management Act. In addition, the Government will continue to implement sound policies that encourage private sector led growth throughout the communities of Vanuatu. These policies will also ensure that the State-Owned Enterprises remain productive over the long term.

(c) Economic Update in 2016

World Economic Outlook (WEO)

The Global economic growth is expected to strengthen by an average 3.6 per cent per year over 2015 – 2016. The global economy is still struggling to regain momentum as many high-income countries continue to face with legacies of the global financial crisis and emerging economies are less vibrant than in the past.

The recent estimates released by the International Monetary Fund (IMF) in April 2015 suggest that the global economy is facing uneven growth between advanced and emerging market economies. The outlook for advanced economies is improving, while growth in emerging market and developing economies is projected to be lower, primarily reflecting weaker prospects for some larger emerging market economies and oil-exporting countries.

Growth in major advanced economies (AEs) is now projected to rise by 2.4 per cent in 2015 and remain the same in 2016 – with US and United Kingdom being ahead of others. Meanwhile; growth in Emerging Market Economies (EMEs) is forecasted to grow by 4.3 per cent in 2015 and 4.7 per cent in 2016. The expected recovery in both the US & UK economies will partly be offset by sluggish growths in the Euro area and Japan as financial hick up remain, tangled with structural bottlenecks. China meanwhile is undergoing carefully managed slowdown since 2014 and concentrating on buffering domestic demand. The disappointing growth in other developing countries last year reflected weak external demand and domestic policy tightening, political uncertainties and other supply-side constraints.

Headline inflation has declined in AEs, reflecting the decline in oil prices, softer prices for the other commodities, and weakening demand in a number of countries already experiencing below-target inflation, such as the euro area and Japan. EMEs inflation also faces lower prices for oil and other commodities which generally contributed to reduction in inflation in 2014.

The latest World Bank global economic prospects release indicates several major forces driving the global outlook: soft commodity prices; persistently low interest rates but increasingly divergent monetary policies across major economies; and weak global trade. In particular, the sharp decline in oil prices since mid-2014 will support global activity and assisted growth in oil-importing economies as resources can now be reallocated. However, it will dampen growth prospects for oil-exporting countries, with significant regional repercussions.

Overall global growth is expected to strengthen modestly in 2015-2016, helped in part by the boost in global demand from lower oil prices and policy changes. However, recovery remains fragile in a number

of AEs, marked by weak investment, and medium-term growth is low in many economies. Raising actual and potential output therefore will continue to be a general policy priority.

Vanuatu Economic Outlook (VEO)

The category 5 magnitude cyclone Pam has redirected policy makers to refocus on policy priority that will assist with the recovery, rehabilitation and reconstruction over the medium term. The agriculture sector (mainly root crops, coffee and forestry) has been severely affected in the Shefa and Tafea province affecting farmers' income in both medium and long term. Furthermore, the unfavourable external conditions for commodity prices add less value to domestic production with no incentives to raise production for export. This will exacerbate pressure on the level of foreign exchange earnings which will ultimately affect the level of foreign reserves. Meanwhile, the government is embarking on necessary steps to address any potential pitfall likely to be generated as a result of possible setback from incoming receipts from foreign earnings. As normalcy in business cycle starts to gather momentum, correction in market forces are expected at play supported with stable domestic demand that should drive domestic production going forward. It is vitally important of the government to take the lead in formulating sustainable policies (following finding from the PDNA) to address the recovery the impact from cyclone Pam towards sustainable economic growth. With these developments, the agriculture sector is expected to grow by 0.8 per cent in 2015 and return to trend in 2016 and 2017 by 2.4 and 2.5 per cent respectively.

The Industry sector is expected to offset the downward impact to growth caused by tropical cyclone Pam. Buoyed by on-going structural reform headed by the Government, fiscal policy is expected to drive economic growth over the next few years as the Government is expected to acquire more fixed assets through concessional external borrowings with a surge in growth to reach 4.6 per cent in 2017. These planned activities will boost domestic demand with consumption expecting a positive spill over effects/impacts on VAT collection. Furthermore, there will be more jobs created mainly in the construction sector that should raise the average income of the formal working group. On the other hand, any extended delay in project implementation will greatly affect the growth forecast while the internal capacity to accommodate these projects rolling out at the same time is a concern in the medium term. Furthermore, it is vitally important for the government to spread implementation of large projects over the years to manage inflationary expectation and minimise volatility of economic growth – maintain a sustainable economic growth. Robust growth is expected in 2015 at 16.4 per cent before expanding by a further 17.4 in 2016 and 19.4 per cent two years from now.

On the downside, the services sector is expected to slowdown in the medium term after sustaining serious damages to tourism related infrastructure such as hotels and resorts. Reconstruction in the tourism industry will requires more time and the government needed financial resources to embark on aggressive marketing in Vanuatu's major tourist destination. On the upside, information, communication, real estate and government services are expected to offset weak developments in the tourism industry. Since the services sector consist more than 60 per cent of GDP, any recovery plans targeting this sector should be well formulated and financially committed with support from donor partners to ensure return to normalcy at shorter period of time possible.

The current account is projected to contract in 2015 reflecting expanded trade deficit, offsetting the inflows from tourism earnings and regional seasonal remittances. The strong growth in imports in 2015

estimated to take into account the implementation of major projects driven mainly by the reconstruction after the devastated tropical cyclone Pam in 2015. This expected trend would be maintained in the forecasted period worsening the current account deficit in 2016 before normalisation commencing 2017. The volume of fuel imports and project related goods remain to be the main underlying items in increased imports. Exports earnings are projected to slow down due to low international commodity prices supported by improved external supply conditions. Forecasted tourism earnings are less likely to offset the increasing volume of imports in 2015 to 2017 due to damage sustained by major hotels affecting occupancy. Aid in terms of cash & grants are likely to double starting in 2015 compared to past years. Despite the reduction in tourism earnings and expanded trade deficit, the impact on the official reserves is expected to be minimal but expected to decline significantly in 2016 onwards. Growth in this sector is expected to contract by 0.7 per cent this year and recovery is expected in the projection period at 7.7 per cent and 2.8 per cent in 2016 and 2017 respectively.

The Reserve Bank of Vanuatu (RBV) pursued accommodative monetary policies in response to prevailing weak economic conditions that partly reflected weak external economic conditions. In the monetary sector, money growth was slower than trend growth levels. Liquidity was high among the banking system but credit growth remained constrained. Reserve requirement and the liquid asset ratios were lowered. The RBV's open market operations were conducted in a way that allowed build-up of domestic liquidity. The RBV also adopted an Import Substitution and Export Financing Facility; a credit facility through commercial banks for businesses in both the export and import substitution sectors with the aim to alleviate pressure on the balance of payment.

During the post cyclone period, the RBV undertook further accommodative monetary policies both to support the economy and to provide liquidity support to the banking system. In March 2015, the RBV reduced its Statutory Reserve Deposit (SRD) requirement, which comprises reserve deposits of commercial banks held as required reserves. The RBV policy rate was reduced from 5.2 per cent and linked to the RBV 91-day RBV Note rate, which during the disaster, stood at 1.8 per cent. This therefore represents a significant reduction in the RBV policy rate. The RBV also allowed holdings of commercial banks to be part of their security for the RBV's Secured Advance Facility in addition to the commercial banks holdings of Government bonds and RBV notes. These changes were implemented as part of RBV's responses to support banking system liquidity in response to the Government's decision to allow members of the Vanuatu National Provident Fund (VNPF) access 20 per cent of the retirement package. The RBV also activated the Natural Disaster Reconstruction Credit Facility to all businesses for the purposes of rehabilitation and reconstruction after the disaster.

(d) Budget Management

The 2016 budget will be managed in a way that is consistent with the Public Finance and Economic Management Act. The Government will ensure that there is effective administration, compliance and enforcement of the existing tax to provide enough funding to meet Government expenditure programs and activities. In addition, the Government will continue to commit itself in managing state debt and implement revenue and expenditure measures to achieve a balanced budget in 2016.

(e) Government Debt and Borrowing

The Government will continue to manage State debt at a prudent and sustainable level in 2016 and years thereafter. Beginning 2015, new borrowing will be prioritise towards productive purpose such as capital investment projects that will enhance economic growth and generate future capacity to repay the loans bestowed upon future generations. In addition, repayment of state debt will depend on the revenue raised and implementation of expenditure programmes.

(f) Revenue and Taxes

It was so unfortunate that the government has already encountered major challenges in its projected revenue this year 2015, something it has never anticipated to occur. The suspension of the PR Program and also the loss of revenue (VAT forgone) due to Cyclone PAM earlier this year, were amongst the listed of events that have already imposed major constraints to the forecasted revenue the Government initially intended to raise this year. The Government will now rely on its current revenue base as well as new introduced revenue initiatives to ensure the current gap is kept at some prudent level.

As always the case, the implementation of all approved Government expenditure programmes and activities for 2015 will depend very much on how much the Government can raise, (revenue) and how much it plans to borrow. For 2015, the Government will continue to boost its revenue collection through strengthening the administration of compliance and enforcement of its existing taxes as well as new introduced fees and charges from various ministries. Additionally, the government will continue to implement the outcomes of the 2013 national revenue forum matrix initiatives as well as the outcomes from the non-tax Revenue forum held in 2014, in its effort to raise the required revenue to meet its entire operational needs.

On the international arena, the Government will continue to progress its status with the OECD and Global Forum to counter mal-administrative practices such as tax evasion or avoidance, by working towards establishing a competent Authority as well as enacting it legislations on Tax Information Exchanges Agreements.

(g) Expenditure Programme Policies

The Government will continue to make sure that there is available funding to meet its expenditure plans and activities. In 2016, the Government expenditure programmes will be managed in line with the PFEM Act. Moreover, the Government will also be putting much consideration to expenditure productivity to ensure maximum value of public funds. In this note, requesting and accessing of funds will be linked to the 2016 strategic polices priorities that will improve the welfare of the people and at the same time support economic growth.

In addition, in 2016 the access and usage of funds will be managed in line with the budget targets. Fundamentally, the Government will continue to enforce strict fiscal discipline and effectively implement past COM decisions where necessary to control expenditure programmes in line with budget targets.

4. New Policy Proposals

The Government will continue to allocate recurrent funding for New Policy Proposals (NPP) that are consistent with the Government's strategic priorities identifies in 3 (a).

The NPPs will be strictly considered for funding in 2016 if they are:

- able to be accommodated within the overall aggregate fiscal envelope;
- well researched and detailed proposals to reinforce the Government's key policies and programs;
- 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 2016 budget will include donor funded NPPs. Therefore, the Government will continue to emphasize the importance of using the Government Financial Systems to fund expenditure programmes that are in line with Government priorities.

5. Economic and Fiscal Targets for 2016

In line with the Public Finance and Economic Management Act, the Government will continue to pursue policies towards achieving a balanced budget in 2016. The economic growth rate for 2016 is forecasted to be 3.3 per cent in real terms, while the inflation rate is projected to be around 1.7 per cent.

Budget Targets for 2016	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 20.0 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 20.0 per cent of GDP	Expenditures are consistent with the budget balance objective
Debt Public debt to reach 25 per cent of GDP	Debt maintained at prudent levels so its average share of GDP remains below 40 per cent
Economic Growth Growth forecast at 3.3 per cent	Annual economic growth rate averages at least more than population growth rate (2.3 per cent)
Inflation Inflation forecast at over 4.0 per cent	Annual inflation rate remains below 4.0 per cent

6. Conclusion

The "Principles of Responsible Fiscal Management" will guide the preparation of the 2016 National Budget and it will have more emphasis on allocating funding to the Government policies and priorities.

The PFEM Act (CAP 244) will guide the implementation of Budget 2016 and the Government will remain cautious in every decision making, to ensure that both revenue and expenditure target are met to achieve a surplus budget in 2016. Hence, the Government will continue to remain fiscally prudent and at the same time promote economic growth and raise its people's per capita income.