

THE NATIONAL RESEARCH INSTITUTE
 PAPUA NEW GUINEA
 DISCUSSION PAPER NO. 142



TAXATION POLICIES AND PRACTICES AFFECTING
 BUSINESSES AND INDIVIDUALS IN PAPUA NEW
 GUINEA: OPTIONS FOR REFORM

SUMMARY REPORT AND SUBMISSION TO THE TAXATION REVIEW COMMITTEE

Income derived from export PNG tax law provides for a number of tax incentives which are available to new and existing investors and taxpayers.

Tax Incentives
 Accelerated depreciation provisions, except for new ships and aircraft, are available to new and existing investors and taxpayers.

Accelerated Depreciation
 New industrial plant is eligible for increased depreciation up to 100% of cost. In the case of accelerated depreciation for agriculture and fisheries, expenditure on new plant or article used in agricultural production or commercial fishing activities can be written off 100% in the first year.

Initial Year Accelerated Depreciation
 Initial year accelerated depreciation allows the capital cost of certain new assets to be written down at 100% in the first year.

Type of Plant	Rate in addition to normal depreciation
New Plant (other than residential property with a cost exceeding K1000000) with a life exceeding five years used in Papua New Guinea in manufacturing, construction, transport, storage, communication or agriculture production.	20%
Modification of plant for the purpose of conserving fuel input.	20%
Expenditure on acquiring new non oil-fired plant.	30%
Expenditure on converting oil-fired plant to non-oil fired plant.	30%

OTHER TAXES
 Overview
 The Internal Revenue Commission is responsible for:
 • Gaming Machine Tax
 • Departure Tax
 • Bookmaker Tax
 • Training Levy

GAMING MACHINE TAX
 While the Internal Revenue Commission is responsible for licensing of Bookmakers, Land's Department are responsible for the operation of gaming machines.

DEPARTURE TAX
 There is a departure tax of K30 per person including in your ticket and the airline pays the tax.

BOOKMAKERS TAX
 Bookmakers are registered under the Bookmakers Act. There is a turnover tax payment has been received from the Bookmakers in respect of their operations.



The National Research Institute

Discussion Paper No. 142



**TAXATION POLICIES AND PRACTICES AFFECTING BUSINESSES AND INDIVIDUALS
IN PAPUA NEW GUINEA: OPTIONS FOR REFORM**

Summary Report and Submission to the Taxation Review Committee

by

**Francis Odhuno, Osborne Sanida
Charles Yala and Thomas Webster**

**NRI
The National Research Institute**

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CONTENTS

ACKNOWLEDGEMENTS	iv
ACRONYMS	v
EXECUTIVE SUMMARY/POLICY BRIEF.....	vi
1. COMPANY INCOME (AND WITHHOLDING) TAX RATES.....	1
A Current Situation and Suggested Reforms	1
B Summary Report on Symposium Discussion Session	2
2. TAX COMPLIANCE AND TAXPAYER MORALE	3
A. Current Situation and Suggested Reform Actions	3
B Summary of Symposium Discussion Session	4
3. TAX INCENTIVES AND CONCESSIONS.....	5
A Current Situation and Suggested Reform Actions	5
B Summary of Symposium Discussion Session	6
4. PERSONAL INCOME TAX	7
A Current Situation and Suggested Reform Actions	7
B Summary of Symposium Discussion Session	8
5. GOODS AND SERVICES TAX (GST)	9
A Current Situation and Suggested Reform Actions	9
B Summary of Symposium Discussion Session	10
6. ENVIRONMENTAL TAXES AND OTHER NON-TAX REVENUES.....	11
A Current Situation and Suggested Reform Actions	11
B Summary of Symposium Discussion Session	12
7. CUSTOMS DUTY AND EXCISE TARIFF.....	13
A Current Situation and Suggested Reform Actions	13
B Summary of Symposium Discussion Session	14
8. CUSTOMS AND TAX ADMINISTRATION.....	15
A Current Situation and Suggested Reform Actions	15
B Summary of Symposium Discussion Session	15
9. CONCLUDING REMARKS.....	17
REFERENCES.....	18

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As this summary report is a product of the staff of NRI, who reviewed the Symposium papers and summed up the discussions, the interpretations, and conclusions expressed in this report do not necessarily reflect the views of NRI. Text from the academic papers either quoted or summarised in this report are the responsibility of the authors, not funding agencies.

Francis Odhuno, Osborne Sanida
Charles Yala and Thomas Webster

ACRONYMS

DFAT	Department of Foreign Affairs and Trade
FDI	Foreign Direct Investment
GST	Goods and Services Tax
IRC	Internal Revenue Commission
NRI	National Research Institute
PIC	Pacific Island Country
PNG	Papua New Guinea
SME	Small and Medium Enterprise
UBS	Union Bank of Switzerland (UBS AG)
VAT	Value Added Tax

EXECUTIVE SUMMARY/POLICY BRIEF

The Symposium on *Analysis of Taxation Policies and Reforms Affecting Businesses and Individuals in Papua New Guinea* was held on May 29–30, 2014 in Port Moresby. This report/policy brief summarises the observations, recommendations and discussions of the research papers that were presented at that symposium. The authors of the papers were granted support by the National Research Institute (NRI) to conduct deeper analysis of taxation and related issues accumulated over the past years to: (i) identify concerns with the current taxation system; (ii) describe what a good tax system should be like; (iii) consider options for reforms; and (iv) evaluate the pros and cons of those options.

The papers delve into the changes proposed for the Papua New Guinea (PNG) tax regime. The main points challenged have to do with the multiplicity of taxes, the fiscal burden for those who pay taxes, and the high levels of tax avoidance and evasion in PNG. The topic is of broader interest within and beyond PNG, particularly at this very moment when tax reform is under discussion in regional consultation meetings with the Tax Review Committee. While discussions about the need to update the tax system recognise various key elements for a future taxation system in PNG, we make the following ten recommendations:

1. **Tax Exemptions and Incentives:** Expand the tax base by removing tax exemptions and concessions so that the individual burden may be reduced without a reduction in tax collection. Tax incentives are not appropriate for a richly-endowed third world country with an underdeveloped economy like PNG. We believe that the across-the-board elimination of income tax preferences within a comprehensive reform of the tax system, rather than targeting certain exemptions and concessions, is certainly the easier way to achieve the country's fiscal and economic goals.
2. **Personal Income Tax:** Replace the current personal income tax system with two separate and mutually exclusive forms of income tax: (a) Wage Income Tax; and (b) Investment Income Tax — so that wage income is not added to investment income in calculating tax liability. We believe that the reduction in the burden on individuals who pay tax will only become feasible if the number of taxpayers increase; hence, the government could limit the risk of tax evasion by also lowering the top marginal tax rates for individuals to 30%.
3. **Corporate Income Tax:** In order to increase tax competitiveness in the business sector, the government should consider reducing and equalising all company income taxes at 30%, meaning that all companies, including mining and non-resident companies, should be taxed at the same corporate rate. A further reduction of the company tax rate to 25% over the medium term is recommended to assure steady cross-border investment and capital inflows, promote economic growth, and improve the living standards of Papua New Guineans.
4. **Taxation of Mineral Resources:** Double deduction of mining exploration expenditure should be removed; but the exploration expenditure (anywhere in PNG) should be deductible against operating profits of mining, petroleum, and gas projects. Any exploration expenditure not deducted in a single period should be carried forward at a low accumulation rate. In addition to the 30% corporate income tax, a 7.5–10% Additional Profits Tax is recommended for mining companies.
5. **Government Equity in Resource Ventures:** The Government should strive to rely on rent-based taxes and not dividends from state equity shares in mining, petroleum, and gas companies. The debt-raising capacity of the government can be better used for investing in the much needed economic and social infrastructure than for buying into mining projects.

6. **Goods & Services Tax:** The formula for redistributing the Goods and Services Tax (GST) income should be adjusted to 60:20:20, so that 60% of the internal GST revenue is retained in the province where it was collected; 20% of the internal GST collection should be put into a trust fund to support labour-intensive income and employment generating activities in the less well-endowed provinces; and the remaining 20% should go to the National Government to be added onto the GST on imported products and services.
7. **Environmental Tax and Non-tax Revenues:** Non-tax revenues may not significantly affect the efficiency of free markets, but market failure can occur when businesses don't account for their environmental "foot prints". To promote the quest for a clean and healthy environment, the government should impose taxes on environmentally-related tax bases (energy, motor vehicles, emissions to air and water, wastes, and hazardous chemicals). The objective is not to raise revenue for the government but to achieve clean production and conserve the environment.
8. **Customs and Tax Administration:** The existing tax administration laws and regulations are simplistic and inadequate; hence, a complete overhaul of the legislation to modernise and streamline the administration of tax in PNG is recommended. We believe that merging Customs and IRC into a Revenue Authority will strengthen revenue collection and harmonize the separate tax collection arms. The overall objective would be to provide operational autonomy in revenue administration and enable its evolution into a modern, flexible, and integrated revenue collection agency. The relevant laws and regulations should be codified in a separate Revenue Authority Act.
9. **Customs & Excise Tariffs:** The practice of biannually adjusting excise duty rates with movements in the Consumer Price Index (CPI) is not justifiable on two grounds. First, there is considerable scepticism as to whether the CPI is providing an accurate measure of inflation in PNG; and second, the basic consumer products liable to excise duty are not price-sensitive. It should be possible to generate steady or even increasing revenue by imposing a flat excise tax over the course of twelve months. Hence, excise taxes should be levied at low, uniformly flat rates, which will make them easier to collect and administer.
10. **Broadening the tax base:** Currently there is no capital gains tax in PNG, perhaps because the property (land and housing) and equity (shares and bonds) markets are relatively underdeveloped. The country is yet to unlock a significant part of its land for property development. When this eventuates, it is considered that the sale of personal residential property will normally be exempt from capital gains tax until the country's property market matures. It is also noted that a Securities Commission Bill, a Capital Market Bill, and a Central Depository Bill are currently under discussion and which, if collectively passed into law, would replace the Securities Act 1997. Again, until these significant developments eventuate, capital gains tax on sale of stocks, bonds, and shares is not currently recommended in order to allow a sustained interest and investment in the country's capital market.

1. COMPANY INCOME (AND WITHHOLDING) TAX RATES¹

A Current Situation and Suggested Reforms

- 1.1 Successive PNG governments have been designing tax policies with the intention of attracting foreign direct investment (FDI) and stimulating economic growth. Yet the 50% resident oil company tax and the 48% non-resident company tax rate, compared to the current 30% tax rate for resident companies, are still too high for PNG, a developing country competing to attract FDI. It is also possible that the 10% discrepancy between the 48% non-resident company tax and the 40% special tax rate for non-resident mining companies, which is inequitable, could be having negative effects on investment decisions. It is also inequitable that designated petroleum and gas projects pay 7.5–10% Additional Profits Tax while mineral resource projects do not (which leads to considerable revenue being forgone).
- 1.2 Generally, the current withholding tax rates of 10–17% are within the 10–30% range in most countries around the world. The only exception is for non-resident insurers without a permanent establishment in PNG who pay 48% withholding tax — which is comparatively very high. Yet payments for certain construction-related services are not subject to withholding tax if the payee is certified by the Internal Revenue Commission (IRC) as tax compliant and produces a current compliance certificate.
- 1.3 While the PNG government is encouraging investment in the construction industry — especially in the housing and mining, petroleum, and gas sectors — this should not be to the detriment of the financial (insurance) sector. The high degree of variance within service industries may be restricting participation of foreign investors rather than encouraging them to incorporate in PNG.
- 1.4 In order to design tax policy with incentives that promote desirable investment behaviour and disincentives for undesirable behaviour, the following tax reform options should be considered.
 - 1.4.1 Reduce resident company tax rate from 30% to 25% in the medium term to make PNG's tax regime more internationally competitive.
 - 1.4.2 Equalise the resident and non-resident tax rates at 25% to remove the existing inequities.
 - 1.4.3 Equalise the resident and non-resident mining company tax rates at 25% to remove the existing inequity.
 - 1.4.4 Re-introduce the 7.5–10% Additional Profits Tax for mining companies to remove the existing inequity between resource projects.
 - 1.4.5 In the interest of fairness and simplicity, it is recommended that non-resident contractors and insurers should have 20–25% of their fees withheld and paid to IRC.

¹ Based on Dr Ken Devos' paper on "The Corporate Tax Regime" and Drs Craig Emerson and Diane Kraal's papers on "Petroleum and Gas" and "Mining Reform Options" presented at the PNG Taxation Research and Review Symposium, 29–30 May, 2014 in Port Moresby.

B Summary Report on Symposium Discussion Session

- 1.5 While government revenue may initially decline as a result of these changes, it is the potential increase in investment that will be attracted that is critical; and as long as investment is increasing, the lower tax rate will be sustainable. Bringing the income tax rate for all non-resident companies in line with the resident company tax rate, regardless of the industry category, can also be justified on other grounds.
- 1.6 Besides simplifying company tax administration, taxing all companies at the same rate rather than taxing a few companies at disproportionately high rates will remove the existing distortions in the investment regime. Moreover, the incentive for companies to transfer taxable income offshore would be removed if PNG's tax rate is perceived to be lower than in overseas tax jurisdictions.
- 1.7 The challenge, however, is and always will be to optimize the State's take without adversely affecting the attractiveness of PNG as a global mining, petroleum, and natural gas investment destination. But the nature of the country's geology, topography, and lack of infrastructure, which make for the high cost of translating mineral deposits into equitably-distributed wealth across the country, should also not be ignored. Since most mines face difficult mining conditions, higher commodity prices do not automatically translate to higher profits, as some have required further capital investment. While not advocating for tax incentives, there was considerable debate as to whether any other measure designed to promote greater investment in exploration — like removing the cap on deducting pooled exploration expenditure — would be important for Papua New Guinea.

2. TAX COMPLIANCE AND TAXPAYER MORALE²

A Current Situation and Suggested Reform Actions

- 2.1 IRC collects corporate income tax under a provisional system, but it has faced problems in collecting the taxes. The problem is exacerbated by the limited resources that IRC has at its disposal to conduct effective compliance audits. As a result, PNG has one of the highest levels of tax arrears as a percentage of net revenue (25.5%). The unpaid corporate income tax (as of year 2012) makes up the largest proportion (70%) of total debt owed to IRC, suggesting that non-compliance with this tax is a major concern.
- 2.2 Indeed, PNG has higher levels of tax evasion than the average for Asia and the Pacific, as many high-income corporate taxpayers pay relatively little tax, which has a big impact on tax revenue. Such debts harm the tax administration operations and public finance management; and with rampant corruption in the country,³ citizens experience reduced trust in authority; hence there is little incentive to cooperate and be compliant.
- 2.3 In the absence of a large IRC presence in the country for audit activity, the utilisation of appropriate penalties is vital, as it is strong penalties combined with risk-profiling to focus audit activity and voluntary initiatives that can increase deterrence. However, whereas appeals to morals and reminders of penalties should serve to increase voluntary compliance, the current penalty of K5,000 for late lodgement and K50 for each day of failure to lodge a tax return and pay taxes due are rather lenient.
- 2.4 Therefore, to help discourage aggressive tax avoidance practices, stiffer penalties should be imposed. But reducing tax evasion is not simply a matter of applying higher penalties and/or increasing the frequency of audits. Instead, voluntary compliance will largely be achieved through a combination of service and enforcement functions:
 - 2.4.1 IRC should introduce some form of corporate tax disclosure, which should allow for tracking and monitoring corporate operations and thereby encouraging transparency. That PNG has pledged to publish full and verifiable company payments and government revenues from petroleum, mining, and gas industries under the Extractive Industries Transparency Initiative (EITI) suggest that another company's tax information should not be treated as confidential.
 - 2.4.2 Improving institutions by enhancing law and order, government stability, voice or accountability and reducing corruption should be high on the agenda. Improving the governance structure and the tax administration are also essential to guarantee a successful long-term and sustainable tax compliance strategy.
 - 2.4.3 Rewarding honest taxpayers — the IRC to consider issuing a certificate for “good” taxpayers: knowing of compliant peers can increase tax compliance. Moreover,
 - Firms/individuals receiving this recognition would then capitalize on their improved reputation and image.

² Based on two papers by Mr Marco Piatti, Dr Markus Schaffner and Professor Benno Torgler: “Increasing Tax Compliance in Papua New Guinea”, and “Understanding What Drives Tax Morale” presented at the PNG Taxation Research and Review Symposium, 29–30 May, 2014 in Port Moresby.

³ Ayius, Albert and R.J. May, (eds.), 2007, “*Corruption in Papua New Guinea*”.

- “Good” taxpayers could receive more favourable conditions on the capital market or an increase in the customers’ trust in the firm’s products or services.

B Summary of Symposium Discussion Session

- 2.5 There was a general agreement that compliance generally involves appropriate taxpayer notification and registration, return filing, correct reporting and accurate and timely tax payments. But there are also different forms of non-compliance and not all non-compliance is intentional: the complexity of tax systems, the logistical difficulty of complying, and various other factors may lead to some tax leakage through unintentional non-compliance.
- 2.6 The discussion therefore stressed the importance to a country such as Papua New Guinea of moving away from the deterrence, command and control models that have often dominated in the past and towards models more capable of reinforcing the norms of voluntary compliance: making it easy for those who wish to comply and providing plausible and effective deterrence to those who do not.
- 2.7 The impact upon compliance of factors such as corruption, other institutional factors, and tax administration were deliberated with the general consensus that any further improvements in the quality of governance (lower corruption or higher bureaucratic quality) can increase the efficiency of the tax system in Papua New Guinea.

3. TAX INCENTIVES AND CONCESSIONS⁴

A Current Situation and Suggested Reform Actions

- 3.1 Currently, tax incentives and concessions enjoyed by businesses in PNG depend on the industry and the location of the business activity. The most conspicuous is the case of businesses engaged in mineral, petroleum, and gas extraction that enjoy a range of tax concessions and exemptions: special accelerated depreciation for extraction and capital expenditure; double deduction of exploration expenditure; and a fiscal stability clause at 2 percentage points in addition to the 30% corporate tax rate. Yet there is evidence to suggest that there has not been sufficient revenue collected during periods of high profitability in the mining and petroleum industries.⁵
- 3.2 Generally, tax exemptions and concessions in PNG appear to be inefficiently designed and to favour high-income groups who also often enjoy long tax holidays before they begin to contribute to government revenue; or effectively escape taxation altogether for a large subsequent number of years.
- 3.3 The irony is that the majority of these tax incentives and concessions are provided in project-specific agreements that are not only confidential between the government and the company but also alter and override the general tax legislation, after greatly reducing the effective tax rate. Ultimately, the tax-to-GDP ratio is usually lower than what it should be because the level of foregone revenue is significant — the Treasury ends up with less revenue and some ‘favoured’ companies receive the money.
- 3.4 Certainly, tax incentives and concessions for high-income groups are not appropriate for a richly-endowed, third-world country with an underdeveloped economy like PNG. Hence, eliminating the tax expenditures — both subsidies and exemptions provided through the general tax legislation and negotiated project-specific concessions — for businesses is the first and only path to raising substantial revenue in a progressive way.
- 3.5 There may be economic arguments for reducing or eliminating some income tax expenditures rather than others, but an across-the-board approach is probably more feasible than reducing particular tax expenditures, because lobbying pressures may be less prevalent when no one particular interest or industry is being singled out.
- 3.6 The across-the-board reform measures suggested are:
 - 3.6.1 Eliminate tax breaks — allowable deductions and exemptions — which allow companies in PNG to defer paying taxes but encourage the same companies to shift profits offshore. Non-general tax exemptions also distort investment flows towards industries/firms that are not necessarily the most profitable.
 - 3.6.2 The fiscal arrangements for mining, petroleum, and gas companies should be incorporated into the general legislation and not varied for individual projects or over time.

⁴ Based on three papers: Ken Devos’ paper on “The Corporate Tax Regime”; Craig Emerson and Diane Kraal’s papers on “Petroleum and Gas” and “Mining Reform Options”; and Chris Ohms’ paper on “The Application of the Comprehensive Tax Base Paradigm in the New Millennium: The Role of Incentives” presented at the PNG Taxation Research and Review Symposium, 29–30 May, 2014 in Port Moresby.

⁵ IMF 2013, “*Papua New Guinea: Staff Report for the 2013 Article IV Consultation*”.

3.6.3 Fiscal stability clauses should be removed and should never be used as they have not been effective in reducing perceptions of sovereign risk.

B Summary of Symposium Discussion Session

- 3.7 Tax incentives are generally recognized to be a significant component of many tax systems, and are also considered to be trending upwards in most countries. As investment is very sensitive to tax incentives, tax incentives are important and should be designed to promote growth and create employment opportunities for Papua New Guineans. Tax incentives should target export-oriented businesses — like mining and fishing — that generate large sums of foreign exchange revenue.
- 3.8 Moreover, tax incentives can be effective in encouraging desirable taxpayer behaviour — i.e. ‘good distortion’ of behaviour. For instance, a rule allowing a tax deduction for donations (which might not be available under ordinary principles) can encourage philanthropy — which most would agree is a good thing. The bad side however, is that the tax benefits of a project usually extend well beyond the income tax that is (not) collected from the project, hence the Treasury ends up with less of the revenue it requires for socio-economic development projects.
- 3.9 There were concerns that companies are burdened with high personal income and company taxes, which justifies their continued enjoyment of tax breaks. Tax incentives vary according to circumstances, but some companies appear to have indefinite tax holiday periods, which is unfair and uncompetitive. ‘Tax holidays’ provided to resource projects is one of the tax incentives that is very controversial. In general, tax incentives in PNG are increasingly being seen as ‘redundant and ineffective’ departures from the generally accepted (benchmark) tax structure.
- 3.10 Therefore, for the country’s tax system to be equitable, tax laws should not be designed to produce a favourable treatment for particular types of activities or taxpayers. However, because tax systems differ from country to country, there is no current international consensus as to how tax incentives should be categorized. Even then, the practice of ad hoc tax concessions given by the government to promote investment in PNG — the resource sector seems to be given unnecessary corporate tax holidays even after favourable allowable deductibility provisions are given— should be discontinued.
- 3.11 A level playing field should be created for all business activities to be taxed in the same way and, if necessary, the tax concessions should be the same for all taxpayers. There are a lot of economic activities in the informal sector that are not being captured either under corporate or personal income taxation regimes. To encourage participation in the PNG tax system, the government could consider incentives for small and medium-sized businesses to make it easier for them to comply with a tax system they might otherwise not understand and therefore not be willing to enter. Alternatively, simplified tax rules could be applied to small and medium-sized business without necessarily offering any exemptions.

4. PERSONAL INCOME TAX⁶

A Current Situation and Suggested Reform Actions

- 4.1 Currently, a person's income tax liability is not calculated on an annual basis but according to their pay period — which may be weekly, fortnightly or monthly. The tax liability on wages withheld by employers, and which is remitted to IRC, is declared as “final tax”, unless the individual employees have other non-wage income.
- 4.2 This burden of personal income tax falls only on 5 percent of the country's population, and less than half of that proportion pays 90% of the total personal income tax. Moreover, the top marginal tax rate of 42% is too high, compared to the global average of 31% and the average in Asia of just 28.4%. But there are also problems with how the low- and middle-income earners — the people best placed to invest in micro and small enterprises — are taxed in PNG.
- 4.3 Both the PNG Strategic Development Plan 2010–2030 and Vision 2050 recognise investment by micro and small businesses as representing the foundation for a thriving economy in PNG over the long term. Yet the current system of taxing unincorporated small and micro enterprises remains unfair. It is unfair to a person who owns a micro or small business who also receives a salary or a wage because both his/her business and labour incomes is aggregated to calculate the total tax liability, whereas a micro/small business run by a person with no other income will face a lower marginal rate of tax.
- 4.4 Since the determination of personal tax consists first of the choice of the tax base and then the choice of the tax rate schedule, the higher marginal tax rates applicable to the combined income discourage potential investment by the middle class; it also discourages informal micro/small businesses from transitioning to a formal status. Hence, a level playing field is needed where unincorporated micro and small businesses are taxed in the same way, regardless of the owner's status in the formal workforce.
- 4.5 To achieve this, the Government of PNG would need to do the following:
 - 4.5.1 Abolish the personal income tax system and replace it with two separate and mutually-exclusive forms of income tax — (a) Wage Income Tax; and (b) Investment Income Tax.
 - 4.5.2 Continue treating the Wage Income Tax as a “final tax” collected by employers in accordance with the previous section.
 - 4.5.3 Introduce a new and separate tax scale for the Investment Income Tax so that wage income is not added to investment income in calculating tax liability.
 - 4.5.4 Set the tax rate for the Investment Income Tax at the same rate as the corporate tax rate (30 per cent).
 - 4.5.5 Introduce the same tax free threshold for both forms of taxation (It is proposed that this should be K18,000 per year).

⁶ Based on Theodore Levantis' paper on “A New Look at the Personal Income Tax” presented at the PNG Taxation Research and Review Symposium, 29–30 May, 2014 in Port Moresby.

4.5.6 Scrap the fringe benefits tax system, which is complex and difficult to administer, and tax in full all fringe benefits within the Wage Income Tax system — allowing a minimum threshold of, say K20,000 restricted to housing, car, phone, home travel, and educational benefits only.

B Summary of Symposium Discussion Session

- 4.6 Distribution of wealth is of paramount importance to Small and Medium Enterprises (SMEs), specifically because many middle-class Papua New Guineans venture into SME businesses. These SMEs are especially created to support families of middle-income earners, which is a unique insurance cover or an implicit ‘Wantok tax’ that effectively raises the marginal tax rate for high income earners to more than 42 percent, which is regressive. A flat rate or lower progressive company rate would promote SME business growth and also support the Wantok system by allowing higher-income earners to look after those in the community on low or no incomes.
- 4.7 There is not a strong “saving for retirement” culture in PNG, and the working class in PNG continue to shoulder the income tax burden well into retirement — at present the tax on retirement income is too high. Changing the tax law can potentially help in this situation. The reintroduction of the 1992 concessional tax policy would be a viable option to consider as it has the potential to support long-serving, retiring employees. Moreover, a 2 percent tax rate levied on retiring employees having served over fifteen years, and 5 percent tax rate on retiring employees’ “finish pay” is recommended.
- 4.8 The middle class in PNG is critically important for consumption but their roles and contributions are often downplayed by the tax system. Our tax system must also be geared towards encouraging self-reliance. This means promoting PNG businesses, especially the SMEs, to grow the economy and provide the basis for supporting the middle class and their businesses — the tax base for this country. That is, PNG must not rely on others/foreign investors, and must not continue to rely on foreign aid to support our National Budget.
- 4.9 In light of the complexity mentioned above, there was general consensus that removing the business and investment incomes from the personal income taxation regime is the way forward for PNG. The reason is that the compliance requirements for the returns are complex for simple, uneducated people who engage in business activities. And it is also costly to engage accountants and tax agents to prepare and submit returns on their behalf. Therefore, creating a more formalized legal structure for SMEs and reducing the lodgement requirements could potentially deal with the situation.

5. GOODS AND SERVICES TAX (GST)⁷

A Current Situation and Suggested Reform Actions

- 5.1 GST was introduced (as Value Added Tax — VAT) in PNG in the early 1990s at a time when the economy was experiencing a general downturn and deepening recession, which exacerbated the decline in government revenue. At that time a VAT was seen as a public policy that could revamp the economy and reduce the government's budget deficit, even after abolishing provincial sales tax and cutting both customs duty and excise tariffs and personal income tax rates.
- 5.2 While anecdotal evidence suggests GST is the most broad-based tax in PNG, its greatest problem is that its current 40:60 distribution between the national and provincial governments is flawed. As this distribution is premised on the principle of the origin of the internal GST collection, it is unfavourable to the least-developed provinces. Yet GST has become an important component of government revenue utilised in promoting equitable growth and development across provinces.
- 5.3 The GST also imposes a heavy tax burden on disadvantaged consumers, including the very poor individuals and rural dwellers in the least-developed provinces and urban (informal) settlements. Yet the goal of any tax policy should be to enhance the national welfare, especially when the country's natural resource revenues are not disappearing in the short, medium, or foreseeable future.
- 5.4 Nevertheless, considering that GST promotes competitiveness of domestic products and services with imported products and services, and considering also that it has the potential of raising more revenue in a more sustainable manner, it is recommended that:
 - 5.4.1 GST should not undergo major structural change. It is believed that the current 10% GST is reasonable — a higher rate is not needed in the wake of projected strong resource revenue flows; a lower rate is not justifiable given IRC's limited resources for collecting the tax, and the need to compensate the provinces where the tax is originally collected.
 - 5.4.2 However, it is proposed that the formula for redistributing the GST income should be adjusted to 60:20:20.
 - 5.4.3 This revenue-sharing arrangement will ensure that the collection effort of each province is handsomely rewarded with the retention of 60% of the internal GST revenue collected in the respective provinces.
 - 5.4.4 But not all the provinces in PNG are similarly endowed, so 20% of the internal GST collection should be put in a trust fund designed to enhance labour-intensive income and employment generating activities in the less well-endowed provinces.
 - 5.4.5 The balance of 20% would go to the National Government to add onto the GST that it collects on imported products and services.

⁷ Based on Agogo Mawuli's paper on "Goods and Services Tax: An Appraisal" presented at the PNG Taxation Research and Review Symposium, 29–30 May, 2014 in Port Moresby.

B Summary of Symposium Discussion Session

- 5.5 The GST Act is the youngest of the tax regimes in PNG. It is very short and has straight-forward provisions that are easy to understand. The exemptions and exceptions are also clear and specific; not many of them are conditional upon specific performance. The rate of 10% applied across all taxable items is the beauty of PNG GST simplicity in practice — and the general consensus is that this tax should continue without any rate variation.
- 5.6 But there were questions as to whether GST on imports is really necessary, and whether it adds significantly to government revenue. It would seem that GST on importation of goods into PNG by most businesses results in no net revenue to the State, but the timing of its collection is also a potentially significant cost to business. To deal with this situation, the payment of GST on imports should be combined with the regular GST payment by the 21st day of the month. In other words, payment of the GST due on imports should be deferred until the due date for lodgement of the GST return. Allowing the input tax credit for the payment in the same return would also relieve the importer of a huge cash-flow burden. The only group that will be disadvantaged is the unregistered village-based businesses who pay GST on their inputs but cannot claim them back as registered businesses do.
- 5.7 GST was introduced in PNG as a broad-based tax affecting all consumers at a time when there was a growing need to increase tax revenue and increase the country's economic competitiveness. That it is regressive in nature was not considered; hence the 10% rate applies to all goods and services. The most generic implication is that GST affects poorer people more than the rich because poorer people tend to spend a larger portion of their income on basic consumer goods. And because the majority of the poor in PNG live in the village, it is argued that GST affects rural dwellers more than it affects urban dwellers. The consensus was that removing GST from basic food items, health, and educational supplies — widening the scope of exemptions — should be considered.
- 5.8 As noted before, addressing the problems of SMEs and the poor is a strong prerogative for the government's development agenda in the rural sectors of PNG. Perhaps more research effort could go into exploring whether rural-based businesses are disadvantaged by the application of GST, as suggested by a study commissioned by the Morobe Provincial Government some years ago. Such a study is particularly needed in light of the alternative view that GST is likely to result in inefficient resource allocation in favour of the informal/shadow economy dominated by subsistence and semi-subsistence activities.
- 5.9 One could spend vast resources trying to unravel the complex problems of PNG's SMEs and poor households, but studies of the GST definitely have a place among the numerous studies that go beyond income-related issues. In-depth, village-level studies may then be tested in the urban areas in a more focussed way to make the GST effect on SMEs and the poor in PNG more generalizable.

6. ENVIRONMENTAL TAXES AND OTHER NON-TAX REVENUES⁸

A Current Situation and Suggested Reform Actions

- 6.1 Non-tax revenues, e.g. stamp duties, with ad valorem rates ranging between 0.4 and 5% (mineral and petroleum licence fees are specific at PGK10,000 per licence) contribute a small proportion of total government revenues: about 6% in 2013, and projected to double in 2014. Thus, these “other taxes” do not appear to significantly affect the efficient operation of the free market; and hence not much can be said about them. But environmental taxes can be used to address the failure of markets to take environmental impacts into account when incorporated into the prices paid and received for goods and services.
- 6.2 Currently, there are no environmental taxes in PNG, yet there is increasing concerns about environmental pollution and degradation. Lobby groups have identified submarine tailing disposals into the Basamuk Bay and the destruction of the Ok Tedi ecology,^{9, 10} for example. Moreover, as PNG continues to rely on mineral resource revenues, environmental pollution and degradation from mineral resources activities are likely to increase.
- 6.3 There has been more polluting behaviour by households as the country’s population and income continue to grow; meaning, for example, that the one-off sales duty on imported vehicles will be ineffective in reducing traffic congestion and urban air pollution. Increasingly, individuals and firms in PNG appear to only consider their private interests and are rarely mindful of the damage they do to the environment. Therefore, the greatest environmental threat throughout the country is the rapid and often over-harvesting of resources for short-term benefit for foreign companies more than the local economy.
- 6.4 To promote the quest for a clean and healthy environment, polluters should be made to pay for the negative external impacts of their production and consumption activities. Taxes should be imposed on environmentally-related bases (energy, motor vehicles, emissions to air and water, wastes, and hazardous chemicals) that can have important impacts on the environment. The objective is not to raise revenue for the government but to achieve clean production and conserve the environment — such as mitigating climate change impacts.
- 6.5 The following measures are suggested:
 - 6.5.1 In respect of motor vehicles,
 - 6.5.1.1 Impose an annual road tax on all motor vehicles.
 - 6.5.1.2 Ban the importation of vehicles more than 10 years.
 - 6.5.1.3 Impose an environmental levy proportionate to the age of the used imported vehicles.
 - 6.5.2 In respect of household waste,

⁸ Based on John Asafu-Adjaye’s paper on “Environmental Tax in Papua New Guinea” presented at the PNG Taxation Research and Review Symposium, 29–30 May, 2014 in Port Moresby.

⁹ Oxfam Australia, “Impacts of Mining”, <https://www.oxfam.org.au/explore/mining/impacts-of-mining/>

¹⁰ Elizabeth McKinnon, 2002, “The environmental effects of mining waste disposal”.

- 6.5.2.1 Impose/increase fines for littering to discourage the use (and dumping) of plastic bags and bottles.
 - 6.5.2.2 Ban the importation of refrigerators using chlorofluorocarbons in their cooling systems.
 - 6.5.2.3 Ban the importation of incandescent light bulbs as they have little energy and economic efficiency.
- 6.5.3 In respect of the ecosystem,
- 6.5.3.1 Establish “Payment for Ecosystem” to encourage wise use of the country’s natural resources.
 - 6.5.3.2 Replace the current area- and quota-based taxes on fisheries and forestry sectors with volume-based taxes.

B Summary of Symposium Discussion Session

- 6.6 There was considerable discussion about the many attractive features of environment taxes in PNG, mainly to conserve the environment. That the country’s current and future prosperity depends on the people’s wise stewardship of our natural resources is not in question; the question is whether the present-day tax payers are morally and socially obligated to pay environmental taxes for environment conservation purposes. Even if they are, they may be having no basis of doing so because the present value of the ecosystem — forest and marine environments — is difficult to quantify. If they are not, then lessons can be drawn from Bougainville (where the depleted resource is the environment) experience to enhance this concept: The extractive industries there failed to combat their negative impact on the environment.
- 6.7 But the forestry sector is also one of the most challenging in terms of environmental damage — and the loss of economic services to people as a result of deforestation — for a one-off profit. Here, environmental taxes may be used as a deterrent to deforestation, with taxes drawn from this and other environmental bases diverted to fund further environmental analysis and reforestation efforts, with any additional funds returned to the government.
- 6.8 But there were also contrary views expressed at the Symposium. The alternative view, while claiming that the paper presented at this Symposium provided little relevance to the various functions of environmental taxes, argued for the protection of marginal profits, which is useful for international comparison of environmental forest impact. This view generally held that trees are a relatively high-value “crop” and easy to grow, with scope to expand the forests and range of species grown. It was recommended that government should provide subsidies to logging companies, with specific incentives for tree-felling based on the value of the wood. But as argued in the papers on tax incentives presented earlier, subsidising private investment through tax incentives is not good policy.
- 6.9 Some participants made the more specific charge that some local businesses are benefitting from support provided by way of taxes imposed on their competitors’ imported materials for housing. Yet after enjoying that benefit for several years their efficiency has still not improved in order to be competitive and reduce the costs of housing. This case provides evidence that tax incentives are redundant and ineffective, leading to the suggestion that a cost-recovery model in the form of environmental taxes to promote biodiversity protection would be more useful.

7. CUSTOMS DUTY AND EXCISE TARIFF¹¹

A Current Situation and Suggested Reform Actions

- 7.1 In the beginning, the government relied on import tariffs to protect local industries, with the determination of duty rates — including exemptions and reduced rates — based on the prevailing trade and fiscal policies. But the main purpose has been to raise revenue to finance government spending. Over time, however, there have been a series of tariff reduction programmes undertaken at 5-yearly intervals, with the result that: i) with the exception of goods that can potentially be produced in PNG, duty rates for most imported goods were set to zero, i.e. duty free; and ii) the structure of duty rates for goods that can potentially be produced locally were consolidated into three bands reflecting intermediate, protective, and prohibitive rates.
- 7.2 While no changes were subsequently made to the tariff review program, every other review concluded that the program was largely achieving its objectives — the protective rates have particularly supported agricultural, mining, and certain service industries to remain in business. Also, the shift of focus to import GST ensured that tariffs on imports were no longer required, as the import GST collections may have more than adequately compensated for the import duty that would have otherwise been collected on zero-rated and exempt imports. However, a number of issues raised in the 2003 and 2007 tariff reviews still remain.
- 7.3 First, customs officials are often concerned with blanket exemptions, particularly for general consumer goods destined for impact projects, which as an administrative burden, not only cause delays in the clearance process but the delays also result in increased handling costs. Second, the exemption from import GST on goods deemed as exclusively for major impact projects is unfair to local businesses. Third, the high excise tax on imported motor vehicles generally regarded as luxury items in PNG means that the acquisition and ownership of vehicles remains a mirage for many an ordinary Papua New Guinean, especially those who reside in the urban areas. Fourth, the biannual adjustment of excise tariff rate based on the movement of the Consumer Price Index (CPI) is unrealistic and inconveniencing to local manufacturers, as it affects their budget and cash flow.
- 7.4 To address these concerns, it is suggested that:
- 7.4.1 The blanket nature of import duty and import GST exemptions should be dispensed with as had been proposed by the 2000 Tax Review Committee and the 2003 and 2007 reviews of the Tariff Reduction Program. Instead, only specialised, heavy equipment and machinery for impact projects listed in both the Harmonized Systems Tariff and Customs Procedure Codes (CPC) should be granted exemptions.
- 7.4.2 Both new and second-hand motor vehicles with engine capacity up to 1500cc should be granted zero rates with only the import GST to be paid; those with engine capacity of more than 1500cc to 1800cc should be given a lower excise rate of 10% plus the import GST to be paid.

¹¹ Based on Mr Pius Saun's paper on "Customs Duty and Excise Tariff Arrangement for Papua New Guinea Tax Reform" presented at the PNG Taxation Research and Review Symposium, 29–30 May, 2014 in Port Moresby.

7.4.3 All imported motor vehicles having the year of manufacture of five (5) years or nearing the fifth anniversary of the year of manufacture should be banned and a hefty penalty imposed on any importer whether commercial or private under the administrative penalty provisions of the Customs Act. The vehicle should be confiscated and destroyed.

7.4.4 Since the goods subject to excise tax are not price-sensitive, i.e. have inelastic demand, the government should consider imposing a flat excise rate over the course of one year instead of the biannual or piecemeal changes to assist the predictability of the tax burden for corporate budgets and at the same time avoid the likelihood of an unwieldy and inefficient tax system.

B Summary of Symposium Discussion Session

7.5 In the majority of Pacific Island Countries (PICs), the tariff structure is much more a question of government revenues but for PNG it may be slightly different since there are competing industries that need some protection. Even then, people (citizens) often pay higher prices when inefficient industries are protected through tariff barriers. The good news is that such protections are expected to end ultimately, as long as PNG remains committed to its international partners regarding tariff reduction programs. The only problem is that even if tariff reduction is central to PNG's tax reform, global partners, in the wake of increasing international competition with failing domestic industries, have begun to look inwards. Hence, it would be necessary to have a fresh look at the tariff reduction agenda.

7.6 In the context of the competing dimensions of tariff reduction (rates against collection efficiency), it may be wise to examine the leakages in the system. Making the customs process (i.e. tariff application and collection process) more effective, could easily compensate for the reduction of tariff rates. This means putting in place better monitoring systems that can maximise collection and compensate for revenue reduction due to rate reductions. Thus excise taxes can be levied at low, uniformly-flat rates, which makes them easy to collect and administer, thereby creating less inefficiency.

8. CUSTOMS AND TAX ADMINISTRATION¹²

A Current Situation and Suggested Reform Actions

- 8.1 Improving customs and tax administration is a major challenge for the government since it needs to have a system that accommodates the interests of both the revenue agency and taxpayers: Revenue agencies strive to maximise compliance and raise the maximum amount of revenue with the least cost and effort; taxpayers prefer a simple tax compliance model that involves minimum time and monetary compliance costs. It is, however, hard to find the middle ground because PNG's IRC continues to face a number of problems, mainly:
- 8.1.1 How to tax a vast (unregistered) informal economy with little financial infrastructure and manpower;
 - 8.1.2 A complex tax system coupled with poor taxpayer education;
 - 8.1.3 Poor tax compliance, possibly due to poor attitudes towards paying taxes.
- 8.2 Even then, strategic planning has become an important tool used by the IRC to guide the deployment of (limited) resources, which, at the moment, are linked to its major functional areas — audit, collections, taxpayer service, etc. A sizeable proportion (about 23%) of IRC's expenditure has been going towards modernising its automated systems — IRC is implementing the Standard Integrated Government Tax Administration System (SITGAS). Thus, developing and sustaining a system that produces, stores, processes, and transmits tax information is a priority objective of the IRC.
- 8.3 SITGAS, when successfully implemented, will be a significant milestone, as it will, among other benefits, allow PNG taxpayers to file electronic tax returns and pay their tax bills electronically; it will also allow IRC to fairly assess, process and reconcile tax returns in an efficient and timely manner. However, IRC may not be able to achieve its objectives if it does not introduce an item- and taxpayer segment-based system of organising its activities — a complete shift from a function-based tax administration model.
- 8.4 Even as IRC is pursuing its objectives through a combination of selective investments (in ICT), this should be supported by reforms in other strategic areas in the short and medium term. The existing laws and regulations of tax administration, for example, are simplistic and inadequate; there is therefore an urgent need to overhaul the tax administration legislation to modernise and streamline IRC's administration of tax. Tax administration should be codified in a separate Tax Administration Act.

B Summary of Symposium Discussion Session

- 8.5 There are a number of valuable lessons that might be passed on from other tax jurisdictions, like the Netherlands' tax administration model, but national revenue bodies face a varied environment within which they administer customs and taxation systems; hence 'copy-pasting' a system is hardly possible. Attempts to reform tax

¹² Based on Roneil V. Prasad's paper on "Scoping Paper: A Modern and Rational Tax Administration System for Papua New Guinea" and Pius Saun's paper on "Customs Administration and Modernisation" presented at the PNG Taxation Research and Review Symposium, 29–30 May, 2014 in Port Moresby.

administrations must therefore be sensitive to the wide variety of environmental and cultural conditions in the country. Most important, perhaps, is that in most circumstances major tax administration reform may not even be possible in the absence of major political, social, and economic changes.

- 8.6 In addition to the governance and capacity challenges facing IRC and PNG Customs (which are independent of each other), there was considerable debate as to whether these revenue bodies should be delinked from Treasury. In many tax jurisdictions, autonomy or semi-autonomy of the revenue agencies has emerged as the means for countries to achieve their objectives. Although autonomy allows the revenue agencies to discharge their duties without undue (external) control, complete autonomy may not be the most viable option as the customs and tax administration agencies would be less accountable to the state, particularly to the Treasury department, in terms of revenue performance.
- 8.7 With or without (semi) autonomy, it was generally agreed that it is the modernisation of customs and tax administration bodies to increase their efficiency, effectiveness, and fairness that will most effectively influence taxpayers to improve compliance.

9. CONCLUDING REMARKS

- 9.1 Government expenditure plays a crucial role in the development of PNG; but these expenditures are limited, first and foremost, by the limited taxable capacity of the economy. Therefore, an increase in government revenue is greatly needed, both to make possible increased expenditure on public infrastructure and social services (such as tuition fee-free primary education and free primary healthcare policies) and to cover the servicing of the (controversial) borrowing of PGK 3 Billion (AUD 1.3 billion) loan from Swiss investment bank UBS to buy back shares in Oil Search Limited, which has been added to the budget deficit.
- 9.2 To ensure that tax and non-tax policies, revenue collection, and administration are relevant, effective, and efficient, the Government of Papua New Guinea decided to undertake a comprehensive review of the country's fiscal regime to reflect the country's current and medium-term socio-economic growth and trends. The Tax Review Committee is poised to issue its report in 2015. The research papers presented at the Symposium in May 2014 in Port Moresby and summarised in this report weighed in with sensible tax reform proposals. The two main points to note are:
 - 9.3 First, for a country as dependent as PNG on the inflow of capital and skills from abroad, the influence of the tax system on this inflow is obviously of greatest importance. The tax policy adopted should therefore be based on two major considerations: (i) that it is desirable to have a tax structure favourable to capital inflow, since PNG cannot to any degree offer the attractions of large, proved mineral, oil and gas deposits at favourable locations – due to the difficult terrain and unavailability of infrastructure; and (ii) that to tax the net earnings of all enterprises at uniformly low rates will help to assure the viability of the enterprises once established and increase Treasury's revenue stream. If tax rates remain high by international standards, accompanied by the tax holidays and exemptions to "favoured" enterprises, the Treasury will end up with less revenue.
 - 9.4 Second, the tax burden in PNG is high by international standards and increasing it will make the PNG economy even less attractive to international investors. Therefore, the desired increase of revenue should be secured not by any (substantial) increase in the proportion of total money incomes taken by tax, but by: (i) the elimination of tax breaks – there is no need for a tax system full of tax exemptions in place over a number of years; and (ii) the expansion of revenue-generating activities, which will lead to increased collection of tax and to increased yield of GST and import and excise duties.

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