REVIEW OF THE INFRASTRUCTURE TAX CREDIT SCHEME

1. In addition to work outlined in the terms of reference, the Taxation Review was requested by the Government to:
   - Review the infrastructure tax credit scheme which applies to the mining and hydrocarbon sectors
   - Make recommendations on whether the scheme should be extended to include other sectors.

Introduction

2. The infrastructure tax credit scheme allows the State, using mining and petroleum companies as contractors, to build infrastructure without the need for an appropriation from Treasury. However, the right to determine if projects are built first rests with the resource companies. By not exercising their rights fully, some K71.8 million in contingent liabilities were in place in September 1999.

<table>
<thead>
<tr>
<th>Table 5. Infrastructure Tax Credits (millions of kina)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
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<tr>
<td>-----------------------------------------------</td>
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<tr>
<td>MRSF taxes paid</td>
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<tr>
<td>Credits claimed</td>
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<td>Credits claimed as % of taxes paid</td>
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<tr>
<td>Max tax credit on current year income</td>
</tr>
<tr>
<td>Difference for year (excess credits)</td>
</tr>
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<td>Credits carried forward</td>
</tr>
</tbody>
</table>

† To end September 1999
Source: Internal Revenue Commission

Review of the Scheme

3. Several important weaknesses characterize the scheme:
• The scheme diverts a large sum of money from the Mineral Resource Stabilization Fund (the fund into which resource companies pay their taxes).

• Projects which are built under the scheme are not necessarily in accordance with national priorities as defined by the State. Neither the Department for Planning and Monitoring, nor the Department for Finance and Treasury, are involved in the approval process for projects. Funds are rarely set aside for the maintenance of projects.

• The scheme lacks transparency since the tax expenditure is not reported in the National Budget (see page 11 for additional discussion). There have been cases where the scheme has also been misrepresented to local communities as expenditure by the companies, rather than tax expenditure by the Government.

• Insofar as the companies do receive a benefit from the scheme, it is inappropriate for the State to forego revenue. Companies would undertake some of the projects as part of building better community relations and responsible corporate behavior.

4. However, there are also benefits to the scheme. The projects almost certainly represent value-for-money for the State. Insofar as projects accord with national priorities, there is probably no cheaper way of having them built.

5. Submissions have been received both from the PNG Chamber of Mines and Petroleum and the public. The Chamber has requested an extension of the scheme, so that it might cover maintenance of government infrastructure, training of government personnel, and funding of community health programs.

6. One of the arguments in favor of the scheme is that resource companies have an advantage over government in the provision of infrastructure. It is difficult to see how the training of government personnel, or the provision of health services, fits in with this advantage. On the other hand, allowing for the maintenance of government infrastructure would match with the company's strengths, and would help to overcome one of the problems associated with the scheme: that it contributes only to new works, which will themselves have to be maintained at public expense.
Recommendations

7. The Taxation Review recommends that:

R - 78. The allowable infrastructure tax credit be reduced from 2% of assessable income to 0.75% of assessable income, beginning in the 2001 tax year (2001/2002 in the case of substituted accounting periods).

R - 79. The carryforward be reduced by: limiting carryforward of current and future year's excess credits to two years; and, limiting the carryforward of excess credits relating to prior years to 31 December 2002.

R - 80. Maintenance of government infrastructure should be allowed as a tax credit.

R - 81. The Department of Planning and Monitoring should be made responsible for the administration of the scheme; supported by the Departments of Mineral Resources and Petroleum and Energy, and the IRC and provincial administrators.

R - 82. The infrastructure tax credit scheme should be reported as tax expenditure in the National Budget, in order to improve transparency and facilitate comparison with other areas of development expenditure. This should include projections, estimates and actual tax expenditure.

Extension of Infrastructure Tax Credit Scheme to Agricultural Industries

8. The Taxation Review received submissions arguing in favor of an extension of the infrastructure tax credit scheme to the agricultural sector. However, special allowances are already made for taxpayers engaged in agriculture ("primary production" in the Income Tax Act). Their spending on roads is an allowable deduction (not a depreciation), provided it is undertaken in the course of earning income. The deduction is allowable whether or not the taxpayer owns the land to which the improvement was made. Thus, spending on infrastructure which will benefit the taxpayer attracts a tax benefit in the form of a deduction.

9. The Review found no compelling arguments in favor of allowing the spending to attract a tax credit. Three problems are evident. First, the chief strength of the existing tax credit scheme (as in force for mining and petroleum companies) is that it
takes advantage of the capacity of resource companies to provide infrastructure at a lower cost than the State. It is not clear that any but the largest agricultural producers will have an advantage in this regard. Second, it is not clear how the concept of “direct benefit” would be applied to the agricultural sector. The existing scheme includes only projects which will not be of direct benefit to the taxpayer. A third problem would be the monitoring of the scheme. The small number of companies eligible for the current infrastructure tax credit scheme makes monitoring the scheme manageable. Currently, only about thirty companies, all of whom fall within the remit of IRC’s resource monitoring unit, are eligible for tax credits. Expanding the scheme would increase the call on the Commission’s resources.

10. Any particularly worthy projects, for which the Government is considering the allowance of a tax credit, could be funded with an appropriation as part of the National Budget.

**Recommendations**

11. The Taxation Review recommends that:

    R - 83. There should be no change to the current system of allowing tax deductions (not credits) for infrastructure spending by agriculture firms.

**Revenue Implications**

12. Changes to the scheme will limit the companies right to commit the State to expenditure. This could save up to K50 million from being diverted every year.
REVIEW OF EXCISE TAX REGIME AND TARIFF ARRANGEMENTS

1. The Taxation Review was requested to:
   - Review the excise tax regime and methods by which excise rates are set.
   - Review the process by which general import tariffs are examined and set and the duty drawback system and relevant procedures.
   - Recommend necessary changes to: excise rates and collection procedures, especially with respect to alcohol, tobacco and petrol
   - Recommend changes to the processed by which import duties are examined and set, and advise on the arrangements to hear allegations of dumping; and report on the duty drawback system, and advise on changes if necessary.

Excise Tax Regime

Background

2. Manufacturers of excisable goods in Papua New Guinea are major contributors to the national economy not just as a source of revenue to government but also as a provider of direct and indirect employment and capital expenditure. In 1999, these industries contributed some K211 million which accounted for 13% of consolidated revenue.

3. The current excise system resulted from a major reform in 1996 when Papua New Guinea was required to meet its obligations to the World Trade Organization by reducing tariffs on imported goods. Today, excise duty is chargeable on both locally manufactured goods and on imported goods of the same class. Although the system generates satisfactory volumes of revenue, it has created a number of problems that remain unresolved.
Current Issues

4. First, the current system lacks transparency. The basis of the system is a manufacturer's "distributor price" upon which excise duty (ad valorem or by percentage) is levied. However, this price has no legal basis and bears little relationship to the cost of production or an ex-factory price. Competition is hindered and new entrants are deterred by the fact that the distributor price is treated as confidential.

5. Second, the design of the tax system encourages the sale of highly alcoholic spirits. Because taxes are effectively levied at the same rate on every liter of spirits, there is little price incentive to encourage the production or consumption of lower strength products. Indeed, in sharp contrast to international norms, overproof spirits (those with 50% or more alcohol by volume) are often cheaper to buy than underproof spirits. This has social costs which are not reflected in the tax structure.

6. The third set of concerns reflects the ease with which successive governments have changed rates of excise. Since 1996 changes which have often been large in magnitude have been announced with little notice, making production planning very difficult.

7. Finally, the very high levels of protection in the form of high rates of import duty have encouraged smuggling and under-invoicing of excisable goods, as well as unnecessarily restricting consumer choice. The current system of having alternate rates for import duties (such as "the higher of K14 per liter or 55% of landed value of spirits") leads to unnecessary confusion.

Move to Specific Rates

8. In order to resolve some of these problems, an alternative system of collecting excise duty has been proposed. Instead of raising a tax based on the selling price of the product (ad valorem), a fixed (specific) charge will be levied on specific quantities of products being imported or produced. The imposition of specific rates of duty is recognized as being an effective and efficient system for collecting excise revenue. Under the proposed regime, alcohol products will attract a specific rate for each liter of pure alcohol, while tobacco products will attract a specific rate for each 1000 cigarettes or each kilogram of tobacco.

9. The excise system being proposed is administratively less complex and is more transparent. By introducing specific rates of duty, there is less reliance on the declared value of the goods and confusion with alternative rates of duty (e.g. 55% or K 2.20 per liter) will be minimized.
10. In the case of alcohol products, it is proposed that excise duty will now be directly related to the volume of alcohol, so that drinks with a higher alcohol content will attract higher excise duties. This would alleviate the current situation where spirits comprising 57% by volume of alcohol (ABV) are levied at the same rate of excise as spirits of 38% ABV.

11. For beer, three new specific rates will be created. The rate on low alcohol beer will be lower per liter of pure alcohol (LAL) than that on high strength beer. It is hoped that this will encourage the production and importation of low alcohol beer. It will certainly result in higher taxes being paid by consumers of stronger beers.

12. All wine will ultimately pay the same rate per LAL as underproof spirits. However, as a transitional measure, it is proposed to allow payment of a reduced rate per LAL on cask wines until May 2001. This will allow importers of cask wines to sell their stock on hand and prepare for what will be much higher excise rates.

13. For spirits, two new specific rates will be introduced. The rate for overproof spirits will be 10% higher, per LAL, than the rate on underproof spirits. This will substantially increase the excise payable on alcoholic drinks with a strength of 50% ABV or above. However, the proposed change will be phased in over 12 months, in order to allow local manufacturers time to adapt. Local manufacturers have indicated that they may cease production of overproof drinks altogether. It is anticipated that this will mean that drinkers will switch to lower strength products. This will protect the revenue base (as the excise on underproof products will remain the rate in force currently), and will presumably result in fewer drinking-related social problems.

14. At the same time, the Taxation Review intends to lower import duty rates across each of the industries. Several products, such as bottled wine and imported spirits, are now sold only in small volumes, because of the very high taxes imposed. It is hoped that new revenue can be generated by lowering the price of these products. The Taxation Review has consulted extensively with local manufacturers, and has come up with a set of rates which will provide adequate protection to local industry, while allowing for importation of goods at rates which are not prohibitive.

15. In order to accommodate existing manufacturers, it is recommended that the lowering of import duty rates be phased in over several months.

Indexation and Clearances

16. By changing from an ad valorem to a specific system, the automatic indexing of the tax base (i.e. the price of the excisable product) will be lost. Instead, it is proposed that specific rates be increased automatically twice every year, in May and November.
It is suggested that the maximum rise imposed at any one six-monthly interval be limited to 2.5%.

17. A new clearance system is also proposed. Under the system, manufactures would be allowed to clear unlimited quantities of goods at all times. However, during quota months (which would be in May and November), only clearances up to the average monthly clearance made in the previous six months would be allowed at old excise rates. Any clearances beyond the quota would take place at the new rates of tax. Additionally, all clearances after the end of the quota month would be at the higher rate.

18. The new excise system has been widely discussed between the IRC, the Taxation Review, and industry. It has been agreed to by all parties. If the Government accepts the recommendations, the Taxation Review wishes to caution strongly again raising specific rates before November 2002. This will allow the new system to become entrenched, and will allow manufacturers to adapt to competition with what will be larger volumes of lower cost products imported from overseas. Furthermore, it is recommended that the operation of the entire system be assessed in 2002.

**Recommendations**

19. The Taxation Review recommends that:

R - 84. The 40% ad valorem import excise on concentrated spirits should be repealed immediately

R - 85. Beginning in May 2001 all specific excise rates should be increased by 2.5% every six months, until and including November 2002.

R - 86. A quota system should be put in place so that so that during May and November of each year a quota is in force. The quota will be equal to the average of monthly clearances during the previous six months. Clearances in May and November up to the value of the quota can be effected at current excise and import duty rates. Clearances in May and November in excess of the quota will be cleared at the new duty rate in force.

R - 87. The current excise duty and import duty rates for beer, spirits, wine, ready-to-drink beverages, cigarettes, and tobacco, should be replaced according to the table below.
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<tr>
<td>(PER LAL)</td>
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</tr>
<tr>
<td>Import duty</td>
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<td>60.00</td>
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<tr>
<td>&gt;4.6% abv</td>
<td>46.70</td>
<td>47.87</td>
<td>49.06</td>
<td>50.29</td>
<td>51.55</td>
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<td>3.1% - 4.5% abv</td>
<td>40.21</td>
<td>41.22</td>
<td>42.25</td>
<td>43.30</td>
<td>44.38</td>
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<tr>
<td>&lt;3.0% abv</td>
<td>32.83</td>
<td>33.65</td>
<td>34.49</td>
<td>35.35</td>
<td>36.24</td>
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<td><strong>SPIRITS (PER LAL)</strong></td>
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<tr>
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<td>Containers &lt; 2 liters</td>
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<td>52.11</td>
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<td>54.75</td>
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<td>Containers &gt;= 2 liters</td>
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<td>with soft drink)</td>
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<td>65.00</td>
<td>60.00</td>
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<td>&gt;4.6% abv</td>
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<td>3.1% - 4.5% abv</td>
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<td>Import duty</td>
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<td>60.00</td>
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<tr>
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<td>30.99</td>
<td>31.77</td>
<td>32.56</td>
<td>33.38</td>
</tr>
</tbody>
</table>

**Revenue Implications**
20. The proposed excise tax rates are largely unchanged from the current rates. However, import duty rates are falling. It is expected that this will stimulate the importation and sale of products, which will generate revenue. The Taxation Review believes that this will bring in additional revenue, rather than only diverting revenue from existing excisable products.

**Review of Tariff Arrangements**

**Background**

21. In July 1999, the Government embarked on a tariff reform program, starting with the removal of all provincial sales taxes and the removal of import duties of 11% on basic items (including many household items). Duties were replaced with a single rate of VAT of 10%. Some import duties were retained at reduced rates to protect local industries and some luxury items were subjected to excise taxes.

22. The implementation of the tariff reform program was delayed by eighteen months due to delays in passing the complementary VAT legislation. However, the timetable for implementing the tariff reduction was reduced by six months to compensate; the envisaged seven-year program was revised to six and a half years. Gradual reductions are planned to take place in the following manner:

| **Table 6. Time schedule for the tariff reform program** |
|-------------|-------------|-------------|-------------|-------------|
| Intermediate rate | 30%        | 25%        | 20%        | 15%         |
| Protective rate    | 40%        | 35%        | 30%        | 25%         |
| Prohibitive rate    | 55%        | 50%        | 45%        | 40%         |

Source: IRC

23. The White Paper explained the principles which govern the tariff reform program. The relevant points have been reproduced in Box 1.

**Box 1 Principles of the Tariff Reform**

- The 10% VAT will be charged on imports based on c.i.f. value plus customs duty (i.e. the domestic sales price);
- The provincial sales taxes will be replaced by a revenue sharing arrangement between the national and the provincial governments;
- The import tariffs will gradually be reduced from 1999 to 2006 - i.e. over 8 years [now reduced to 6.5 years];
• The import tariffs on capital equipment, inputs and raw materials will be reduced to zero;
• The intermediate import tariff on goods (with close substitutes or domestically produced alternatives) will gradually be reduced from 40% to 30% in 1999, to 25% in 2001, to 20% in 2003 and down to 15% in 2006. The tariff is applied to goods that are one company’s final product while being an input to another company’s production. The tariff will also be applied to products that potentially could be produced here but need moderate level of protection to make this attractive;
• The protective tariff rate will gradually be reduced from 55% to 40% in 1999, to 35% in 2001, to 30% in 2003 and to 25% in 2006. The tariff will apply to products that are manufactured in Papua New Guinea and require tariff protection for some time;
• Products at very high tariff rates will gradually be phased down to the prohibitive rate of 55% in 1999, to 50% in 2001, to 45% in 2003 and down to 40% in 2006. The tariff will be used for a few products that require additional protection for a limited amount of time;
• A few exceptional products will be treated outside this general framework due to contractual obligations or other factors such as previously very high levels of protection. This category includes alcoholic beverages, sugar, tinned mackerel and tobacco products;
• Excise duty will apply both to imports and domestically produced products. The list of excisable items (currently alcoholic beverages, tobacco products and petroleum and fuel) will be expanded to include motor vehicles and “luxury” items.
• The real effective level of protection will be reduced less than nominal tariffs since the tariffs on inputs will be eliminated;
• There will be no more “commercial” exemptions and only a very small number of targeted exemptions with clear and proven social benefits;
• Presently, mining and petroleum companies are being treated more favorably than other companies since the import duty they are paying is capped by an average basket rate of duty. With tariff rates coming down, this average will be significantly reduced which will have a negative impact on domestic industries. It is therefore proposed to repeal the reduced rate of import duty for all existing and future mining, petroleum and gas projects and treat them similarly to other companies;
• A number of products that are produced in Papua New Guinea have been reclassified to give them protection. If in the future, new products will be produced here and these will require some protection it can be considered then to include them in the list of either intermediate or protected goods.

Source: White Paper on Tariff Reform

Impact of Tariff Reform Program on the Economy

24. The tariff reform program will open the PNG economy and expose the private sector to more international competition. The reform program aims to prompt the private sector to be more cost effective, efficient and productive. Over time, it is hoped that tariffs reductions will encourage a more efficient allocation of resources along lines of comparative advantage. Economic theory and simulations of the PNG economy predict that the tariff reform program will increase welfare. However, since
the tariff reform program only commenced recently it is still too early to assess the actual impact on the economy.

**Timetable for Tariff Reduction**

25. At the suggestion of the World Bank, the Taxation Review considered the effect of accelerating the tariff reform program, from 6.5 years to 5 years. In doing so, several issues were considered:

- effects on government revenue;
- effects on investor confidence; and
- effects on consumer welfare.

26. At the time that the tariff reform program was developed, some local companies argued that they were being exposed too soon to international competition. The seven-year period of gradual reduction was agreed upon by the various stakeholders and international institutions to allow them that opportunity to make their businesses more efficient. As noted above this was later reduced to six and a half years.

27. This program resulted from very extensive consultations between government departments and the private sector. It is a program which is very much “owned” by the people who are involved. This high degree of ownership has made the program very robust, even in the fact of political instability. For example, the business community (including both importers and local manufacturers) rallied in support of the introduction of VAT and the tariff reforms, at a time when many politicians were speaking out against the reforms.

28. The Taxation Review has noted that investor confidence in Papua New Guinea is slowly recovering after a period of serious economic and political instability. As shown elsewhere in this report, there have been particular concerns about the stability of the tax regime.

29. The Taxation Review is mindful that there would therefore need to be strong arguments for an acceleration of the tariff reduction timetable.

30. The Taxation Review used a simple simulation static model to assess the impact of accelerating the tariff reform program from 6.5 to 5 years. The model used actual 1997 import data, adjusted for economic growth, and applied hypothetical tariff rates to this. It was found that the effect of accelerating the tariff reform program was a reduction in government revenue of around K27 million (at 1997 prices). The effects on consumers and overall economic welfare were difficult to predict, however the Taxation Review concluded that these would be relatively small, given minimal
acceleration to the tariff reduction timetable. The Taxation Review therefore concluded that the tariff reform timetable should remain as it is.

Changes in Classifications

31. The White Paper suggests that "If in the future, new products will be produced here and these will require some protection it can be considered then to include them in the list of either intermediate or protected goods." In practice, this function has been carried out by the IRC. To the IRC's credit, it appears to have acted fairly in this regard, taking into account both the needs of consumers (including domestic businesses) and consumers.

32. In theory, the function for reviewing tariff rates rests with the Industry Assistance Board. The Board, chairmanship of which rests with the Secretary for Trade and Industry, has been largely defunct since the inception of the White Paper.

33. While initially in favor of formalizing the process by which tariffs are reviewed, the views of the Taxation Review have since changed. In public consultations, many businesses put forward strong objections to effecting any changes to the current tariff reduction timetables. It was felt that changes are not always communicated clearly to ports, leading to confusion about rates. Furthermore, it was noted that the ability to influence change is unequally distributed among businesses. Those in Port Moresby, for example, are clearly better able to put forward an argument for raising or lowering rates.

34. The Taxation Review does not support any further modification of the tariff schedule. It was decided that certainty of the regime would outweigh any benefits from correcting any existing anomalies.

Eliminating Import Duty Exemptions

35. The Taxation Review is concerned at the level of discretion in the fiscal regime and advocates a generally applicable regime. In the case of import duties a major area of discretion has been the ability for successive governments to grant import duty exemptions as a means of attracting investment. The Taxation Review found that since there are no data on tax expenditure, the cost of this form of industry assistance is unknown.

36. The intention of the tariff reform program was to put in place a generally applicable framework for import duties, which balanced the needs of domestic industry, potential investors and consumers. Part of this package was the elimination of import duty exemptions. Despite this and the Government's repeated statements
about “doing away with special deals,” import duty exemptions continued to be given. In particular, the exemptions have continued to be an area of discretion in the negotiation of project agreements and have led to a substantial level of non-productive rent-seeking activities. Furthermore, the Taxation Review received many complaints from the manufacturing sector that the import duty exemptions have led to major investors procuring goods internationally rather than using PNG-made products.

**Antidumping Procedures**

37. Under the *Customs Tariff (Dumping and Subsidies) Act*, the Government has the power to levy antidumping duties, restrict imports, etc. However, this Act is not consistent with the provisions of the World Trade Organization. If the Act were to be used, it could be legally challenged before the WTO, and the PNG Government would be obliged to reverse the action which was taken.

38. There are three problems with the Act:

- First, the definition of the “normal value” of a product is in contravention of the WTO agreement. The Act defines a “normal value” as the price of a similar good sold in a third country. In fact, according to the WTO Agreement, the determination must be the price of a good sold in the exporting country. Only when goods are exported from centrally-planned economies (such as the People’s Republic of China) can reference be made to a third country.

- Second, the Act allows action to be taken retroactively. According to the WTO agreement, action may be taken only after an investigation has been started.

- Third, the Act does not go far enough in defining how an investigation would be undertaken. This could be defined through regulations. Procedures must outline how an investigation is started, and how it will gather its evidence.

39. In light of the problems with the Act, the Taxation Review recommends that it be repealed. In order to institute antidumping actions, the law would have to be rewritten and considerable resources devoted to proving instances of dumping.

**Recommendations**

40. The Taxation Review recommends that:

R - 88. There should be no change to the tariff reduction timetable.
R - 89. There should be no formal mechanism by which tariff classifications are considered. In very exceptional cases, the IRC and Department for Finance and Treasury can consider rate changes.

R - 90. Legislative changes should be introduced to remove discretion in granting import duty exemptions to commercial projects by amending section 9 of the Customs Tariff Act (1990).

R - 91. The Customs Tariff (Dumping and Subsidies) Act should be repealed.

Revenue implications

41. There are no estimable revenue implications to the changes recommended above.
REVIEW OF THE OPERATION OF THE VALUE ADDED TAX

1. The Taxation Review was requested to:
   - Review the operation of the value added tax, in order to assess whether it is being implemented efficiently, fairly, and with minimum disruption to businesses and consumers.
   - Recommend modifications that would improve its operation.

Background

2. In July 1999, the Government introduced the value added tax. VAT has many advantages over the previous system of using import tariffs to generate revenue. It increases transparency and reduces distortions. Countries which have introduced value added tax have become more efficient and more able to compete in the world market. This in turn has created more business opportunities.

Impact of VAT on the Economy

3. The new VAT is intended to reduce economic distortions associated with cascading taxes and the taxation of exports (which must compete in global markets). Economic theory and simulations of the PNG economy predicted that the VAT increased overall welfare. However, since the VAT was only introduced recently, it is still too early to assess the actual impact on the economy. Clearly though the VAT has been a significant benefit to export industries, notably agriculture, manufacturing and petroleum.

Implementation of VAT

4. The revenue figures for VAT indicate that a successful start was made in the implementation of VAT. Most large companies are paying VAT and inland revenues are expected to increase now that the major transitional provision has ended. There have, however, been a number of “teething problems”, which are to be expected with the introduction of such a major tax reform. Compliance during the first year, for example, was disappointing, but there are now signs that its improving.
5. The Taxation Review based its findings and recommendations on a number of sources. The IRC has been monitoring the implementation of the VAT closely and has set up systems and procedures for ongoing monitoring of progress; these include quarterly implementation reports and monthly Revenue Reports. The Taxation Review also received valuable comments from provincial governments and members of the public through submissions and meeting during the provincial visits.

6. The main implementation issues that the Taxation Review consider were:
   - Strengthening IRC's capacity;
   - Improving compliance with the VAT; and
   - Ensuring refunds and payments are made in a timely manner.

Strengthening IRC’s Capacity

7. The IRC has successfully established the main VAT office in Port Moresby, which acts as the central processing point for VAT and technical advice. Offices in other provinces have been established: Eastern Highlands, Morobe, Madang, Western Highlands, West New Britain, Manus, Sepik and Southern Highlands. Offices in other provinces are planned.

8. Delays in securing adequate funding and appointing and training the necessary staff have meant that VAT has got off to a slow start. However, the IRC is to be commended for have effectively utilized resources from elsewhere within the organization to ensure that the transition went smoothly. Key areas where there work remains to be done include setting up provincial VAT offices, training new staff and setting up computer systems for the lodgment of returns.

Compliance with VAT

9. The Taxation Review observed that while around 19,000 companies are registered for corporate income tax and 10,000 for group employers tax, only around 7,000 are registered for VAT. This appears to indicate that there are significant numbers of businesses which are failing to comply with the law by registering for VAT. Improvements in IRC’s information technology systems and consolidation of IRC’s tax registration would enable effective cross-referencing and improve compliance in this area.

4 Southern Highlands office operates out of Hagen.
10. During the first eight months of VAT, the only one-quarter of registered businesses lodged returns. This poor level of compliance was addressed by the IRC, who recruited more auditors and inspectors and vigorously chased up businesses failing to comply by issuing final notices. The IRC has also increased the pace of VAT audits and complemented this by carrying out simultaneous VAT inspections as part of its regular salaries and wages audits. The Taxation Review’s view is that the consolidation of these audit functions is an efficient approach and a good utilization of IRC’s resources.

Payments to Provinces

11. Under the arrangements with the provinces, the following distribution mechanism was agreed:

- provinces receive 30% of the net total VAT collections.
- provinces receive an amount based on the base entitlement they were paid in 1999 plus a share of the increase in net VAT based on their contribution to inland VAT collections.

12. The Taxation Review has noted that there were initially delays in making payments to provinces. The IRC is now making payments to the provinces on the 21st of each month, as required by the law.

Recommendations

13. The Taxation Review recommends that:

R - 92. In the short-term, sufficient resources should be allocated to the IRC in the 2001 Budget to ensure that the VAT division is fully staffed, the necessary auditors and inspectors are recruited and trained and the provincial offices are established.

R - 93. In the medium-term, the IRC should give consideration to consolidating business registrations, and assessing and auditing functions in order to improve efficiency as part of its overall strategy of improving tax administration (refer to section on tax administration).
Revenue Implications

14. In the medium-term, additional funding for the IRC will allow additional compliance-related activities, which should enhance collections of the value added tax.
REVIEW OF THE PROCESS OF TAX POLICY FORMULATION

1. The Taxation Review was requested to:
   - Review the process of tax policy formulation.
   - Recommend ways to set up a sound and effective process of tax policy formulation that safeguards the fairness and durability of the tax system.

2. Reader may wish to note additional comments on tax administration related specifically to the Mining and Hydrocarbon Review (page 49).

Findings

3. The Taxation Review found that there are serious weaknesses in tax policy co-ordination. Although in theory the Department of Finance and Treasury is responsible for tax policy, tax changes have often taken place without full consultation or agreement from the Department of Finance and Treasury. The result has been that there has been a lack of consistency in the application of taxation principles across sectors and corresponding lack of fairness. Whilst some industries have successfully lobbied for favorable tax regimes, others have been less successful and have become relatively worse off. This, in part, has given rise to more intensive lobbying, politicization of the tax system and instability within the tax system.

4. The Taxation Review found that although the Government's stated policy for attracting investment is based on transparency and creating a generally applicable framework for taxation, that is attractive to all businesses, there are significant amounts of discretion. Particular examples of discretion include redefining goods and services to allow more favorable tax treatment (e.g. export sales exemptions and gas versus petroleum fiscal terms) and import duty exemptions.

5. Many of these areas of discretion have become known as special deals and these are a symptom of poor tax policy co-ordination and ad hoc tax policy formulation. These agreements are particularly undesirable from a public policy perspective because they give rise to non-productive rent seeking behavior, speculation of corruption. They also undermine competition, fragment the tax system and increase the complexity of tax administration.
6. Elsewhere in this report the Taxation Review has made recommendations with regard to removing discretion with regard to import duty exemptions, export duty exemptions and gas versus petroleum fiscal terms. It has been beyond the scope of the Taxation Review to identify and review all areas of tax discretion.

7. The Functional and Expenditure Review of the Department of Finance and Treasury has identified the need to strengthen the tax policy function in the Fiscal Branch of the Economic Policy Unit; possibly with the engagement of an expert(s) from the IRC or a local accounting firm. The Taxation Review supports this recommendation and adds that it is not just important to strengthen the quality of tax policy advice in this branch, but to also strengthen the co-ordination of tax policy formulation.

Recommendations

8. The Taxation Review recommends that:

   R - 94. Wherever possible a generally applicable framework of taxation should be adopted in preference to discretionary powers.

   R - 95. The tax policy function should be strengthened in the fiscal branch of the Department of Finance and Treasury.

   R - 96. Consideration should be given to the engagement of one or two experts from the IRC or a local accounting firm to help strengthen this function.

   R - 97. NEC procedures and guideline should be amended to stipulate that only tax policy submissions approved by the Minister for Finance and Treasury will be considered.

   R - 98. A mechanism to provide a conduit for private and public-sector contributions to tax policy articulation should be developed.

Revenue Implications

9. The recommendations lead to no immediate changes to revenue generation.
REVIEW OF TAX ADMINISTRATION

The Taxation Review was asked to:

- Review the qualitative aspects of tax administration and costs of compliance.
- Recommend ways to: i) enhance, streamline and simplify tax administration, and where necessary, general costs of compliance; and ii) safeguard the fairness and integrity of the tax system.

Introduction

1. There are significant costs with the administration of the tax system. There are direct costs – the cost of running the IRC – and indirect costs, which taxpayers must bear. These indirect costs take on a variety of forms: i) the cost of time spent filling out tax forms, ii) costs of record keeping, and iii) the cost of accountants and lawyers. In the US, it has been estimated that the indirect costs are at least five times greater than the direct costs.

2. The administrative costs of running a tax system depend on a number of factors:

- They depend in what records would be kept in the absence of taxation. Many businesses keep records for their own internal management purposes and computers have greatly reduced the costs of keeping records for businesses. The tax system therefore imposes a relatively small additional burden on these kinds of business. However, small businesses, which keep few records, and which often are not computerized, face a relatively large additional burden.

- They depend on the complexity of the tax code. Much of the cost of administering the tax system comes from special provisions in the tax code. For example, the deduction of certain types of expenditure requires that records be kept on these types of expenditure.

- Differentiation of rates across individual and categories of income gives rise to attempts to avoid taxes and this cost money. Similarly, designing and enforcing provisions of the tax code to reduce tax avoidance also costs money.

3. This section deals with reducing direct and indirect costs of the tax system. In particular:
• Reducing direct costs by improving the efficiency of the IRC; and
• Reducing indirect costs by reducing compliance costs.

Background

4. In September 1992, the Taxation Office and the Bureau of Customs were merged. This merger was effected by way of enabling legislation to create the IRC with an executive comprised of the Commissioner General, Commissioner for Tax and Commissioner for Customs.

5. The Commissioner General has overall oversight of the operations of the IRC and reports to the Minister for Finance and Treasury (the portfolio is currently held by the Prime Minister). He is supported by two Commissioners, eight Assistant Commissioners, twenty-four divisional directors and thirteen functional or sectional managers. The IRC employs 780 officers; with 250 employed in 23 provincial offices around PNG. In 2000, the IRC has a budget of K26 million.

Performance of the IRC

6. In general, the IRC has managed the increasing revenue needs of the government well, as shown in the table below. From 1995 to 1998 funding and revenue collected increased in tandem. There was a large jump in funding in 1999, on account of the implementation of the value added tax.

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Revenue (millions of kina)</td>
<td>992.4</td>
<td>1,109.8</td>
<td>1,267.7</td>
<td>1,374.5</td>
<td>1,411.0</td>
</tr>
<tr>
<td>Expenditure (millions of kina)</td>
<td>12.0</td>
<td>145.0</td>
<td>15.7</td>
<td>18.8</td>
<td>25.0</td>
</tr>
<tr>
<td>Staff on strength</td>
<td>429</td>
<td>434</td>
<td>493</td>
<td>578</td>
<td>617</td>
</tr>
<tr>
<td>Expenditure per officer (thousands of kina)</td>
<td>28</td>
<td>34</td>
<td>32</td>
<td>32</td>
<td>41</td>
</tr>
<tr>
<td>Revenue per officer (millions of kina)</td>
<td>2.3</td>
<td>2.6</td>
<td>2.6</td>
<td>2.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Expenditure/Revenue</td>
<td>1.21%</td>
<td>1.35%</td>
<td>1.24%</td>
<td>1.36%</td>
<td>1.77%</td>
</tr>
</tbody>
</table>

Source: IRC

7. The IRC’s business practices and systems define the way it operates. Divisions are organized along functional lines, for example; assessing, appeals and dispute resolution, collections, audit and enforcement, port and border controls, general external client service and internal corporate services. The latter includes an amalgam
of services such as corporate budgets, information technology, human resources management and public affairs. Many of these functions are governed by enabling legislation, regulations and standard systems and procedures typically found in many revenue administrations.

8. The IRC's strong performance notwithstanding, the Taxation Review found that several problems which impinge on the operational capacity and effectiveness of the IRC:

- The structure of IRC along functional lines has been a self-imposed constraint in terms of long-term focus and strategic development. There are problems of staff "protecting their own turf." There has been a cultivation of an insular culture rather than one that takes into account the broader corporate interests of the IRC and key stakeholders, and the external operating environment and condition.

- Current business practices and systems are constrained by the established organizational structure and the present information technology platform - the two primary instruments through which the IRC conducts its business.

- The IRC suffers from the current syndrome of conducting government business by annualized budgeting and resource allocation. This has created a mindset and culture that encourages short-term planning, sometimes resulting in wastage, duplication and focus and concentration on short-term results.

9. The Taxation Review suggests that these are the primary reasons why past efforts to improve the IRC's organizational structure and customer services have not been fully implemented, despite modest gains on a limited basis.

**Strategic Planning**

10. The Taxation Review found that there is a need for the IRC to develop strategic corporate planning as a facet of its business mandate, operations and institutional culture. This entails strategic business planning with specific medium to long-term objectives and strategies and more focused short-term operational work plans. This would help to focus the organization on the establishment of future objectives, based upon the identification of relevant internal and external factors. A strategic business plan would help to clarify the services the IRC provides, the methods it would use and performance targets.

11. The major elements involved in the formulation of a strategic business plan include articulation of a corporate vision, analysis of the organization's mission and objectives, the internal strengths and weaknesses of the organization, the threats and
opportunities provided by the external environment and the managerial values and corporate culture. The more widespread and objective the data gathering, the more likely that the strategic business plan will be based upon a solid foundation, rather than speculation.

12. The Taxation Review recommends that:

   R - 99. The IRC should develop a strategic business plan that clearly articulates the organization’s medium to long-term objectives and strategies.

   R - 100. The IRC’s corporate affairs division should be realigned to coordinate and drive strategic development and monitor implementation of the strategic plan.

**Corporate Governance**

13. Provisions for the appointment of the Commissioner General by the Minister for Finance and Treasury are contained in the *Income Tax Act*. The Act provides for the appointments of the Commissioners of Tax and Customs by the Minister upon recommendation of the Commissioner General. The Taxation Review found that there have been laxity and anomalies in the present statutory provisions governing the manner of appointments, including the mandate, authority and aspects of accountability for these important senior positions. The law as it is drafted is silent in many areas and leaves the judgement call to conventions and political discretion, which again is dependent on prudential management and governance. There is a need to strengthen the system of appointments of the Commissioners and those at Commissioner levels and to ensure adequate statutory safeguards.

14. Presently, the Commissioner General is the only senior official in the IRC subject to the leadership code. Office holders of the post of Commissioner for Tax and Commissioner for Customs are not subject to leadership code. To complement and strengthened accountability and overall corporate governance it is recommended that the positions at Commissioner levels be also subject to the leadership code. Additional modes of accountability and checks and balances should be provided by retention of the monitoring and supervisory role presently played by the Department of Finance and Treasury and auditing mandates of the Auditor General.

15. The Taxation Review recommends that:

   R - 101. The appointment of the Commissioner General and the Commissioners should be given explicit statutory sanction with guaranteed tenure of service and adequate provision for accountability.
R - 102. The Commissioner General and Commissioners for Tax and Customs should be subject to the leadership code and, consequently, scrutiny of the Ombudsman Commission.

R - 103. The IRC, as part of its statutory obligation and its general corporate governance, should publish and table in Parliament a supplementary management report in addition to the annual reports on its performance and operations.

R - 104. The IRC as part of integrity enhancement and corporate governance develop a specific code of ethics for its staff and a taxpayer service charter.

Institutional Strengthening and Capacity Building

16. The Taxation Review observed that the IRC has not invested time and resources in upgrading its systems to cater for future growth and development. The ASYCUDA systems used exclusively in the customs operation is developed as an independent system and has no overlap or compatibility with other information technology systems. Even more noteworthy is the fact that the IRC is slow to embrace use of new technology such as the Internet as a critical interface and service to all its clients or intranet for its internal interface with all its personnel.

17. The IRC lacks officers with the breadth of knowledge, experience and strong potential to assume the mantle of senior management positions. This poses risks for sustaining strong leadership and management of the IRC, especially at the levels of Commissioner General, Commissioner and the mid tier levels currently held together by a cadre of long-serving expatriate officers.

18. The Taxation Review recommends that:

R - 105. The IRC should critically appraise its information technology systems and either upgrade or consider the viability of outsourcing.

R - 106. The IRC's Human Resources Division should strengthen its recruitment process, and articulate and formulate in-house policies in respect of an IRC specific succession plan and an equal opportunities policy.

R - 107. All complex cases in respect of tax defaulters should be outsourced to external lawyers at the sole discretion of the Commissioner General or the Commissioners.
The IRC Budget

19. The IRC suffers in much the same way as other government departments from delayed disbursements of funds from the Department of Treasury. This has two effects upon its ability to generate revenue. First, the delays can lead to cutting back on travel outside of Port Moresby (travel is funded out of the goods and services budgets). Inspections and audits in other parts of the country are considered very important by the IRC, as they enhance taxpayer compliance and bring in substantial revenue. Second,

R - 108. The IRC should work closely with the Department of Treasury and Finance to develop a mechanism for self-funding its operations, but within the normal framework of budgetary appropriations.

Consolidating and Rationalizing Systems and Structures

20. The Taxation Review found that despite the merger of the Taxation Office and the Customs Office in 1992, many of the benefits of economies of scale remain to be realized. There is a great deal of potential for the consolidating, streamlining and rationalizing the IRC's structure and systems. The Taxation Review found that the current tax administration is hampered by rigid bureaucratic structures. Essentially, there is a need to make a profound shift towards embracing modern business principles and practices. As an example, consider the issue of mail. The IRC could improve its mail management systems by using color-coded mails to save costs and time in sorting and handling incoming and outgoing mail. Automatic mail dispensing machines could be used to process large volumes of mail, etc.

21. Practically all tax payments are settled by cash or by cheque. The cash payments are paid at the cashier's office. Cheque payments, on the other hand, are paid at the cashier's office or mailed or delivered by courier to various collection points. Payments by cheque, which comprise 99% of the transactions, usually require 7 days to clear. There is potential for rationalizing collection points and entering into arrangements with commercial banks to collect and remit taxes. This would make it more convenient for individuals and small businesses to pay their taxes, as they would have access to more points of payments which are secure and efficient. In addition, it would contribute to a lower transaction cost as well as reduce public debt interest (by speeding the processing of payments).

22. There is a need to simplify registration of businesses and individuals for corporate income tax, personal income tax, and the VAT, in addition to general
business registration. This is needed to provide a sound platform for effective information management, enhance voluntary compliance and reduce cost of compliance for the clients and revenue administration.

23. The Taxation Review found that there is potential for rationalization of IRC’s functions. For example, since no tax appeals have been heard for some years and no tax ruling has been issued, there is potential for IRC to improve its resource allocation by refocusing the Appeals and Advising Division.

24. The Taxation Review found that no audits have been conducted on large corporations. This poses a grave risk to the revenue and, it allowed to degenerate further, will in fact serve by default to perpetuate and foster non-compliance. It is imperative that this institutional deficiency be corrected.

25. The Taxation Review recommends that:

- **R - 109.** The IRC should consolidate client registration for individuals and businesses; with each taxpayer being given a single tax number.

- **R - 110.** The IRC’s mail management systems should be consolidated, streamlined and rationalized.

- **R - 111.** The IRC should consolidate assessing functions of all tax type where it is feasible.

- **R - 112.** The IRC should structure assessing functions along business lines of large businesses, small and medium enterprises, and individuals and sole proprietors to more effectively address their special needs.

- **R - 113.** All audit functions should be consolidated to bolster and improve the effectiveness of compliance by: outsourcing large audits/investigations (particularly the resource sector); intelligent profiling according to compliance risks; improving and enhancing the IRC’s information gathering and matching capacity; and compelling banks by law to render information on all transactions above K10,000.

- **R - 114.** The IRC should consolidate and rationalize it’s collection points and explore, as part of it’s service outreach to clients, the viability of entering into arrangements with commercial banks to collect and remit taxes.
R - 115. The IRC should work closely with the Department of Finance and Treasury to streamline and improve the tax refund process, along similar lines to VAT refunds.

R - 116. The appeals and advising division of the IRC should be realigned and reorganized to focus exclusively on advising (i.e. especially issuing of more structured rulings and legal interpretations), policy articulation and dispute resolution.

Client Focus

26. There is a need for the IRC to re-orient itself towards a culture of client services. The Taxation Review noted that there are two primary developments and trends that have and will continue to place demands on governments to embrace client service as a cornerstone for their delivery of goods and services to all their stakeholders.

- Increasing globalization is a powerful imperative for governments and their respective civil service agencies to become more efficient in order to remain competitive.

- Businesses and individuals in PNG are demanding and expecting quality service from the Government.

27. The Taxation Review recommends that:

R - 117. As part of its strategic business plan, the IRC should reorient itself towards a culture of client services.

Baseline Analysis Work

28. The analysis of the tax base is critical to determine whether revenue collections have been fully maximized within confines of the present taxing statutes and, if not, what measures are necessary to correct the problem.

29. Over the years new imposts and new taxes have added to the cumulative burden of costs of compliance with tax obligations and laws by the clients and the revenue administration. It is important to measure the impact, extent and magnitude of the costs of compliance.

30. Swift clearances of cargo and facilitation of trade at the point of entry into Papua New Guinea is critical to businesses and the nation’s competitiveness. It is therefore important to review it with a view to facilitating swift and timely clearances of trade goods and services.
31. The Taxation Review recommends that:

R - 118. Baseline studies and analysis should be conducted on the tax base, costs of compliance and IRC cargo clearance systems to assist the qualitative process of tax/fiscal policy formulation as well as daily management decisions and strategic planning.

Consolidation of Tax Statutes and Codes

32. The evolution and development of tax laws and policies over the past 40 years has resulted in a myriad of changes to the tax laws that can be found in various pieces of legislation. This often results in poor or even wrong interpretation and application of the law. It is therefore essential to consolidate and reorganize all the taxing laws, codes and subsidiary regulations.

33. The Taxation Review recommends that:

R - 119. All tax statutes, codes and subsidiary legislation be rearranged and properly codified in a structured and easily comprehensible manner as part of the overall emphasis of client service.

Revenue Implications

34. In the medium-term, improving the IRC’s ability to administer the tax code will increase compliance at a lower cost. However, additional funding may be needed in the short-term, in order to allow the IRC to implement recommended changes.