

Possible Reform Directions

Question 5.1 - would stakeholders support, in principle, an increase in GST to either 12.5% or 15%, as part of broader efforts to reduce PNG's reliance on income taxes (notably personal income taxes) and spread the tax burden so everyone pays their fair share? Who would be the most severely affected by an increase in the rate? How could these impacts be managed?

Question 5.2 - What are the benefits in implementing a flat rate GST system for small businesses? What problems might it raise?

Question 5.3 - What would be the impact of changing the administration of zero-rating to bring it in line with international best practice for GST?

Question 5.4 - Is a deferral scheme useful in PNG? What safeguards would be required to implement such an arrangement?

Question 5.5 - What further organisational arrangements would facilitate improved cooperation between IRC and PNGCS?

CHAPTER 1: CONTEXT

The Goods and Services Tax (GST) is a broad-based consumption tax that is levied on the supply of goods and services. GST is a form of indirect tax on household consumption (that is, a tax on goods and services that is ultimately borne by the end-user consumer). From a design perspective, the GST is a value-added tax (VAT)¹.

GST Revenue Sharing

Since 2004, inland GST collections have been distributed between national government and provinces on the basis of 40 percent to the national government and 60 percent to provincial governments. These arrangements are set out in the *Goods & Services Tax Revenue Distribution Act 2003*.

While the provision of adequate funding is an important issue for provincial governments, there is no fundamental reason why GST should be the main source of this funding. However, revenue sharing has been a feature of a number of other taxes, notably gambling taxes.

However, the prime focus of this paper is to examine the role of GST within the overall tax arrangements of PNG and to seek ways to ensure that tax collection is efficient, sufficient for PNG's revenue needs and equitable. Therefore this paper does not consider revenue sharing issues related to the GST. This is not to suggest that revenue sharing is unimportant, only that it should be dealt with separately.

Basic Operation of GST

The PNG GST is a value-added tax (VAT). It has a standard rate of 10 per cent which is added by the supplier of the good or service to the pre-GST price.

¹ The terms GST and VAT are generally interchangeable. The term VAT refers to the mechanisms by which the tax is collected and is usually not well understood by the general public. The term GST refers to the broad base of the tax, i.e. goods and services and this is usually clearer for the public. Most older versions of the tax are called VAT, whereas more recent usage tends to favour GST.

This means that the tax component is one-eleventh of the actual final price paid for any good or service (supply).

The Standard Case

One of the basic design features of the value-added tax model is the requirement that all businesses throughout the supply chain add GST to the price of their supplies (sales) and claim input tax credits (ITCs) for the GST paid on their inputs. The business then remits the net GST (i.e. GST collected less ITCs) to the Internal Revenue Commission (IRC). This model;

- ensures that each business only pays net tax on the value it actually adds within the supply chain;
- passes the tax through the supply chain to the final consumer;
- implements a crucial part of the compliance arrangements as each business has an incentive to make sure that its suppliers correctly invoice so that in turn it may verify its claims for ITCs;
- minimises tax losses in the case of fraud as a business can generally only avoid the tax on its own value-added.

Figure 1: Representation of standard taxable transaction

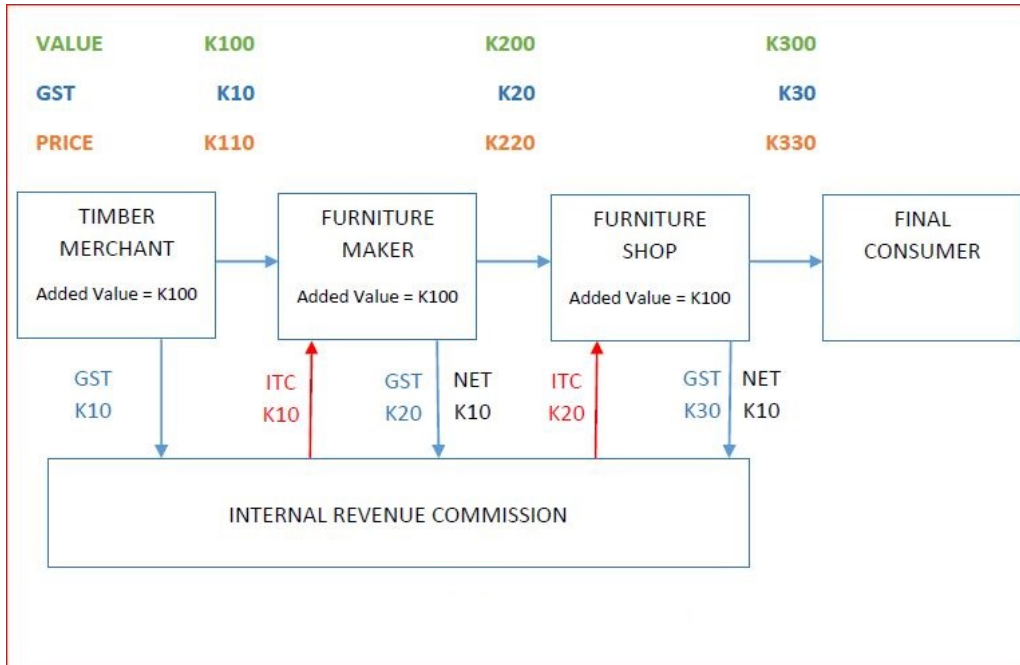


Figure 1 is a simplified explanation of how the GST operates throughout the supply chain. In practice, each supplier has a variety of inputs and ITCs are claimed across the entire operations of the business, not on a transaction by transaction basis. Although the GST is collected by businesses, the tax is actually passed onto the final consumer.

The ITC system is designed to remove the cost of tax on business inputs. Access to ITCs is an essential part of the GST system. Without ITCs, a multi-stage tax would “cascade” making the final rate of tax variable and dependent on the length of the supply chain. ITCs are allowed for all of the tax paid by a registered business on its inputs, including capital expenses. ITCs are usually offset against a business’ GST liabilities and the business remits the net tax to IRC.

If credits exceed liabilities then a refund is due. This will be the normal position for suppliers of zero-rated supplies, e.g. exporters, and also occurs commonly with new businesses as start-up costs can be higher than receipts in the shorter term.

A well-designed and effective compliance program is important as international experience shows that false claims for ITCs is one of the most significant forms of fraud in GST.

GST special cases

Concessional treatment is provided by **exemption** or **zero-rating**.

a. In an **exempt** transaction, the business does not add GST to its price but is not eligible for an ITC, so there is some tax remaining from the purchases made by the business and this is embedded in the final price to the consumer.

b. In a **zero-rated transaction**, the business does not add GST² to its price but also retains eligibility for an ITC. This means there is no GST embedded in the final sale price to the consumer.

International Transactions

The internationally accepted standard is that GST on international transactions is based upon the destination principle. This means tax is collected in the country where the final consumption occurs. To achieve this exports are free of GST (and eligible for ITCs) and imports are taxed. This ensures that domestic consumption is the base for GST but, more importantly helps to ensure that exports remain competitive in the international market.

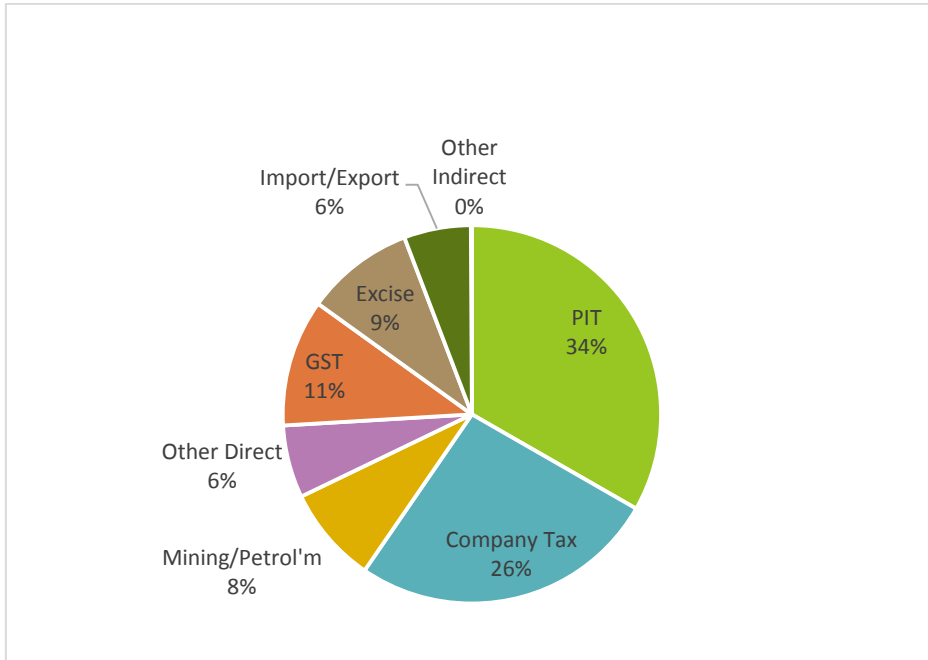
Why impose GST?

Value-added taxes, like GST, have grown in popularity over the years and are now a major source of revenue in more than 150 countries. Many of the reasons for imposing GST are linked to the principles of good tax policy outlined in the Review's Issues Paper No 3.

The GST was introduced around the same time as PNG's tariff reduction program, resulting in a change in the tax mix away from trade taxes towards indirect taxes. However, GST only accounts for 11 per cent of total tax revenue and these changes did not significantly alter PNG's reliance on income taxes.

² More formally the rate is zero so the GST added is zero.

Figure 2: Tax Mix (% of total tax revenue) 2014



Source: Final Budget Outcome, 2014

Competitiveness and efficiency

Value-added taxes are generally regarded as highly efficient taxes because they apply to a very broad base (most final consumption goods and services) (IMF 2011). Furthermore, unlike other indirect taxes (such as import duties, goods taxes or sales taxes), the GST does not introduce distortions at different stages in the production process.

Taxes on consumption such as GST are generally considered to impose lower economic costs than taxes on labour (such as personal income tax (PIT)) and investment income (such as company taxes). For an open economy the size of PNG, investment is likely to be more mobile than consumption, suggesting GST should be a more stable tax base than, for example, corporate tax.

Because GST effectively only taxes final consumption, but frees transactions between businesses from GST, it does not distort the prices in the production process. A well-designed GST does not hinder businesses in their production

decisions. On the other hand having to collect and pay GST imposes compliance costs on businesses.

Question 1.1- do stakeholders agree that GST should continue to be an important part of PNG's revenue mix?

GST and 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. Relying on a narrow-based and progressive income tax system puts the tax burden on only a small part of the economy (the formal sector). Taxing consumption is fairer as it taxes all people's consumption.

GST is relatively hard for people to avoid, so it applies more broadly across the economy. And because GST taxes consumption – a good indicator of living standards – it can be regarded as relatively fair.

To some extent those who perceive the GST as unfair may be comparing it with the personal income tax, where tax paid rises proportionately as income levels rise. But this overlooks weaknesses in income tax: which doesn't tax the large informal sector and is one of the most challenging taxes to administer.

Nevertheless an increase in the GST rate would flow through to increased prices and this would have an impact on low income earners.

- The impact on subsistence farmers will be reduced. However, the price of items such as tools, building materials, clothing, fuels and food items such as rice and canned fish may increase.
- Low income earners who earn wages will be compensated to the extent PIT rates are reduced.

Few taxes are very well suited to the address fairness – which would be best addressed by specific expenditure programs aimed at improving living standards across the board (for example, in education) but with an emphasis on low income earners.

Simplicity

GST, if well implemented, can be simple to administer and yield major revenues for a country. A good tax system should be simple enough for taxpayers to understand and meet their tax obligations. It should also minimize the administrative costs for government and for the taxpayer.

However, as we will discuss later, ineffective administration can make the system more complex and open to abuse and loss of revenue through fraud. Therefore, the success of GST depends on the tax administration's capacity, especially modernized processes for enforcement and compliance.

General design features

There are a number of general design features common to GST regimes around the world that are worth noting. Some of the issues taken into consideration in designing GST include:

- The **rate** – a single rate of GST promotes simplicity whereas varying rates for different classes of goods and services adds significant complexity;
- The **threshold** – as large businesses will provide the bulk of the revenue, the registration threshold should be set at a level which captures revenue without threatening the tax administration's capacity to manage effectively;
- The **tax base** – whether it is applicable to a wide or narrow base;
- **Concessions** – is the tax base eroded by exemptions and zero-rating;
- **Administration** – does the tax administration have adequate capacity to effectively and efficiently administer the tax, including the ability to deal with fraud?

It is generally agreed that a good GST system will include a single rate, a broad base with few concessions, a threshold within the administrative capacity to administer and an effective administration with modernized procedures for enforcement and compliance.

The PNG GST meets most of these requirements however complexities caused by mechanisms to provide some concessions on the basis of administrative convenience present significant challenges.

CHAPTER 2: OVERVIEW OF PNG'S GST REGIME

GST was introduced in PNG in 1999 as a key component of the tariff reform program and reforms in the indirect taxation regime. These reforms were designed to broaden the tax base and reduce dependence on personal income tax. They were also intended to reduce reliance on volatile trade taxes while maintaining government revenue. The tariff reform was a part of PNG's broader trade liberalization commitment as a result of its membership of APEC in 1993 and WTO in 1996.

The original PNG tax was called VAT and was adopted from the New Zealand GST. The tax was renamed GST in 2003. The change of name is not particularly significant.

GST is a comprehensive consumption tax administered by the national government which replaced the former provincial sales tax system. GST has a uniform rate of 10 per cent with certain classes/supply of goods and services zero-rated or exempt.

At the time of introduction, the registration threshold was set at K100,000 gross annual turnover. Thirteen years later in 2012, this was increased to K 250,000. Many small to medium-enterprises are registered for GST under the voluntary registration provisions.

GST in PNG is administered under the legislative framework of the *Goods & Services Tax Act 2003 (GSTA)* and *Goods & Services Tax Regulation 2005*. GST in PNG is administered by the Internal Revenue Commission (IRC) and the PNG Customs Service (PNGCS) collects GST on imports. GST on imports is then transferred to a trust account maintained by the IRC from which GST refunds are paid out.

What is subject to GST?

GST is imposed on the supply of goods and services by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

The definition of taxable activity is broad and means any business activity which is carried on continuously or regularly by a person, whether or not for a profit. It includes the activities of a public or local authority.

Zero-rated Supply

A zero-rated supply is a form of concessional treatment. In a zero-rated transaction, the business does not add GST to its price but is eligible to claim ITCs. Therefore, there should be no embedded GST in the price to the consumer.

In PNG, the following supplies are zero-rated:

- Exported goods and services;
- Supply by duty-free shops to international travellers;
- Goods not in PNG at the time of supply;
- Ship and aircraft stores for use outside of PNG;
- Medical supplies;
- Supplies of fine metal;
- Supplies to prescribed foreign aid providers;
- Supplies to resource companies;
- Supplies to non-profit bodies (religious, charity and community organizations); and
- Supplies of crude oil by a resource company to a local refiner.

The zero-rating of exported goods and services is intended to ensure that domestic GST is not passed on to overseas buyers. This is consistent with the destination principle which is applied throughout the world. Without this, PNG sourced goods and services would be less competitive internationally so zero-rating of exports is important for developing international trade.

For administrative reasons, PNG has specifically zero-rated supplies made to resource-companies, foreign aid providers and non-profit bodies. *This in fact has added complexity in administration and opened up the system for fraud.*

Question: Is the current scope of zero-rating appropriate? Is there any item which should be changed, deleted or added? Are there better ways of achieving the intended concessions?
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Exempt Supplies

Exempt supplies are another form of concessional treatment. An exempt supply does not have GST added to the final price but suppliers are not eligible for input tax credits. This means that GST on inputs is embedded in the price paid by the final consumer. In PNG, the following supplies are exempt from GST:

- Financial services
- Supply of fine metal
- Medical / health services
- Education services by educational institutions
- Public road transport (PMVs and taxis)
- Retail of newspapers to readers
- Betting, lotteries and games of chances
- Postage stamps
- Housing and motor vehicles provided to employees by their employer
- Discretionary exemptions notified by gazettal.

Question: Is the current scope of exempt supplies appropriate? Is there any item which should be changed, deleted or added? Are there better ways of achieving the intended concessions?

GST Threshold

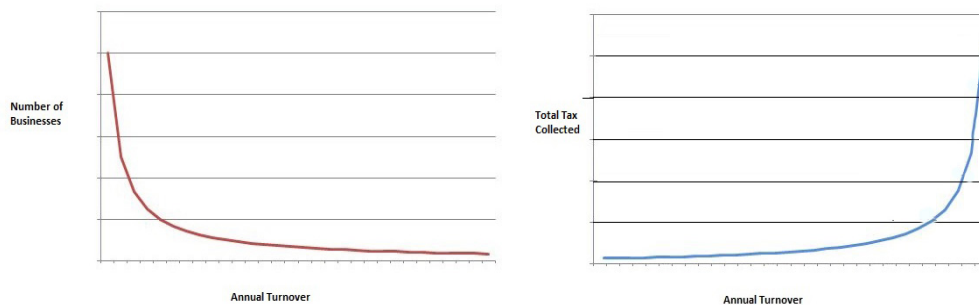
Registration thresholds are a key factor in determining the overall administrative requirements (and effectiveness) of the GST. Higher thresholds reduce administration costs for IRC and compliance costs for smaller businesses.

It should be noted that only registered entities may charge GST on their supplies and that entities reaching the turnover threshold are required to register. Unregistered entities cannot legally charge GST. They are also unable to claim ITCs so supplies by unregistered businesses contain embedded GST from any inputs to the business. Effectively supplies by unregistered businesses are the same as exempt supplies. Businesses below the threshold may voluntarily register, in which case they must charge GST and are eligible for ITCs.

As most tax will be collected from large companies, the tax foregone with a higher threshold will not necessarily be large. There will be large numbers of very small businesses but their total tax paid will be relatively small.

Figure 3 shows idealised distribution curves for business turnover and GST contribution. In any economy, there is typically a very large number of businesses with small annual turnover and these contribute a very small amount of the total tax collected. Conversely, the largest companies will contribute the bulk of the revenue.

Figure 3: Idealised distribution of business turnover and GST collections



If the threshold is set too low, the compliance cost for both IRC and the businesses themselves is unlikely to be worth the potential revenue gains. Indeed applying compliance resources to small business at the expense of large business may lead to revenue loss. As supplies by unregistered businesses are effectively exempt supplies, the only tax foregone is on the value added of the final supply which contains non-refundable GST.

The current GST threshold is K250,000 or around US\$90,000 and this is a relatively high threshold. By comparison, GST thresholds in the region include Samoa US\$35,000, Vanuatu US\$37,000, Indonesia US\$47,000 and Fiji US\$49,000. Looking more widely afield, Thailand's threshold is US\$39,000, Cambodia US\$122,000 (for goods) and Singapore US\$750,000³.

³ Currency conversions as at May 2015

Current advice suggests thresholds could be around US\$100,000 or more⁴ and on this basis, the current threshold appears to be reasonable. There are some 21,000 businesses currently registered.⁵ Detailed analysis of collections by turnover would need to be undertaken before any changes to the threshold could be justified.

Question: – is the current registration threshold of K250,000 too low or too high? Do stakeholders see a need to increase (or decrease) the threshold?

Voluntary registration for small businesses can overcome a bias which may arise if larger registered businesses choose to only deal with other registered businesses in order to maximise their own input tax credits. However, voluntary registration can also undercut the administrative efficiencies which is one of the key purposes of setting a threshold in the first place.

Question: – is the option for voluntary registration bringing in too many taxpayers below the threshold into the GST system?

Contribution of GST to revenue

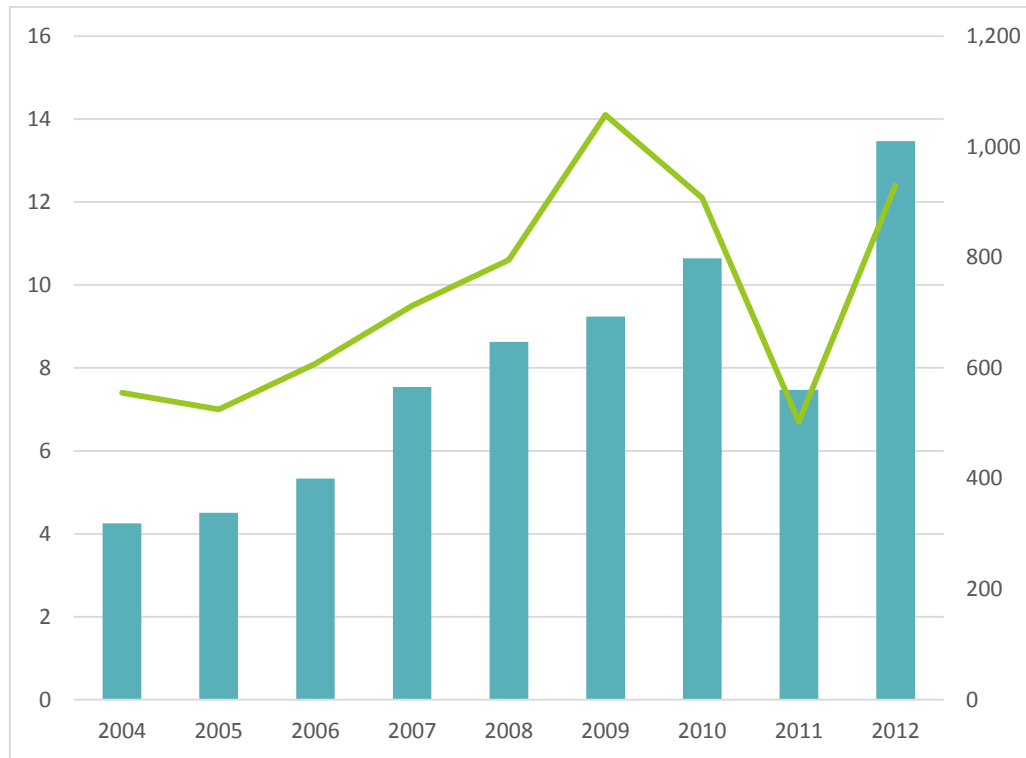
GST is a significant contributor to PNG tax collections, contributing 12.4 per cent of the overall tax revenues in 2012. As a tax on final consumption, GST should generally track changes in GDP⁶ but PNG collections have been volatile over time. This may reflect administrative problems or the impact of major economic changes such as the LNG project.

⁴ Bird R and Gendron P-P (2011), *The VAT in Developing and Transitional Countries*, Cambridge University Press, page 115.

⁵ IRC data

⁶ GST should actually follow private consumption which relates closely to GDP. However, there are no adequate data on either GDP or private consumption available.

Figure 4: GST as proportion of Tax Revenues (%) (LHS) and GST Collections (K million) (RHS)

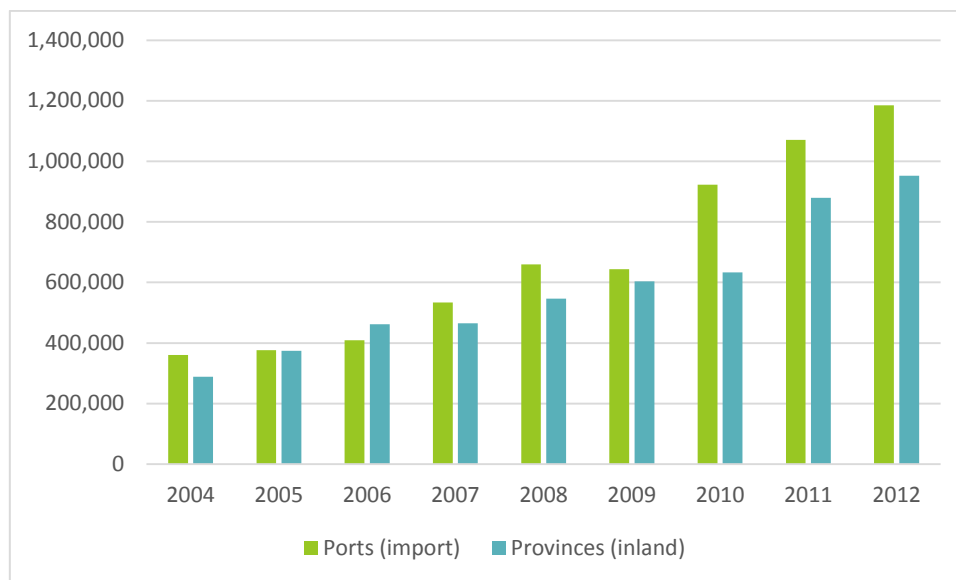


Source: National Economic and Fiscal Commission⁷ and IRC data

The trend in GST collections is illustrated in Figure 5 below which shows collections from 2004, with a breakdown for GST collected on imports and inland GST.

⁷ Quoted in Mawuli A (2014), *Goods and Services Tax: An Appraisal*, NRI Tax Symposium Paper, http://taxreview.gov.pg/wp-content/uploads/2014/09/nri.tax_symposium_goods.services.tax_paper.pdf

Figure 5: Inland and Import GST (K million) 2004-2012



Source: IRC data

GST Refunds

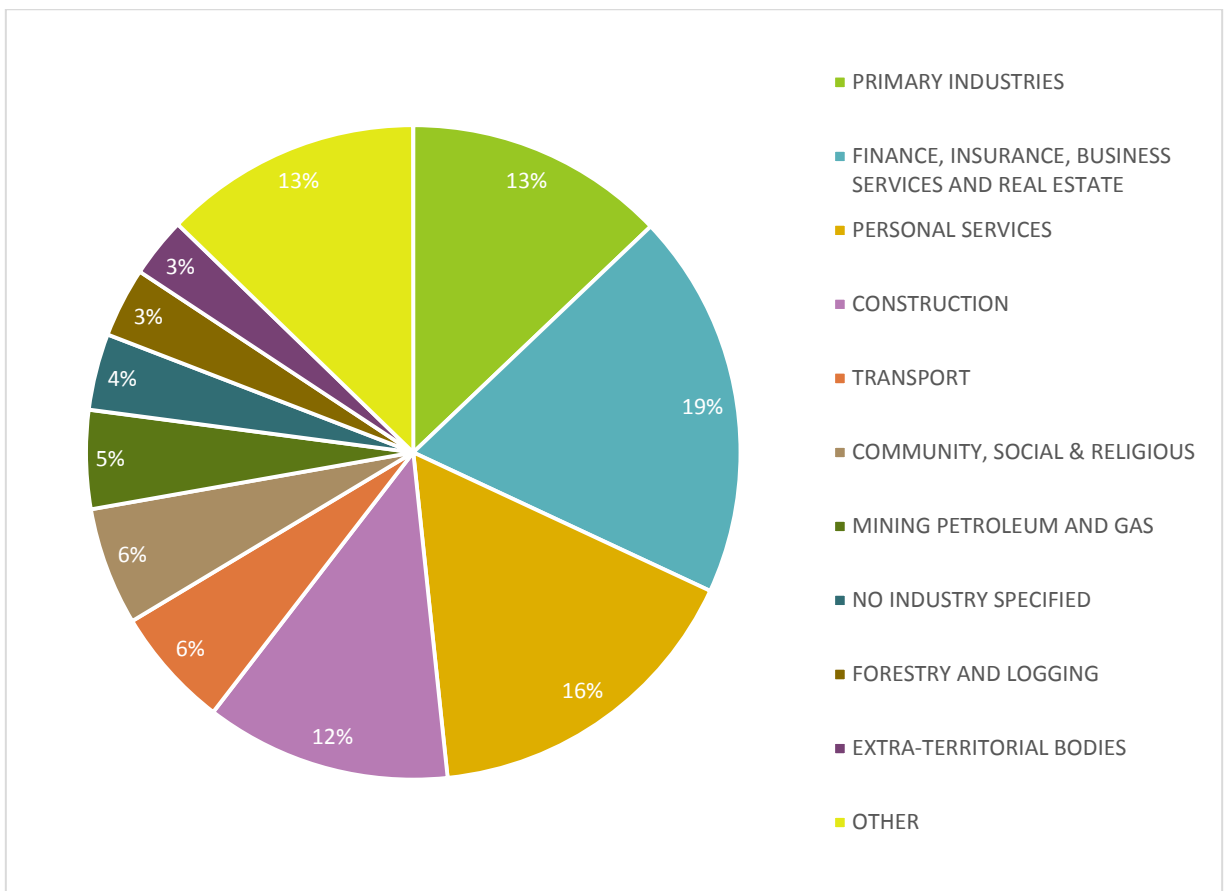
Sometimes taxpayers are entitled to a GST refund. This occurs when ITCs are more than GST payable on the business's operations in a particular tax period. Refunds are generally available for businesses which make predominantly zero-rated supplies or when a business is making capital investments such as during a start-up phase or expansion. In the latter case, ITCs on capital purchases may exceed tax liabilities and it is a measure of the effectiveness of the administration that refunds are made in a timely fashion.

Businesses making zero-rated supplies are typically exporters and, in this case, zero-rating is intended to remove domestic tax from exports in order to maintain competitiveness in international trade. There are also special cases where zero-rating is used for policy purposes, e.g. medical supplies.

However, the zero-rating arrangements in PNG are unusual in that supplies provided to resource companies (who are exporters) and aid and charitable organisations (zero-rated for policy reasons) are themselves zero-rated. This adds to complexity and raises significant compliance issues for IRC as it means that potentially many more businesses who would not otherwise be eligible

become entitled to refunds. This is reflected in figure 5 which shows that mining itself receives relatively few refunds as these are claimed by their suppliers.

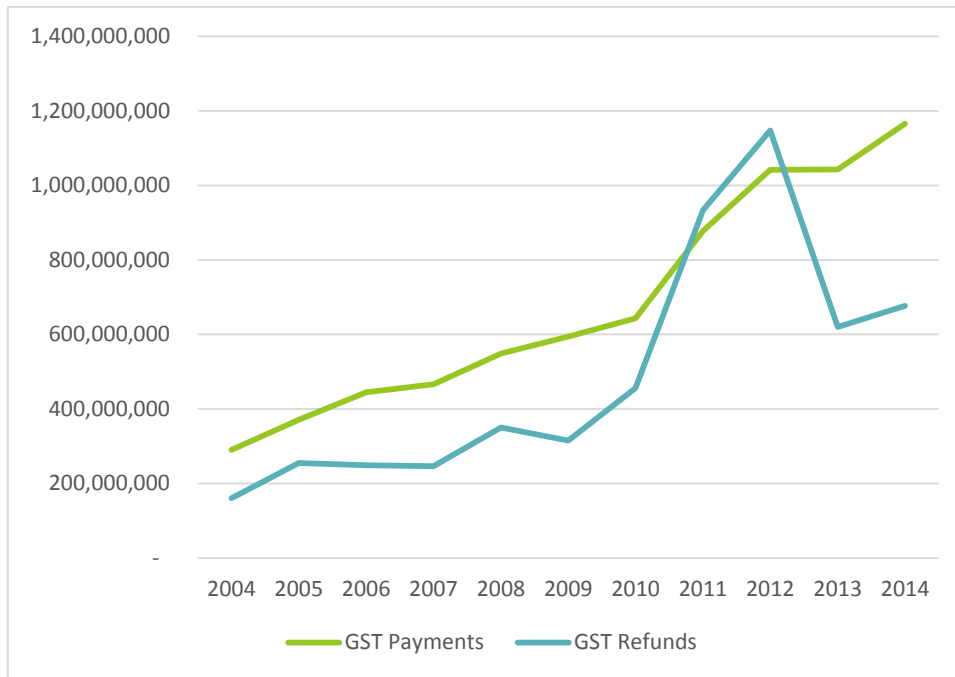
Figure 6: GST refunds by industry sectors (2014)



Source: IRC data

The relative value of refunds generally relates to the net GST collection but has changed significantly over time. This presumably relates to the large capital expenditures associated with the LNG projects – in 2011 and 2012 refunds were actually higher than the net collections.

Figure 7 Net GST Collections and refunds Paid (K)



Source: IRC data

Because of the design of the GST and its operations throughout the supply chain, ITCs can comprise a large proportion of gross tax liabilities. More complex supply chains have more business to business transactions and so will have a higher ratio of ITCs to gross tax. The actual ratio will vary depending on the overall make-up of a country's economy and the design of its GST.

By way of comparison, in Australia total input tax credits are equal to around 90 per cent of gross GST liability and total refunds (which are included in ITCs in the Figure 8) are slightly more than the total net GST collection.

Although comparable data for ITCs is not available, the IRC data shows that on average refunds in PNG have averaged 68 per cent of the net collection.

Figure 8: Australian GST liabilities and credits 2010-11 (\$million)

a.	Gross GST Liabilities	239,723
b.	Input Tax Credits	216,738
c.	Deferred GST on Imports	20,087
d.	Net GST liabilities (a-b+c)	43,071
e.	Total refunds	43,208

Source: Australian Taxation Office (2012), **Taxation Statistics 2009-10**, ATO, Canberra.

CHAPTER 3: CHALLENGES FOR PNG'S GST

Zero-rating for resource companies (and others)

As previously discussed, resource companies are predominantly exporters and their exports should be zero-rated to promote international trade and in line with the destination principle. However, the way this zero-rating is administered has led to significant problems.

In 2000, the legislation was amended to provide that all intermediate supplies (except cars) to resource companies “for use solely in carrying out [their] resource operations” were themselves zero-rated.⁸ This appears to have been done for administrative and cash-flow convenience for resource companies but has resulted in significant problems.

Firstly, this may extend the actual concession for exports to domestic supplies if those supplies are part of their resource operations. Resource operations are defined by reference to the *Income Tax Act 1959* and include amongst other things refining of petroleum products, exploration, construction and transportation. Where the boundary really exists is a question of legal definitions. However, it is possible that the result is that anything that a resource company does is zero-rated under the legislation.

Another problem is the use of the word “solely” as it is extremely difficult, perhaps impossible, for a supplier or the IRC to determine at the time of supply what the end use will be for many supplies.

The biggest issue though is that zero-rating like this throughout the supply chain is poorly targeted and undermines the basic design of a value-added tax. This concession means that contractors and suppliers of resource companies do not charge GST when invoicing the resource companies but claim a refund of their own ITCs. Indeed as Figure 6 shows, the largest portion of refunds is claimed by the finance and personal services sectors. As most of their supplies are exempt supplies, these sectors would not normally be expected to be large refund claimants.

⁸ This was originally section 20(1)(d) in the *Value Added Tax Act 1998*, now section 21(1)(d) of GSTA.

The problem gets worse as there seems to be a practice of zero-rating even further back to include supplies to suppliers. This does not appear to be the intent of the legislation but this is now established practice and presents a significant compliance challenge. There should be immediate compliance action to stop this.

This system has severely challenged the integrity of the GST in PNG as there appears to be growing fraud with an ever-increasing number of contractors who inflate their input tax credits or do not declare their other taxable activities. The number of staff at IRC have not increased proportionately to deal with the increase in the number of taxpayers requesting for refunds.

The original design feature was that supplies (sales/export) **by** resource companies would be zero-rated as they are exports. The resource company would pay all its contractors and suppliers the GST they charge and claim a refund from the IRC. This is much easier to administer because there are not many operating mines and resource companies in PNG.

Question: What would be the benefits and problems of changing the current arrangement so that only exports by resource companies are zero-rated? Would this improve compliance with the policy intent underlying the existing concessions?

Discretionary Exemptions

As identified in Issues Paper 5 on Tax Incentives, exemption from GST can be granted by the Government via a Gazettal Notice.⁹ This 'exemption' provision has been applied to a range of projects and is mostly used by the entities to not pay GST, especially on imports.

The meaning of exempt supply under the GST Act is that GST is not added to the cost of the supply and input tax cannot be claimed back. The way this exemption appears to operate is to provide effective zero-rating rather than exemption.

⁹ GSTA, section 25(8)

This problem has been supported by a submission to the Review¹⁰ which highlighted the complexity of administering these provisions and the revenue risk to the State where these provisions have been abused. *“Having too many otherwise taxable supplies zero-rated/exempted is impracticable and places tremendous strain on the already capacity strapped revenue agencies of IRC and Customs”*.

Payment of Refunds

One of the basic design features of the GST is that businesses only need to remit the tax collected (output tax) on supplies they make net of the tax they pay (ITCs) on supplies received. If tax paid is greater than tax collected then they are entitled to a refund.

Eligibility for ITCs (and thus refunds) will vary between different sorts of businesses. For example, excess ITCs leading to refunds are usually generated by exporters, new businesses where purchases to establish the business often exceed sales in the start-up period, and businesses which make predominantly zero-rated supplies such as medical supplies.

IRC has had ongoing problems with access to funds to pay refunds. In part this relates to the problem around transferring funds from Customs. Customs collects import GST at ports and apart from Port Moresby, all the other centres transfer this money through commercial banks to the Bank of PNG. This transaction takes time to get cleared and then transferred to the Customs Revenue Account held with the Bank of Papua New Guinea. After receiving a warrant from the bank, Customs advises BPNG to transfer the import GST to the National Goods and Services Trust Account maintained by the IRC. Refunds are then paid out of this trust account.

If refunds are not able to be paid in a timely then this may create significant cash flow issues particularly for businesses making zero-rated supplies. Options to reform the current arrangements for resource companies (and others) may well stand or fall on the IRC's ability to manage this issue.

Question: – do stakeholders agree that the refund system is slow and open to abuse? Will making the system simpler and fraud-proof by reducing the number of taxpayers due for refund improve the system?

¹⁰ Bre, P, *Response to Issues Paper 5 - Tax Incentives*, http://taxreview.gov.pg/wp-content/uploads/2015/04/15.03.29_advantages.disadvantages.ti_submission_pauline.bre.pdf

Refund Fraud

It is well recognised internationally that fraudulent claiming of input tax credits is a significant compliance challenge. As we have seen elsewhere, the design of some elements of the PNG system have facilitated GST refund fraud.

A significant amount of GST revenue is lost annually through fraud and abuse of exemptions and zero-rating. Fraudulently obtaining GST refunds is a lucrative business for dishonest taxpayers who take advantage of the system by claiming ITCs they are not entitled to.

Critical areas of concern in GST refunds:

- The large number of refund claims and the increase in taxpayer base as a result of zero-rating of supplies to resources companies, aid projects, educational institutions and religious, charity and community organizations makes checking eligibility difficult.
- The withholding arrangement in the coffee industry which was implemented to cater for the difficulty of compliance enforcement has opened up more fraud in the industry.
- The IRC has inadequate numbers of staff and an ineffective compliance program results from these resource constraints.
- There have been concerns about collusion between refund processing officers and taxpayers and tax agents, lack of staff training to detect fraud and general administrative problems.

Effectively administering GST refunds should be a priority.

General Non-Compliance

There is a widespread view that many small to medium businesses are not complying with their obligations. This includes not registering for GST but charging GST to customers and not remitting it to IRC. It has not been possible to assess the prevalence of this problem but this is something that should ordinarily be considered a routine compliance matter for the tax authority.

GST refunds to educational institutions

Education services provided by an educational institution (defined) is an exempt supply. No GST is charged nor can ITCs be claimed. However, educational institutions are able claim input tax credits on educational materials used by the students in their learning¹¹.

This is an area where there is widespread fraud where dishonest tax agents collude with schools to obtain more GST refunds than what they have actually paid. The fees or commissions for these corrupt tax agents go as high as 40% of the refunded amount. Now that the Government's policy on tuition-free (TFF) education is being implemented, consideration could be given to repealing this provision.

Question: – do stakeholders agree that exemptions for schools under Section 31(16) of the GST Act be removed?

¹¹ GSTA section 31(16)

CHAPTER 4: VIEWS FROM CONSULTATION

As part of its blue sky consultation process, as well as ongoing consultations, the Review has received a number of submissions that have addressed the future of PNG's GST regime.

Appropriate GST rate

Many submissions have called for a reduction in the burden of personal income taxation (PIT), which is borne by less than 7 per cent of the population, i.e. those in the formal sector.

Some submissions have opposed a GST rate increase and argued instead for improvements to the administration of the system. While administration should be improved this is a longer term goal and adjusting the rate also has its merits.

One submission¹² suggested that there should be a reduced rate of GST of 3 – 4 per cent for basic needs such as food, books and newspapers, some health care items and service such as cleaning and barbers. The submission argued that a reduced rate would improve equity within the GST and “mitigate the implications of a disproportionate tax system”. Multiple rates are used in some countries but they can add significantly to complexity.

A number of submissions argued that, as covered in Issues Paper 4 Tax Incentives, the GST base in PNG is eroded by exemptions. There has not been any cost-benefit analysis of tax incentives. Whilst it may be difficult to stop exemptions already granted, no new exemptions should be granted.

GST exempted and zero-rating on imported goods

A submission also proposed that “only certain exemptions should be allowed to entities because of international conventions such as Diplomatic (Consular Privileges & Immunities) and other international aid organizations or other entities for social reasons such as to churches, educational institutions, charities

¹² KPMG, [Comprehensive Fiscal Regime Review \(Taxation and non-Taxation\) - 2013-2015](http://taxreview.gov.pg/wp-content/uploads/2014/07/14.05.15_bsc.submission_kpmg.pdf), http://taxreview.gov.pg/wp-content/uploads/2014/07/14.05.15_bsc.submission_kpmg.pdf

and not-for-profit operations who may operate below the GST registration threshold”.

A submission from the National Research Institute¹³ has proposed that exemptions may be appropriate but that the current process is subject to abuse. It argues that the GST has a heavy burden on the poor and that the first consideration in providing exemptions should be consumer welfare.

Resource companies GST concessions

A submission to the Review suggested that the GST taxation policy intent on GST concessions be reviewed and clarified as the GST Act treats transactions by resource companies (entities that have registered interests or tenement holders) in several ways.

Imports: Import of goods (other than cars) to be used solely in resource operations by resource companies are exempted from import GST under Section 7(f) GST Act. This end-use-oriented provision is very difficult for Customs to administer because Customs declarations are done based on tariff lines, that is, based on the characteristic nature of the goods at the time of import. Specific exemptions based on tariff lines are easier to administer. For end-use exemptions like this, Customs cannot determine whether the goods will be ‘used solely’ in resource operations once it leaves Customs control.

IRC and PNGCS lack the audit and administrative capacity to undertake audits to determine if the goods have been used solely in resource operations. There has been clear abuse of this provision where resource companies over-import materials for a project under the exemption and divert to other non-resource operations.

Contractors importing goods for the resource company have also been using this provision or s21(1)(d) and Section 7(1)(f) to exempt the payment of import GST on the goods. This should not happen and fiscal provisions of project agreements should not be contrary to the GST Act.

¹³ National Research Institute, Response to Consultation Questions in Issues Paper No.5: Tax Incentives, http://taxreview.gov.pg/wp-content/uploads/2015/04/15.03.03_advantages.disadvantages.ti_.submission_nri.pdf

CHAPTER 5: POSSIBLE REFORM DIRECTIONS

This Chapter explores possible reform directions for PNG's GST regime going forward. As noted earlier in this paper, whilst specific consultation questions are included, interested stakeholders are encouraged to raise any relevant issues as part of their submission.

GST Rate

The rate of GST in PNG is at the lower end of rates in the region.

Figure 9: Regional GST/VAT Rates

Australia	10%
Fiji	15%
Indonesia	10%
Kiribati	12.5%
New Zealand	15%
Philippines	12%
Samoa	15%
Vanuatu	12.5%

The PNG rate is higher than in other regional countries such as Malaysia (6 per cent), Japan (8 per cent) and Singapore (7 per cent). However, it is significantly lower than most African countries where almost three quarters of the countries have a rate of 15 per cent and more, and only four have rates below 13 per cent. It is also lower than Europe where the European Union has a minimum rate of 15 per cent and a high rate of 27 per cent in Hungary.

Setting a GST rate depends on revenue goals, the overall mix between direct and indirect taxes, equity and consideration of alternatives. These are essentially political decisions although increasing the rate may increase non-compliance.

The Review's view is that the most appropriate way to tax the large informal sector is a broad-based consumption tax like GST. The GST rate could be increased to pay for the cost of a PIT reduction. An increase in GST rate could also replace reductions in import duties as a result of the Tariff Reduction Program (TRP).

Any increase in the GST rate will have an inevitable impact on low income earners as discussed previously (GST and fairness).

Question: - would stakeholders support, in principle, an increase in GST to either 12.5% or 15%, as part of broader efforts to reduce PNG's reliance on income taxes (notably personal income taxes) and spread the tax burden so everyone pays their fair share? Who would be the most severely affected by an increase in the rate? How could these impacts be managed?

GST Base

Notwithstanding the administrative problems (see below), zero-rating is largely limited to exports (including resource companies which are predominantly export industries). The other zero-rated items are medical supplies, fine metals, foreign aid providers, non-profit organisations and crude oil supplies to a local refiner.

Medical Supplies. Concessions for health related goods and services are not unusual throughout the world, although most countries either exempt these or provide a reduced rate. Australia is a notable exception as it zero-rates most health and medical services - including drugs, medicines and health related goods.

Foreign Aid. Foreign aid concessions are typically demanded by aid providers, either as part of formal treaty arrangements or contractually. The concession itself may be reasonable but the current legislation treats zero-rates **all** supplies to aid providers in a similar way to resource companies. This has the same compliance problems.

Non-profit bodies (religious charitable and community). The concession here is limited to bodies "approved by the Commissioner" and only to the extent that inputs are not for profit making activities. A key consideration is that such bodies should not gain a commercial advantage if their activities compete with other providers. Again the legislation zero-rates all supplies made to these bodies raising the same compliance issues. Many countries exempt these bodies rather than zero-rating and may also provide other concessions such as a higher registration threshold.

Crude Oil. The zero-rating of supplies of crude oil to local refiners appears to be an incentive for refiners to use domestic product. This is an unusual concession although its revenue impact should be nil (this should be a "wash"

transaction with output tax offset by ITCs) unless there are compliance problems. Oddly, by the same logic, it does not appear to offer much of an incentive except for a relatively small cash flow advantage.

Fine metal. The tax treatment of fine metal is consistent with international practice. The first supply by the refiner is zero-rated with subsequent supplies being exempt. The rationale for this is that fine metal prices may be internationally defined and a local refiner would not be able to pass on any GST. Exempting subsequent supplies is consistent with the treatment of financial services. Sales of things made from fine metal, e.g. jewellery, are treated as taxable supplies at the standard rate.

Going Concerns. Sales of businesses as going concerns are zero-rated. This is to reduce the cash flow implications of transactions which would otherwise give rise to offsetting tax and ITCs. Without this start-up costs may cause significant problems for new businesses.

Land. Under GSTA¹⁴, the transfer of land is not a supply and therefore is not taxable. Improvements to the land do not receive this treatment and so are taxable when they are made as part of a taxable business.

Financial Services. Standard international practice is to exempt financial services, primarily because it is difficult to assess the actual value of the supply - for example, what is the service component of a loan?

Health, Education and Postal Services. Exemptions for these services is primarily a concession based on their status as public goods. However, some inputs for these services are also zero-rated, e.g. medical supplies. Educational institutions are also able to claim ITCs for text books, writing materials and similar supplies to students.¹⁵

PMVs and Taxis. This exemption is a pragmatic solution to the difficulties of collecting tax from this sector.

Gambling. Gambling services are exempt as they are subject to specific taxes under the *Gambling Control Act*.

¹⁴ GSTA, Section 12

¹⁵ GSTA, Section 31(16)

The current GST does have a reasonably wide base and the options for expansion are limited:

- Exports should remain zero-rated as taxing them would be a barrier to PNG products entering international markets;
- The zero-rating of medical services is unusual but changing their treatment to exempt may be unpopular;
- The most practical change to the base would appear to be changing the administrative arrangements for zero-rated supplies in resources, aid and non-profit organisations. This is discussed further below.

Question: What changes should be considered to the current zero-rating and exemption categories?

Voluntary Registration

A registration threshold opens the question of what should be done with businesses below the threshold. PNG allows voluntary registration for small businesses but compliance is an issue.

Special provisions could be made to simplify tax collection tax from voluntarily registered businesses. For example, the UK has a flat rate system based on turnover. The rate is calculated by reference to the industry averages for ITCs vs VAT liability. The standard UK VAT rate is 20%, but under the flat rate system, a retailer pays 4% of total turnover while an accountant pays 14.5% to settle their VAT liabilities. This reflects the fact that a retailer would have relatively higher credits due to purchases of stock whereas an accountant primarily provides intellectual services which do not depend on large taxable external inputs. Under this arrangement the supplies made are considered to contain VAT at the standard rate and recipients would be entitled to an input tax credit under the standard arrangements. The business using the flat rate has no general eligibility for credits although special arrangements apply for large capital purchases.

As discussed in Issues Paper No 7, there could be merit in developing a small business income taxation system for businesses with turnover below the GST registration threshold. Such a system could include both income tax and GST. This would simplify compliance arrangements for businesses with a turnover below the threshold, i.e. voluntarily registered.

The use of this or some similar arrangement could facilitate a change to the current arrangements in the mining and coffee industries where compliance has been a significant problem with small suppliers.

Question: What are the benefits in implementing a flat rate GST system for small businesses? What problems might it raise?

Improving compliance

There appears to be significant non-compliance. Although it is never possible to achieve 100 per cent compliance, there are obvious opportunities to improve and fixing compliance might provide significant extra revenue irrespective of any changes to the rate. This would inevitably require more resources for IRC but this should be considered as an investment and provide a clear return to the revenue.

One particular problem is the mechanism that has been chosen to provide zero-rating for the resources industry, aid organisations and non-profits. While the policy behind the zero-rating is not uncommon practice, the unique feature of the PNG legislation is that **all** supplies **to** mining companies, non-profits and aid providers are also zero-rated.

The usual approach internationally is to zero-rate specific goods and services rather than providing the concession based on particular types of recipient. This means that the supplier making the final zero-rated supply is expected to pay GST on supplies they receive but is eligible for ITCs. For example, all exports would be zero-rated but the concession should only apply to those supplies. If a resource company makes other supplies, e.g. local sales of surplus equipment, than those would be a taxable supply and GST should be included.

The current approach means that the potential for fraudulent claiming of ITCs is greatly expanded:

- The number of zero-rated supplies and suppliers is increased as all intermediate supplies to the relevant industries are also zero-rated despite being taxable supplies if made to other recipients. This provides the potential for suppliers to disguise taxable supplies as zero-rated;

- The usual discipline of the GST system is compromised as there is no incentive for the recipient to ensure that adequate documentation is maintained by suppliers;
- Compliance action by IRC needs to focus on a large number of suppliers, not just the end supplier.

To address this problem, Section 7(a) and (f) and Sections 21(1)(c), 21(1)(d), 21(1)(e) and 21(1)(f) of the GST Act should be removed. This change will reinstate one of the key integrity measures of the GST system - i.e. each business will have the incentive to ensure that its suppliers are correctly invoicing so that they can properly claim their ITCs.

This proposal is likely to generate objections from resource companies (and others) on cash flow grounds.¹⁶ However, while these cash flow impacts are real they are proportionally small and can be managed if IRC provides refunds in a timely manner (see below). The introduction of a GST deferral scheme for imports (see below) will also assist to reduce cash flow impacts.

The withholding arrangement in the coffee industry, which was implemented to cater for administrative problems, has also opened up the GST system to fraud through inflating of ITCs and burdened the IRC in assessing refunds. This provision should be removed and the administrative practice should be stopped. GST should operate as it is designed to do.

Question: What would be the impact of changing the administration of zeroing, especially as it applies to resource companies, aid organizations and non-profits, to bring it in line with international best practice for GST? What are your views concerning removal of the withholding arrangements for the coffee industry?

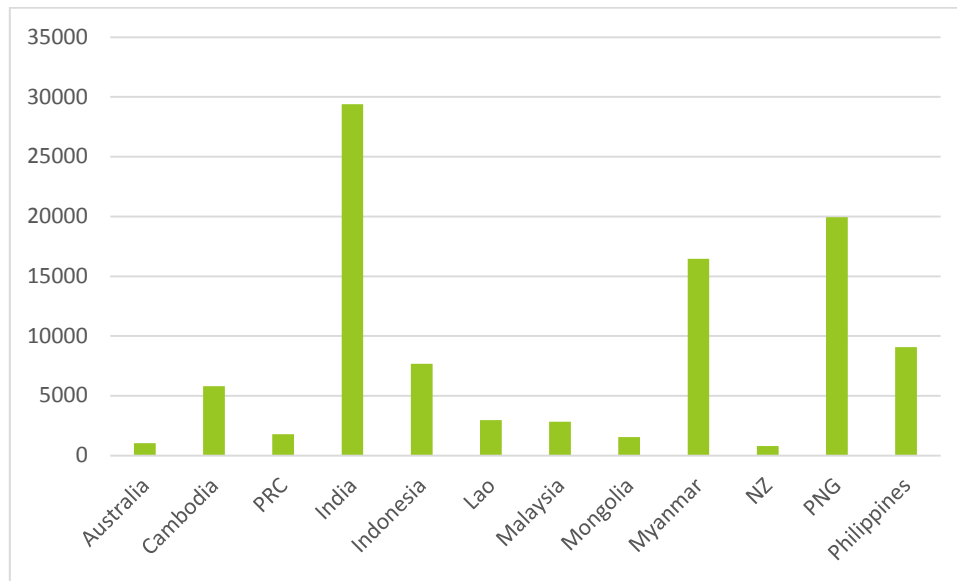
IRC organisation, resources and skills

The IRC has relatively low resources compared to other revenue administrations. In PNG, there is one IRC officer for every 20,000 people. By comparison Australia has around one tax officer per thousand people and NZ one for 800. As the chart shows, it is not only developed countries that have a

¹⁶ See for example Oil Search, Submission to Tax Review Committee, P45, http://taxreview.gov.pg/wp-content/uploads/2014/06/31.05.14_mpt.submission_oil.search.pdf

low ratio of population per tax officer and many developing countries have significantly higher resources. The Solomon Islands Internal Revenue Division has an establishment of 117 positions with 103 filled¹⁷, giving a ratio of one tax officer for some 6,000 people, i.e. more than three times PNG's rate.

Figure 10: Population per Revenue Staff



Source: Derived from ADB data¹⁸

The IRC resource problem is compounded by the large numbers of unfilled positions. In 2014 only 351 full time equivalent (FTE) positions were filled from an establishment of 581 FTE. It is interesting to note that IRC does not appear to have a particularly high attrition rate, currently around 3.6 per cent per annum.¹⁹

¹⁷ Ministry of Finance and Treasury (2014), **Annual Work Plan 2014**, Honiara accessed at http://www.mof.gov.sb/Libraries/Corporate_Documents/Ministry_of_Finance_and_Treasury_Annual_Work_Plan_2014.sflb.ashx

¹⁸ Araki S and Claus I (2014), **A Comparative Analysis of Tax Administration in Asia and the Pacific**, ADB. See the Review Issues Paper Number 3 for a more detailed discussion.

¹⁹ Araki and Claus, page 28.

However, the overall staffing is unsatisfactory and needs to be addressed urgently. A range of changes to the organisation should be considered:

- improving the focus on training;
- expanding cadetships and/or scholarships;
- improving pay and general conditions; and,
- structural changes within the IRC.

A modest proposal could be to aim to achieve the filling of at least 95 per cent of the establishment within one year and to double total staff numbers within two years. In the medium term, IRC will need to grow further it is to be able to adequately administer the tax system.

Discretionary power to grant GST exemptions

The review is considering the provision of tax incentives across all taxes. Issues Paper No 5 has made a number of suggestions on how this process should be managed including the establishment of a national framework and a committee to oversee these. This would be a significant improvement over the existing arrangement, but for GST, is only a second best option.

Sections 25(8) and (9) provide a discretionary power for particular supplies to be exempted from GST. This appears to be intended as a mechanism to provide incentives for particular projects.

However, the intent of GST is a transaction based tax where the final consumer bears the tax, rather than the business that makes a supply. In addition, the basic legislation provides that exports are zero-rated. Thus, there is no need for these provisions as the GST should not be a cost to business, rather businesses should be able to pass on the cost to consumers or obtain a refund from the IRC. The only real benefit to business might be a small cash flow benefit and an administrative gain through simplifying their tax affairs.

The cost to PNG is significant unnecessary complexity and loss of revenue through widespread abuse of these provisions - sometimes by those who obtain them, other times through their suppliers.

The best option is to simply repeal these two sections. To smooth implementation it may be desirable to consider grandfathering arrangements so that existing arrangements are restricted to those already in place but not available for any future projects.

The drafting of section 25(8) is unclear as to whether it is actually intended to make supplies exempt or zero-rated. The use of the terminology “exempt from Goods and Services Tax” confuses exactly what is intended. If the section is retained it should be amended to clarify its intent.

Deferred GST on Imports

In 2013 IMF²⁰ recommended a GST deferral scheme and this was also discussed in the issues paper on Mining & Petroleum Taxation. The issue has also been raised in submissions.

A number of jurisdictions implement this scheme, where payment of GST on importation of goods is unpaid (or deferred) until filing of the next GST return, at which time there will be a credit available to offset the potential GST on the imported goods. This benefits both the taxpayer and revenue administrator in that it means there is less need to provide GST refunds.

The Review has identified GST refunds as a particular area of concern in administration, with taxpayers raising concerns about delay in timely refunds. A GST deferral scheme would take pressure off the IRC, at no cost to revenue.

Design of deferral system around the world differs, and they usually operate at the exercise of the revenue administrator’s discretion, allowing only taxpayers with a good compliance history to partake in the scheme.

Implementation of such a scheme would require close collaboration with PNGCS (who collects GST as if it were Customs Duty at point of entry) and IRC the provider of refunds. Such a scheme should only be implemented once data exchange between IRC and Customs is fully operational. However, the Review considers that there is merit in taking the first steps towards a GST deferral scheme by putting in place the legislative powers to enable the scheme to operate.

Question: Is a deferral scheme useful in PNG? What safeguards would be required to implement such an arrangement?

²⁰ Mullins P, Puyo DM, Le Leuch H & Strongman J (2013), **Papua New Guinea: Reform of the Extractive Industries Fiscal Regimes**, IMF.

Organisational split between IRC and Customs

Most of the revenue functions are provided by IRC but PNGCS still retains revenue functions related to imports and exports. This system has only been in place since January 2010 when Customs and IRC were separated into two agencies.

Differing organisational objectives and cultures can undermine the efficient collection of revenue. One example of this is the current problem of transferring import GST between the agencies.

Both IRC and PNGCS are now statutory authorities. It is important that the two agencies work together in administering the taxes.

Question: What further organisational arrangements would facilitate improved cooperation between IRC and PNGCS?
