Papua New Guinea Taxation Review (2013-2015)

Issues Paper No.3:
The case for tax reform and broad reform directions

Prepared by
Taxation Review Committee

October 2014

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TABLE OF CONTENTS

FOREWORD

In 2013, the O'Neill-Dion Government committed to comprehensively review PNG's revenue regime with the main aim of ensuring that it remains relevant, efficient and effective.

Government revenue is critical to funding essential services and infrastructure for Papua New Guinea, to share the benefits of prosperity across families, communities and regions and to lay the foundations for future growth. Consequently, this Review is a high priority of the Government and an important platform of its economic and fiscal strategy.

The last comprehensive taxation review was undertaken in 2000. PNG has undergone substantial economic, fiscal and technological developments over the past 13 years, so it is timely that another review is done to ensure the country's tax system is modern, robust, is in line with economic, social, technological and political changes, and is able to support the country's medium and long-term economic and social development objectives. While formally titled a 'Tax Review', the Review will, in fact, consider other sources of revenue, including non-taxation revenues.

This paper, the third in a series of issues papers to be released by the Tax Review Committee, is focussed on making the case for tax reform and then presenting an initial, overarching assessment of PNG's tax system. Unlike the other Issues Papers this paper is not focussed on any particular area of taxation but, rather, seeks to place these subsequent papers (and ultimately the final report) in the broader PNG context and set forth a possible broad direction for reform.

Also unlike other Issues Papers, this paper does not include numerous consultation questions other than in a few key areas where initial feedback from stakeholders is welcomed. However feedback and comments on the PNG context and the broad directions for future reform is sought and encouraged. As noted above, many of these issues will nonetheless be picked up again in specific Issues Papers and in the Final Report.

The paper is based on work (undertaken by Harry Greenwell, seconded from the Australian Treasury, and a consultant, Neil Motteram) which has been carefully considered by the Tax Review's technical team and the Committee itself in finalising this Issues Paper. The Committee wishes to thank Mr Greenwell and Mr Motteram for their work.

The Committee looks forward to receiving submissions on this paper and to future engagement with interested stakeholders on the future of Papua New Guinea's tax system.

Sir Nagora Bogan, KBE
Chairman, Tax Review Committee

Tax Review Committee

The Government has appointed a Committee of 5 persons to undertake this Review. The Committee is comprised of the following distinguished Papua New Guineans, who collectively have significant experience in tax policy and administration, trade and business:

1. Sir Nagora Bogan (Chairman);
2. David Sode (Deputy Chairman);
3. Sir John Luke Crittin (Member);
4. John Lohberger (Member); and
5. Lady Aivu Tauvasa (Member).

The Committee formally commenced work on 1 September 2013. It will submit an interim report to Government in advance of the 2015 Budget. This interim report will provide an update of the Review, outline possible broad directions for reform and identify any early wins that the Government may wish to consider as an initial step towards tax reform. The main final report, which will set forth a possible substantive tax reform package going forward will be provided to the Government by mid-2015.

The Committee is supported by a technical team (Secretariat) which was established by the Department of Treasury. Members of the Secretariat are seconded from the Department of Treasury, Internal Revenue Commission, PNG Customs Service, Department of Finance, Department of Trade, Commerce & Industry and an advisor from the Australian Treasury. The Secretariat is also supported by international technical consultants and advisors where appropriate.

The technical secretariat undertakes the day-to-day activities of the Review, including research and analysis (drawing on international benchmarking standards and practices, global and regional trends in tax policy design and administration, and academic modelling), preparing papers and briefings for the Committee, drafting reports, and arranging and managing stakeholder consultations.

Objectives and Scope

The objectives of the Review are:

- To align PNG's revenue system with its development aspirations of being a competitive middle income nation in the Asian century;
- To realign the tax system to diversify the economic base by leveraging and strategically deploying windfall gains derived from non-renewable extractive sectors to support, stimulate and grow renewable and sustainable sectors such as agriculture, fisheries, tourism, forestry, added value processing, including growing and developing Small to Medium Enterprise (SME) sector.
- To improve the competitiveness and efficiency of PNG's tax system so as to attract capital and grow, retain and encourage investment, employment and economic development;
- To enhance the fairness, simplicity and transparency of PNG's taxation system and in so doing to build taxpayer confidence in our tax system;
- To recommend practical options to change PNG's tax mix between the levels of taxation on land (including resources), capital and labour;
- To improve taxpayer compliance including considering options to enhance services to taxpayers and reduce the cost of compliance through the use of modern and user friendly technology; and
- To review PNG's non-tax revenues with the aim of ensuring that fees are appropriate, fair and cost effective.

The Review is broad and includes considerations of personal income tax (PIT) corporate income tax (CIT), excise and customs tariff arrangements, the goods and services tax (GST), mining and petroleum taxation, property and capital gains tax, non-tax revenue (including charges and levies), tax administration (including taxpayer compliance and the efficiency, simplicity, collection effort and protocols of PNG's tax revenue administration), small business taxation and the advantages and disadvantages of tax incentives.

Consultation Process

The Committee is consulting widely with stakeholders. International experience shows that broad and effective consultation is critical to the proper, fair design, successful delivery, implementation and sustainability of any tax reform measures. The Review is being done through five (5) stages:

Step 1. 'Blue sky' consultation. In December 2013, the Committee invited all interested parties to give their perspectives on the broad directions for reform and key priority areas. The due date for submissions was 30 April 2014, which was later extended to mid-May 2014. Some 44 submissions were received and are available for viewing (unless specified as confidential) via the Tax Review website (www.taxreview.gov.pg). Submissions provided as part of this consultation will help guide the direction of the Review, ensure that key areas of public interest are addressed plus will help build a consensus for the need for reform.

Step 2. Consultation on Issues Papers. The papers will cover specific taxation areas and issues identified above (this paper being the one exception). The purpose of this stage of consultation is to promote more targeted discussion and debate, to assist the Committee draft its recommendations. More issues papers will be released throughout 2014 and the first quarter of 2015.

Step 3. Tax Symposium. This symposium was jointly hosted by the Committee and the National Institute of Research (NRI) on 29-30 May, 2014 in Port Moresby. Various international and local tax experts were invited and presented technical papers in respect of major reform areas as per the terms of reference. Outcomes of the symposium provided an additional rich throve of reform options for consideration by the Committee and provided an additional repository of information and data for future reforms.

Step 4. Use of social media. The Committee also used the powerful tool of social media as a modern medium to generate informed dialogue and discussions on tax reform in Papua New Guinea. It hosted a web site with information on the work of the Committee which to date has received over 4,000 visitors. It also has a specific tax reform face book blog with over 1,500 followers. Matters of substance generated by the social media is also included for consideration by the Committee.

Step 5. Consultation on Draft Final Report. The final stage of public consultation will focus on the Draft Final Report prepared by the Committee. The Draft Report will draw on the feedback gained from previous stages of consultation which will be put forward for further discussion and eventually the Committee's evaluation of all relevant areas and aspects of taxation and non-tax revenue. All of the above combined, will help form the reform recommendations for the Government.

Regional Consultations. As part of the overall Review process, consultation has and will continue to include open forums in provincial centres. To date, well attended open forums have been held in Lae, Kokopo, Madang and Port Moresby. Time constraints have prevented the Committee from visiting other provinces at this stage but further regional meetings are planned including for the Highlands and Bouganville later this year.

To ensure transparency, the Committee runs quarterly updates of its work through advertising in the print media and direct mailing to stakeholders.

Notices of regional forums are and will continue to be widely advertised in the Post Courier and The National newspapers so as to allow the public and relevant stakeholders to read more about the issues including the timetable of exchanges with the Committee and the Secretariat.

All submissions should be sent via mail and/or email to:

Head of Secretariat
Tax Review Secretariat
c/- Department of Treasury
PO Box 542, Waigani, NCD

Email: papers@taxreview.gov.pg

Submissions in response to this paper are due by Friday 14 November 2014.

For any other general enquiries, email: info@taxreview.gov.pg

NOTE: To ensure there is transparency in the consultation process, all submissions are published on the Tax Review website (www.taxreview.gov.pg) unless the submission is by justification, marked '**CONFIDENTIAL**'.

Executive Summary

Taxation affects all members of society directly or indirectly and so all Papua New Guineans have reasons to care about creating a better tax system. This Issues Paper makes the case for tax reform and explains how a better tax system can play a key role in Papua New Guinea's future prosperity and development and better distribute the tax burden fairly across our nation. It also presents an initial, overarching assessment of PNG's tax system that includes proposals for broad reform directions and some initial recommendations.

Principles for good tax policy

There are five general principles that should guide the design and administration of good tax policy:

1. **Revenue**: A good tax system should raise sufficient revenue to ensure that the government can deliver services that meet the community's needs.
2. **Competitiveness and efficiency**: A good tax system should promote economic growth and thus drive more jobs, higher incomes, more services, lower prices and less poverty.
3. **Fairness**: A good tax system should be fair: it should create a level playing field for businesses and it should ensure that taxpayers each pay their fair share.
4. **Simplicity**: A good tax system should be simple enough for taxpayers to understand and meet their tax obligations. It should also minimise the administrative costs for government and for the taxpayer.
5. **Trust in and accountability of government**: A good tax system including a reliable tax administration should build trust and confidence in government and should be transparent and encourage greater government accountability and integrity.

By ensuring that the tax system better reflects these principles, tax reform can make an important contribution fulfilling the government's strategic priorities and thereby help to address PNG's development challenges.

Broad directions for reform

The Tax Review Committee is considering the following broad directions for reform of PNG's tax system.

Strengthen revenue administration (IRC and PNGCS): strengthening the revenue administration must be an immediate and ongoing priority. This includes organisational strengthening and also legislative reform that supports better administration (such as simplification and modernization of income tax legislation, or reviewing collection and enforcement powers). Also, in recognition of the critical importance of good quality data, both IRC and PNGCS should collate and, where appropriate, publish more of their own data.

The Committee notes more generally the critical role of good data in informing good tax policy development and the constraints faced by the Review given current data limitations[1]. The Committee commends the recent Government decision to provide further funds to the National Statistics Office. It goes without saying that good reliable data improves the quality of Government decision-making.

Strengthening overall revenue collections: consistent with PNG's Medium Term Fiscal Strategy, any tax reform measures should at least arrest the decline in projected tax revenues as a proportion of GDP.

Shift the tax burden from a narrowly based personal income taxes towards a more broadly-based GST and resource taxes: over time, increase the efficiency of the tax system by shifting the tax mix away from income taxes towards the Goods and Services Tax (GST) and/or resource taxation.

Reduce tax exemptions and lower tax rates: where possible, reduce tax exemptions and use the revenue savings to reduce tax rates. In particular, move to eliminate the practice of awarding tax exemptions through project agreements. Finally, report the cost of all such exemptions annually through the budget process.

Introduce a capital gains tax: capital gains are a form of income which is not taxed in PNG. This income should be taxed – making the tax system fairer and more efficient. A capital gains tax should be a medium-term priority and the timing of its introduction must be dependent on the IRC having the administrative capacity to implement it. Consideration could be given to using the revenues from a CGT to aid in lowering corporate taxes and the top marginal personal income tax rate thereby ensuring the competitiveness of PNG's corporate and personal income tax regime.

[1] The Committee does, however, acknowledge the ongoing assistance of the IRC and PNGCS in providing the data that they do have access to

Put in place an extractive industries revenue regime that better ensures PNG benefits from future increases in resource prices: consistent with the suggestions in Issues Paper 1 on Mining and Petroleum Taxation, PNG should consider introducing a more progressive tax regime across its extractives sector, with a greater reliance on sensibly framed rent taxes such as the Additional Profits Tax.

Reform taxation of SMEs: there needs to be greater recognition of the challenges small businesses face in complying with their tax obligations and the role that this plays in limiting the opportunities for growth of these businesses and their contribution to the development of the country. To address this, consideration could be given to the introduction of a simplified tax system for small businesses centred around a 'presumptive tax' based on turnover or cash flow – however, this should be a medium- or long-term priority because any success will be dependent on the administrative capacity of the IRC.

Non-tax revenue: develop a modern, broad based policy framework that provides for a clear, simple and efficient management and administration of all non-tax revenue in PNG. Consideration could also be given to a proper and simple mechanism for the adjustment of fees and rates.

A phased approach to reform: while tax reform should not be unnecessarily delayed, it should be undertaken after much and careful consideration. A phased approach should be adopted, (perhaps along the lines in the table below) to provide tax payers and the Government a clear roadmap of implementation of tax reforms.

Broad direction for reform	**Short-term (1-2 years)**	**Medium-term (2-5 years)**	**Long-term (5-10 years)**
Strengthen revenue administration			
Maintain or strengthen overall revenue collections			
Shift tax mix from income taxes to indirect and resource taxes			
Reduce tax exemptions and lower tax rates			
Introduce a capital gains tax			
Reform the extractive tax regime to ensure greater progressivity			

Reform taxation of small businesses			

Consultation questions

Below are the various consultation questions posed in the paper. As noted above, given the nature of this Paper, there are fewer specific questions as compared to other papers (more targeted questions will be posed in subsequent Issues Papers). In addition to responses to these questions, comments are welcomed on any of the issues/directions posed in the Paper.

Principles for Good Tax Policy

Question 1.1 – do stakeholders agree that the principles identified in this Chapter should help to guide PNG's tax reform process? In the PNG context, are some principles more important than others?

How tax reform relates to PNG's development challenges and priorities

Question 3.1 – how can PNG take advantage of this current tax reform process to help it to achieve its development goals and priorities?

Assessment of PNG's tax system: broad directions for reform

Question 4.1 - would stakeholders support a reduction in personal income taxes, particularly for those on lower incomes, if this were paid for through an increase in the GST?

Question 4.2 - what are stakeholder's preliminary reactions to the broad reform directions outlined in this Chapter?

Question 4.3 - do stakeholder's agree to the need for a staged tax reform process?

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OVERVIEW

Taxation affects all members of society directly or indirectly. Some individuals and businesses pay income taxes, although these probably only reach a minority of the population. However, all Papua New Guineans pay taxes when they buy goods or services that are subject to the Goods and Services Tax (GST), import duties or excises. In addition, the tax system has wide-ranging impacts on the economy and, therefore, the livelihoods of most Papua New Guineans, through the incentives or disincentives it creates for work, consumption, saving, investment and trade.

Finally, taxation affects society by giving the Government the revenue streams necessary to fund government services. All Papua New Guineans have reasons to care about creating a better tax system.

The first aim of this Issues Paper is to make the case for tax reform and explain how a better tax system can play a key role in Papua New Guinea's future prosperity and development.

- The case is based on five key principles for the design and administration of good tax policy that are outlined in Chapter One.
- Chapter Two briefly steps aside from the discussion of tax policy to review PNG's development challenges and the government's strategic priorities.
- This provides the context for a discussion of how each of the good tax principles can address the nation's development challenges and priorities (Chapter Three).

The second aim of this Paper is to present an initial, overarching assessment of PNG's tax system based on the five principles set out earlier.

CHAPTER 1: PRINCIPLES FOR GOOD TAX POLICY

There are five general principles that should guide the design and administration of good tax policy:

1. **Revenue**: A good tax system should raise sufficient revenue to ensure that the government can deliver services that meet the community's needs .
2. **Competitiveness and efficiency**: A good tax system should promote economic growth and thus drive more jobs, higher incomes, more services, lower prices and less poverty.
3. **Fairness**: A good tax system should be fair: it should create a level playing field for businesses and it should ensure that individuals each pay their fair share.
4. **Simplicity**: A good tax system should be simple enough for taxpayers to understand and meet their tax obligations. It should also minimise the administrative costs for government and for the tax payer.
5. **Trust in and accountability of government**: A good tax system including a reliable tax administration should build trust and confidence in government and should be transparent and encourage greater government accountability and integrity.

This chapter explains the merits of each principle and also expands on the research and analysis that underpins each one. Subsequent chapters discuss the relevance of these principles for PNG's broader development challenges and also how the *application* of these principles should be adapted to reflect the characteristics of Papua New Guinea's society and economy.

Revenue

The principal objective of any tax system is to ensure that the government has sufficient funds to provide services to the community. Put simply, the government can only provide and maintain good quality schools, reliable roads, effective police services, clean health clinics and professional public services if it has enough money to pay for and maintain them. Tax reform can help to ensure that the government has a strong, reliable tax base to fund future expenditures.

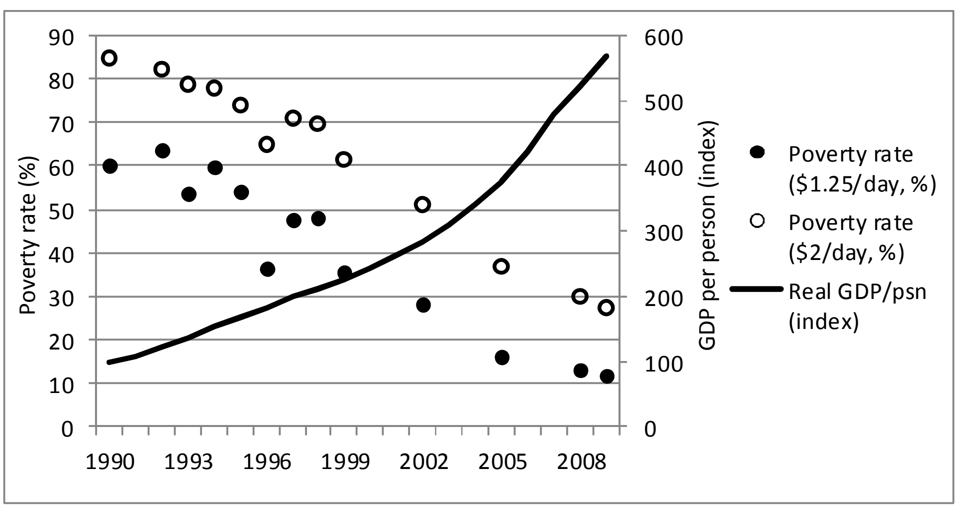
Competitiveness and efficiency

Tax reform can help to make PNG an attractive place to do business and thereby stimulate sustained economic growth. This, in turn, will help to create more jobs, higher wages, more services and lower prices for more Papua New Guineans. In other words, sustainable economic growth, driven by tax policy and other economic reforms, is essential to fulfil the government's vision for PNG to become a smart, wise, fair, healthy and happy society by 2050.

Furthermore, the experience of countries as diverse as China, India, Botswana, Malaysia and Brazil demonstrate that strong, sustained economic growth is also highly effective in reducing income poverty. For example, China's real Gross Domestic Product (GDP) per person grew by almost 10 per cent per year between 1990 and 2009 (Chart 1). And extreme poverty fell from 60 per cent to 12 per cent over the same period. In a study of growth and poverty in PNG, Chandy (2009, p4) summarises the recent research findings on the relationship between poverty and growth:

> *… growth in GDP reduces poverty across regions, across times, in both the short and long run. Over 80 per cent of the variation in incomes of the poor within developing countries can be explained by variation in GDP per capita, making GDP growth an indispensable component of any development strategy. … However, this relationship is not static, with comparable periods of growth capable of generating both small and large reductions in poverty.*

Chart 1: Economic growth and poverty reduction in China



Sources: Poverty data: World Bank MDGs database. GDP data: IMF WEO database, April 2014 release

Tax payers will naturally seek to minimise the tax they pay. This can create distortions where a tax is too high or poorly designed. For example, businesses may substitute capital equipment for labour where the tax system acts as an incentive through more favourable treatment of capital equipment, or investors may shift their investments from one type of business to another.

In each of these cases, taxes distort taxpayer choices so that, typically, they engage in (or shift their resources towards) less productive activities.[2] These economic distortions (also known as 'deadweight losses') mean that the overall costs of taxation reflect these economic costs, as well as the costs of the tax itself.

An efficient, well-designed tax system can reduce the economic costs it creates. In other words, an efficient tax system should ensure that it imposes no more than the minimum burden on the economy for each extra kina of tax revenue.

What makes a tax system efficient?

A whole field of research – 'taxation economics' – is devoted to this question. However, there are two conclusions that are particularly relevant for PNG's tax system.[3]

The first core finding of tax economics is that, in general, it is more economically efficient to apply a low tax rate to a broad base – 'broaden the base, lower the rate' (Bird 2010b; IMF 2011). This means that it is preferable to apply low rates to a larger group of taxpayers than to apply higher tax rates to a small group of taxpayers. The reason that it is less costly to have a broad base, low rate system is that, as tax rates increase, the resulting economic distortions multiply much more quickly. Conversely a narrower tax base (with higher rates applying) has a much greater impact on economic activity, including tax minimisation and avoidance activity.

This conclusion has important implications for PNG's tax system. For example, whenever the government decides to exempt certain businesses from the company income tax, it then has to apply a higher tax rate to other taxpayers in order to collect enough revenue. Similarly, almost all capital gains are untaxed in PNG, which means that other taxpayers pay higher taxes

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2 Taxes will generally lead to unproductive distortions and greater inefficiency. However, in cases where taxes apply to pollution or other negative externalities, they can help to reduce market failures and thereby increase economic efficiency.

3 Other important conclusions from tax economics include, for example, the efficiency benefits of tariff reductions, value-added taxes over other indirect taxes and the taxation of pollution or other negative externalities. These conclusions are addressed where relevant elsewhere in this paper.

than they would otherwise. These issues are discussed further in Chapter Four.

A second conclusion from tax economics is that taxes on 'mobile tax bases' that can easily move overseas (such as companies or skilled workers) tend to be less economically efficient than 'immobile tax bases' (such as property and natural resources, consumers or low- or semi-skilled workers). This is because the biggest economic cost of taxation is the way that it distorts behaviour away from the most productive activities that will be of most benefit to the nation. Taxes on mobile activities result in bigger distortions of behaviour and hence greater economic inefficiencies. The increased mobility of many companies is a key reason why many countries have lowered their company tax rates in recent decades (IMF 2011, pp18, 33-34).

This conclusion can help guide decisions about the appropriate 'tax mix': how much revenue should be collected from taxes on income, consumption, resources, property or trade? The tax mix is perhaps the key question for determining the efficiency of the tax system, and is also addressed in Chapter Four.

Fairness

Tax reform should ensure that everyone pays their share of the costs of government services. A perception of fairness is important to ensure that taxpayers have confidence in the tax system and in the government more generally. The alternative – a perception that some privileged people get special treatment from the tax system, while others have to bear a heavy burden – will reduce voluntary compliance and reinforce negative attitudes about the government's willingness to serve the people. This, in turn, can have a corrosive impact on democratic participation in debates about government policy: if people feel the government will not listen, they will be reluctant to contribute their views.

There are three (3) basic issues to consider in assessing the fairness of the tax system.

First, just because a tax is charged to a person or business, this does not mean that they ultimately pay the cost. For example, if personal income tax rates go up, it is natural to think that this is an extra tax on workers. But if workers demand higher wages in return, then the cost of the tax really falls either on business owners (if the higher wages reduce profits) or their customers (if the higher wages result in higher prices). Similarly, if company tax rates fall, this does not necessarily mean that companies receive the benefits. In competitive markets, companies will still achieve the same profits as before and the benefits of the tax reduction will flow through to workers (in higher wages) or consumers (in lower prices).

In other words, the 'legal incidence' of a tax (who is required to pay the tax) and the 'economic incidence' of the tax (who ultimately bears the cost of the tax) are usually different. Unfortunately, however, determining the true economic incidence of a tax is complex. In the context of this paper, it is just important to remember that it is a complicating factor in any discussion about the redistributive impact of the tax system.

Second, a fair tax system should ensure that taxpayers who are engaged in similar activities should be taxed in the same way. This is the principle of 'horizontal equity'. For example, it is unfair if some businesses receive exemptions from company income tax while similar businesses do not. Creating a level playing field for businesses not only improves the competitiveness and efficiency of the economy (as argued in the previous section); it also improves the fairness of the tax system as well. In the same way, it is also unfair to individuals if some income (for example, from wages and salaries) is taxed while other income (such as capital gains on investments or profits from informal businesses) is not. Applying similar taxes to all forms of personal income also has both equity and efficiency benefits.

Third, a fair, 'progressive' tax system should ensure those with greatest ability to pay contribute a greater share of the tax burden. This is the principle of 'vertical equity'. The personal income tax (PIT) is often seen as the main tool for achieving vertical equity but its role may be overstated, for several reasons.[4] First, the PIT only applies to a small fraction (probably no more than 5-10 per cent) of the population, which limits its role in redistribution of income. Second, it is possible that high PIT rates affect the transfers that formal sector workers are able to provide to wantoks back home in rural towns or villages. Third, as noted earlier, the 'economic incidence' of the PIT (or other taxes) may be different from the 'legal incidence' so it is often hard to determine to what extent workers, consumers or business owners are truly bearing the cost of a tax. And finally, the distributive impact of a tax change needs to take account of other taxes that are being replaced or the additional expenditure that taxes will finance. For example, the introduction of the GST in 1999 was probably progressive because it replaced a number of regressive trade and provincial taxes. For all these reasons, the PIT should only be seen as one part of determining progressivity of the tax system.

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[4] For further analysis of the redistributive role of the PIT, value-added taxes (like the GST) and the tax system more generally, see Gibson (1998), Emran and Stiglitz (2007), Bird and Zolt (2005) and IMF (2011, pp7-8, 25-26). Some of these issues are discussed further in later chapters.

Simplicity

Tax systems not only impose direct costs (the tax itself) and economic costs resulting from distortions in behavior, they also create compliance costs for taxpayers and administrative costs for government.

Compliance costs – the costs of filling in tax forms, keeping tax records, making tax payments and responding to requests for information from tax administrators – are just as much of a burden on taxpayers as the tax costs and economic costs, and so there is just as much reason to try to minimise them.

Complex tax systems also increase the costs of tax administration for government, which in effect wastes some of the tax revenue that is collected. Tax reform can contribute to reducing the complexity of the tax system and thereby reducing the compliance costs and administrative costs that it creates.

Trust in and accountability of government

Tax reform matters for good government. Tax reform can also minimize opportunities for corruption in government.

Tax policy that establishes a broad, visible and consensual tax system can build trust in the tax system and in government more generally. A tax system that is well designed *and well administered* will ensure that people in similar circumstances pay a similar amount of tax or, in other words, that everyone pays their 'fair share'. A well-administered tax system will also ensure that it is easy for individuals and businesses to comply with the tax system. All of these outcomes can help to improve confidence in good government.

A well-designed tax system can limit the number of decisions that need to be made by ministers or officials thereby reducing opportunities for corruption.

More broadly, it can increase government accountability and thereby strengthen the democratic state. It may do this in the following ways:[5]

- First, a broad-based system means that governments have incentives to promote broad-based prosperity and economic growth, since this prosperity will drive future growth in tax collections.

- Second, a broad-based system means that governments have incentives

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5 The following discussion draws on the following articles from the literature on taxation, governance and state-building in developing countries: OECD (2008a, 2008b, and 2010), Moore (2007), IMF (2011, pp42-44) and Keen (2012, Section V).

to improve their tax administration in order to ensure the strength of future revenue collections. Improved tax administration can, in itself, help build greater trust in government and it may also spur improvements in other areas of government administration.

- Finally, the tax system plays a key role in the ongoing tension between the interests of the people of PNG and the interests of their representatives and the government. This tension may, in the wrong circumstances, lead to conflict but it may instead lead to a constructive 'tax bargain' in which 'citizens accept and comply with taxes in exchange for government providing effective services, the rule of law and accountability' (OECD 2010, p10). Moore (2007, Section 5) describes a conceptual model where a broad, visible but consensual tax system causes taxpayers to mobilise to resist tax demands or to monitor the use of tax revenue. As a consequence, the state and citizens bargain over revenues, resulting in: better tax policy, better acceptance of taxation by citizens, greater scrutiny of expenditure, and improved expenditure policy.

In other words, a tax system that applies broadly to large sections of the population will naturally provoke basic, important questions from taxpayers:-

- Why does the government need to collect so much tax?
- Are other taxpayers contributing their fair share?
- How are these taxes affecting business and the economy?
- How is the money being spent and could it be spent more effectively?

Throughout the world, these are some of the fundamental questions that citizens and taxpayers must and should ask of their governments to ensure that they are responding to the needs and expectations of the people. A country's tax system has a role in stimulating this discussion.

One way to illustrate the importance of a broad tax base is to consider the opposite scenario: the resource curse. Apart from the local economic impact ([i]'Dutch Disease'), highly resource-dependent countries often depend on a small number of large taxpayers and, as a result, suffer a deterioration in the effectiveness and accountability of government.[6] For example, the OECD

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[6] In theory, similar issues could apply to countries that are highly aid dependent, although it is likely that there are some relevant differences between aid flows and resource rents. Also, the evidence of any negative impact of aid on governance is more ambiguous than in the case of resource dependency. For further discussion, see OECD (2010, Chapter 4), OECD (2008a, Section III) and Moore (2007, p22).

(2008a, p17) summarises evidence for countries not including PNG that are heavily dependent on oil. It found that governments in these countries tend to:

- have few incentives to promote broad economic development,
- be independent of citizen-taxpayers, and therefore unresponsive to them,
- use oil revenues to buy off opposition, and to fund repressive internal security, and
- attract external military and political support.

What are the practical policy implications of seeking to improve governance through a more broadly based, visible but still consensual tax system? To answer this question, it will help to clarify each of the key terms: 'broad-based', 'visible' and 'consensual'.

The idea of a 'consensual' tax system may seem unlikely, since all tax systems are ultimately coercive. However, some tax regimes can be much more coercive than others if, for example, tax assessment and collection are 'conducted in ways that are likely to be validly perceived by taxpayers as arbitrary, extractive, unfair or brutal' (Moore 2007, p25; see also OECD 2008a, p23). While such coercive taxation is likely to provoke a response from taxpayers, it is hardly likely to stimulate a constructive tax bargain between citizens and the state.

The more 'broadly based' tax system clearly implies that there should be a large number of taxpayers, all else equal. But it need not imply that everyone should be subject to tax since it is likely that most of the governance benefits described earlier will be derived from a tax base that is 'broad enough' (Moore 2007, p24). The decision about what is enough is a matter of judgment that should be guided not only by governance considerations but also the other principles of good taxation and, in particular, the importance of minimising compliance and administrative costs.

Transparency of the Taxation System

Taxpayers will only ask questions about the taxes they pay if they are aware of them. Consequently, it is important that taxes are 'visible', even if political leaders would prefer that they were not. However, attempts to increase the 'visibility' of taxes need not imply that all revenue should simply be shifted towards the most visible taxes (typically personal and company income taxes).

Dutch Disease describes the economic impact of major resource projects driving exchange up to the detriment of local suppliers and manufacturers

In general, an efficient tax system will include a variety of different taxes to ensure that it can apply low rates to a broad economic base. Consequently, the visibility of a tax should generally be tested against close substitutes. For example, value-added taxes like the GST are generally more visible than other indirect taxes like import duties (OECD 2008a, pp22-23; Moore 2007, pp24-25; see also OECD 2010, pp37-38).

There are various ways to create a more broadly based, visible but still consensual tax system. Many of these would be consistent with the other principles for good tax policy. These include, for example:[7]

- **reduce exemptions**: reduce exemptions and eliminate discretionary powers for ministers or officials to award tax concessions in order to reduce perceptions of special treatment of certain groups and to reduce the potential for corruption.
- **report 'tax expenditures'**: the tax authority should publish timely data on 'tax expenditures' and tax revenues in order to improve public understanding, perceptions and scrutiny of remaining tax exemptions or concessions.
- **minimising arbitrary exemptions and concessions:** moving away from project specific exemptions and concessions to transparent template arrangements for similar projects.
- **adopt a value-added tax**: shift away from trade taxes towards a value-added tax (like the GST) in order to make indirect taxes more visible, especially to small businesses.
- **strengthen tax administration**: move to self-assessment to separate the assessment and collection functions and substantially expand audit capacity, thereby minimizing opportunities for corruption.
- **improve taxpayer services and rights**: improve taxpayer services (information and advice to taxpayers) and taxpayer rights (access to administrative reviews) in order to improve relations with taxpayers and thus voluntary compliance.
- **engage with stakeholders**: improve communications and engagement with business and taxpayer associations, civil society organisations and with taxpayers so as to facilitate the 'tax bargaining' process between society and the state.

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7 This list is largely based on OECD (2010, Chapter 3) and Keen (2012, p20).

- **strengthen tax policy units**: strengthen tax policy units within Treasury Departments that are capable of informing, proposing and taking ownership of major tax reforms.

There are two (2) main points of divergence between the typical recommendations based on the other good tax principles and proposals that are shaped by governance considerations.

The first suggestion is that there may be value in the earmarking of taxes for specific expenditure purposes, since it is important for taxpayers to see their money going to a worthwhile use (OECD 2010, pp39-41; Bird 2008, pp19-20). This runs counter to conventional advice on sound public financial management that expenditure should be assessed and prioritised through the annual budget process: earmarking, if effective, just adds unnecessary rigidity that may interfere with this prioritisation process (IMF 2011, pp42-44). Further consideration of earmarking must balance these competing considerations.

The second divergent recommendation is to broaden the base to include more of the informal business sector (OECD 2008, pp25-26; OECD 2010, pp43-44). One benefit of extending taxation to the informal sector is that it may increase the engagement of small businesses in the political process. A further benefit is that taxation of informal sector operators may increase the willingness of *formal* sector businesses to comply with taxation (since they feel they are on a more level playing field with informal competitors).

Finally, improved taxation of informal business may lead to greater 'formalisation' of those businesses, resulting in benefits both for the small businesses themselves and for the broader economy.

Expanding taxes into the informal sector runs counter to conventional advice, however, because it is likely to be administratively costly, relative to the revenue raised. It may also impose undue tax or compliance burdens on small or micro businesses.

Consequently, the real test is whether it is possible to design a small business tax regime that avoids or minimises these problems whilst capitalising on some of the benefits mentioned earlier. Several countries have attempted such tax arrangements and they are covered in Chapter Four.

Question 1.1 – do stakeholders agree that the principles identified in this Chapter should help to guide PNG's tax reform process? In the PNG context, are some principles more important than others?

CHAPTER 2: PNG'S DEVELOPMENT CHALLENGES AND STRATEGIC PLANS

This chapter deviates from taxation issues to consider PNG's current development challenges in the context of the government's strategic development plans. This provides the setting for the following chapter, which draws the link between tax reform to the nation's challenges and plans.

Hardship and poverty in PNG

Hardship and poverty have been a constant part of PNG's history and remains so today with increasing population growth, urban drift and challenges of service delivery. PNG's fundamental development challenge is to reduce the that hardship and poverty currently experienced by many of its citizens.[8] Even after a period of strong economic growth, around 40 per cent of the population experienced hardship in 2009-10, where 'hardship' refers to households whose consumption fell below the level required to meet their basic needs for food, shelter, clothing and other basic services (Adelman *et al* 2014, Chapter 2; see also Gibson 2014 and IMF 2013, p5). The data suggest that households in rural areas and those with a greater number of children were more likely to experience hardship than otherwise.

Other measures of hardship and wellbeing tell a similar story. The Human Development Index (HDI) goes beyond simple measures of income per person to include two further dimensions of wellbeing: health (life expectancy) and education (years of schooling). In 2012, PNG was ranked 156th out of 187 countries on the HDI in 2012, a ranking that was largely unchanged in recent years.[9]

The Millennium Development Goals take a multi-dimensional approach to hardship and poverty, assessing countries' progress to address: extreme

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8 In this paper, the term 'hardship' is preferred to 'poverty', based on the reasoning set out in Adelman *et al*(2014, p23). Recent analysis of hardship in PNG is based on data from the 2009-2010 Household Income and Expenditure Survey. These results should be interpreted with care since they may, in part, reflect methodological choices or problems with data quality, rather than the underlying level of hardship. Nonetheless, these results give the best and most recent general indication of hardship in PNG. For further details, see Adelman *et al*(2014, Chapter 2), IMF (2013, p5) and Gibson (2014), and for earlier analysis of poverty and hardship in PNG, see Gibson (2000), Chandy (2009), Cammack (2009), Abbott and Pollard (2004) and World Bank (2000 and 2004).

9 The HDI reflects three dimensions of wellbeing: health (life expectancy), education (years of schooling) and income (GNI per person).

poverty and hunger, access to primary education, gender equality and empowerment of women, health (child mortality, maternal health and combatting diseases), and environmental sustainability (including access to safe drinking water and improved conditions for urban slum dwellers). The 2014 Pacific regional MDGs tracking report found that PNG was way behind in meeting any of the 'global' MDGs. Furthermore, even on the seven 'localised' targets that PNG set for itself in 2003-04, the country was only 'on track' for two targets (reducing extreme poverty and reducing child mortality).[10]

The past decade: some progress but still much to do

In the past decade, PNG has made some significant progress in improving economic prosperity and expanding the delivery of some basic services to more of its population.

The latest resources boom – first in minerals in the mid-2000s and now in gas production – has fuelled PNG's longest period of sustained economic growth since independence. According to the available data, real growth in GDP has been positive since 2003 and real GDP *per person* has grown at almost five per cent per year since 2007 (Chart 2).[11] This growth was broadly based: strong growth occurred not only in the mining and petroleum sectors but also, for example, in the construction, transport and communication sectors (ADB 2014b, p1). Furthermore, GDP growth was accompanied by even stronger growth in formal employment.

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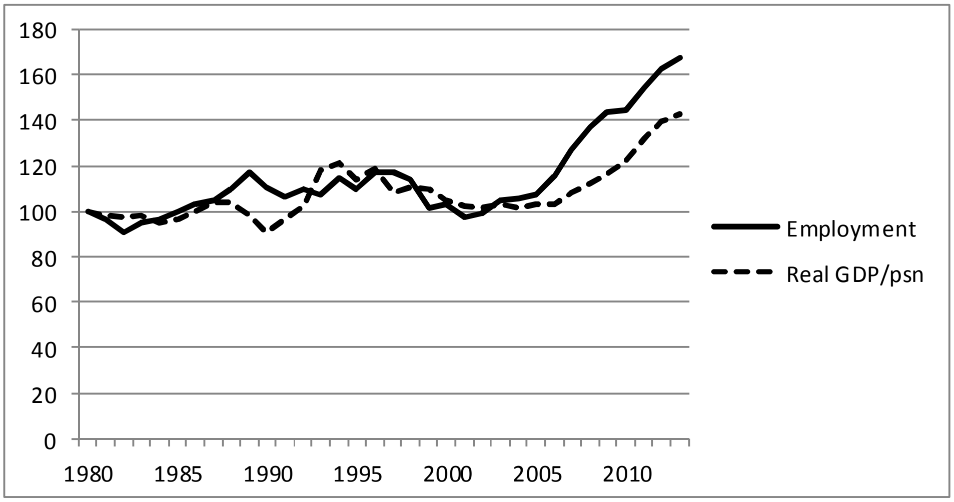
10 'PNG considered the global targets associated with the MDGs as over-ambitious, unrealistic and therefore out of reach.Consequently, in 2003-2004, PNG developed its own set of national targets and indicators associated with each of the MDGs, tobetter reflect the realities in the country. PNG assesses its MDGs progress against these localised targets.' (PIFS 2012, p121)

11 PNG's GDP data must be interpreted with care as significant data limitations mean that it is hard to draw firm conclusions about year-to-year movements (see ADB 2014a, Box 3.33.1, p241 for a further discussion of these data issues). The data are probably sufficient, however, to give a fairly accurate indication of the broad trends described here.

Chart 2: growth in employment and real GDP per person (index)



Sources: Employment: ADB Pacific Economic Monitor, July 2014. GDP: IMF WEO, April 2014 release.

Economic growth has been supported by improved macroeconomic policy that has resulted in a period of relative macroeconomic stability. Unlike previous resource booms, this boom has not (yet) resulted in a currency crisis, uncontrolled inflation or a crisis in government debt. By contrast, successive macroeconomic crises between the late 1980s and the late 1990s meant that PNG required IMF bailouts on three occasions (in 1990, 1995 and 1999). The improved macroeconomic stability is due to the macroeconomic framework that was developed between the mid-1990s and the mid-2000s:

- **Fiscal policy**: Medium-term fiscal strategies that aim to keep government debt low and sustainable, and ensure that government expenditure does not contribute to excessive inflation.
- **Monetary policy**: An independent Bank of PNG with responsibility for monetary and exchange rate policy.
- **Exchange rate management**: An exchange rate that largely reflects market forces, thereby helping the economy absorb the impact of changing prices in the international economy.

PNG's strong economic performance is not necessarily a good indicator of improvements in wellbeing or reductions in hardship in the country. GDP per person is, after all, only a measure of the *average*; the distribution of incomes also matters for 'inclusive growth'. Furthermore, to the extent that GDP growth reflects increased production by foreign companies (and therefore outflows of profits to foreign owners), that growth will overstate the improvements in living standards for Papua New Guineans. Finally, GDP growth is a poor indicator of welfare in resource-dependent countries because it does not account for the depletion of natural resources (Howes 2014).[12] Nonetheless, the IMF (2013, p5) argues that hardship may have declined since the early 2000s as the economy improved.[13]

In addition to PNG's economic performance, there has also been some progress in the delivery of basic services, often due to policy reforms that harnessed the role of the private sector. The most notable example is the dramatic expansion in communication services since the introduction of mobile phone competition in 2007. Within two years, average call rates for both domestic and international calls fell by 11-51 per cent and access to mobile phone services had expanded from around 130,000-140,000subscribers in 2007 to over one million in 2009 and perhaps 2.7 million today (Batten, Gouy and Duncan 2009, pp10-13; CIA World Fact Book entry on PNG).This expansion also led to increased income earning opportunities and various spin-off services in banking, payments, and market information (ADB 2012, pp28-29; ADB 2014b, p3).

Similarly, a series of reforms in the early 2000s led to improvements in financial services (Biggs 2007). In the late 1990s, the National Provident Fund (NPF) was heavily indebted and incurring substantial losses. New legislation was introduced and NPF was restructured: the newly established NASFUND eliminated its outstanding debt and soon returned to profitability. Nambawan Super went through a similar transformation and now both superannuation funds deliver consistent returns for members and are major investors in the local economy. Similarly, major reforms in two local banks converted them into what is now the Bank of South Pacific, a strong, locally owned competitor to the other major banks. And although there is still a long way to go to improve access to loans for small local businesses, there has also been a rapid increase in microfinance services, especially savings facilities for people living in smaller towns and villages. This has been driven by the establishment of new microfinance providers like Nationwide Microbank (NMB) and PNG Microfinance Ltd (PML).

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[12] An alternative measure of national income – real net national disposable income (real NNDI) – would address the last two points (outflows to foreign owners and depletion of natural resources) and is thus a better indicator of changes in average living standards for Papua New Guineans. However, the data required for this measure are not available for PNG.

[13] While the poverty rate appears to be essentially unchanged since the last household survey in 1996, the IMF suggests that it is likely that poverty probably increased between 1996 and the early 2000s due to weak macroeconomic conditions (poor growth and high inflation) but that subsequently declined as the economy improved.

Other basic services however, remain inadequate. In 2012, a review against the MDGs found that, compared to other developing countries, PNG had low literacy rates, high infant and maternal mortality, poor access to improved drinking water sources or sanitation facilities and a high prevalence of underweight children aged under five years (PIFS 2012, pp121-133; see also PIFS 2013, p21). And a recent series of reports reveal the considerable risks of crime and violence within the country (Lakhani and Willman 2014a, 2014b, 2014c).

A recent study of the different barriers to poverty reduction and economic development in PNG identified four (4) critical constraints (ADB 2012):

- weaknesses in governance and institutions (particularly delivery of public services, law and order, corruption, and managing land and land titles)
- poor infrastructure and infrastructure services (particularly transport, electricity, and water supply)
- shortages of skilled human capital, and poor and unequal access to affordable and quality education
- lack of and unequal access to affordable and quality health services.

Although the government's strategic planning documents were prepared prior to this study, the government's vision, goals and targets respond to each of these constraints. The following paragraphs briefly describe the government's vision and goals and Chapter Three then draws the link between these plans, the country's challenges and the role of tax reform.

The government's strategic plans

The government has developed a series of strategic plans that respond to the development challenges set out in the previous chapter. These plans are set out in three complementary documents and are overseen by the Department of National Planning and Monitoring:

- Papua New Guinea Vision 2050 ('Vision 2050'),
- the Development Strategic Plan 2010-2030 (DSP), and
- the Medium Term Development Plan 2011-2015 (MTDP).

In addition to these overarching strategic plans, the government has also prepared a Medium Term Fiscal Strategy 2013-2017 (MTFS) which includes a more specific focus on revenue and taxation.

Vision 2050 maps out Papua New Guinea's development initiatives between 2010 and 2050 and identifies strategic pillars underpinning economic growth and development. The Development Strategic Plan translates the strategic pillars of Vision 2050 into policy directions with clear objectives and targets. The MTDP outlines possible resource allocations and guides the development of sector policies and plans, consistent with the Vision 2050 pillars and the DSP policy directions.

The remainder of this chapter briefly reviews the key goals and objectives of these three guiding documents as well as the Medium Term Fiscal Strategy.

Papua New Guinea Vision 2050

The overarching goal of Vision 2050 is for PNG to become a 'smart, wise, fair, healthy and happy society by 2050'. Vision 2050 identifies seven strategic pillars to achieve this goal:

- human capital development, gender, youth and people empowerment;
- wealth creation;
- institutional development and service delivery;
- security and international relations;
- environmental sustainability and climate change;
- spiritual, cultural and community development; and
- strategic planning, integration and control.

The Development Strategic Plan 2010-2030

The Development Strategic Plan (2010-2030) describes a set of policy initiatives designed to support its overarching goal of transforming Papua New Guinea into a middle income country by 2030. It sets out the following broad objectives, organised according to the five National Goals and Directive Principles of the Constitution:

- **Integral human development**: provide citizens with the opportunity to achieve their potential by offering quality education for all and a world class health system, developing a skilled workforce and equipping entrepreneurs with the skills they need to grow their businesses
- **Equality and participation**: to give all citizens an equal opportunity to participate in and benefit from the nation's development by delivering

transport, electricity, education, health and business services to rural areas, where the vast majority of the country's population lives

- **National sovereignty and self-reliance**: strengthen Papua New Guinea's national sovereignty through economic policies and good governance which will facilitate foreign investment in the country and alleviate its reliance on aid
- **Natural resources and environment**: manage Papua New Guinea's natural resources to ensure their benefit can be sustained through current and future generations, in particular focusing resource revenues on nation building while at the same time being environmentally responsible
- **Papua New Guinea ways**: improve the effectiveness of services in the law and order, land, education and health sectors in order to foster Papua New Guinea's rich cultural heritage

The DSP then sets out a series of goals for different sectors of the economy that, taken together, are intended to fulfil these five objectives.

The Medium-Term Development Plan 2011-2015

The MTDP is a five year rolling development plan designed to provide a guiding framework to ensure that there is a coordinated approach by the various arms of Government policy towards achieving the government's goals for economic growth and development. The broad sectoral priorities of the MTDP, also called the MTDP enablers, are:

- unlocking land for development
- improving law, order and justice
- establishing good quality national transport corridors that connect rural populations to markets and services
- providing higher and technical education and training to address the skills shortage within the labour force
- providing universal access to primary and secondary education
- providing key public utilities including electricity, clean water and communications
- improving health outcomes

The Medium Term Fiscal Strategy (2013-2017)

The MTFS was first included in the 2013 Budget and then updated in the 2014 Budget. It complements the government's strategic plans by outlining an approach to fiscal policy to help the government achieve its broader development and economic goals. It outlines a number of 'rules' covering expenditure, revenue, debt and deficit policy. The revenue aspects are considered in more detail in the following Chapter.

Chapter 3: How tax reform relates to PNG's development challenges and priorities

By ensuring that PNG's tax system better reflects the principles outlined above, tax reform can make an important contribution towards fulfilling the government's strategic priorities and thereby help to address PNG's development challenges. This chapter links each of the five principles to the government's priorities. A summary is provided in Table 1.

A sustainable revenue base for government service delivery

One of the broad challenges that PNG faces, as outlined in Chapter Two, is to improve the delivery of government services. Vision 2050 recognises this challenge under the 'institutional development and service delivery' pillar. It is also embedded in several of the broad objectives of the DSP, including 'Papua New Guinea ways' (improve the effectiveness of services in the law and order, land, education and health sectors) and 'equality and participation' (deliver transport, electricity, education, health and business services to rural areas). As a result, it is also reflected in several of the MTDP enablers, including: law, order and justice, transport infrastructure, higher and technical education, primary and secondary education, and health.

A strong, stable revenue base can support government service delivery without having to rely on increased government debt. In addition, a stable, predictable revenue base makes it easier to plan future government expenditures on services or infrastructure without threatening the government's medium term fiscal objectives. The trends, composition and pressures on PNG's revenue base are discussed further below.

The MTFS recognised that ensuring effective revenue collection is a key pre-requisite in supporting broader development and macroeconomic stability objectives.

A competitive and efficient tax system that supports strong economic growth

Another fundamental challenge for PNG is to maintain strong economic growth. The government has recognised this challenge in the 'wealth creation' pillar of Vision 2050 and the DSP's objective (also reflected in the Tax Review's terms of reference) that PNG will be a prosperous middle income country by 2030.

There is also a more specific reference to improving economic efficiency in the MTDP, which reinforces the importance of reducing tax exemptions to improve economic efficiency: 'The Government will continue to promote level playing fields by avoiding preferential treatment, including tax concessions and subsidies' (MTDP, p7).

The Tax Review Committee strongly supports the above principle.

This same principle is also reflected in the MTFS which identifies the need to 'restrict taxation exemptions and special arrangements' with a particular focus on eliminating special tax concessions for all new resource projects.

Fairness: individuals paying their fair share of taxes and businesses competing on a level playing field

PNG faces an enormous challenge in reducing the high rates of hardship and inequality described in Chapter Two. Tax reform can contribute to this task by creating a more competitive and efficient tax regime; one that promotes economic growth and as described earlier, reduces poverty. Furthermore, a well-designed tax system can help to reduce inequality by ensuring that members of society pay their fair share of taxes. Indeed, this will also address a closely related issue for PNG – one of perception of unfairness in the collection and expenditure of government revenues.

Simplicity: minimising compliance and administrative costs

It is a truism that a simplified tax system makes it easier for taxpayers to comply and for officials to administer. In the same vein, this makes it harder for taxpayers to evade paying tax and harder for officials to engage in corruption. This is an important goal of the DSP and MTDP which call for high standards of public sector management in all levels and institutions of government. The same aim is clearly reflected in Vision 2050's pillar of '*institutional development and service delivery*' and the DSP objective of strengthening PNG's national sovereignty through economic policies and good governance.

Building trust in government and accountability of government including public service

Many Papua New Guineans do not trust their government, either at the political and the bureaucratic level. Allegations of corruption are made daily and suggestions of incompetence are frequent. The fundamental challenge of improving the effectiveness of PNG's government and institutions is highlighted in the '*institutional development and service delivery*' pillar of Vision 2050 and the DSP objective to '*strengthen PNG's national sovereignty through economic policies and good governance*'. In other words, 'high standards of public sector management in all levels and institutions of government' are essential.

Building trust requires transparency

An effective taxation system requires broad community support and participation. This requires broad confidence in the system itself. Only through an open, honest and transparent system where the fairness can be seen by all, can we build and maintain that community trust.

Table 1: Tax reform principles and PNG's strategic plans

Tax principles	Vision 2050 pillars	DSP 2010-2030 objectives	MTDP 2011-15	MTFS 2013 - 2017
1. *Revenue*: a sustainable revenue base for government service delivery	• Institutional development and service delivery • Human capital development	• PNG ways: improve the effectivenes s of services in the law and order, land, education and health sectors	MTDP enablers: law, order and justice; national transport corridors; higher and technical education and training; universal access to primary and secondary education; health	• Ensure revenue collections are maintained to support development and macroeconomic stability objectives
2. *Efficiency*: an efficient tax system that supports strong economic growth	• Wealth creation	• Vision: PNG will be a prosperous middle-income country by 2030 • Strengthen sovereignty through economic policies and good governance	• Private sector-led economic growth: promote a level playing field for business by avoiding preferential treatment, including tax concessions or subsidies	• Maintaining revenue collections in integral in ensuring macroeconomic stability which in turn underpins growth.
3. *Fairness*: all individuals paying their fair share and businesses competing on	• Vision: We will be a … fair society by 2050, where being 'fair' means that	• Equality and participation : to give all citizens an equal opportunity	• DSP/MTDP goal: Vulnerable and disadvantaged people will have the	• Maintain equitable taxation regimes with a focus on compliance

a level playing field	resources and opportunities are equitably distributed	to participate in and benefit from the nation's developmen t	support that they require to meet their right to a minimum standard of living	
4. Simplicity: minimising compliance and admin costs	• *Institutional development and service delivery*	• *Strengthen PNG's national sovereignty through economic policies and good governance*	• *DSP/MTDP goal: Attain high standards of public sector management in all levels and institutions of government*	• *Identified the need for reform of and ongoing support of IRC and PNG Customs Service*
5. Trust in and accountability of government	• Institutional development and service delivery	• National sovereignty and self-reliance: [see above]	• DSP/MTDP goal: Attain high standards of public sector management	• Institutional development

Question 3.1 – how can PNG take advantage of this current tax reform process to help it to achieve its development goals and priorities?

CHAPTER4: ASSESSMENT OF PNG'S TAX SYSTEM: BROAD DIRECTIONS FOR REFORM

This chapter provides an overarching assessment of PNG's tax system, drawing on the principles for good tax policy. Based on this assessment, the chapter also identifies broad reform directions under the following headings:

- Revenue administration (IRC & PNGCS)
- Overall revenue objective
- Tax mix
- Tax exemptions
- Taxation of capital gains
- Resource taxation
- Taxation of small, informal businesses

Finally, this chapter also discusses the need to adopt a phased approach to tax reform that can be pursued over the short-, medium- and long-term.

Revenue administration: IRC and Customs

Tax administration is important for all five of the principles for good taxation, since it affects how much revenue is raised, fairness (who pays), efficiency (whether there is a level playing field), complexity, trust in government administration and transparency (of the tax system) For all these reasons, good revenue (tax and customs) administration is central to any tax reform process.

The cost, efficiency, effectiveness and transparency of revenue administration are increasingly a concern for the government and taxpayers in PNG. Revenue administration is also under constant pressure to justify its cost, to request additional funding and deal and cope with intense competition to attract and retain competent personnel, and the deployment of resources. This is further exacerbated by fast and constant social, economic, technological, demographic and environmental changes.

Notwithstanding the efforts of many committed IRC and customs officials, feedback from consultations and submissions to date suggests that there is considerable scope for improvement. Many submissions complained about poor compliance and enforcement resulting in different forms of tax evasion.

Examples included GST or withholding provisional tax that was collected by businesses but not remitted to the IRC. Other submissions expressed concern about complex forms, the need for greater engagement with other government agencies, and scope for improved processes for communicating, education and disseminating information to taxpayers.

In recognition of the importance of revenue administration, the Tax Review has commissioned diagnostic studies of the revenue functions of both IRC and PNGCS which will provide a more reliable assessment of the current positions. Ongoing feedback from submissions and consultations will contribute to these processes, as will the results from a recent study that compares 22 revenue administrations in Asia and the Pacific (Araki and Claus 2014). The findings from this study provide some indications of the IRC's strengths and areas for future development: they are summarised in Table 2 and are discussed further below.

Table 2: Comparative assessment of PNG IRC

Area of tax administration		PNG IRC: comparison with Asia-Pacific region	
Institutional arrangements	Oversight Board of Tax Admin	M	No oversight board. Some others (4/14) had oversight boards.
	Autonomy	H	Yes to all six categories, comparable to most others.
Internal organisation	Internal organisation	M	Largely function-based organisation. Some others (8/22) also use taxpayer segmentation
	Large taxpayer unit	L	No LTU yet, although it is being considered Most revenue admins (16/22) have LTU
	Office network	H	19 offices, 0.39m people per office. This ratio is around the median value.
Human resource management	Number of staff	L	Staff-on-strength: 351. Staff-to-population ratio is low relative to other countries.
	Attrition rates	H	Attrition rate of approx. 3.6% in 2011. This is below the median attrition rate.
	Other aspects of HRM	M	IRC satisfactory in most areas but lacks flexibility to reward good performance (unlike 13/20) staff satisfaction surveys (unlike 13/21).
Budget and expenditure	Salaries expenditure	L	Salaries/total spend: 44% (2010), 38% (2011). Lowest ratio of all countries in both years.
	ICT expenditure	M	ICT/total spend:22% (2010), 23% (2011). Ratio at the higher end of the range.

	HR expenditure	M	HR/total spend:4% or total budget (2010), 6% (2011). Ratio at the higher end of the range.
	Relative expenditure	M	Spend/revenue: 0.61% (2010), 0.47% (2011). Close to the median, but on the low side.
Taxpayer identification and filing	Registered taxpayer population	?	Comparison not possible due to a lack of comparable registration data.
	Income tax withholding regimes	H	Yes to all six categories, comparable to most others.
	Use of taxpayer identifiers	H	Yes to all six categories, comparable to most others.
Electronic taxpayer services	In-house ICT function	H	Yes, comparable to most others.
	Electronic tax filing systems	?	Data not available. Some other countries allow electronic filing.
	Electronic tax payment	L	Limited payment options. Some other countries allow, eg, phone or internet banking, or direct debit
	Other electronic taxpayer services	L	Incomplete information via web site (most others have comprehensive sites), no social media platform (about half have such platforms)
Tax audits	Tax verification performance	H	Value of verifications to tax collections: 2.2% (2010), 2.5% (2011). Appears to be consistent with performance elsewhere.
	Information gathering and search powers	H	Generally strong but no power to request information from third parties (unlike 15/21)
Arrears collection	Tax debt management	L	Debt outstanding to net revenue: 19% (2010), 25% (2011). IRC was in the bottom 2-4 countries.
	Enforcement powers	M	Generally strong but asset seizure only through courts (unlike 16/22) and names of debtors cannot be publicised (unlike 12/22)
Tax disputes	Institutional arrangements for admin review	H	Yes to 3 out of 4 categories. A few other countries have a specialised tax court.
	Operational performance in admin review	L	Cases finalised:17% (2010), 39% (2011) Lowest or second lowest ratio of all countries.
	Number of review cases per taxpayer	M	High number of cases per 1,000 taxpayers; may be due to dissatisfaction with IRC assessments

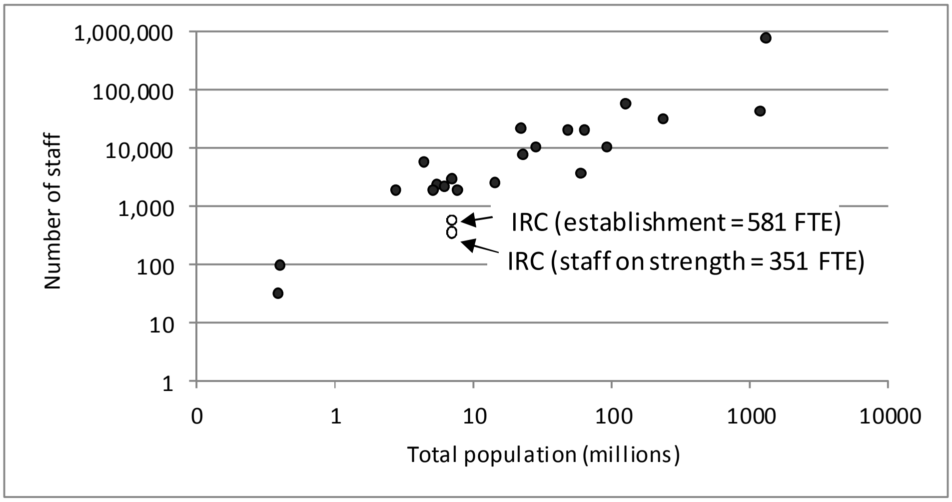
Source: Araki and Claus (2014) and PNG Tax Review.
Notes: ratings of high(H), medium(M) or low(L) are purely based on a comparison with other revenue administrations, not on an in-depth study of IRC's capabilities.

The IRC has a number of strengths, relative to other revenue administrations in the region. At the organisational level, it has followed modern practice of structuring its work based on functions (such as tax assessment, collection, audit and debt management), its office network appears to be broadly appropriate for PNG's size, and its staff attrition rates appear to be satisfactory. In terms of taxpayer registration and filing (assessments), the IRC has a system of taxpayer identification numbers and related information matching purposes. It also has an effective set of income tax withholding regimes. Finally, the IRC's audit performance (measured by the value of tax verification efforts to revenue collections) is sound.

There are also areas where, based on a comparison with other revenue administrations in the region, IRC may have scope for improvement. For example, the IRC can continue to improve its staff levels by filling vacant positions within its current establishment. Within the 22 countries surveyed, there was a strong correlation between the number of staff and the size of population. Based on this simple analysis, the IRC appeared to have relatively few staff-on-strength in 2011 (the time of the survey), and would still be on the low side even if it filled its staff establishment (Chart 3). This issue, and others, will be examined in more detail by the diagnostic study that has beencommissioned by the Tax Review.

There is no doubting the dedication of many of the IRC staff, particularly in the Regional Offices. Equally, the Committee found genuine frustration in the regional offices given apparent challenges from the IRC Head Office to effectively support and manage their officers based outside of Port Moresby. The Committee is advised that there are measures underway to rectify some of these challenges. Notwithstanding this the Committee has received numerous concerns and complaints about the lack of targeted audit and enforcement.

Chart 3: number of staff and total population, 2011



Source: Araki and Claus (2014, Table 7 and Figure 7)

The PNG Customs Service is also working to strengthen its administrative and enforcement capacity. In June 2009, the National Executive Council decided to separate the customs and taxation operations of the Internal Revenue Commission, with the aim of enhancing the capacity of the PNG Customs Service to fulfill its responsibilities for border security and enforcement, trade facilitation, and revenue protection and collection.

During a five-year transition period from 2010 to 2014, PNGCS has focused on building its institutional capacity as a new, separate organization. This process is based on a strategic action plan that identifies areas for improvement, drawing on a diagnostic review undertaken by the World Customs Organization in late 2007. Key priorities are summarised in Table 3.

Table 3: PNG Customs Service – strategic priorities

Area for improvement	Action taken by PNG Customs Services
Strategic management	• Developed PNG Customs Service Plan 2013 - 2017 with strategies, outcomes and performance measures • Annual Work Plans & Monthly Work Reports • Efficient use of resources to achieve corporate objectives • Management Training • Re-alignment of current structure • Transformation of PNG Customs Service into an independent statutory authority is in progress

Compliance strategy	• Compliance Assurance Strategy in place • Encourage Voluntary Compliance • Post Clearance Audit Introduced
Optimal use of ICT	• 80% of all declared Customs ports are connected to the Customs ICT network and ASYCUDA • The business process of trade facilitation, revenue and data collection is 100% automated with 80% of cargoes processed without Customs intervention • Cargo Manifest roll-out • V-SAT Project in progress • Asycuda World project in progress • Electronic banking/pre-payments/internet banking/direct deposits initiatives in progress • 24 hours online access for entry processing • Business Continuity Plan in place
Human resource management and development	• Staff Strength - Recruitment in progress • Establishment of Customs Training Institute within DWU • On-going training - Number of staff trained
Extensive use of risk management	• Risk-based selectivity criteria in the Asycuda • Strategic Risk Management Policy in place • Developing Risk Management Plans
Introduction and effective use of advanced technology	• Container Examination Facility project in progress • Introduction of scanners at Jacksons Airport
Better co-ordination of external relationships	• MOUs with regional Customs Administrations for co-operation and sharing of information • MOUs and increased work partnerships with relevant government agencies • Membership to Regional & International Organizations • MOUs and dialogue with relevant industry groups • Community and industry awareness

PNG Customs faces a number of challenges that impact on revenue administration and on national security vis-a-vis:

- PNG's location between Asia and Pacific with a large unmanned land and sea border makes it vulnerable to cross-border criminal activities. In particular, smuggling of contraband goods poses an ongoing risk to import duty revenues.

- The expansion of several major economic activities (extractive industries, fisheries, aviation and telecommunications) all contribute to increased border movements through the international airports and seaports. Customs faces the challenge of timely clearance of conveyances, people and goods while at the same time ensuring that correct duties and taxes are assessed and collected.

- PNGCS will always have to manage the potential for corruption, like any revenue administration. Customs management has ongoing measures and strategies to counter this risk including awareness among staff and management.

- Finally, building the institutional capacity of PNGCS Customs is an ongoing responsibility. Priorities include: improving staff levels and training, adoption and expansion ICT infrastructure, modernization of legislation and general orders, and improvements to corporate governance.

In the Committee's observations of and discussions with PNGCS officers, there was very good evidence of genuine enthusiasm, a team spirit and a clear understanding of their roles and responsibilities.

Joint IRC and PNGCS Objectives

A common challenge for both IRC and PNGCS is their role in data gathering and sharing. Data is crucial to effective revenue administration and it also has broader spillover benefits for policy making and more generally academic research.. In other words, these data represent a 'public good' and so both the IRC and PNGCS should seek to collate and, where appropriate within the bounds of confidentiality requirements, publish more of the data that is available to them.

Possible role of a strategic oversight board?

PNG is poised for unprecedented rapid socio-economic growth on the back of the LNG Project. This will inevitably entail increasing pressure and stress on revenue administration.

One possible means of mitigating and managing this is to reform revenue administration to incorporate an oversight board to ensure revenue administration adapts to evolving changes and s congruent and abreast of modern business practices. The supervisory board will typically provide:

- overall governance oversight including strategy (formulation and ensuring the strategy is implemented);

- a business model (ensure structure and institutional framework is aligned with changes and reform);
- corporate culture (ensure the right organizational culture is developed and inculcated etc…);
- accountability and transparency;
- setting performance standards (including service standards);
- evaluation and remuneration;
- risk management stewardship; and
- prudential financial management and controls.

One possible area of reform in the area of tax administration that the Tax Review Committee will be exploring further is the introduction of an independent oversight board to oversee the work of IRC and PNGCS.

As outlined in the recent ADB study on tax administration, such an oversight Board exists in a number of jurisdictions in the region and can generally be seen to have three main benefits (Araki and Claus 2014, p 8):

- although the Board's chair tends to be a Ministry of Finance official, a clear separation between the oversight function and the executive function creates an environment where the executive section of a tax administration can focus on daily tax collection operations with minimum political intervention;
- as the board is normally composed of members with different backgrounds including from the private sector, it can ensure that a tax administration adopts flexible policies that consider human resources management, budget allocation, and organizational restructuring in response to a rapidly changing economic and business environment; and
- because the board is distant from the daily operation of tax administration, it can exercise the checks-and-balances function over the executive section, enhancing the protection of taxpayers' rights

Proposed direction: strengthening revenue administration should be an immediate and ongoing priority for tax reform. This includes institutional strengthening and legislative reform that supports better administration (such as simplification and modernization of income tax legislation, or reviewing revenue collection and enforcement powers). Also, in recognition of the spillover benefits of good quality data, both IRC and PNGCS should collate and, where appropriate, publish more of their data. Consideration could be given to introducing an independent oversight board to assist the revenue administrators.

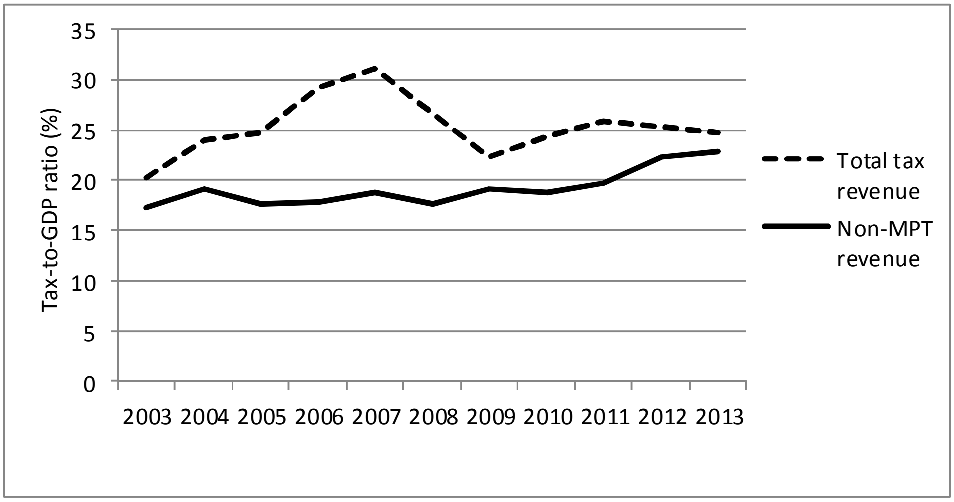
Overall revenue objective

While the government will make decisions about the required level of revenue each year as part of the budget process, a robust tax system should provide a stable revenue base. This reduces the need for sudden changes to taxes that create uncertainty for taxpayers, in addition to the extra tax costs they may have to bear.

In recent years, PNG's tax collections appear to have been reasonably stable at around 25 per cent of GDP (Chart 4). This is close to the average for the past decade however tax collections were far less stable prior to 2010, fluctuating between 20 per cent of GDP in 2003 and 31 per cent in 2007. This data must be interpreted with caution, however, because there are significant limitations to the quality of nominal GDP data. It is possible that GDP is significantly understated and that this has become more of an issue over time. If this is the case, the ratio of tax to GDP may be lower than it appears and the ratio may also have declined in recent years as data errors became more pronounced.[14]

[14] The National Statistics Office has not released GDP data since 2006. Since then, Treasury has produced GDP figures by estimating the value-added in each sector of the economy and then applying weights for each sector to derive an aggregate figure. These sector weights were last updated in 1998 and so do not reflect the major changes in the structure of the PNG economy over the subsequent period (such as the growth in the resources and communications sectors). For further discussion of issues with the quality of GDP data, see ADB (2014a, Box 3.33.1, p241).

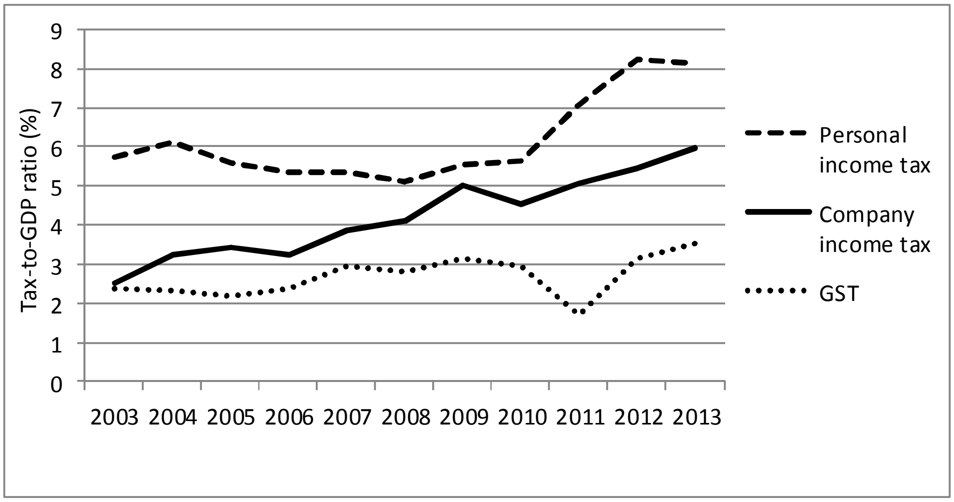
Chart 4: tax revenue as percentage of GDP



Source: *Budget Volume 1* (various years, Appendix 3), and PNG Tax Review calculations.

Recent strength in income tax revenues may disguise a future threat to the revenue base. Real company income tax (CIT) collections have grown strongly over the past decade and real personal income tax (PIT) collections have grown very rapidly in recent years (Chart 5). It is possible that this is due to the surge in economic activity driven by the construction phase of the PNG LNG project and, specifically, that this drove up company profits and salaries for high-income workers. If this is the case, recent strength in collections may prove temporary, suggesting that future income tax revenues could weaken.

Chart 5: trends in GST, PIT and CIT (% of GDP)



Source: *Budget Volume 1* (various years, Appendix 3), and PNG Tax Review calculations.

A separate challenge over the next decade will be to manage expectations of the revenues flowing from the PNG LNG project.

Another issue that is relevant to the overall revenue objective, but which is beyond the terms of reference of this Review, relates to the effectiveness of expenditure – that is, how well the revenues collected are eventually used. It may be arguable that revenues should be collected only to the extent that they can be effectively expended. Certainly the Medium Term Fiscal Strategy 2013-2017 identifies the link between Government expenditure and effective service delivery as one of the greatest challenges facing PNG going forward. Nonetheless, the same document highlights the importance of maintaining revenue collections.

Given the discussion above, any recommendations for reform should *at least* aim to maintain revenue at around the same level as recent years. In other words, recommendations should, at a minimum, be 'revenue neutral' so that any tax reductions for some taxpayers must be accompanied by tax increases for others. In addition, it may be appropriate to adopt 'revenue positive' measures, especially if it appears that some existing revenue sources are likely to decline.

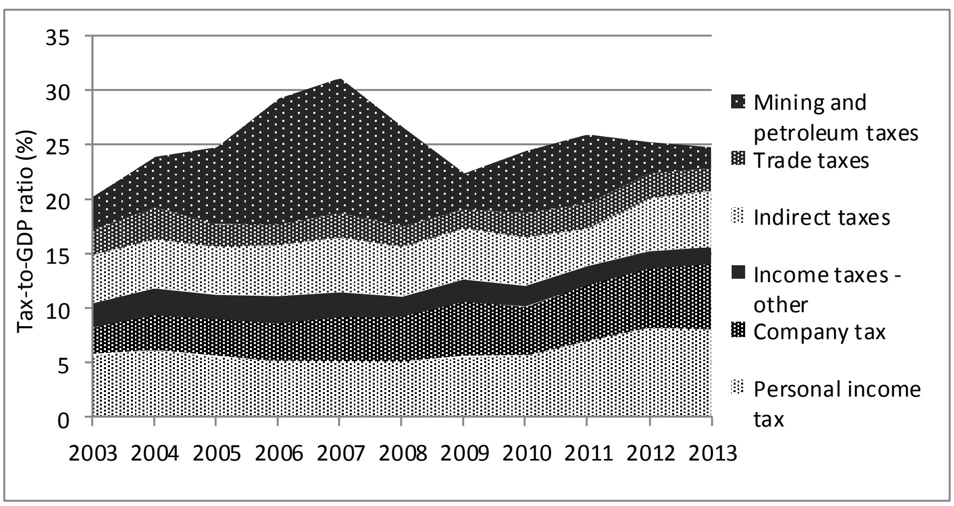
Proposed direction: in order to maintain the revenue base, proposed reforms should *at least* be 'revenue neutral' and it may be appropriate to pursue 'revenue positive' measures.

Tax mix

The overall tax mix shapes major incentives (or distortions) for consumption, work and investment and so it is a major driver of the efficiency of the tax system. Consequently, the appropriate 'tax mix' is mainly a function of the efficiency of key taxes. The appropriate mix may also depend on other considerations, aside from efficiency, however it is usually simplest to assess efficiency first and then make adjustments for other considerations where necessary.

The tax system depends heavily on income taxes, which were over 70 per cent of all revenues every year since 2005 (Chart 6).[15] Mining and petroleum tax (MPT) collections were very strong in the mid-2000s but fell in the past five years due to a decline in commodity prices and a depletion of reserves while PIT and CIT grew strongly. As a result, non-MPT income taxes accounted for almost 60 per cent of total revenues over the past five years. By contrast, indirect taxes (GST and domestic excise) collected were around 16-20 per cent and trade taxes (duties and excise on imports, and export duties) accounted for the remaining 7-10 per cent.

Chart 6: Revenue shares by major tax type



Source: *Budget Volume 1* (various years, Appendix 3), and PNG Tax Review calculations.

Income taxes play a much more significant role in PNG than in neighbouring countries like Solomon Islands, Fiji, Vanuatu, Samoa or Tonga. Revenues from

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15 The main income taxes are PIT, CIT and MPT. Others are: dividend withholding tax (DWT), interest withholding tax (IWT) and gaming tax.

income taxes also make up a bigger share of PNG's total tax take than in some comparable resource-dependent countries like Bolivia, Mongolia and Mozambique. This raises the question of whether the current tax mix, which has little reliance on the GST but heavy dependence on income taxes, has produced the most efficient tax system for PNG.

Certainly, in terms of the rate, PNG's GST is relatively low by regional standards (see Table 4 below). Moreover the IMF indicates that the average VAT rate applying in developing countries is around 16% (IMF 2011, p25).

Table 4: Regional comparison of GST Rates

Country	GST Rate (in percent)
PNG	10
Fiji	12.5
Samoa	15
Tonga	15
Vanuatu	12.5

Although PIT and CIT are important revenue sources for PNG, economic tax theory suggests that these tax bases are likely to be less efficient than other taxes on less mobile bases. By contrast, the consumption taxes like the GST are generally regarded as highly efficient, as is MPT. This implies that efficiency of the tax system, and thus the competitiveness of PNG's economy, could be improved by reducing PNG's reliance on income taxes and making greater use of the GST and resource taxation. The remainder of this section provides the supporting analysis for this conclusion.

Value-added taxes like the GST are generally regarded as highly efficient taxes because they apply to a very broad base (most final consumption goods and services).[16] Furthermore, unlike other indirect taxes (such as import duties, goods taxes or sales taxes), the GST does not introduce distortions at different

[16] Emran and Stiglitz (2007) offer a contrary view but for brief rebuttals of their arguments and restatements of the prevailing wisdom, see IMF (2011, pp26-27) and Keen (2012, pp11-12).

stages in the production process.[17] The GST was introduced around the same time as PNG's tariff reduction program, possibly resulting in a change in the tax mix away from trade taxes towards indirect taxes. However, these changes did not significantly alter PNG's reliance on income taxes.

Personal and company income taxes tend to be less efficient partly because their tax rates are much higher than other taxes. For example, compared to the 10 per cent GST rate, workers earning more than K35,000 per year pay an *average* PIT rate of 20 per cent or more.[18] And most companies will have an *effective* tax rate of around 25-30 per cent.[19] As mentioned above, high tax rates tend to produce disproportionately high economic costs.

CIT may also be becoming less efficient for other reasons. Globalisation means that foreign investors 'shop around' for the most attractive tax regime and existing domestic and foreign companies are more able to shift their operations overseas. In other words, the company tax base is becoming more mobile and therefore the CIT is likely to result in greater distortions and deadweight losses than previously. (By contrast, the personal income tax has some efficiency advantages because it mostly applies to a relatively immobile group of taxpayers. Few workers can readily move overseas to take advantage of lower tax rates.)

Resource rent taxes tend to be more efficient than other company taxes to the extent that they apply to 'economic rents' (that is, windfall profits that exceed the 'normal' return on investments).[20]In this context, these are 'location specific rents' –rents derived from the need for an enterprise needing to locate in a specific jurisdiction (a mining companies must be in PNG to mine PNG's gold).In addition, resource rent taxes capture some of the value of resource depletion so that the government can, in principle, reinvest these revenues to maintain the nation's stock of assets. For example, investment in infrastructure or education can boost the country's national wealth and thus offset the decline in its natural resource assets. Of course, one limitation of resource taxes is that

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17 This is because the GST is designed to apply only to final consumption goods; intermediate goods that are used in the production process receive an input tax credit.

18 The *average* PIT rate is the total tax paid divided by income and is always less than the *marginal* tax rate in a progressive PIT regime. The rate cited here assumes that the taxpayer does not claim any dependent or school fee rebates.

19 The *effective* CIT rate may be lower than the statutory rate of 30 per cent due to exemptions or deductions like accelerated depreciation.

20 The efficiency of taxes on resource rents is discussed further in the "resource taxation" section below and also in Issues Paper No. 1: Mining and Petroleum Taxation (PNG Tax Review 2014, especially p19).

they are subject to the volatility of commodity prices (though this can be mitigated, such as through the creation of sovereign wealth funds).

Finally, excises can be efficient taxes if they apply to goods where demand is relatively unresponsive to changes in prices (that is, they are 'price inelastic'). Just like immobile tax bases, this reduces the distortionary 'deadweight losses' created by the tax (IMF 2011, p39).

Overall, there are likely to be significant improvements in the efficiency of the tax system if the government changes the way it collects revenue so that it derives more from the GST and resource taxes, and less from income taxes. As discussed in Chapter One, a more efficient tax system is important for economic growth, jobs growth and poverty reduction. Nonetheless, one aspect of this proposal – a shift from PIT to GST – is likely to provoke concerns about the fairness, since this PIT has 'progressive' tax scales whereas the GST applies a flat rate to most consumption.

Certainly, one concern about too high a reliance on GST and other, similar consumption taxes, is their potentially regressive nature – that is, its potential to have a disproportionate impact on those individuals on lower incomes. This is because such individuals must spend a higher proportion of their income on the goods and services covered by the tax (and for many products, for example flour, rice etc… they do not have the discretion not to buy these products) - although in terms of absolute numbers higher income earners with greater spending power are likely to bear a higher burden. This has led a number of countries to look at exempting certain basic food items from GST.

Fairness concerns deserve serious consideration but they also require careful analysis. As discussed in Chapter One, there are several factors that means the redistributive role of the PIT may be overstated: it only applies to a small fraction of the population, it may reduce the transfers to *wantoks*, and the legal incidence of the PIT (on formal sector workers) may not reflect its economic incidence. Similarly, the GST may not be as regressive as it appears. In particular, only medium and large businesses are required to register for the GST and so many locally produced goods (especially foods and crafts) will incur little or no GST.[21] Since locally produced goods are likely to comprise a large share of consumption for many households in rural areas, this suggests that an increase in the GST will have a relatively smaller impact on them. Each

21 Consumption items that are produced using imported goods will include some GST in their prices, since imported goods are subject to GST. However, this will still only be a fraction of the full GST rate that applies to goods produced by medium and large businesses.

of these possibilities needs to be assessed in making an overall evaluation of the fairness of changing PIT and GST rates.[22]

Proposed direction: over time, increase the efficiency of the tax system by shifting the tax mix away from income taxes towards the GST and resource taxes.

Having regard to the above discussion and given the significant number of submissions received by the Review to date on the need for PNG to reduce the overall revenue burden on salary and wage earners, the preliminary view of the Tax Review Committee is that there may be merit in the short term for PNG to consider shifting the tax burden from the personal income tax system to the GST. Under such an approach, in the Committee's view, the emphasis should be on delivering income tax cuts to those on lower incomes.

The Committee is interested in stakeholder's views and reactions to such a reform.

Question 4.1 - would stakeholders support a reduction in personal income taxes, particularly for those on lower incomes, if this was paid for through an increase in the GST?

Tax exemptions

Tax exemptions and incentives will be the subject of a separate issues paper that the Tax Review is expected to release later in 2014. In advance of that paper, this section reviews: the costs of tax exemptions, the risks that they may be ineffective, the alternatives (direct subsidies), the reasons why tax exemptions may sometimes be appropriate, and some principles for the design of tax exemptions in these circumstances.[23]

In general, there is a considerable range of cost involved when giving tax exemptions or incentives:

- **Revenue Loss**: Tax exemptions cause a loss in current and future revenue. Another threat to revenue when providing exemptions to one group of taxpayers is that this creates pressure from other taxpayers for the same exemption ("exemption creep").

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22 More general questions about the effectiveness of the PIT as a tool for redistribution are discussed by Bird and Zolt (2005). For some analysis of the impact of a GST on poor Papua New Guineans, see Gibson (1998).

23 For a more detailed discussion of the costs, risks and alternatives to tax exemptions, see Villela*et al* (2010, pp6-12).

- **Inefficient and Unfair**: Tax exemptions are inequitable and inefficient as they create different tax treatments between and within sectors. This can lead to distortions in the allocation of workers or investment to different activities. Furthermore, tax exemptions mean that, if the government is to achieve its revenue target, taxes must be higher for other activities, which have the potential to harm economic efficiency and compliance, and causes inequities.

- **Corruption**: Tax exemptions can create opportunities for tax abuse and corruption. An example of such abuse can be transfer pricing between related parties to ensure profits are made in exempt activities and deductions in fully taxable activities.

- **Complexity**: Special tax treatment complicates tax administration and compliance. These complications often arise because of the need to monitor the incentives due to concerns with abuse. The administration and compliance difficulties are especially likely where the tax administration is also weak.

In many cases, tax incentives may also be ineffective in promoting business or investment. While tax incentives will be successful in attracting some businesses to invest in PNG, these incentives tend to attract "footloose firms" that leave as soon as the incentive expires. PNG needs investors who are committed to the country and who will make a lasting contribution to the nation's development.

In other cases, tax incentives will be redundant: their purpose is to attract new investment but instead they often merely provide a windfall benefit to investors who may have invested anyway. This leads to a waste of government revenues.

Furthermore, tax exemptions are often less effective incentives than direct spending or subsidies. Direct subsidies allow for greater control on costs because overall spending is limited by the budget allocation. By contrast, the cost of tax exemptions is uncertain and unlimited. Direct subsidies are also more transparent, because they must be approved in the budget each year. Finally, subsidies may be more equitable because they can be more carefully targeted. By contrast, tax exemptions often deliver the greatest benefits to those with the highest incomes.

Despite their costs and the risks of being ineffective, exemptions or incentives may be appropriate in some cases. For example, incentives may aim to encourage activities that produce benefits for society that the private market does not fully take into account ("positive externalities"). Incentives for training or research and development are often justified on this basis.

Incentives may also be justified to offset the high costs of doing business. Taxes are not the most important factor in investment decisions in PNG but it is possible that tax exemptions could be used to compensate businesses for the costs of, say, poor infrastructure, crime problems, corruption, or unnecessary red tape.[24] But there are limits on the ability of the tax system to compensate for inadequacies in other aspects of government policy or infrastructure. Furthermore, these other costs of doing business are hard to quantify so tax concessions can significantly over- or under-compensate. In many cases a Government may be better off using the revenue that would have been foregone in the incentive to fix directly the underlying problem.

If the government chooses to offer tax exemptions or incentives, there are several principles that should guide their design.

First, in the past, tax concessions have been granted on a project basis through project agreements. This is not the preferred tax policy approach. If tax concessions are provided, they should instead be made available on an industry-wide or sectoral basis to create a level playing field for competing firms in an industry. Furthermore, the assurance and certainty of equitable treatment for all investors may encourage further investment in the economy. This can be achieved by developing and publishing 'template project agreements' that form the basis of any new projects within the country. This will have the added benefit of assisting State agencies, including the State Solicitor General, to develop new project agreements in a timely manner (PNG Tax Review 2014, p.57).

Second, the least harmful form of tax incentive is 'accelerated depreciation', which accelerates the depreciation of an asset but does not increase the total allowable depreciation beyond its initial investment cost. It is less costly for revenue collections than income tax holidays, investment allowances or tax credits. Also, accelerated depreciation generally provides less scope for tax abuse.

Third, 'investment allowances' and 'investment tax credits' are more cost effective than income tax holidays. An investment allowance allows a certain percentage of the cost of an asset to be expensed at the time that it is purchased, in addition to the normal allowable depreciation. With an investment tax credit, a certain percentage of the investment cost is deducted from taxable income. Unlike tax holidays, these credits require actual

[24] For recent analysis of the costs of doing business in PNG, see INA (2013) and World Bank (2013).

investment by the business, allow better targeting of particular types of investment, and their fiscal costs are more transparent and easier to control.

Finally, information on all 'tax expenditures'(including exemptions, credits or allowances) should be made readily available to decision makers, taxpayers and the public.[25] This includes analysis of the costs of tax expenditures, which should be reported annually in the budget alongside other government expenditures. This is critical for monitoring and controlling the cost of tax exemptions. In addition, it is preferable that tax exemptions should be clearly set out within the relevant tax laws rather than, for example, mining or gas legislation or in project agreements.

One of the challenges in moving away from project specific tax incentives is that whilst it may be easy to agree to do this in theory, in reality firms may wish to continue to seek and obtain such concessions in practice. There may be a case, therefore, to not proceed with any broader, structural reforms that benefit businesses until there is broad political and business consensus of the need to move away from project incentives.

Proposed direction: where possible, reduce exemptions from PIT, CIT or other taxes and use the revenue savings to reduce tax rates. In particular, move to eliminate the practice of awarding tax exemptions through project agreements, particularly where the tax exemptions are 'invisible'. Finally, report the cost of 'tax expenditures' annually through the budget process.

Taxation of capital gains

Individuals and businesses receive 'capital gains' whenever they sell an asset (other than trading stock) for more than they paid for it. These assets may include property (houses or buildings), financial assets (shares, etc), mining and petroleum tenements, or intangible assets. Most capital gains are untaxed in PNG.[26]

[25] 'Tax expenditures' are defined as revenues that are foregone as a result of preferential tax treatment. Common forms are exemptions (exclusions from the tax base), allowances (deductions from the base), credits (deductions from liability), rate relief (reduction of the tax rate), and deferrals (postponing payment). For further details on tax expenditure budgets and analysis, see Villela*et al* (2010).

[26] Gains on the sale of property acquired for profit-making purposes are taxed as income gains but this rule is inadequate for two reasons.From a policy perspective, it should not matter whether the income (capital gain) is motivated by profit-making or some other objective: all income should be taxed similarly. From a practical perspective, this rule is hard to administer(and creates uncertainty for taxpayer) since it requires the IRC to establish a person's motives when they buy an asset.

If capital gains were taxed then the tax system would be fairer, investment decisions would better focus on economic activity, and revenue collections would be strengthened.

Failure to apply a tax to capital gains undermines the principle of *horizontal equity*, since this income is untaxed while other types of income are subject to PIT or CIT. There are also strong *vertical equity* arguments that support taxing capital gains, as these gains tend to be made by the well off.[27]

The absence of a capital gains tax is also *inefficient* because it distorts investment choices towards assets that offer returns as capital gains, and away from taxed investments. For example investment in property is advantaged compared with investments that pay interest (such as bonds or loans) and thus are taxed. By distorting investment decisions, the income tax system can lead to an inefficient allocation of resources within the economy. In this way, it can detract from the country's productivity and future living standards.

A capital gains tax would *strengthen revenue collections* by expanding the tax base and reducing opportunities for income tax avoidance. Currently, the lack of capital gains taxation is a significant structural defect in the tax system that allows tax planners to convert taxable income into untaxed capital gains. For example, shareholders may decide not to pay (taxable) dividends but instead retain the profits and increase the value of their shares. Once these shares are sold, the shareholders receive a (non-taxable) capital gain.

There is significant potential revenue in the long run with the introduction of a CGT. This is particularly true in relation to the taxing of gains from the transfer of mining, oil and gas interests (the non-taxation of which can create significant tensions in a country, Mozambique being a recent example). Moreover the non-taxation of these gains may be contributing to foreign entities speculating on exploration/prospecting licenses (that is, holding onto the license without undertaking genuine exploration).

Consistent with the principle of *simplicity*, careful design and consultation with stakeholders could help to limit the complexity of a capital gains tax system. It would also be important to strengthen the capacity of revenue administration in preparation for such a change. Consequently, given the other benefits listed above, capital gains tax should be a medium-term reform priority.

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[27] Vertical equity can be further strengthened in the design of a capital gains tax. For example, it is common to include thresholds to ensure that small transactions or personal items are not subject to capital gains tax. It is also possible to exempt gains on sale of the main home.

The Committee will prepare a separate Issues Paper further exploring the case for and design of a capital gains tax in PNG.

Proposed direction: the income from capital gains should be taxed – this will make the tax system fairer and more efficient. A capital gains tax should be a medium-term priority and its timing will be dependent on the IRC having sufficient administrative capacity to implement it.

Resource taxation[28]

The taxation of PNG's extractives sector was considered at length in Issues Paper 1. This section draws on the discussion included in that paper.

PNG's mineral and petroleum resources are a finite and non-renewable resource. Their extraction permanently depletes the nation's wealth. Furthermore, the right to extract non-renewable resources allows private firms to potentially gain windfall profits (also known as "resource rents") when project revenues exceed the "normal" return that would otherwise be available to capital investments. For both these reasons, PNG needs to ensure that the exploitation of these non-renewable resources is done in a way that maximises the economic benefits to the citizens of the country.

In particular, a major challenge is to ensure that Papua New Guineans receive a fair return on their natural resources through strong revenue collections. This section reviews the appropriate taxation arrangements for resource projects, discusses the effectiveness of resource taxation during the mining boom, and briefly addresses the issue of volatility in resource revenues.

The appropriate tax regime for resource projects is a combination of ordinary tax arrangements (company income tax and royalties) and an additional tax on resource rents. PNG currently applies a resource rent tax on designated gas projects through the additional profits tax (APT), and has previously applied the APT to other resource sectors.

The State also extracts resource rents through its option to take an equity interest in resource projects. As highlighted in Issues Paper 1, there are a number of limitations in using State equity interests, rather than resource rent taxes, as the main mechanism to gain a share of rents, including[29]:

28 This section is based on PNG Tax Review (2014).

29 See PNG Tax Review (2014, pp36-39) for further details.

- The decision to take up an equity interest is a complex one that is made more difficult by the asymmetry of information between the State and the project sponsor. This places heavy demands on the State bureaucracy and carries the risk that the State will unwisely invest in costly or risky projects (or will opt not to invest in projects that prove to be highly profitable).
- State participation in projects can reduce clarity between the commercial and non-commercial roles of the State, creating the temptation to grant concessions to projects even when these are clearly not in the State's interest.
- Often there is a disconnect between dividend flows and loan obligations arising from financing the State's equity participation. In many cases, the dividends are received by a State nominee that has little responsibility to meet the loan obligations and, as a result, these revenue streams may be misused or over-committed (when they are needed, in part, to repay debt).
- The budget process may become less effective and less transparent if dividend flows are effectively taken 'off budget'. This can occur if the State nominee has the first call over dividend revenues either to support State participation in the project or, more generally, other activities of the nominee.

Given these issues, Issues Paper 1 explored the idea of more effectively utilising a rent tax, such as the APT, across the various extractive sectors. Such an approach would ensure that the government would automatically receive a share of resource rents rather than relying on a decision to take a share through the take up of an equity interest.

In submissions to Issues Paper 1, stakeholders highlighted the need for certainty and stability in the mining and petroleum tax regime. The Tax Review Committee recognizes the critical importance of stability for long-lived investment projects such as those in the resource sector. It also acknowledges that the recent decline in key commodity prices is already affecting prospects for future resource investment. However, because resource rent taxes are 'progressive' (that is, they raise more revenue when commodity prices are high), they are less likely to be altered in response to commodity price movements. Therefore, in addition to their other benefits, resource rent taxes are likely to contribute to future certainty and stability in the mining and petroleum tax regime.

One of the key challenges if PNG were to move towards a broader rent tax applying to its extractive sector is how this would be balanced with the current right to obtain an equity interest in a project - particularly given the broad political and wider support for state ownership interests in projects. A number of submissions to Issues Paper 1 suggested that, given the current focus on state equity interest, it would be inappropriate for PNG to consider moving towards a broader use of a rent tax at this stage.

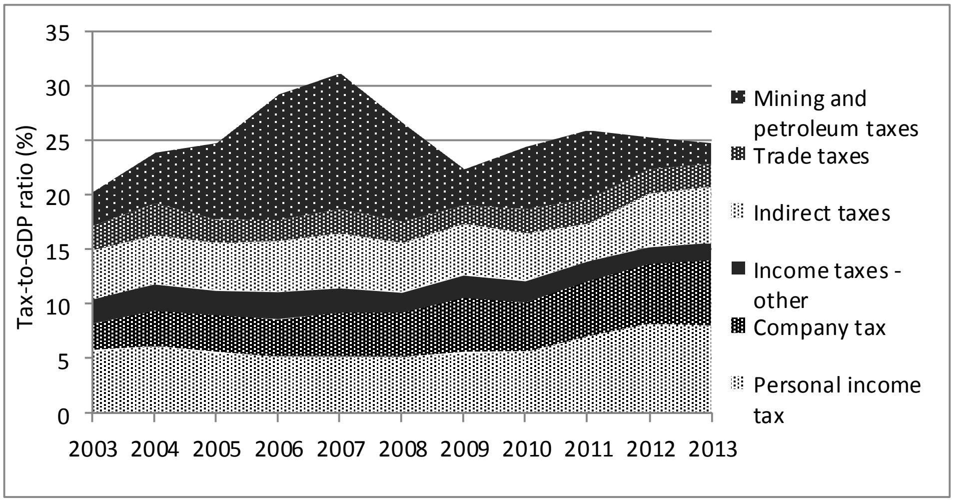
The Committee acknowledges the very strong sentiments supporting the State taking an equity (indeed a significant equity) interest in major projects. In assessing the views of this debate, it is the responsibility of the Committee to make a clear and impartial assessment of which of the alternatives would provide the best financial return now and in the future.[30]

Having regard to the complexities of this issue, the Committee is continuing to consult and engage with industry and Government and will provide its recommendations as part of its draft Final Report. However, it is worth noting that in the mining sector, where no rent tax (such as the APT) exists, it is rare that the Government has exercised its right to take up to a 30% equity interest in a project. Indeed, the only mining projects in which the Government has chosen to exercise its full right to take up an equity interest are the special cases of the Ok Tedi and Tolokuma mines. This means that the Government has had to rely on the small royalty and ordinary corporate income tax system to extract revenue from most projects (and has foregone corporate income tax revenues from the Ramu Nico project as a result of a ten-year income tax holiday).

This suggests that, during the past decade, PNG extracted very little of the windfall profits (resource rents) achieved by mining companies as a result of the mining boom. This may appear surprising, since mining and petroleum tax revenues were strong during much of the past decade, especially between 2005 and 2008 (Chart 7). However, this only reflects revenue collections from the company income tax regime, which applies to ordinary profits and does not target resource rents.

[30] The Committee also acknowledges that there is a review of PNG's mining and petroleum legislation currently underway which will fairly deal with these issues.

Chart 7: mining and petroleum tax collections



Source: *Budget Volume 1* (various years, Appendix 3), and PNG Tax Review calculations.

The other major issue with mining and petroleum taxes is that they are highly volatile revenue sources, principally due to the instability of key commodity prices (see Chart 7). The choice of tax regime may influence this volatility and, in fact, resource rent taxes are likely to exacerbate it. However, the principle responsibility for managing this volatility falls to the government's medium- and long-term fiscal frameworks including the Medium-Term Fiscal Strategy and, critically, the planned Sovereign Wealth Fund.[31]

Proposed direction: consistent with the suggestions in Issues Paper 1 on Mining and Petroleum Taxation, PNG may wish to consider introducing a more progressive tax regime across its extractives sector, with a greater reliance on rent taxes such as a more effective Additional Profits Tax.

Taxation of small, informal businesses[32]

The informal sector, or informal economy, looms large in PNG and certainly reaches a much larger share of the population than the formal sector. The Tax Review plans to release a separate issues paper later in 2014 on how the tax system applies to informal businesses (and to small and medium

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[31] For further discussion, see Government of PNG (2010), World Bank (2010), IMF (2013, pp9-10) and PNG Tax Review (2014, p35).

[32] For further discussion of informal businesses and taxation, see: Loeprick (2009), Stern and Loeprick (2010), OECD (2008, pp25-26), OECD (2010, pp43-44), IMF (2011, pp39-41) and Keen (2012, pp15-19).

enterprises(SMEs) more generally). In advance of that paper, this section focuses on one group within the informal sector – small, informal businesses – and discusses the barriers faced by these businesses. It then reviews the current tax rules for small, informal businesses and identifies tax simplification measures that could benefit informal businesses and the broader tax system.

For the purposes of the tax system, there are several quite distinct groups within the broad 'informal sector'.[33]

- **Hard-to-tax professions**: some professions may be 'informal' in the sense that they have not registered with the IRC and so are evading their tax obligations. These hard-to-tax groups should be subject to normal compliance and audit functions and so are not discussed further in this section. Alternatively, special collection rules can be put in place to better ensure compliance (the business payments system in PNG would be an example of this).

- **Other small, informal businesses**: many micro and small businesses operate in the cash economy. Some may be highly profitable and so should contribute their fair share of the tax burden. There may be other benefits of ensuring that more of these businesses are registered with the tax system, provided the compliance and administrative costs are not too great. This is discussed further below.

- **Informal (cash) workers**: employees of large organisations should be subject to provisional tax. Workers who are not subject to provisional tax and who earn above the tax-free threshold are obliged to submit a tax return for assessment. In cases where this does not occur (that is, employers do not collect provisional tax or workers do not submit a tax return), this should be subject to normal compliance and audit functions and so is not discussed further below.

- **Informal (subsistence) workers**: these workers should not be subject to tax, for obvious reasons.

The remainder of this section focuses on small, informal businesses. There are many factors that contribute to the "informality trap" – the idea that being small and informal makes it hard for businesses that want to expand to escape from being small and informal (Loeprick 2009, p2; Stern and Loeprick 2010).[34]

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[33] For a more general discussion of different types of informal activity in both urban and rural regions of PNG, see Conroy 2010 (pp192-194).

[34] This does not imply that all informal businesses do or should want to formalise, only that some (perhaps many) informal businesses have little choice due to the barriers they face. See

Business growth depends on access to finance but informal businesses will often experience even greater barriers to formal financial services than other small and medium enterprises. In addition, informality may mean that businesses have limited access to some markets (especially government procurement or contracts). Furthermore, informal businesses will have incentives to stay small to help evade authorities but this small scale is likely to result in diseconomies of scale. And evading the authorities is likely to create other costs and general uncertainty that discourages the business from trading or investment.

Informal businesses, by definition, are not registered with the IRC for tax purposes (nor are they registered as businesses with the Investment Promotion Authority, IPA). These businesses may, however, still be subject to indirect taxes (such as GST, import duties or excise) on goods and services that are used by the business.

Strictly, under current tax rules, all businesses – large and small –should be taxed on their 'accounting profits' that are calculated using principles devised by the accounting profession. These principles address complex issues mainly related to allocating income and expenses to a particular financial year. For small businesses, the costs of complying with these rules may be disproportionately high. These costs include registration, understanding the tax system, record keeping, filing and payment, audits and dispute resolution.

Small businesses are unlikely to be a major source of revenue. Consequently, the main objective for tax policy in relation to small, informal businesses should be to help them escape the informality trap described earlier. If tax policies and administration can support greater formalisation and growth of small businesses, this can have benefits for the small businesses themselves and for the broader tax system (in terms of fairness, simplicity, efficiency and government accountability).

Tax reform can help small businesses to escape the informality trap (Stern and Loeprick 2010; Loeprick 2009). The first step is tax simplification. It may be possible to achieve some simplification through administrative decisions taken by the IRC (for example, by introducing simplified forms, information and payment processes for small businesses). However, any major improvements are likely to involve a new, simplified tax regime based on a 'presumptive tax' that replaces some or all other tax obligations for small businesses. This means that, rather than establishing an income tax liability directly, based on

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Conroy 2010 (pp194-95) for a discussion of the limits on formalisation and merits of informality.

accounting profits, the liability is determined indirectly based on business turnover or some other indicator.[35]

The second step is to support these policy and administrative changes with dedicated taxpayer services targeted at small businesses and that are designed to reinforce the benefits of formalisation. This could include the provision of basic business services, such as book-keeping and marketing advice. It could also include assistance to small businesses to coordinate with other parts of government administration.

As argued above, the principle objective of simplified tax arrangements should be to benefit small, informal businesses and to support those who wish to formalise to do so. In addition, a simplified business tax regime is likely to have broader benefits for the tax system:

- **Efficiency**: Encouraging formalisation will help innovative small businesses to grow: innovation and entrepreneurship are important drivers of economic growth.[36] There are also efficiency benefits from creating a level playing field that reduces tax biases against formal businesses.
- **Future revenue**: Some small, informal businesses will expand over time. If they remain outside the tax system as they grow, revenue collections will suffer. Registering them early can help grow future revenues.
- **Fairness**: Some informal businesses are profitable and so should pay tax and contribute their fair share of the tax burden. If the tax system is seen to be fair, this should help improve compliance by other formal businesses.
- **Government accountability**: including more of the informal sector within the tax system may increase the engagement of small businesses in the political process and thus help improve government accountability.

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35 Other indicators used for presumptive taxes include: floor space in a shop, size or quality of farmland, number of employees, number of seats on bus, or the number of seats in a restaurant.

36 "Many studies have been carried out demonstrating the benefits of formalization and shown that activities in the informal sector are less productive than formal ones" (Stern and Loeprick 2010, p10).

The capacity of the tax administration will be critical to the success of any new tax arrangements for small, informal businesses. It is the administration that will be required to:

- implement any new presumptive taxation arrangements
- simplify forms and processes that small businesses encounter
- provide information and taxpayer services
- minimise compliance costs generally

Consequently, any policy changes should be be pursued in close collaboration with the IRC and only once it is clear that there is the capacity to administer the policy reforms successfully.

Proposed direction: the tax system should recognise the challenges that small businesses face in complying with their tax obligations, the disincentive that this poses to 'formalise' and the consequent limitations that this imposes on their growth and the government's revenue. Consideration could be given to a 'presumptive tax' on turnover or cashflow – however, this should be a medium priority as its success will be heavily dependent on the administrative capacity of the Internal Revenue Commission (IRC).

Non-tax revenue

Non-tax revenue (the fees and charges charged by various Government agencies) forms a significant part of PNG's revenue system. As with an effective taxation system, a well structured and administered non tax revenue system can help to support overall Government revenue and fiscal objectives and can also assist lead to more efficient allocation or re-distribution of Government resources.

PNG inherited a non-tax revenue system from its colonial administrators and in many instances the policy frameworks underlying this system (and in some instances even the fees and charges themselves) have not evolved. As it is appropriate to reconsider the tax system to ensure that it remain relevant to today's, modern PNG, there is an urgent and compelling need to examine the broader non-tax revenue system.

The Committee's preliminary investigations into non-tax revenues highlights a number of challenges in the management of these revenues, in particular in ensuring that fees and charges are updated on a regular basis, based on sound policy. On this basis there is scope to consider the development of a sound policy framework to guide the management of PNG's non-tax revenues going forward.

Proposed direction: develop a revised policy framework for the management and administration of non-tax revenues across all of government to better suit today's modern PNG.

A phased approach to tax reform

These broad directions for tax reforms can make a noticeable contribution to economic growth, in addition to improving the fairness, simplicity and revenue-raising capacity of the tax system, and trust in government more generally. Therefore, reforms should not be delayed unnecessarily. But reforms should not be rushed either. Even once consultations are completed, revenue administrations and stakeholders both need time to prepare for implementation.

The comprehensive plan for reform that this Review is seeking to map will be a multi-year undertaking spread over ten (10) years and will require funding and resource commitments and mobilization. This requires the establishment of robust institutional systems to facilitate multi department co-ordination and collaboration and to ensure consistent and sustainable implementation. This will also require the assignment of oversight and implementation of the tax reform recommendations to dedicated senior officers in Treasury, the Internal Revenue Commission and the PNG Customs Service.

The proposed phases for tax reform over the next decade are summarized in Table 4.

Table 4: a phased approach to tax reform

Broad direction for reform	Short-term (1-2 years)	Medium-term (2-5 years)	Long-term (5-10 years)
Strengthen revenue administration			
Maintain or strengthen overall revenue collections			
Shift tax mix from income taxes to indirect and resource taxes			
Reduce tax exemptions and lower tax rates			
Introduce a capital gains tax			

Extend the APT so that it applies to all resource rents			
Separate review of non-tax revenue and related issues			
Reform taxation of small, informal businesses			

Question 4.2 - what are stakeholder's preliminary reactions to the broad reform directions outlined in this Chapter?

Question 4.3 - do stakeholder's agree to the need for a staged tax reform process?

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4