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PERSONAL INCOME TAX REGIME IN PAPUA NEW GUINEA

by

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Key message

The existing income tax system is completely inappropriate for PNG and is in need of major reform. The current design presents a significant drag on broad based economic growth and is a major impediment to private sector development through micro and small enterprises. It is therefore completely out of touch with the development agenda of Papua New Guinea.

Summary of core recommendations

Recommendation 1: Abolish personal income taxation and replace with two new mutually exclusive taxes ô (i) Wage Income Tax; and (ii) Investment Income Tax.

Recommendation 2: For Wage Income Tax, retain the existing scheme of õfinal taxö declaration on all taxes deducted from wages by employers.

Recommendation 3: Introduce a new tax scale for Investment Income of a tax free threshold at K50,000 and a tax rate of 30 per cent for all amounts thereafter (in line with corporate taxation).

Recommendation 4: The tax free threshold should not apply to non-residents for the Investment Income Tax of Recommendation 3.

Recommendation 5: For Wage Income Tax of residents, replace the existing 6-tier tax scale with a 2-tier scale with a tax free threshold of K18,000 and a tax rate of 30 per cent above K18,000.

Recommendation 6: For Wage Income Tax of non-residents, replace the existing 5-tier tax scale with a flat tax rate of 33 per cent for all income.

Recommendation 7: Until other parts of the tax system are reformed to accommodate the loss in revenue associated with Recommendation 5, introduce an interim 3-tier tax scale for Wage Income Tax of residents which would be the same as the 2-tier scale except for a tax rate of 40 per cent for all wage income above K70,000.

Recommendation 8: Introduce an interim 2-tier tax scale for Wage Income Tax of non-residents with a 33 per cent tax rate for earnings up to K70,000, and a 42 per cent tax rate for all wage income above K70,000.

Recommendation 9: Abolish dependent rebates.

Recommendation 10: Abolish the existing system of fringe benefits tax and replace with a simplified system where all fringe benefits are taxed in full in the Wage Income Tax system, except for housing, car, phone, home travel and education benefits up to a combined threshold of K20,000. Beyond K20,000, they are taxed in full.

Some perspective on Papua New Guinea’s personal income tax system

The personal income tax system of PNG is derived from the colonial era when the Australian administrators transposed the system from Australia. For Colonial times and in the early years of independence this may well have been entirely appropriate because very few Papua New Guineans were captured in the income tax system. Instead, it was the Australian workers living in PNG who were the main contributors to income tax at the time.

Of course, PNG has changed a lot since those days, particularly in the last decade. Discriminatory pay in the Public Service has been removed and there is now a large and growing Papua New Guinean middle class of professionals and business people. But the philosophy and design of the income tax system ô that existed mainly to tax Australian workers ô has largely remained static.

Whether or not this historic personal income tax regime is appropriate for the PNG of today requires some carefully considered analysis within the context of where the country sits now on the path toward economic and social development. From the outset, any such careful analysis needs to dismiss acquired wisdoms of what is appropriate in the Western World for rich countries. So for example, if something works well in Australia or in the OECD, there should not be a presumption that it will also work well in PNG.

On the administrative side of the income tax regime, the challenge is finding the right balance between fairness of the regime and the administrative cost for Government to effectively enforce the regime. For countries in the developed World, the scope for collecting income taxes is deep. Under these conditions, there is opportunity to invest in a strong administration system that places an emphasis on fairness.

The contrast for PNG is strong. The Internal Revenue Commission struggles in its function to enforce tax compliance and PNG cannot afford to sink scarce resources into a larger tax bureaucracy. These circumstances mean that PNG needs to adopt a very different strategy to income tax administration than is found in rich countries such as Australia.

This report will take a fresh analytical look at the personal income tax system in the context of PNG and navigate its way to a design in accordance with the structure of the economy, the characteristics of the labour market, and the Governmentøs agenda of prioritising spending on nation building services ô not on bloated bureaucracies.

The existing personal income tax system

PNG has a 6-tier progressive income tax regime for personal taxation as shown in Table 1. The upshot of the progressive system is that the income tax rate at the margin rises progressively as income rises, starting at 0 per cent for annual incomes below K10,000 and rising in 5 steps to reach 42 per cent for incomes above K250,000. Non-residents do not benefit from the tax free threshold of K10,000, so have a 5-tier system.

Taxable income includes wage income and income derived from returns on investments. So interest income on bank deposits, dividend income, rental income from properties, and income from unincorporated businesses are all part of taxable personal income. Investment income only becomes taxable once it reaches a threshold of K100.

Expenses incurred in earning taxable income are able to be deducted, but only when they are in excess of K200 a year. So for example, interest expenses and maintenance expenses on a rented property are deductible. There are also allowable deductions for items not related to earning income. These include deductions according to the number of dependants and gifts to charities.

The treatment of fringe benefits paid by the employer is complicated with some benefits exempt, some partially exempt, and others not exempt. School fees paid by the employer are exempt as are leave fares for employees to return to their place of origin. Allowances for the provision of cars and meals are subject to income tax, but at predetermined rates ô there is a weekly prescribed taxable income amount for motor vehicles and a prescribed amount for meals according to the number of meals provided. The taxation of motor vehicle allowances becomes further complicated with the requirement to calculate the extent that the vehicle is provided for personal use. Telephone allowances are also subject to income tax, but only to the extent they are used for personal purposes.

The taxation of allowances for housing are particularly complicated. Where the allowance is paid direct to the employee it is not exempt. Some degree of exemption is allowed when the housing is provided directly by the employer, but this depends on where the housing is in PNG, and depends on the market value of the home.

Table 1: The 6-tier personal income tax regime of Papua New Guinea

	Taxable income	Residents	Non-residents
Tier 1	K0 ó K10,000	0%	22%
Tier 2	K10,000 ó K18,000	22% of amount above K10,000	22%
Tier 3	K18,000 ó K33,000	30% of amount over K18,000 + $1760	30% of amount over K18,000 + $3960
Tier 4	K33,000 ó K70,000	35% of amount over K33,000 + $6260	35% of amount over K33,000 + $8460
Tier 5	K70,000 ó K250,000	40% of amount over K70,000 + $19,210	40% of amount over K70,000 + $21,410
Tier 6	Over K250,000	42% of amount over K250,000 + $91,210	42% of amount over K250,000 + $93,410

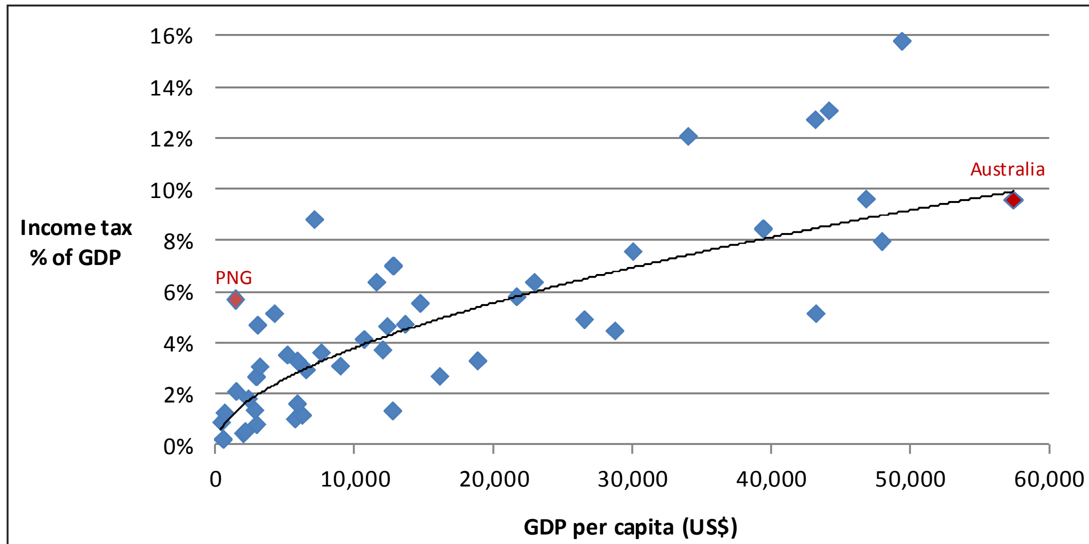
How much revenue should be raised from personal income tax?

Revenue raised from personal income taxes in PNG is at about 6 per cent of GDP, which is very high compared to other countries with similar per capita GDP. This is clear in Figure 1, which plots the level of personal income tax revenue as a share of GDP against GDP per capita for a range of countries where data is available. Figure 1 reveals a clear global pattern of increased reliance on personal income taxation as countries become richer.

Personal income tax revenue for PNG is found to be more in line with that seen in middle income countries rather than low income countries. Amongst the 20 countries in Figure 1 with GDP per capita below US$7,000 in 2010, PNG easily had the highest level of personal income taxation. Besides PNG, only four of these countries collected more than three (3) per

cent of GDP in personal income taxes. Put another way, the rate of personal income taxation in PNG is more than double of the majority of low income countries.

Figure 1: Personal income tax revenue versus GDP per capita (countries where UN data is available), 2010



Source: Compiled using data from the websites of PNG Treasury, Australian Bureau of Statistics, and UNDATA.

That such a high level of income tax is raised in PNG is quite extraordinary given the very low levels of formal employment. Labour market statistics in PNG are very poor, but a study in 2000[1] found that in the late 1990s less than 3 per cent of the population had formal jobs in the private sector. Although this share is likely to be higher now, it wonøt be much higher given that by far the majority of the population still work informally in rural areas. In contrast, for the developed world, most of the working age population are taxed ô yet in PNG income tax revenue raised as a share of GDP is similar to that found in the developed world.

The high rate of personal income tax revenue in PNG might best be explained by the combination of high tax rates and high wages for skilled workers in comparison to what is found in other low income countries ô particularly for foreign skilled workers. High wages for skilled workers and the heavy dependence on foreign skilled workers is explained by the low priority given to higher education over the last 3 decades.

What is the right level of personal income tax revenue for PNG? Should it be somewhere under three (3) per cent of GDP like in most other low income countries? PNG being out of step with the rest of the world does not necessarily mean that PNG is wrong.

But the broad evidence would weigh against this high level of taxation. In Figure 1 we can see that Australia sits at the opposite end of the chart to PNG thanks to a World-leading level of GDP per capita. The economic structure and level of economic development of Australia is therefore at the opposite end of the spectrum to PNG. It would be reasonable to argue that

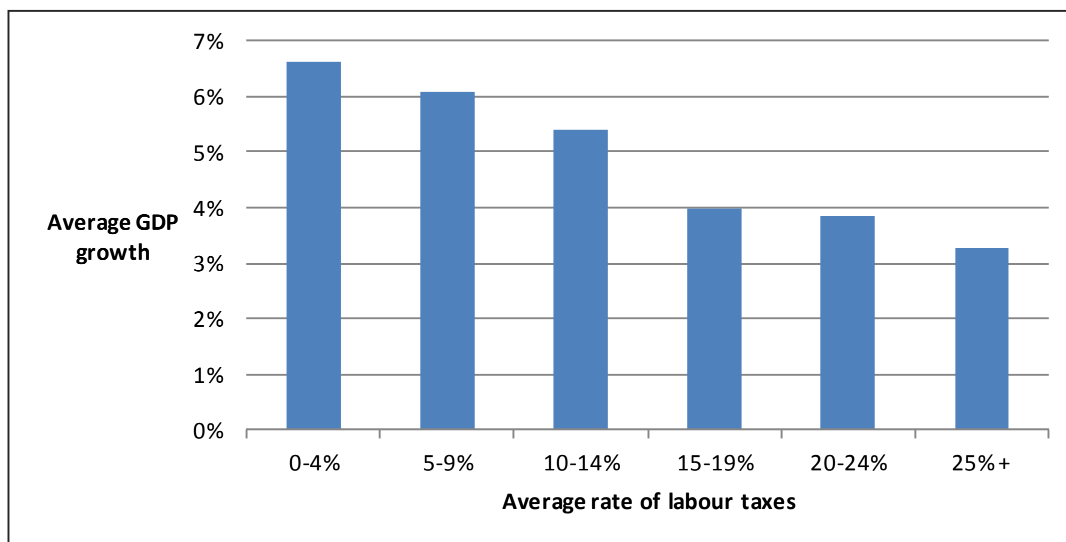
[1] Levantis (2000)

the tax systems of countries should be designed very differently to accommodate the comprehensive differences in their economic structures. However, PNG has a personal income tax system inherited from Australia with a multi-tiered tax rate scale that very much parallels that of Australia.

Harder evidence that PNG depends too heavily on personal income taxation is provided in Figure 2, which compares average rates of economic growth with average rates of labour taxes amongst 44 countries that have a low level of human development. A clear pattern emerges of lower economic growth as labour income tax rates rise. Amongst countries with labour tax rates at 4 per cent or below, the average rate of economic growth over the years, 2007-2012, was 6.6 per cent ô exactly double that of countries with high rates of labour taxes of 25 per cent and above.

The pattern seen in Figure 2 of progressively higher growth outcomes as labour tax rates become lower are too clear to be coincidental or spurious. The findings in Figure 2 demonstrate that high levels of labour taxes are an impediment to economic development in low income countries. Based on the evidence we see in Figures 1 and 2, PNG would best be served by developing a personal income tax system that would raise about half of what is currently raised, with more onus shifted to other forms of taxation.

Figure 2: Average labour income tax rates versus average rate of GDP growth over 2007-2012 for all countries at a low level of human development



Sources: Compiled using labour tax rates from *PWC Paying taxes*, and average growth rates calculated from the IMF Global Economic Outlook database available on the IMF website.

The unfair yet sensible scheme of "final tax" for wage income

An important measure in place to ease the administrative burden of processing tax returns is the declaration of õfinal taxö for the tax on wages withheld by employers. The existing procedure for wage earners is that the tax liability on their pay is deducted by the employer and the employer remits that tax to the Internal Revenue Commission (IRC). The amount that is deducted is the õfinal taxö and is declared as the final tax liability of the tax payer, and so

the tax payer does not need to engage further with the IRC ô unless they have other non-wage income.

What this means is that a personøs income tax liability is not calculated on an annual basis but according to their pay period ô which may be weekly, fortnightly or monthly. For example, where an employee is taxed on a fortnightly basis, the tax scale in Table 1 is rescaled to a fortnightly tax table.

The õfinal taxö policy makes sense from the perspective of simplicity of administration, but it can be unfair. This is because a personøs income tax liability is not calculated on an annual basis but according to their pay period (weekly, fortnightly or monthly) and the progressive tax scale means that average tax rates rise as wages rise (see Figure 3a). As a result, the tax liability of individuals over the course of the year will be higher than what it would have been had the tax liability instead been calculated on an annual basis ô except in the case where individuals receive exactly the same pay each pay period over an entire year.

For example, if a person earns K3,000 a fortnight then the tax liability would be K862 a fortnight. If over the course of a year that person works for only 6 fortnights and is out of work for the rest of the year, then the tax liability over the year becomes K5,172, despite only earning K18,000. If the tax was instead calculated annually, then the income tax liability would only be K1,760.

In the context of PNG, this compromise in fairness for the sake of simplifying the administrative system is the right way to go. The administrative burden on the Government and on the public is kept to a minimum by cutting back on the need to lodge tax returns. If PNG were to follow procedures of annual returns seen in rich countries, the tax bureaucracy would need to be stepped up substantially at significant cost. Moreover, the public would be subjected to the administrative burden of annual returns, including the costs associated with hiring tax agents.

Another consideration adding support to the existing system is that when people shift out of formal employment they often secure informal employment which is hidden from the tax system. Hence, for those worst affected workers who shift in and out of formal employment and receive inconsistent earnings over the course of the year, working in informal employment provides an offsetting buffer in their tax liability.

A new way forward for investment income

Investment by micro and small businesses represents the foundation of a thriving, broad-based economy. The Governmentøs long-term planning documents ô Vision 2050 and the PNG Development Strategic Plan 2010-2030 ô recognise this and place private sector development of small-scale enterprises at the forefront of the development agenda.

With small-scale private sector development so important for PNGøs future, taxing the income of small enterprises needs careful consideration. On one hand, it is preferable to steer away from taxing fledgling small-scale enterprises to help them establish and flourish. On the other hand, taxation of successful businesses represents a crucial part of the tax base.

Medium and large businesses would normally be corporatised and so are taxed through the corporate income tax system. However, uncorporatised businesses are taxed through the

personal income tax system. Where a personøs income from business and investment exceeds K100 over the year, that income is taxable in the personal income tax scales (Table 1) and must be declared. The tax free threshold of K10,000 applies, which means micro-businesses with low incomes may be exempt from income tax.

But if a person who owns a micro/small business also receives a wage income, then the investment income must be added to the wage income to calculate the total tax liability. For example, if a person earns wages of K70,000, and has a micro enterprise that earns K10,000, then the total taxable income is K80,000. The extra K10,000 business income will be taxed at the marginal rate of 40 per cent (see Table 1).

Clearly, there is a big problem here with how micro and small businesses are taxed. The people best placed to invest in small and micro businesses are wage earners, as they already have a cash flow. Yet these potential investors are severely curtailed by high marginal tax rates, even for micro-businesses with notional incomes. This might well explain the high prevalence of informal businesses and the difficulty in encouraging businesses to transition to a formal status. So not only does this mechanism of taxing the small business sector curtail investment in the sector, it also shifts people into informality to avoid taxes.

Moreover, the system of taxing micro and small enterprises is grossly unfair and uncompetitive. For example, a micro business set up by a wage earner on K70,000 a year and earning K10,000 will be taxed K4,000 on the business earnings while the same business set up by a person with no other income will have a tax liability of zero. The same business owned by another wage earner who instead decides to keep the business informal will also have a tax liability of zero. Even a medium or large business operating in the same sector will only be liable to K3,000 in tax.

This method of applying income taxes to micro and small businesses is another legacy of a tax system inherited from PNGøs rich neighbour, Australia. Significant reform is needed to bring the system in line with what is appropriate for PNG in the context of the development plans of PNG. Most importantly, a level playing field is needed where micro and small businesses are taxed the same way, regardless of the ownerøs status in the formal workforce. The way forward for PNG would be to do the following:

1. Abolish the personal income tax system and replace it with two separate and mutually exclusive forms of income tax ô (i) Wage Income Tax; and (ii) Investment Income Tax.
2. Continue treating the Wage Income Tax as a õfinal taxö collected by employers in accordance with the previous section.
3. Introduce a new and separate tax scale for the Investment Income Tax so that wage income is not added to investment income in calculating tax liability.
4. Set the rate for the Investment Income Tax at the same rate as the corporate tax rate (30 per cent).
5. Introduce a tax-free threshold for Investment Income Tax of K50,000.
6. For non-residents, the tax rate would be set at the corporate rate for all income so that the tax-free threshold does not apply.

The reasons for this way forward are clear and unambiguous, and include:

- consistency with the Governmentøs agenda of promoting micro and small enterprises;
- the establishment of a level playing field across all micro and small businesses, regardless of the formal workforce status of the owners;
- the establishment of a level playing field between micro/small and medium/large enterprises with the significant disadvantage of high marginal tax rates removed from micro/small businesses;
- existing informal businesses will have the incentive to formalise ô providing them greater scope to raise finance and expand;
- the self-employed who have low incomes will not be required to pay tax and would be relieved of the administrative burden of submitting tax returns ô providing important equity benefits;
- the tax-free threshold for investment income will replace the current requirement to declare investment income above K100 a year, reducing substantially the administrative burden for the IRC;
- the threshold of K50,000 means that most informal businesses will be able to formalise without incurring a tax penalty;
- the creation of a separate stream for investment income to replace the existing system simplifies the administration of personal tax for the IRC; and
- deductions of investment expenditure against wage income would not be allowed;
  - ✓ adding further to the ease of administration for the IRC; and
  - ✓ removing the practice of negative gearing (declaring losses on property investments) to reduce tax liability on wage income.

One impact of this proposed system is that income from passive investments ô interest and dividends ô will now be subject to the K50,000 tax-free threshold. This means that a high-income wage earner can earn additional tax-free income from these passive investments where the additional income is below the tax-free threshold. However, in the interest of moving to a vastly simplified and improved system, this is a small price to pay. In any case, there are advantages associated with encouraging people to save.

Finding an appropriate top marginal income tax rate

The top marginal income tax rate in PNG of 42 per cent is out of step with what is seen elsewhere in the World. It is at about the level seen across OECD countries where the average top marginal tax rate is 41.5 per cent[2]. But the global average is 31.0 per cent, and the average in Asia is just 28.4 per cent.

This finding reaffirms the findings out of Figure 1 that PNG has a personal income tax system more in line with that of a rich country than a country at PNGøs level of development. To be at a level in tune and competitive with PNGøs neighbours in Asia and with developing countries around the globe, a top marginal income tax rate of about 30 per cent would seem more appropriate.

There are at least five important advantages to lowering the top rate to this level. First it reduces the incentive for tax avoidance, which, at marginal tax rates of 40 per cent and above, is very strong. The incentives for tax avoidance need to be understood in the context of the

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[2] All marginal tax rate information is sourced from the KPMG website http://www.kpmg.com/GLOBAL

limited capacity of the IRC ô meaning that the risk of getting caught practising illegal tax avoidance is not high.

Second, the incentive would be removed for foreign workers and consultants on short-term placements to transfer taxable income offshore. It is quite straightforward to shift taxable income off-shore. For example, by reducing wage rates and allocating large end of year bonuses, or by manipulating visits to PNG, or even by outright avoidance. The scope for shifting income is underpinned by a large grey area when it comes to classifying whether or not short-term consultants are liable for local taxation in PNG. Lowering the top tax rate in PNG would likely result in foreign workers and consultants doing the opposite, i.e. shifting taxable income away from their home country and into PNG. Australia, for example, is the source of many foreign workers and consultants in PNG, and a top rate of 30 per cent would be significantly lower than in Australia. The end result for PNG could well be an increase in income tax revenue from foreigners rather than a decrease.

Third, the lower tax rate raises the incentive to become a high-income earner and to continue investing so as to increase income further ô although this advantage is mostly negated if the proposal outlined earlier to separate wage and investment income is adopted. Fourth, it would be in line with the company income tax rate which would remove the incentive for higher income earners to shift taxable income into companies as a way of lowering their tax burden ô although again, this advantage would mostly be negated if the separated investment income tax system were to be adopted.

The fifth justification is a very important one in the context of PNG. The Wantok system means that people on high incomes are obliged to look after those in the community on low incomes. This is an excellent social system that ensures that all are looked after, but it highlights the failure of Government to provide support and jobs to the needy, and the requirement for individuals to step up to fill the void left by Government. So in a sense, high income earners incur an implicit tax as a result of their Wantok distributions. Moreover, they incur this implicit tax while they are doing what other countries would consider to be the Governmentøs work.

The implicit õwantok taxö means that the effective marginal tax rate for high income earners is even higher than 42 per cent. The Wantok system in PNG means that reducing the top marginal tax rate will make more funds available for redistribution. So paradoxically, it could be argued that in PNG the high top marginal rate is *regressive* rather than progressive.

An important downside to lowering the top marginal rate is the potential impact on Government revenue, which is needed for nation building. But at the top rate of 42 per cent, the PNG tax system might have pushed this argument too far. A high rate of taxation for high income earners is important on equity grounds and revenue raising grounds, but the right balance needs to be struck whereby the tax rate is in line with what is found elsewhere in what is now a global labour market for skilled labour.

The way forward for wage income taxation — residents

To compensate for the potential downside to equity of the recommendation to reduce the top marginal rate to 30 per cent, attention can be placed on lowering the tax burden for people on low and middle incomes through reforms to the progressive tax rate system.

PNG has quite a complex progressive taxation system with six different rates of taxation as well as a tax-free threshold (Table 1). It is difficult to understand how such a complex system could be considered appropriate in PNG. In theory, it sounds appealing to progressively increase the tax rate as peoplesø incomes get higher. But in practice, it is unnecessarily complex and another Australian legacy of a system out of touch with the level of PNGøs development.

At the opposite end of the spectrum is the pure simplicity of a flat tax rate for all personal income earned with no tax-free threshold. But this too would be inappropriate as it would be at odds with equity principles. Moreover, the simplicity of the concept of a flat tax rate does not translate to simplicity in practice; Quite the opposite in fact. A flat tax rate would be an administrative nightmare with millions of liable tax payers instead of tens of thousands. Moreover, most of these liable tax payers have poor education, no access to banking, and live in remote rural areas.

The tax-free threshold therefore serves two crucial functions:

1. It relieves low income earners of the burden of paying income taxes; and
2. It vastly reduces the number of taxpayers who have tax obligations ô thereby reducing the administrative burden for Government as well as the burden for employers and individuals.

The higher the tax-free threshold, the greater the gains in equity and in administrative burden. But how high should the tax-free threshold be? The higher the threshold, the more people that drop out of the taxation net and so the lower the revenue raised. The right balance needs to be struck.

The existing income tax system is further complicated with the system of rebates for dependants. This concept ô adopted from Australia ô is designed to relieve the tax burden for people with dependants. Again, this is totally out of place in PNG and an unnecessary administrative burden. Most wage earners in PNG will be able to claim the full rebate, making the idea of the rebate pointless. Moreover, anyone not able to claim a rebate will still be supporting dependants through the wantok system ó making it unfair that they should miss out. Rebates should be abolished and lowering the tax scales for all people will more than compensate for this.

It is proposed that for all residents, the wage income tax system should comprise the following characteristics (see Table 2):

- a flat tax rate of 30 per cent for all residents;
- a tax free threshold of K18,000; and
- no dependant rebates.

The logic of a tax rate of 30 per cent was outlined in the previous section and the 30 per cent tax rate currently cuts in at K18,000 (Table 1). Figure 3a shows that the simple concept of a flat 30 per cent tax rate combined with a tax free threshold of K18,000 is more progressive than the existing complex 6-tier system for people on low-middle incomes. High income earners are also beneficiaries, but lowering the top marginal rate to an internationally competitive level is fundamental ô particularly in view of the implicit õwantok taxö described in the previous section.

There would be a number of important advantages for PNG in taking this path forward:

- the personal income tax system would become simple and easy to understand with a shift from a 6-tier to a 2-tier progressive scale (see Table 2);
- the tax scales become more progressive for low-middle income earners;
- people earning between K10,000 and K18,000 will no longer be liable for tax;
  - ✓ which is good for the poor; and
  - ✓ which reduces the administrative burden for Government and employers;
- the top marginal rate and revenue raised from wage income taxation will come into line with PNGøs neighbouring developing countries in Asia instead of in line with rich OECD countries;
- the international evidence suggests that the reduction in the marginal rates and in the revenue from income taxation will provide impetus for higher economic growth; and
- the pointless dependant rebates would be removed.

The way forward for wage income taxation — non-residents

The philosophy behind the existing system for non-residents is difficult to understand. Poverty and low incomes in PNG are not normally associated with non-residents. With this in mind, it is a good thing that non-residents do not have access to the tax-free threshold. But it is difficult to understand why PNG would extend its affirmative action on income equity to non-residents through a 5-tier progressive tax system.

Non-residents who come to work in PNG are normally skilled professionals and trades people attracted by the opportunity to earn higher incomes than they would at home. In this case ô and without any need for PNG to extend concerns on income equality to non-residents ô the only logical form of taxation would be a single tax rate on all income.

So what flat tax rate should be adopted for non-residents? On the face of it, the 30 per cent tax rate proposed for residents might equally be chosen for non-residents. But this would discount the earlier discussion of the implicit õwantok taxö and the important practice of high income earners redistributing their income to the poor through the wantok system. Clearly, non-residents will not be doing this and instead will return their income to their place of origin.

It would therefore seem logical to set a higher rate for non-residents. At the same time, the tax rate needs to be internationally competitive in the context of the global labour market. It was explained earlier that developing countries tend to have a top rate of about 30 per cent while OECD countries average 42 per cent. With the majority of foreign workers in PNG coming from OECD countries, a flat wage income tax rate of 33 per cent would be justified. At this rate, high income earners coming to PNG would be less inclined to shift their reported earnings for tax purposes off-shore, and will be taxed at a higher rate than local income earners to compensate for the implicit õwantok taxö.

An interim approach for the Wage Income Tax

If the above proposed wage income tax scales were to be adopted in PNG, revenue raised from personal income taxes would fall sharply. Modelling analysis based on the estimated income profiles of the labour force suggests that the average rate of income tax across all workers under the existing system is about 21 per cent. This would fall to a minimum of 15

per cent under the proposed system ô although it is likely to be higher than this, with the lower top rate attracting non-residents on short term work to declare their income in PNG.

Taking a conservative approach and assuming the 15 per cent average rate, income tax revenue would drop by nearly 30 per cent. In the 2014 Budget, revenue collections from personal income tax is forecast to reach K2,746 million in 2015. If, for example, the proposed regime were to be introduced in 2015, along with the 30 per cent tax rate for investment income proposed earlier, then revenue would drop by K728 million to K2,018 million.

The maintenance of the tax base would require these losses to be recovered from other sources of revenue. As such, a radical overhaul of the tax system would be needed. However, implementing radical change is difficult. Instead, a pragmatic approach might be needed to shift the regime in sequence over time, with the proposed 2-tier income tax scale being the end goal. The reform process could therefore best be served by first implementing an interim scale.

Table 2: The proposed 2-tier Wage Income Tax regime for PNG and the interim 3-tier regime

	Taxable income	Residents	Non-residents
The final 2-tier wage income tax regime			
Tier 1	K0 ó K18,000	0%	33%
Tier 2	Over K18,000	30% of amount above K18,000	33%
The interim 3-tier wage income tax regime			
Tier 1	K0 ó K18,000	0%	33%
Tier 2	K18,000 ó K70,000	30% of amount above K18,000	33%
Tier 3	Over K70,000	40% of amount over K70,000 + K15,600	42% of amount over K70,000 + K23,100

An appropriate interim scale would be one that has much less impact on revenue collections, but makes big shifts towards the two-tier system. Under the existing system, the 40 per cent tax rate cuts in at K70,000. The interim regime could retain the 40 per cent tax rate for residents at this threshold as the new top rate. In this case, in the interim, the 6-tier scheme for residents would be cut back to a 3-tier system. For non-residents, the interim top rate could be kept at 42 per cent which is equivalent to the OECD average and is set higher than the rate for residents in recognition of the implicit õwantok taxö. The details of the interim 3-tier regime and the final 2-tier regime are detailed in Table 2.

The average tax rate for the interim proposal is estimated to be 17 per cent and the revenue raised in 2015, if it is implemented, would drop to K2,230 million from the forecast level of K2,746 million under the existing regime. This interim regime therefore achieves the objective of mitigating the impact on revenue whilst taking a big step forward toward the end objective of the two-tier scheme.

Figure 3a shows how the equity characteristics of the proposed tax regime for low-middle income earners is improved with average tax rates dropping sharply for those earning less than K30,000 a year. For example, the average tax rate for people earning a modest K20,000 is currently 12 per cent, but this would drop to just 3 per cent under the proposed system. At a high income level of K300,000, the average tax rate is just over 37 per cent in the existing system and would drop only marginally to 36 per cent under the interim regime.

The implications for non-residents of a flat tax rate replacing the 5-tier system is seen at Figure 3b. Non-residents on lower incomes lose out, while those on higher incomes benefit. Under the interim regime, the liability for high income earners ô both resident and non-resident ô stays much the same.

Figure 3a: Average wage income tax rates for residents under the existing, the proposed, and the interim tax scales

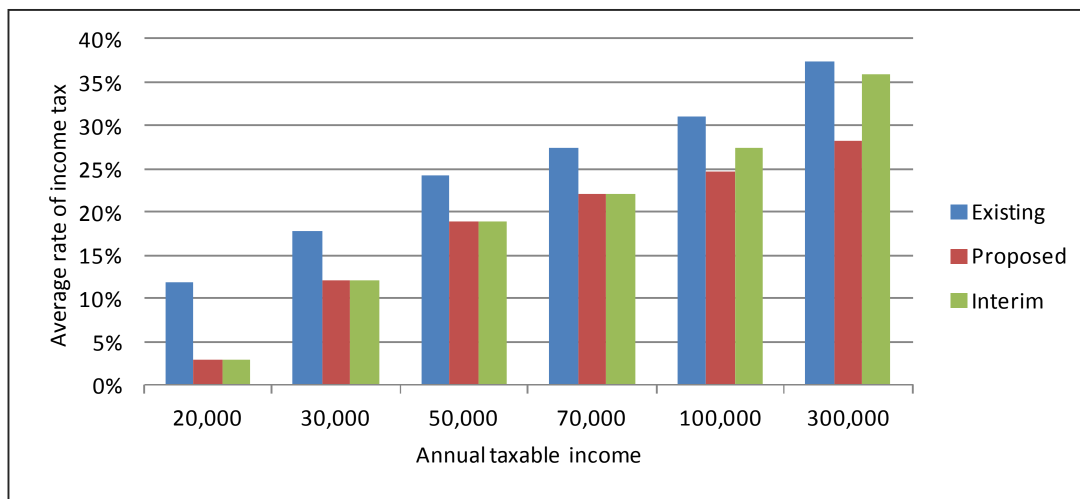
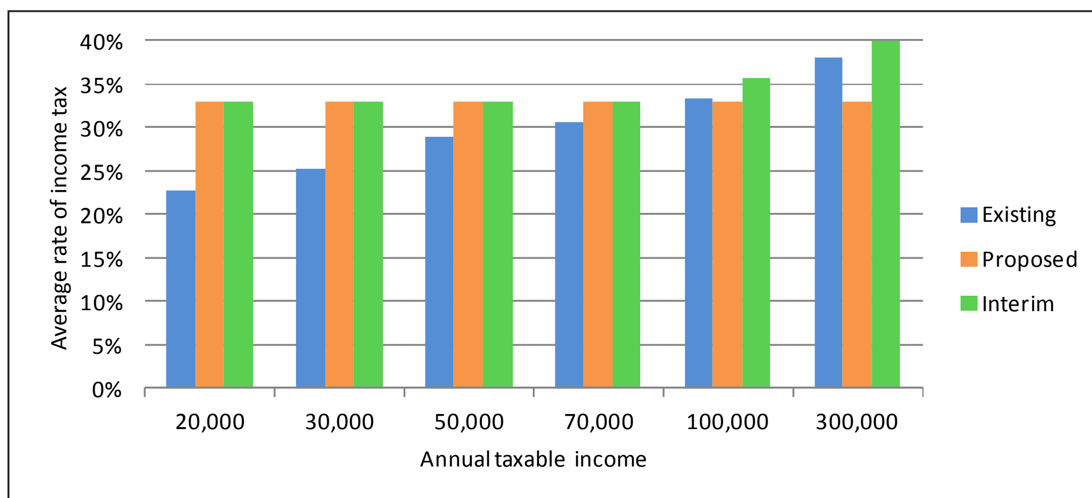


Figure 3b: Average wage income tax rates for non-residents under the existing, the proposed, and the interim tax scales



Taxation of fringe benefits

Fringe benefits are personal living expenses that are paid by the employer. By packaging a salary so that fringe benefits are provided and the wage rate is reduced to compensate for the fringe benefits, a personøs income tax liability can be reduced. This is because the fringe benefits are not declared as income.

To get around this mechanism for tax avoidance, the tax system has in place rules for taxing fringe benefits. In the interests of fairness, this is a usual practice in tax systems, particularly in rich countries.

Earlier it was explained that the system of taxing fringe benefits in PNG is complex, with a range of inclusions and exclusions. Some benefits are partially excluded such as housing, motor vehicle and phone benefits, raising the bar for complexity and enforcement. The rationale behind the complexity is to cut out the provision of fringe benefits as a way of avoiding tax, whilst retaining a degree of exemptions to allow for fringe benefits that are necessary in the course of employment. For example, a personøs electricity bill would seem to be an entirely personal expense and so should be taxed if it is provided as a fringe benefit. However, a phone provided to an employee is exempt from tax to the extent that it is used for business purposes.

The complex system of taxing fringe benefits means that to administer and enforce the system properly is very costly and difficult both for the Government and the employer. Moreover, the complexity increases scope for avoidance ô adding further to the difficulty of enforcing compliance. This raises questions of whether such costs are out of balance with the benefits of tax revenue and increased fairness.

For PNG, the way forward is to scrap the existing complex system and replace it with a simple, easy to administer and easy to enforce system. A fair yet simple design would be to tax in full all fringe benefits within the Wage Income Tax system, but allow a minimum threshold. So for example, the minimum threshold could be K20,000 a year. In this case, where employees are provided housing, car, or other benefits that add to less than K20,000, then these will not need to enter the tax system and so will not need to be declared. Benefits that exceed K20,000 would be taxed in full by the amount they exceed K20,000. For example, if the fringe benefits are worth K30,000, then the first K20,000 would be exempt, leaving the remaining K10,000 to be taxed in full.

The fringe benefits made eligible for the threshold should be restricted to the items for which fringe benefit exemptions are currently available including housing, car, phone, home travel, and education benefits. Other items should be fully taxable without a threshold, as they are now. For example, if an employer was to pay an employeeøs electricity bill, then that should be taxed in full and not be subject to a threshold.

The benefits of the proposed way forward are:

- a large number of workers currently captured by fringe benefits tax will drop out of the system ô substantially reducing the administrative burden for employers and the Government;
- complexities associated with exclusions, inclusions and partial exemptions are removed with everything included after K20,000 ô providing further substantial gains in the administrative burden for employers and the Government;

- fringe benefits that are clearly not employment related will continue to be taxed in full;
- the revenue impact should be about neutral or positive as a result of;
  - ✓ losses in fringe benefits tax collections for those falling under the threshold more than made up for by higher taxes paid on fringe benefits for high-income earners; and
  - ✓ increased compliance by businesses due to much easier enforcement and reduced scope for avoidance.
- the fringe benefits tax would keep its focus where it should be ô on high-income earners who are shifting large amounts of income into fringe benefits.

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