Adam Smith International

SUBMISSION TO THE TAX REVIEW COMMITTEE

Recommended Tax Reforms for Papua New Guinea

April 2014

1. The Purpose of this Submission

This submission is a response to the Tax Review Committee's call for papers on potential areas of tax reform in Papua New Guinea (PNG). Our Submission is based on our extensive international experience of tax reform around the world, combined with knowledge and experience of PNG's tax system gained by working side-by-side with the Internal Revenue Commission (IRC) intensively since July 2012.

Our Submission is split into three parts:

- » Adam Smith International's support to the IRC;
- » Proposals for Tax Policy Reform; and
- » Proposals for Tax Administration Reform.

2. Adam Smith International's support to the IRC

Adam Smith International has been providing technical assistance to the Internal Revenue Commission (IRC) since July 2012 in connection with the implementation of a new tax administration system, SIGTAS. SIGTAS will automate all taxes and licences, and cover all aspects of the tax management process including taxpayer registration, assessments, audit and cashing. SIGTAS will also enable the electronic transfer of payments.

SIGTAS will enable the IRC to operate more efficiently and transparently. It replaces an antiquated system which relied heavily on paper records. Increased visibility of taxpayer data will help the IRC increase tax collections and focus its taxpayer audit efforts. Standard processes and forms will generate significant improvements in efficiency and accuracy.

The system will help the PNG Government meet its target of increasing tax collections to PGK 11.26bn by 2017.

3. Proposals for Tax Policy Reform

3.1. Comprehensive Reform of the Income Tax Act *(within two years)*

The Income Tax Act (ITA) as it exists is not ideally suited to PNG, i.e. a developing country experiencing rapid growth. The law would be well suited to an economy with a highly capable national tax administration already in place, with taxpayers well used to a culture of compliance. In PNG the IRC is struggling to achieve fully national outreach, and is faced with severe obstacles to operating in remote locations.

PNG would be better served by simple tax laws, e.g. a limited number of revenue products, a focus on ease of administration, and keeping policy simple. This would help ensure better enforcement in connection with transfer pricing, thin capitalization, and other serious issues across many industry sectors. There are numerous examples of tax structures that would be better suited to PNG, e.g. within the region East Timor would be a good model to follow.

We believe that tax policy could be reformed, the ITA rewritten, gazetted and publicised within two years. Since the existing tax policy has evolved over time, with layer upon layer of complexities added since 1975, we feel that a complete re-write is a better solution than investing heavily in reworking specific areas of the ITA. That said, we also recommend tackling some specific issues immediately, and these are set out below.

3.2. Incentives for taxpayers *(within one year)*

We believe there is a critical and urgent need for the Government of Papua New Guinea (GoPNG) to repeal all private project and company level agreements that include exemptions and other concessions. These include, but are not limited to, tax holiday periods that are not permitted by the ITA, exemptions for tax returns and documentation lodgement under tax holiday periods; administrative concessions such as allowing taxpayers to keep books and records in a foreign currency; and specific project-level concessions against various tax types.

Repealing exemptions and other concessions would generate very significant extra revenue directly as the formal tax base is broadened, and it would also reduce administration costs for the IRC significantly. Reducing administration costs would provide a direct saving to the IRC, and would also enable resources to be focused on activities that generate most revenue.

Ad hoc exemptions and other concessions are ultimately unlikely to promote investment and private sector development. There is a wealth of evidence that investment is hindered by the lack of predictability and fairness of concessions. Taxpayers are looking above all for a stable and predictable tax system, and ad hoc treatment of some taxpayers is a huge red flag to most businesses.

A better way to incentivise taxpayers would be to include in the ITA more competitive rates, access to industry standard investment incentives such as accelerated depreciation and unlimited loss carry-forward, and a transparent business environment where everyone, e.g. state owned businesses, and businesses having a significant state-owned share, are paying taxes on a level playing field.

As the tax base is broadened and compliance is improved, there will be scope to reduce rates, and there is no better incentive than this for taxpayers.

3.3. Stamp Tax Reform *(within one year)*

In reality, the Stamp Tax provisions are far too complex to implement in light of land titling inadequacies, and the difficulties of administering the tax system in remote regions. There is no central asset registry, and the IRC's provincial infrastructure is not well developed.

Many of the provisions are not particularly relevant in the PNG environment. Generous exemptions and concessions, e.g. for those transacting on their second or third property, are unenforceable given the state of land titles. These exemptions and concessions are easily over-ridden by the ease of obtaining the 'first buyers exemption'. The exemptions and concessions are also misguided from a policy perspective, because in a country with such high income disparity there is an argument that those people wealthy enough to own/trade in multiple properties should be taxed at full rates, not given preferential rates.

We suggest a detailed analysis of the Stamp Duty Acts, and the six different types of transactions covered by them. Significant streamlining in administration can be achieved, and revenue could be increased. The best way to increase revenue from Stamp Taxes is to improve the ability of the GoPNG to administer these in the provinces, see further below for more on this.

We believe these changes could be designed within three months, and implemented as soon as the GoPNG can pass and gazette the changes.

3.4. Turnover Tax on Bookmakers *(within six months)*

The Turnover Tax on Bookmakers and the administration of the Betting Books is a classic example of a tax type that is not worth the administrative burden/expense of its administration. We recommend a complete re-write of this tax type vis-à-vis how it is administered, eliminating the need for all individual 'chits' currently generated at source. We believe that a reworking of this section of policy would result in slight additional revenue, and would be extremely well received by the industry in terms of reducing compliance burden.

We believe these changes could be designed within three months, and implemented as soon as the GoPNG can pass and gazette the changes.

3.5. 'Nuisance Taxes' *(within three months)*

By our estimation, some 38 revenue products exist in PNG. Several of these products have never been enforced, or are enforced in such a piecemeal way that the revenue generated does not even meet IRC operational expenses. Removal of these nuisance taxes would reduce administration costs and increase confidence in the tax system.

We believe the IRC would generate more revenue, more fairly, and more effectively if there was a focus on four primary revenue products, Individual Income Tax, Corporate Income Tax, GST, and Mining and Petroleum Tax. A few withholding regimes could supplement/support these four revenue products.

Removal of nuisance taxes could be achieved within three months.

3.6. Salary and Wages Tax *(within one year)*

The Salary and Withholding Tax (SWT) is the single largest contributor to overall GoPNG revenue. However, reforms to it could increase SWT revenue further, and reduce the costs of administration and compliance.

SWT has six salary bands, which creates administrative and compliance complexity. SWT compliance and revenue would increase if the band structure was flattened and the number of bands reduced.

Restructuring the bands would allow for a reduction in the top marginal rate in line with other countries in the region. This would incentivise work, and reduce attempts to evade.

We do not recommend reducing the tax-free threshold for SWT. Instead we suggest small, affordable contributions at lower salary levels to encourage a culture of tax compliance.

We believe full recommendations for reform could be completed within four months, and that implementing the changes could take another eight months.

3.7. Rental Withholding Tax *(within one year)*

We recommend consideration of a ‘Rental Withholding Tax’ to target revenue leakage in the booming real estate industry, particularly in the large urban centres of PNG. To summarise, such a tax would place the burden of remitting appropriate withholding tax on rental income on the tenants of properties, on behalf of the property owners. Owners would be incentivized to then submit annual income tax returns to declare global income, and access any legitimate expenses they may have. Consideration would be made in the implementation to ensure that additional pressure is not brought on the already inflated rental markets of Port Moresby and Lae. We believe the additional revenue generated would be significant for the GoPNG. Having implemented such a tax successfully in Afghanistan, we are confident that a similar product could be utilised effectively in PNG.

We estimate this would take one year to implement from start to finish, including analysis, drafting, preparing SIGTAS and tax forms, training staff, and communication to the public.

4. Tax Administration

As a general observation, in our 22 months working with the IRC, we are tremendously encouraged by the initiatives undertaken by the administration. Considering the significant challenges faced by the IRC, what they have achieved to date is admirable. We would like to express confidence in the existing leadership team and its strategies as communicated in the IRC’s strategic plan.

The IT team that we support is among the best we’ve worked with in any developing country. Integrated automation is the future for the IRC, and a continued commitment to the ongoing training and capacity of this group will be a very sensible investment for the IRC in the long-term.

We believe that there is still significant room for further administrative improvements, and we have set out below some of our ideas in this regard.

4.1. SIGTAS *(ongoing)*

We firmly believe that the IRC should continue to implement SIGTAS. It is important to note that changes take time to yield benefits for tax administrations. When we ‘go live’ with a new initiative, it is often 4-6 months before we are able to begin demonstrating gains, this is simply because of the length of time it takes for taxpayers to comply with the new regime. Changes undertaken by the IRC are accretive, and will combine to have a strong impact over time, e.g. it is difficult to quantify what the impact is of going live with SIGTAS for SWT as a stand-alone measurement without considering the other areas affected by SIGTAS.

Specifically for SIGTAS, we suggest the IRC consider the purchase and implementation of the ‘E-filing’ module. Most likely the SIGTAS module is best suited, however an open, competitive procurement should be undertaken. We have already made significant progress in encouraging taxpayers to pay and lodge their tax obligations electronically, however the IRC will soon outgrow the capacity of these interim systems. A more robust approach will soon be needed as more and more taxpayers take advantage of E-filing.

The E-filing module should be purchased asap, with a view to implementing in 2015/16, in conjunction with already-planned SIGTAS implementation activity.

4.2. A Focus on Improving Compliance *(for the next two years)*

The IRC needs to make a significant and immediate investment in improving taxpayer compliance. We believe that there is a very significant difference between the number of taxpayers registered by the IRC and active businesses in the economy. For those taxpayers who are registered, voluntary compliance levels are estimated variously between 10-20% for most tax types (number of people lodging/paying any form of tax, once registered). Regarding those taxpayers who do not comply, additional support in the area of enforcement across filing/paying/and audit selection is required urgently. Filing enforcement has been practically non-existent, and there are no penalties for non-lodgement for most revenue lines. Audit selection is haphazard. Payment enforcement is limited, and late payment penalties are not applied. Enforcement should be intelligence based, and conducted through an intelligence unit.

The only way at this stage to bring these numbers up to something more palatable is to make an immediate, significant investment in IRC staff, empowering them to make contact, register, and enforce lodgement with taxpayers on the ‘front line’. These staff do not need to be highly skilled or trained, they do not require accounting backgrounds or legal degrees. They need to be literate, ideally computer literate, good communicators, and willing to adapt to new processes. They should ideally be led by international advisers initially, to provide the structure and guidance required.

As proof of concept, in November 2013 Adam Smith International recruited 40 low-level clerical staff as short-term casual hires from a local employment firm, and assigned one international adviser to lead this team. During a four month period that included the Christmas break, this team was trained and deployed, and has already collected an additional PGK 35mn million of revenue that should be sustainable as taxpayers continue to comply. We believe the potential number of taxpayers who need this level of attention requires tripling this effort, and that this will lead to strong revenue gains for the IRC.

This approach could be implemented as soon as the IRC can commit to the funding, and allocate the office space and logistical resources required, e.g. computers/access, telephony, internet, a couple of vehicles for field visits etc.

The long-term vision for these new staff would be to transition them off such fundamental registration and lodgement enforcement, and turn them into the core of the IRC’s taxpayer processing engine. While SIGTAS is highly automated, it still is dependent on people to process payments, key in lodgements, generate reports, and dispatch taxpayer correspondence. We anticipate that a logical IRC staffing size given the complexities of the various revenue products, the logistical issues posed by operating in the country, and the potential revenue base, is approximately 1700+ staff, i.e. a quadrupling in size from current levels. We are of the opinion that this expansion should happen as soon as possible, given the projected growth of the PNG economy once the LNG project comes on stream. Reacting to this fundamental growth in the economy after the fact would mean significant revenue losses for the GoPNG. The IRC should be prepared right now.

4.3. HR Management *(for the next two years)*

The HR function needs to be repaired from the ground up. Having been directly involved with recruitment of low-level staff for the project mentioned above, we know that it is not particularly difficult to screen and contract staff, and to get them operating effectively in short order, i.e. within a month of advertising, we were able to have people start, including induction training, police checks, interviews etc. The existing HR function at the IRC appears to make things unnecessarily complicated. Recent advisory support from the AusAid EPSP program, while helpful, has not fixed this problem. We recommend a dramatic and immediate shake-up of the IRC HR structure, perhaps even utilising an external agency to take over recruitment and contracting activity for a period of time, allowing for capacity to be built, and a ‘cleaning house’ to take place of chronically under-performing staff.

A commitment from internal leadership to let go of staff members, including management level staff, who are repeatedly under-performing would be welcome. The IRC has adopted the approach of simply working around staff who are barriers to progress, e.g. building new teams, and leaving the old teams behind to become irrelevant. As a rule, under-performing staff find it very hard to embrace the sort of change that IRC is going through, and there is a strong argument for filling their positions with more productive personnel. Removing repeated and obvious under-performers would not only free up those positions for more productive people, it would also serve as notice to others that the IRC is a dynamic environment where chronic under-performance is not tolerated.

4.4. Buildings and basic infrastructure *(for the next two years)*

As set out above, our vision for the IRC is one of exponential and rapid growth to overcome many years of relative complacency. This will require an investment in infrastructure in Port Moresby. We suggest that Port Moresby be the primary processing center for most transactions, combined with significant investment in key provincial offices. We suggest that the HQ/Leadership function should be physically removed from the day to day processing operations, thereby freeing up more floor space for taxpayer transactions, files, and staff. This will require the acquisition/lease of a second building to accommodate the executive, and a continued focus on refurbishing the existing Revenue Haus.

With that in mind, it is worth noting that the building management of the IRC Revenue Haus appears unable to maintain the building to a satisfactory standard, i.e. functioning bathroom facilities, functioning elevators, and roofs and windows that do not leak. This is a major limitation on the effectiveness of IRC staff.

A significant and immediate investment in the major provincial offices of the IRC should be a priority, especially in Lae, Mount Hagen, and perhaps Kokopo. Suitable office space needs to be sourced, a significant investment in staffing made, and there should be a commitment to strong central office control of provincial activities. This will all contribute significantly to broadening the tax base, and ensuring consistent treatment of taxpayers in provincial locations.

These offices all require network connectivity to SIGTAS so that staff can receive payments, and issue statements/notices of assessment in the provinces directly. Additional lodgement/registration support similar to that being provided in Port Moresby should be utilised to address the very poor compliance in these provinces. A travel budget to ensure regular monitoring and presence from Port Moresby HQ to manage the provincial activities is necessary, as is the support of resident international advisers to help with the setup of the provincial office structures.

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