Papua New Guinea
Taxation Review
Report to the Treasurer
Part 2 of 2: Detailed Analysis

Tax Review Committee

October 2015
Cover Picture: Children at Adventure Park, Port Moresby.
Taken by Nahshon Tamba and edited by the Tax Review Committee
INTRODUCTION

This Volume 2 provides further detail on the issues and recommendations contained in Volume 1.

This volume commences with a discussion of the principles for good taxation policy used by the Review in its research and considerations. Discussions on the main issues covered in this report draw on, and should be read in conjunction with the Issues Papers released by the Review.

While most of the issues raised in the Issues Papers are dealt with in the discussion below, not all of the issues have been fully considered.

Issues Papers

The following Issues Papers were released over the course of the Review:

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NOTE: Issues Papers for Customs Tariff, Non-Tax Revenue including Land and Property Tax were not done.

This Volume also discusses taxation issues concerning the Autonomous Region of Bougainville and a brief SUMMARY of a report on PNG Land and Property Tax Reform, and Non-Tax Revenue, recently produced by the International Monetary Fund.
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Issues Paper No. 3: *The Case for Tax Reform and Broad Reform Directions* explored the five general principles that should guide the design and administration of any good tax policy. These five principles have been the policy framework for the Review’s analysis:

- **Revenue:** A good tax system should raise sufficient revenue to enable the government to deliver services that meet the community’s expectations.
- **Competitiveness and efficiency:** A good tax system should promote economic growth and thus drive more jobs, higher incomes, more services, and less poverty.
- **Fairness:** A good tax system should be fair: it should create a level playing field for businesses and it should ensure that taxpayers each pay their fair share.
- **Simplicity:** A good tax system should make it as simple as possible for taxpayers to comply with their tax obligations. It should also reduce administrative costs for government.
- **Trust in government and accountability of government:** A good tax system, including a reliable tax administration, should help build trust in government. It should also support greater government accountability.

Issues Paper No.3 discussed the relevance and value of these principles for PNG’s broader development challenges and also how the application of these principles should be adopted to reflect the characteristics of PNG’s society and economy. This chapter explains the merits of each principle and expands on the research and analysis that underpins each one.

**Revenue**

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

Taxes distort choices. Inevitably, imposition of taxes can influence the choices people make. Consequently, it affects revenue raising outcomes.

Some taxes cost more to collect. Some taxes distort choices more than others. In doing so, reduce prosperity. In general, taxes on less mobile factors of production such as real property are less distorting than taxes on more mobile factors of production such as financial services. Taxes on consumption are less distorting than taxes on incomes. Taxes on consumption encourage saving and investment that leads to higher long-term prosperity. Income taxes are generally associated with lower economic growth than taxes on consumption and property. All other things being equal, shifting towards consumption-based taxes substantially increases the incentives for economic growth.

Tax reform can help to make PNG a more attractive place to do business and stimulate sustained economic growth. This, in turn, will help to create more jobs, higher wages, and more services for more Papua New Guineans. Sustainable economic growth, driven by tax policy and other economic reforms, is essential to reducing poverty and fulfilling the Government’s vision for PNG to become a “Smart, Wise, Fair, Healthy and Happy Society by 2050”.

Furthermore, the experience of countries as diverse as China, India, Botswana, Malaysia and Brazil demonstrate that strong, sustained economic growth is also highly effective in reducing poverty.

Taxes will always create disincentives for work, saving, consumption, trade or investment and, as a result, taxpayers will change their behaviour towards other activities. For example, workers may work less and spend more time at home, savers may save less and consume more, or investors may shift their investments from one type of business to another. In each of these cases, taxes distort taxpayers’ choices so that, typically, they engage in (or shift their resources towards) less productive activities.¹ These economic distortions (also known as ‘deadweight losses’) mean that the overall costs of taxation reflect these economic costs, in addition to the costs of the tax itself.

An efficient, well-designed tax system will minimise economic costs. In other words, an efficient tax system will impose no more than the minimum burden on the

¹Taxes will generally lead to unproductive distortions and greater inefficiency. However, in cases where taxes apply to pollution or other negative externalities, they can help to reduce market failures and thereby increase economic efficiency.
economy for each extra kina of tax revenue. What makes a tax system efficient? A whole field of research – ‘taxation economics’ – is devoted to this question. However, there are two conclusions that are particularly relevant for PNG’s tax system.²

The first conclusion is that, in general, it is more economically efficient to apply a low tax rate to a broad base – ‘broaden the base, lower the rate’ (Bird 2010b; IMF 2011). This means that it is preferable to apply low rates to a larger group of taxpayers than to apply higher tax rates to a small group of taxpayers. The reason that it is less costly to have a broad base, low rate system is that, as tax rates increase, the resulting economic distortions multiply much more quickly.

This conclusion is important when considering the exclusion of certain businesses or types of income from taxation. For example, whenever the Government decides to exempt certain businesses from the company income tax, it then has to apply a higher tax rate to other taxpayers in order to collect enough revenue for the services it wishes to provide. Similarly, most capital gains are untaxed in PNG, which means that other forms of income are taxed at higher rates than they would otherwise. Consequently the granting of exemptions or the excluding of certain types of income from taxation means that a tax system will be less efficient.

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

These conclusions can help guide decisions about the appropriate ‘tax mix’: how much revenue should be collected from taxes on income, consumption, resources, property or trade as a proportion of total aggregate revenue?

²Other important conclusions from tax economics include, for example, the efficiency benefits of tariff reductions, value-added taxes over other indirect taxes and the taxation of pollution or other negative externalities. These conclusions are addressed where relevant elsewhere in this paper.
Fairness

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

There are four (4) issues to consider in assessing the fairness of the tax system.

1. Legal and Economic Incidence

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

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

2. Horizontal Equity

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

3. **Vertical Equity**

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

4. **Intergenerational Equity**

Taxation of natural resources and retirement savings also raise questions about the obligations of one generation to sustain the quality of life for future generations. In PNG this must be a key consideration in future policy design and implementation.

**Simplicity**

Tax systems not only impose direct costs (the tax itself) and economic costs resulting from distortions in behaviour, they also create compliance costs for taxpayers and administrative costs for government. Simplifying tax processes can reduce both these costs.

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3For further analysis of the redistributive role of the PIT, value-added taxes (like the GST) and the tax system more generally, see Gibson (1998), Emran and Stiglitz (2007), Bird and Zolt (2005) and IMF (2011, pp7-8, 25-26).
Compliance costs – the costs of filling in tax forms, keeping tax records, making tax payments and responding to requests for information from tax administrators – are just as much of a burden on taxpayers as the tax costs and economic costs, and so there is enough reason to try to minimise them.

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

**Trust in Government and Accountability of Government**

A tax system that is well designed and well administered will ensure that people in similar circumstances pay a similar amount of tax or, in other words, that everyone pays their ‘fair share’. A well administered tax system will also ensure that it is easy for individuals and businesses to comply with the tax system. All of these outcomes can help to improve confidence in good government.

Tax reform absolutely matters for corruption and good government. A well-designed system will limit the number of decisions that need to be made by ministers or officials and will thereby reduce opportunities for corruption.

More broadly, tax policy that establishes a broad, visible and consensual tax system can build trust in government, increase government accountability and thereby strengthen the democratic state. It may do this in the following ways.  

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

Second, a broad-based system means that governments have incentives to improve their tax administration in order to ensure the solidity of future revenue collections. Improved tax administration can, in itself, help build greater trust in government and it may also spur improvements in other areas of government administration.

Finally, the tax system plays a key role in the ongoing tension between the interests of citizens and the interests of their representatives and the government. This tension may, in the wrong circumstances, lead to conflict but it may instead lead to a

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4The following discussion draws on the following articles from the literature on taxation, governance and state-building in developing countries: OECD (2008a, 2008b, and 2010), Moore (2007), IMF (2011, pp42-44) and Keen (2012, Section V).
constructive ‘tax bargain’ in which ‘citizens accept and comply with taxes in exchange for government providing effective services, the rule of law and accountability’ (OECD 2010, p10).

A tax system that applies broadly to large sections of the population will naturally provoke basic, important questions from taxpayers: Why does the government need to collect so much tax? Are other taxpayers contributing their fair share? How are these taxes affecting business and the economy? How is the money being spent and could it be spent more effectively? Throughout the world, these are some of the fundamental questions that citizens and taxpayers must ask of their governments to ensure that they are responding to the needs and expectations of the people. The tax system has a role in stimulating this engagement.

One way to illustrate the importance of a broad tax base is to consider the opposite scenario: the resource curse. Highly resource-dependent countries often depend on a small number of large taxpayers and, as a result, suffer a deterioration in the effectiveness and accountability of government. For example, the OECD (2008a, p17) summarises evidence for countries that are heavily dependent on oil. It finds that governments in these countries tend to:

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

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

The idea of a ‘consensual’ tax system may seem like an oxymoron, since all tax systems are ultimately coercive. However, some tax regimes can be much more coercive than others if, for example, tax assessment and collection are ‘conducted in ways that are likely to be validly perceived by taxpayers as arbitrary, extractive, unfair or brutal’ (Moore 2007, p25; see also OECD 2008a, p23). While such coercive

5In theory, similar issues could apply to countries that are highly aid dependent, although it is likely that there are some relevant differences between aid flows and resource rents. Also, the evidence of any negative impact of aid on governance is more ambiguous than in the case of resource dependency. For further discussion, see OECD (2010, Chapter 4), OECD (2008a, Section III) and Moore (2007, p22).
taxation is likely to provoke a response from taxpayers, it is hardly likely to stimulate a constructive tax bargain between citizens and the state.

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

Taxpayers will only ask challenging questions about the taxes they pay if they are aware of them. Consequently, it is important that taxes are ‘visible’, even if political leaders would prefer that they were not. However, attempts to increase the ‘visibility’ of taxes need not imply that all revenue should simply be shifted towards the most visible taxes (typically personal and company income taxes). In general, an efficient tax system will include a variety of different taxes to ensure that it can apply low rates to a broad economic base. Consequently, the visibility of a tax should generally be tested against close substitutes. For example, value-added taxes like the GST are generally more visible than other indirect taxes like import duties (OECD 2008a, pp22-23; Moore 2007, pp24-25; see also OECD 2010, pp37-38).

There are various ways to create a more broadly based, visible but still consensual tax system, many of which are consistent with the other principles for good tax policy. These include, for example⁶:-

- **reduce exemptions**: reduce exemptions and eliminate discretionary powers for ministers or officials to award tax concessions in order to reduce perceptions of special treatment of certain groups and to reduce the potential for corruption;

- **report ‘tax expenditures’**: publish data on ‘tax expenditures’ and tax revenues in order to improve public understanding, perceptions and scrutiny of remaining tax exemptions or concessions;

- **adopt a value-added tax**: shift away from trade taxes towards a value-added tax (like the GST) in order to make indirect taxes more visible, especially to small businesses;

⁶This list is based on OECD (2010, Chapter 3) and Keen (2012, p20).
• **strengthen tax administration**: move to self-assessment sooner than later to separate the assessment and collection functions, thereby minimizing opportunities for corruption;

• **improve taxpayer services and rights**: improve taxpayer services (information and advice to taxpayers) and taxpayer rights (access to administrative reviews) in order to improve relations with taxpayers and thus voluntary compliance;

• **engage with stakeholders**: improve engagement with business and taxpayer associations and with civil society organisations in order to facilitate the ‘tax bargaining’ process between society and the state; and

• **strengthen tax policy units**: strengthen tax policy units within Treasury Department such as, establishing a separate division with capacity to inform, propose and take substantive ownership of these major tax reforms.

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

The second divergent recommendation is to broaden the base to include more of the informal business sector (OECD 2008, pp25-26; OECD 2010, pp43-44) or more specifically the hard-to-tax sector — businesses, usually small and medium businesses which are not known to and do not engage with the IRC. One benefit of extending taxation to the informal economy is that it may increase the engagement of small businesses in the political process. A further benefit is that taxation of informal economic operators may increase the willingness of *formal* sector businesses to comply with taxation (since they feel they are on a more level playing field with informal competitors). Finally, improved taxation of informal business may lead to greater ‘formalisation’ of those businesses, resulting in benefits both for the small businesses themselves and for the broader economy.

Expanding taxes into the informal economy runs counter to conventional advice, however, because it is likely to be administratively costly, relative to the revenue raised. It may also impose undue tax or compliance burdens on small or micro businesses. Consequently, the real test is whether it is possible to design a small
business tax regime that avoids or minimises these problems whilst capitalising on some of the benefits mentioned earlier.
CHAPTER 2: REVENUE ADMINISTRATION

Introduction

The Review’s terms of reference included an examination of the efficiency and simplicity of revenue administration. In particular the business model, governance framework, strategy, people competencies, structure, systems, process including information technology as an important business enabler.

Tax administration issues were discussed in detail in the Review’s Issues Paper No. 3: The Case for Tax Reform and Broad Reform Directions.

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

Remarks from stakeholder consultation are mixed. Some say, the PNG tax system by international standards is relatively sound, but what needs fixing is Revenue Administration. Others say that the bare bones fundamentals of IRC and PNGCS are fundamentally sound and do not require radical surgery or reengineering. Hence, why fix what is not broken?

Notwithstanding the efforts of many committed IRC and PNGCS officials, feedback from consultations and submissions suggests that there is considerable scope for improvement. Many submissions complained about poor compliance and enforcement resulting in different forms of tax evasion, fraud and corruption. Other submissions expressed concern about complex forms, the need for greater engagement with other Government agencies, and scope for improved processes for communicating, education and disseminating information to taxpayers.

PNG’s revenue administration system has considerable challenges. Some of these have been captured in the independent diagnostic reviews of the IRC and PNGCS undertaken by Deloitte Touche Tohmatsu and PricewaterhouseCoopers, respectively. The Review also had extensive consultations and exchanges with the IRC and PNGCS.
The diagnostic reviews, stakeholder’s inputs and the Reviews research and analysis forms the basis for reporting the *Findings, Recommendations and Policy Rationale for the Reform in IRC and PNGCS.*

For the purposes of this Review, the term ‘Revenue Administration’ means the Internal Revenue Commission (IRC) and the Papua New Guinea Customs Service (PNGCS).  

The main role and responsibility of the IRC is to administer all taxes mandated by law and collect revenue for the State. Key mandates for PNGCS on the other hand extends to ensuring border security, facilitating legitimate trade and travel and revenue protection and collection.

**Why Reform in Revenue Administration?**

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

PNG’s tax system cannot be administered in the way it has been for the past three decades especially in view of rapidly changing conditions globally and regionally. Good and highly efficient and effective revenue administration is a significant contributor to good governance.

There are many reasons impelling reform in revenue administration. Some of the reasons specifically relevant for PNG are discussed in this chapter.

- First, there has been considerable *underinvestment* in revenue administration since independence and lack of proactive leadership and investment management. This has contributed to the acute levels of sub-optimal performance. In 2014, the IRC and the PNGCS raised total tax revenues of K9.6 billion constituting 82% of domestic revenue.  

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7 Both the IRC and PNGCS are the principle revenue administrators in PNG.


9 According to the Mid-Year Economic and Fiscal Outlook Report 2015 released by Treasury Department - In 2014, total revenue collection from tax, non-tax and grants in 2014 was K11.5 billion. The collection from both Revenue Administrators was K9.6 billion which was slightly over 82% of total revenue collected in 2014 budget. IRC collected K7.1 billion and PNGCS collected K2.5 billion.
adequate investment in IRC and PNGCS, the two major business drivers and principal revenue generators will be worth every kina and toea in substantive value addition. From the perspective of democratic governance, national interest, and prudential and responsible economic and fiscal management, it is prudent that the Government take immediate measures to adequately resource IRC and PNGCS so they improve their roles as major revenue generators and drivers of economic growth.

- Second, in an attempt to address the problems caused by underinvestment above, both the IRC and PNGCS were attracted to the idea of converting to Authority status. The rationale by both agencies was to overcome the cumbersome public service requirements in regards to salary remuneration and terms and conditions for their staff that was less attractive to that offered elsewhere by the private sector. There were concerns that staff turnover of qualified staff was very high. The Government supported this move and both organizations now have authority status. Asserting the role of the Authority brings more challenges and requires greater management creativity and close scrutiny of what the administrative and governance framework is needed.

- World-wide mergers and integration of tax and customs is still fashionable and is a popular reform initiative largely because of the commonality of revenue collection and economies of scale. Over forty countries around the world have fully merged tax and customs function while some have undertaken partial merger for economies of scale in infrastructure and ICT and improved sharing of intelligence and monitoring of taxpayers.

- Third, tax policy and tax laws create the potential and legal basis for raising tax revenues, but the actual amount of revenues collected depends on the efficiency and effectiveness of revenue administration.

- Fourth, the quality of revenue administration influences the investment climate and private sector development. Taxpayers or investors contemplating investment are not only concerned about the tax system, but also how it is administered. Revenue administration that is perceived to be arbitrary discourages investment. Similarly, the efficiency of customs administration in clearance processes impacts mobility and flexibility of trade and investments inflows and outflows.¹⁰

¹⁰ Ibid
Fifth, weaknesses in enforcement capacity of revenue administration places law-abiding firms and individual taxpayers at a competitive disadvantage, as their competitors in both the formal and informal sectors get away with tax evasion.

Sixth, tax and customs administrations in the absence of strong leadership, governance and ethics are subject to high risks of revenue leakages. The government suffers major leakages as dishonest revenue officials allow unjustified tax breaks to tax evaders. Honest taxpayers suffer as corruption in revenue administration leads to harassment, intimidation, inflated assessments, delays in processing and service delivery, high litigation cost and leniency towards non-compliant competitors.

These six major challenges including others underscore the urgency for significant Revenue Administration reform.

**Best Practice**

According to internationally accepted principles, revenue administration should:

- promote voluntary compliance;
- be efficient, by raising the maximum amount of revenue under the law with the least cost and effort;
- be effective and administratively capable of delivering the desired policy objectives;
- equitable, offering fair treatment of taxpayers; and
- promote and support sustainable economic development and preservation of the environment.

*Experience suggests that it is not a good idea to ignore the administrative dimensions of tax reform. One cannot assume that whatever policy designers can think up can be done or that administrative problems encountered can be easily remedied. The real tax system people and businesses faced reflects not just the tax law but how it is actually implemented in practice. How a tax system is administered affects its yield, its incidence, and its efficiency. Tax administration is too important to policy outcomes to be neglected by tax policy reformers.*

Prof. Richard. M. Bird
Challenges and Deficiencies

Consultations and the independent diagnostics of the IRC and PNGCS revealed the following challenges:

- an economy which is expanding very fast and rapidly becoming large and complex;
- rapid changes in business and trade trends and practices;
- emergence of internet, e-commerce and cross border trade and commerce,
- growth in size, scope, reach, and financial clout and complexity of multinational corporations;
- trade liberalization and harmonization;
- dramatic and rapidly changing demographic shifts (i.e. large influx of foreigners, change in the mix and composition of taxpayer population, emergence and growth in the SME and informal sectors);
- rapid and constant change in technology and communications;
- rapid change and mobility of financial and capital markets;
- social, cultural and environmental changes;
- growth and complexity in transnational crime;
- endemic increase and systematic graft and corruption\(^{12}\); and
- an upwardly mobile and affluent work force.

At the domestic level, deficiencies include:

- no clear overarching policy framework consisting of key policies to anchor and guide the tax system and Revenue Administration, such as economic, fiscal, tax specific, trade and investment policies;
- weak and increasing unstructured systems in governance frameworks;
- serious gaps and deficiencies in leadership and management ethics;
- out-dated business models still being applied in organizational structures and processes;
- not enough oversight and accountability of performance across the board;
- deficiencies in organizational culture, especially in work ethics and soft skills;


\(^{12}\) Corrupt revenue administration would be expected to collect less official revenue, and a poor quality of the public sector can increase coverage resistance to taxation that expresses itself in tax avoidance and evasion. There is evidence too that political instability is associated with low tax ratios. Bird, Martinez-Vazquez and Torgler (2008) find that greater political “voice” and accountability is associated with higher revenues.
• philosophy and strategy to inculcate client service is lacking;
• no effective and efficient debt management strategy and processes taking into account the struggle to collect revenue given poor attitudes toward paying tax, resulting in low tax compliance; relative tax complexity and poor taxpayer education;
• no simplified system for taxing SMEs;
• misalignment and incongruence with modern business practices;
• many out-dated systems and processes including record keeping and filing systems;
• weak and effective compliance and enforcement;
• mandate and capacity to tax a growing informal economy and with little financial infrastructure; and
• tangible and creditable evidence of graft and corruption in GST refunds, large scale criminal syndicates involved in customs fraud.

At the international level, tax challenges for revenue administration include:

• capital flight;
• lack of relative power in negotiations around foreign direct investment;
• tax competition;
• transfer pricing abuse by multinational firms\(^{13}\), and more recently;
• cross border transactions through e-commerce and web portals which fall outside the ambit of rules of ‘residency’ and ‘source’ or ‘place of incorporation’.

The Review believes that the recent granting of autonomy for both agencies is inadequate to make revenue administration efficient and effective. What is really required and is critically overdue is a holistic and fully integrated solution or approach to ensuring that the IRC and PNGCS perform their parallel responsibilities under their mandate and functions with greater commitment and efficiency.

\(^{13}\) According to the best qualified estimates illegal money flows from developing countries totalled $US 641 to $US 979 billion in 2006 (Kar and Cartwright-Smith (2008) In 2006 the total registered money flows into these countries (including China and India) is estimated at $US 206 billion (IMF World Economic Outlook database), while the total development assistance was $US 106 billion (OECD). In other words even the lowest estimate indicates that money flowing out of these countries in an illegal manner is greater than the money flowing into them legally. In addition, Tax Justice Network and Christian Aid suggest that revenue losses from one method-transfer mispricing, may be as high as 5 -10% of total tax revenue in many low-income countries (Prichard, 2009 Cobham 2005).
Findings

The key findings and suggested ways forward from the diagnostic reports of the IRC and PNGCS is captured in Appendix B.

In summary the key reform recommendations are categorised in three parts.

Part 1: Contains recommendations on Policy, Governance and Strategic aspects of Revenue Administration reform and extends to priorities designed to close the serious gap in voluntary compliance, client service, significant gaps in GST administration, containment and management of tax arrears administration, and investments in capacity development of senior and middle level managers.

These specific recommendations apply to the whole organization. They cut across functional lines, are expected to have very high-level outcomes and support the strategic goals and the highest level objectives based on the Review findings and diagnostics.

Part 2: Recommendations are in respect of core functional business drivers and enablers and, appropriate, includes some recommendations for deeper and intensive diagnostics of each functional business drivers.

Part 3: Extrapolates the main recommendations gleaned from the diagnostics of IRC and PNGCS so that both can incorporate them in their work plans and commence remedial actions.\(^{14}\)

The Review believes the design of the reform measures, are practical, doable and not prescriptive.

Where appropriate, the Review highlights areas which require further in-depth diagnostics and recommends best practice diagnostic tools and templates.

\(^{14}\) Full copies of the independent diagnostic reports on IRC and PNGCS and comments from both Revenue Administration agencies can be accessed from the official Tax Review Committee web site, www.taxreview.org.pg
Part: 1 – Policy, Governance, Strategy and High Impact Goals

Policy Framework

Recommendation (1): A clear, sound and good quality suite of policy framework consisting of economic, fiscal, tax and trade and investment policy be formulated as the overarching guidance, purpose and mission for PNG’s revenue administration.\(^\text{15}\)

Such a policy framework will guide the government to help manage PNG’s social, economic or political challenges. It can also better define the roles and responsibilities of various agents and the allocation and distribution of resources to address the challenges and mitigate risks.

Good quality policy and especially one that is clear, and is understood by administrators and citizens promotes good governance. Good and transparent governance is underpinned by sound policies and vice versa\(^\text{16}\).

Governance Model

Recommendation (2): The IRC and PNGCS adopt a new, robust and modern governance model for revenue administration.

This is critical to:

- providing the overarching strategic guidance to implement tax reform measures;
- ensuring proper and effective implementation of reform measures, in so doing, achieve administrative and operational efficiencies; and
- help maintain competencies in leadership and management of revenue administration functions in the long run for the country.

Governance is the institutional or structural framework that determines the responsibility, authority and accountability of government institutions. In the context of

\(^{15}\) Refer to suggested templates of relevant suite of policy framework in Volume.1 of the Tax Review Reform, Key Findings and Reform Directions. Especially, the recommended economic, fiscal and tax policy templates.

\(^{16}\) Numerous taxpayers and businesses have expressed concern about the uncertainty in tax policy and the negative impact it has on personal tax affairs and on businesses. Some complained about the risks of retrospective tax laws and announced tax policy decisions that were not yet enacted by the National Parliament.
revenue administration these parameters dictate the relative autonomy of a given government organization in terms of control and applicability of public service policies.\(^{17}\)

**Central Revenue Administration Board**

**Recommendation (3): Establish a Central Revenue Administration Board (RAB) with appropriate design features.**

A RAB would provide governance, management oversight and strategic leadership and direction for the IRC and PNGCS.

The design and scope of the RAB will depend on policy choices and the design features which take into account the peculiar operating circumstances and conditions of PNG. Key features of the RAB should include:

- Enacting of a new Revenue Administration Act to establish the RAB. This will also require consequential amendments to the Internal Revenue Commission Act 2014 and Papua New Guinea Customs Service Act and other related Taxing Acts.
- The Ministry for Treasury will be responsible for the RAB and the RAB will report to the Treasurer.
- Appointment of members of the RAB will be done by the National Executive Council (NEC) at the recommendation of the Treasurer.
- The RAB must comprise highly ethical, qualified and competent members from the public and private sectors and civil society.
- The RAB will be responsible for strategy, policy and general oversight of IRC and PNGCS, but excluded by law from involvement in operational issues.
- The Department of Treasury will still be responsible for fiscal and tax policy. The RAB will support and provide advice on the practical and administrative dimension of tax policy.
- The Commissioner General of the IRC and the Chief Commissioner of PNGCS will be ex-officio members of the RAB.\(^{18}\)

\(^{17}\) The term “governance” is used more broadly. The World Bank uses six dimensions to measure governance: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption.

\(^{18}\) The Commissioner General of Internal Revenue and the Chief Commissioner of Customs will have dual reporting relationship – to the Minister for Treasury for the administration and enforcement of the revenue laws, and to the RAB for the strategic planning and execution, management, operations and performance of the Internal Revenue Commission and PNG Customs Services respectively.
The RAB must be supported and funded as a priority under the 2016 Budget to mobilize and assist to implement this reform. It will also assist with short term strategies to maximise revenue collection to assist mitigate the present fiscal distress.

The RAB will have a permanent Secretariat.

**Transitional and Implementation Team**

**Recommendation (4):** Treasury, in close conjunction with IRC and PNGCS, establish an interim transitional and implementation team to oversee establishment of the RAB.

This transitional team should develop:

- An Implementation Plan.
- A Project Management Plan.
- A Change Management strategy.
- A Communication and key stakeholder engagement strategy.

**Transformation and Modernisation**

**Recommendation (5):** The RAB to assist the IRC and PNGCS to put in place a transformation and modernisation strategy.

This can also entail preliminary assessment of the maturity level of respective strategies. A strategy maturity level guideline is cited in Appendix A. An analysis through established modelling methods be done to analyse the potential to mobilize revenues, tax burden, tax gap, and measurement of core activities. This is illustrated below.

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19 IRC and PNGCS have Strategic Plans for 2014 – 2017.
20 There are three Strategic Plan Maturity levels which provide a litmus test for the strategic plan maturity level of IRC and PNGCS. See Annexure.1.
## Strategic Analysis of Tax System

<table>
<thead>
<tr>
<th>Level of Analysis</th>
<th>Core Measurement</th>
<th>Strategic Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whole economy (Potential to raise revenue)</td>
<td>Revenue Effort versus Capacity</td>
<td>Potentiality to mobilize revenue (given economic and institutional arrangements)</td>
</tr>
<tr>
<td>Whole economy (Tax Policy and Administration)</td>
<td>Tax ratio (Total Tax Rates as % of GDP)</td>
<td>Effectiveness of tax system (Design of bases, rate structure, and administration effort)</td>
</tr>
<tr>
<td>Tax Administration (Outcome)</td>
<td>Compliance Measurement (Tax Gap)</td>
<td>Taxpayer compliance behaviour</td>
</tr>
<tr>
<td>Tax Administration (Output)</td>
<td>Activities indicators (outputs and inputs)</td>
<td>Measure of efficiency of core activities</td>
</tr>
<tr>
<td>Particular sectors of economic agents</td>
<td>Tax expenditure analysis</td>
<td>Quantification of benefits of tax</td>
</tr>
</tbody>
</table>

In addition to the above, the Review draws attention to the following Key Measurement Areas from Revenue Administration – Fit (RA-FIT) tool kit developed by IMF and other multilateral agencies.

### Key Measurement Areas from Revenue Administration – Fit (RA-FIT)

1. Institutional Arrangements (Organizational, Autonomy, Outsourcing, IT, Staffing, Office network etc.
2. Tax to GDP
3. Revenue Composition
4. Cost of Collection Metrics
5. Tax – Taxpayer Registers (Size and Growth rates)
8. Tax – Arrears (Percentage of Collections, Stock and Flow, Taxpayers in arrears as a percentage of Total Collections)
9. Tax – Taxpayer Audit (Mix, Completed Yield, As Percentage of Total Collections)
10. Tax – Objections and Appeals (Stock and flow)
11. Customs – Traffic by Channel
12. Customs – Percentage of Goods Physically inspected
13. Customs – Release Times – Sea, Air and Land
14. Customs – Post Clearance Audit (No Yield)
15. Customs – Percentage of Revenue Foregone Due to Special Relief

**Compliance Gap and Taxpayer Service**

**Recommendation (6): Adopt a two prong strategy in closing the compliance gap and improving taxpayer service.**

Undertake immediate actions to improve taxpayer service and close the growing compliance gap, rein in the dangerous levels of rort and debauchery, and bring more delinquent taxpayers into the system to optimize revenue collection.

Short-term strategies include:

- Provide funding and resource to IRC and PNGCS to undertake a joint street-by-street survey to collect data on all businesses in Port Moresby and Lae then roll out to other major towns. Data collected be matched with data base of registered taxpayers presently held by both revenue agencies.

- Strengthen the Taxpayer Identification Number (TIN) system including by improving collaboration with Investment Promotion Authority (IPA) and commencing the task of better match taxpayer data with IPA data of registered corporations and businesses and partnerships.

- Streamline and improve enforcement and prosecution capacity, well resource the agencies to more effectively enforce compliance and prosecute delinquent taxpayers.

- Concurrently announce an amnesty from all penalties, provided taxpayers lodge all their outstanding tax returns, and pay up all outstanding taxes

Medium to long -term strategies includes:

- Facilitating compliance requires improving both the efficiency and quality of taxpayer services. This requires a strategy aimed at increasing *levels of voluntary compliance* that is anchored on two main pillars. These are:
  a) facilitating taxpayers complying with their obligations; and
  b) enforcing and punishing non-compliance.
The importance of the link between better taxpayer services and tax compliance has always been difficult to prove, but it is widely accepted and is a regular feature of tax reforms.

Compliance Risk Management model\(^{21}\) depicted above provides an example of how to foster the linkage between rendering of quality service and enforcement. In some cases compliance strategies will focus on prevention, i.e. on assisting taxpayers in complying with tax laws. In other cases, and depending on attitudes to compliance, the tax administration will prioritize ‘soft’ forms of control aimed at deterring non-compliance and thereby promoting voluntary compliance. Only in the most severe cases, deployment of the complete set of enforcement powers available to tax administration will be the most appropriate choice. As a result, compliance strategies are implemented in the most cost-efficient way.

Ultimately, IRC and PNGCS must transform the institutional framework, organizational culture, mind-set of its people, and organizational restructure to move from one based on the belief that All Taxpayers Are Generally Delinquent to A Service Orientated Culture Based on the Belief That All Taxpayers Are Generally Compliant.

This will require a paradigm shift in dealing with taxpayers as follows.

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\(^{21}\) The Review has replicated this from the model developed by: Compliance Risk Management: Managing and Implementing Tax Compliance. Centre for tax Policy and Administration. OECD, 2004.
Tax gap analysis has proven to be a useful tool to assess Revenue Administration’s performance over time. By assessing the difference between potential amount of taxes expected to be collected at full compliance level, and actual collections, tax gap estimations provide a strong indicator about the overall effectiveness of revenue administrations to increase tax compliance.

Effectiveness of revenue administrations and reform projects has been measured through changes in Tax GDP ratio. According to this indicator, successful reforms on tax administrations are expected to lead in an increasing tax-to-GDP ratio over time.

**Debt Management**

**Recommendation (7): The IRC and PNGCS must immediately institute effective and more robust debt management strategies, framework and action plans.**

**Immediate Actions**

The Review has ascertained that IRC and PNGCS have K2.7 billion outstanding in arrears (IRC has K1.6 billion and PNG Customs K1.2 billion) as at October, 2015. The debts also include penalties. Diagnostics of both revenue collection agencies show that both do not have robust debt management strategy.

<table>
<thead>
<tr>
<th>TAXPAYER PROFILE</th>
<th>ACTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayers who are generally compliant</td>
<td>Assists and Serve.</td>
</tr>
<tr>
<td>Taxpayers who are unaware of their tax obligations</td>
<td>Educate and prevent.</td>
</tr>
<tr>
<td>Taxpayers who are negligent</td>
<td>Detect and reform through audits, data matching, and risk profiling and voluntary compliance.</td>
</tr>
<tr>
<td>Taxpayers who are errant and delinquent</td>
<td>Penalize, enforcement, investigations, and where necessary prosecute.</td>
</tr>
</tbody>
</table>
It is recommended that both agencies immediately develop a Tax Arrears Management Strategy. This strategy must establish:

- priorities for arrears collection and set performance targets;
- plans should distinguish between different categories of arrears, taking into account the size, nature, and age of the debts and give priority to large and more recent arrears since the latter are tax debts more likely to be collected;
- specialisation in arrears collection needs to be developed, including establishment of a dedicated debt collection function;
- Information Technology (IT) applications such as SIGTAS in the case of IRC and ASYCUDA ++ (i.e. soon to be superseded by ASYCUDA World) in the case of PNGCS should be developed to support debtor profiling and determine optimal collection strategies based on risk assessment; and
- immediately introduce a Tax Liens Act.

**Medium to long-term**

There are several ratios to gauge the effectiveness of tax administration to recover tax debts. The most commonly used is the ratio of aggregate tax arrears to annual net revenue collections of all taxes (cumulative and non-cumulative).

It is further recommended that the IRC and PNGCS conduct upstream diagnostic of tax arrears management. These should examine, amongst other key things, the following;

- Description of the legal basis for tax arrears recovery in the tax procedure laws and or rules and complementary regulations paying special attention to the following issues: access to taxpayer information, seizure of bank accounts, issue of reminders or warning messages when taxpayers fail to meet their tax obligations, sales of seized assets, offset a credit in one tax against a tax debt in another, garnishee order on taxpayers bank account, departure prohibition order against carriers, payment of tax arrears directly to the tax administration by third parties having debts against the taxpayer, procedure to write-off uncollectable debts; and collection techniques entitled by law.
- Budget assigned to the debt collection function as a percentage of total budget.
• Are tax arrears regularly classified by age and by size to identify collectable and uncollectable debts and to define the extent and the nature of actions?

• Are precise and transparent objectives assigned to a debt collection unit and is their performance regularly evaluated? Is there a dedicated unit dealing with tax arrears below a fixed threshold?

• Briefly describe (i) penalties and interest regime applicable to tax arrears; (ii) instalment plans the tax administration is allowed to accord with taxpayers; (iii) amnesties; and (iv) IT systems and procedures in place to manage revenue arrears.

**Goods and Services Tax (GST) Administration**

**Recommendation (8): Overhaul and streamline GST administration to make the system more effective and efficient.**

The Review has ascertained from anecdotal evidence, stakeholder feedback and intelligence that there is substantial and materially huge compliance gap in GST collection of as high as 50 per cent and, amongst all tax, is by far the most significant area of non-compliance. This has resulted in significant loss in revenue which is conservatively estimated to be well over a K1 billion kina.

The problem is exacerbated by multiple factors including lack of service philosophy and culture, weak enforcement, lack of debt management strategy, dysfunctional audit and inspection, and pervasive and systematic corruption.22

There is also massive fraud of GST refunds totalling millions of kina.

Administrative diagnostics also revealed that IRC and PNGCS had major challenges coping with the sheer increase in volume of imports and GST taxpayers during the LNG construction phase. This was complicated by the fact that supplies to resource companies are zero rated.

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22 Note: It should be noted that both IRC and PNGCS have some form of “Zero Tolerance” and “Whistle Blower” policies, but there need to be solid commitment and investment in inculcating values of honesty and ethical behavior together with punishment and criminal prosecution – to help protect the integrity of revenue generators and the integrity of democracy and good governance.
This has inundated and overwhelmed GST administration and resulted in arbitrary application of the law, and was and still continues to be the citadel and source for large scale corruption and rorting of GST refund.

The Review recommends:

- an immediate independent forensic audit of all GST refunds processed for the past seven (7) years or more. This will provide a baseline position and help ascertain the magnitude, scope, extent and depth of revenue loss through the GST refund system; and
- immediate risk profiling of all GST taxpayers, and high risk GST payers should be placed in temporary abeyance pending rigorous audit.

### GST refund by industry in 2014

Amount of GST refunded during the period 2004 to 2013 is as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>GST refunds paid ('000 kina)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>157,141</td>
</tr>
<tr>
<td>2005</td>
<td>254,166</td>
</tr>
<tr>
<td>2006</td>
<td>243,144</td>
</tr>
<tr>
<td>2007</td>
<td>257,427</td>
</tr>
<tr>
<td>2008</td>
<td>315,133</td>
</tr>
</tbody>
</table>

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23 This is in accord with statutory time limitations according to prevailing laws of PNG.
The GST refund arrangement where Import GST is collected by PNGCS and paid into the GST refund account administered by IRC has to be streamlined and rationalised to make the system more efficient and effective and also avoid duplication of the Import GST reporting by PNGCS and IRC.

### Leadership and Management Capability

**Recommendation (9): The IRC and PNGCS to strengthen and build the leadership and management capacity of its senior and middle level managers.**

The Review notes that both the IRC and PNGCS acknowledged that their middle management have been in the past promoted to leadership roles based on their specialist technical skills and competencies. There is need for investing in leadership and managerial capacity development. It is critical for a manager in a modern Revenue Administration to possess qualification, skills and experience in multi-disciplines in order to effectively lead their respective revenue collection agencies and their staff.

Leading and managing Revenue Administration is a very challenging task, and let alone the complexity of managing multifaceted and multi-year transformation and modernisation programs.

This requires inherent fundamental changes in the behaviour and mind set of managers and staff, their sense of mission and purpose of Revenue Administration, their desire to make optimal use of scarce resource to meet organizational objectives, their willingness to pursue powerful tax evaders and withstand the resulting political pressure, their commitment to integrity and taxpayer services.

With the granting of full autonomy to the IRC and PNGCS, it is recommended that both use this opportunity to:

- Restructure and vastly improve and enhance autonomy of Revenue Administration in financial, personnel and all operational functions.
- Vastly improve terms and conditions and remuneration of staff by delinking the standard public service terms and conditions and benchmarking it to the market.
This will improve their ability to attract, retain and sustain good staff, mitigate and prevent corruption, and manage mobility and high turnover of staff.

- Develop “Corruption Risk Map” to guide procedural changes to reduce opportunities for corruption.
- Reduce discretion of revenue officials and simplify procedures.
- A further recommendation is that IRC and PNGCS can use the restructuring as an opportunity to get rid of corrupt, redundant and non-performing personnel.
- As part of this restructure and to enhance placement of highly competent officials with strong integrity and work ethos IRC and PNGCS must institute a rigorous and robust process of recruitment involving psychometric test, test of job-specific skills, interviews and reviews of personnel records and rigorous reference checks.

**Fiscal and Tax Policy Capability**

| Recommendation (10): The IRC, PNGCS and Treasury collaborate to develop specific strategy to grow and develop their capability in tax and revenue administration policies. |

The Review has identified the need to develop capacity of officers within Treasury, the IRC and PNGCS in tax policy analysis, formulation and the administrative aspects. This is to ensure that officers are able to undertake complex tax policy research and analysis, thereby provide the government with sound tax policy advice.

The review therefore recommends hands-on training in applying the latest fiscal analysis and revenue forecasting techniques as well as a good grounding in the principles of tax policy design by leading international experts in the following;

- Principals of taxation
- Tax administration and tax compliance
- Tax reform and implementation challenges
- Fiscal policy and fiscal architecture
- Overview and trends in: consumption taxes, excises, trade taxes, property taxes, income taxes, and taxes on wealth and assets
- Natural resource taxation
- Tax incidence analysis
- Learning about taxes through experiments
- Empirical techniques and models for forecasting revenue
- Regression analysis
- Micro-simulation models: estimating revenue from GST
Part. 2 – Functional and Business Drivers and Enablers of Revenue Administration

Diagnostic Reviews of Core Operations

Recommendation (11): The IRC and PNGCS undertake comprehensive diagnostic reviews of their core operations (i.e. business drivers and enablers) to modernise their respective operational efficiency and effectiveness.

In a comparative study of international experience, the World Bank\textsuperscript{24} identified the following key features of a modernised Revenue Administration:

- A modernised organisational structure that is functions based, and not territorial.
- A performance management system.
- Segmentation by type of revenue payers.
- High level of specialisation for each of the key functions.
- Fully automated business process.
- A single national identification number.
- Risk-based compliance and enforcement program.
- A one-stop service ‘window’ (mostly via the use of call centres) for clients.
- An Integrated IT system.
- The capacity for speedy coordination among government agencies.
- Skilled and professional staff acting with fairness, honesty and transparency.

All these are interconnected and have flow through impact on each other and overall efficiency and effectiveness.

Organisational Structure

The Review recommends that adoption of sound Organisational Strategic Plans by IRC and PNGCS should set the context, tone, tempo, and strategic frame of reference and guidance for the review and design of appropriate organisational structure. This will enable effective implementation of the strategies to transform and modernise revenue administration.

\textsuperscript{24} Integration of Revenue Administration: A Comparative Study of International Experience, a World Bank Study, 2010.
Revenue Administrations are typically organized by *type of taxes, by functions, or by segments of taxpayers*. The most common organizational structure is the ‘hybrid’ structure that shares to a higher or less extent some of the characteristics of the three main models. A brief description of typical organization of Revenue Administration is summarized below.

- **Type of tax model** - In this model, each department or unit administers different types of taxes and has the responsibility of all functions necessary to administer those taxes.
  - Functional model - Separate units/departments administer essential functions or core processes of a tax administration, which includes mainly collection, tax audit, revenue arrears management, and tax disputes.
  - Type of taxpayer model - In this client-based structure, separate units/departments focus on different segments of taxpayers that are established based on different criteria such as turnover, taxes paid or economic sector. Operations of these units and services provided to taxpayers are tailored to the characteristics and needs of these segments.
  - Process-oriented model - This is an innovative experienced by the tax administration of the Netherlands in the early 2000s and there is a growing number of countries using this model. Under this approach, dedicated process-oriented centres have been established to deal with massive processes that apply to all taxpayers e.g. tax return processing, primary checks to all tax returns, and basic information services. Other processes target different taxpayer segments and are tailored to their specific characteristics. The latter include taxpayer assistance and information, control of compliance and revenue arrears management.

- **Taxpayer Segmentation** - In the context of Revenue Administration reforms in PNG and considering the inherent operating conditions, the Review considers it

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25 In order to learn more about organizational structure of tax administration, see Organizational Options for Tax Administration, Charles L. Verhorn and John Brondolo, IMF, 1998. See also OECD Comparative Information Series (2008).
27 Fiji Revenue & Customs Authority has piloted this model with a “one stop” service for selected large taxpayers and assigned senior officers to handle all tax types including a gold award program for highly compliant taxpayers.
relevant to include its observations and recommendations in respect of ‘taxpayer segmentation’ and in particular the popular use of ‘large taxpayer’ segments.

Over the past decades, developments in Revenue Administration reforms have accepted that taxpayers are not homogenous and many countries have moved away from the traditional ‘one size fits all’ model and developed organizational structures based on taxpayer segments. This has started in the early 1990s and has now spread widely to Revenue Administration in developed and developing countries.

The move to taxpayer segmentation becoming a critical and strategic feature of modern Revenue Administration is driven by the compelling imperative to provide services according to taxpayer needs (better focus and mobilization of resources to serve the clients’ needs).

It also has a close correlation to developing compliance strategies that take into account ‘risk management’ concepts and strategic allocation and mobilization of enforcement and audit resources to areas of greatest risks.

- Large Taxpayer Segments - Increasingly, there is more focus on large taxpayer segments resulting in proliferation of Large Taxpayer Units (LTU) in many countries. The Review has developed the model below which emulates the 80/20 rule (Pareto Principle), but more importantly underscores the importance of LTUs.

Increasingly, there is more focus on large taxpayer segments resulting in proliferation of LTU in many countries. The Review has developed the model below which emulates the 80/20 rule (Pareto Principle), but more importantly underscores the importance of LTUs.
The segmentation model also illustrates some conceptual depiction of taxpayer segments and the premise for organizing, mobilization and deployment of resources.

LTU has evolved as a significant feature of modern Revenue Administration because of:

- their importance from a revenue perspective;
- their engagement in large-scale, complex, specialized, and often international operations;
- associated high revenue compliance risks; and
- its role as a significant source of third-party information (and withholding).

The segmentation model is developed by the PNG Tax Review Committee.

OECD (2009) found that 33 out of the 43 countries surveyed had established Large Taxpayer Units (LTU). Additionally, the International Tax Dialogue (2010) study on Revenue Administration in Sub-Saharan Africa found that all revenue bodies expect Botswana had established a LTU. (International Tax Dialogue, 2010, "Revenue Administration in Sub-Saharan Africa").

On average, large taxpayers can secure 60-80 percent of domestic taxes (more in island economies).

The importance of tightening control over this segment derives not only from the amount of revenue that it collects –directly and indirectly through withholding arrangements, but also from the significant amount of third-party information that receives and transmit to the tax administration. This information provides the foundation of the compliance risk management system that all tax audit strategy should be based on.
Many countries that are going through major tax administration reform often start with a pilot of key processes and organizational changes in LTU’s in order to later expand these improvements to other areas and segments of revenue administration.

There is a set of minimum requirements\(^{32}\) to be fulfilled so LTU could work properly, and expected benefits materialized. These are:

- A sound legal framework.
- The criteria applied for identifying large taxpayers vary from country to country, however it is important for tax administration to set clear and simple criteria.
- Standard and transparent procedures.
- The administration of all large taxpayers by the LTU.
- The administration of all national level domestic taxes by the LTU.
- LTU performance of all core tax administration functions.
- Clear reporting lines between the LTU and the Headquarter Office.
- Appropriate job grading and remuneration of LTU staff.
- Effective LTU staff training.
- Identification and regular compilation of key performance indicators.
- Stronger knowledge, skills base and adequate IT is required to handle the LTU segment,

The characteristics of this segment covers companies and taxpayers with very complex tax issues which in many cases involve international taxation call for a significant degree of specialisation of staff and business processes.

In this regard, industry or sectoral specialisation should be strongly promoted with a view to improving audit effectiveness\(^{33}\).

In particular, it is recommended to establish dedicated units within the LTUs to deal with international taxation issues, natural resource taxation, or the financial sector.

Special difficulties arise when there is a group of companies consisting of a parent company and a series of affiliates or subsidiaries normally operating in different countries.

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\(^{33}\) An Integrated Assessment for Tax Administration, Public Sector and Governance Group.
Revenue Administration

Control of consolidated groups is of the essence when it comes to managing this segment in order to avoid that fragmentation of companies result in many companies being subject to a lesser degree of control\textsuperscript{34}.

The Review notes that creating Medium Taxpayer Unit (MTU) to deal with medium-sized enterprises is becoming a trend in modern tax administration, but strongly recommends that this should be a medium term undertaking.

The Review further notes that the current reform recommends a more simplified tax regime for SMEs. The Review recommends that cost effective administrative and organizational arrangements should be piloted for the SMEs\textsuperscript{35} segment.

Revenue Administration Funding

\textbf{Recommendation (12): Adequate funding should be allocated to IRC and PNGCS to undertake their massive transformation and modernisation programs and implement the comprehensive tax reform.}

Comparative benchmarking by the Review established that majority of Revenue Administration agencies are funded through parliamentary appropriations while three (3) countries funded by a fixed percentage of collections\textsuperscript{36}. These practices do not necessarily motivate stronger performance which attests to the significance of a more holistic approach. Only a few countries provide performance-related bonuses to their revenue bodies.\textsuperscript{37}

Revenue Administrators often use the cost-of-collection ratio in assessing efficiency and effectiveness in collection of revenue. This ratio has some limitations because there are other factors that also have a strong influence on the tax system. For example the structure of the economy (i.e. in PNGs case the economy is heavily reliant on the extractive sector), or changes in the economic context.

Other ratios are also used such as;

- Ratio of Revenue Administration expenditure against tax revenue collected.
- Compliance cost and administrative cost as a percentage of revenue collected.

\textsuperscript{34} Ibid.
\textsuperscript{35} Aiming at delivering high quality services and compliance enforcement to non-large taxpayers, medium taxpayer offices are emerging in Indonesia and Francophone Africa. Some innovative small taxpayer approaches are also being applied in Tanzania and small taxpayer offices in Algeria and some Francophone African countries. IMF forthcoming paper on Revenue Mobilization in Developing Countries.
\textsuperscript{36} For instance, in Ghana revenue administration receives 3 percent of collections.
\textsuperscript{37} In Rwanda there is a direct retention of a maximum of 3.5% of revenue collected, and a bonus of 5% of surplus collection. In Malawi, there is a direct retention of 3% of revenue collected, and retention of a bonus of 5% of collection surplus, subject to 3.5 limits on total cost of collection. ITD, 2010.
The Review further recommends the use of the above ratios supplemented by the following important questions to determine the adequacy, appropriateness, quantum and mode of budgetary funding for both the IRC and PNGCS.

- What is the current annual budget of the tax administration in absolute terms and as a percentage of tax collection? Is the given budget sufficient to ensure the efficient implementation of its policies and achievement of its objectives?
- Is the investment expenditure sufficient to ensure that the revenue administration has a level of perception of employee satisfaction, measured by staff survey and their trend over time; and other infrastructure necessary to implement its strategic plan? Has there been some abnormal expenditure on for example ICT in some of the years?
- Is the tax administration permitted to retain any part of its collection i.e. a per cent of collection exceeding it revenue target for its own use?
- Is the cost-of collection ratio differentiating the operating costs from investment costs?
- Is the ratio of administrative expenditure to GDP differentiating operational cost from investment expenditure?

**Human Resource**

**Recommendation (13): Both IRC and PNGCS modernise their respective HR functions with tools needed to improve HR management, enhancing staff development, overhaul out-dated policies and procedures, and provide their respective administration with HR Management and Information systems.**

The Review recommends a complete HR audit and updating of HR manuals describing the job positions and an inventory of required skills and salary levels for each position.

Both IRC and PNGCS as part of their broad strategic plan develop customized HR strategy to manage HR in a coordinated and structured way. This strategy will aim at hiring and retaining skilled staff. The Review recommends use of the following HR ratios:

- total number of full-time employees of revenue administration compared with country population; and
- total number of full-time employees of revenue administration compared with labour force.
In order to support HR reform, the following are considered necessary:

- A staff development program.
- Outsourcing some functions to the private sector.
- A staff performance management system.
- A staff welfare and enumeration management system.

Taxpayer Registration

**Recommendation (14): IRC and PNGCS to modernise their taxpayer registration systems and management.**

Taxpayer registration is the foundation of revenue administration. The Review notes that IRC has commenced introduction of a unique Taxpayer Identification Number (TIN) and recommends that IRC be given support to ensure that this initiative is professionally and diligently accomplished. The Review further recommends that IRC considers the options of interfacing its TIN with the National Identification system in the long-term.

The Review further recommends that PNGCS continue to use the IRC issued TIN number for registration of importers and exporters.

Tax Filing

**Recommendation (15): Modernisation of tax filing systems and management.**

Filing of tax returns in PNG is done manually. The Review recommends, as part the holistic process of transformation and modernization that consideration should be given to electronic filing (E-filing). Electronic filing reduces the costs, for both

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38 Comprehensive systems of taxpayer registration and numbering are a critical feature of the tax administration arrangements in most countries, supporting tax administration processes and underpinning all return filing, collection and assessment activities (Organization for Economic Cooperation and Development, 2009, “Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2008)” prepared by the Forum on Tax Administration)

39 Indeed, most reforming countries have adopted a unique TIN (27 of 43 revenue bodies of surveyed countries in the OECD Comparative Information Series (2008) utilize a unique TIN) while in other countries the number used is not unique to the revenue body For instance in Chile, Denmark, Korea, and Norway a citizen identification number is also used for PIT purposes. In Canada and the US an individual’s social security number is used for personal tax purposes. In Finland and Sweden an individual’s social security number is used for personal tax and individual VAT, a business registration number is used for corporate tax and VAT.

40 The benefits of electronic filing and payment systems, Paul o Dos Santos, IMF, 2007
the taxpayers and the administration, and significantly reduces the risk of data entry errors.

Other significant benefit of electronic filing is the improvement in the quality of information available to the tax administration and resources could be deployed elsewhere.

**Taxpayer Assessment**

**Recommendation (16): The IRC put in place a self-assessment regime.**

The process of determining tax liabilities may be done administratively or by the taxpayer through self-assessment.

The IRC is still using administrative assessment which entails that officials from the tax administration examine tax returns and manually assess the returns prior to issuing the assessment notice. As part of the modernization process the Review recommends that there should be a gradual transition to automate assessments through self-assessment.

The Review notes from independent diagnostic review that the IRC has been applying a default self-assessment to some taxpayers, but notwithstanding that it has back log of unassessed tax returns. IRC has indicated that it is looking at partial self-assessment for large corporate taxpayers.

Considering the patent insufficient staff levels, let alone those with the requisite technical skills and experience, the Review recommends a dual approach to recruit competent personnel and expand the base and use of self-assessment.

Comparative evaluation by the Review shows an upward trend where increasing number of Revenue Administration are moving to self-assessment because of the following;

- More comprehensive and targeted approach to providing help and assistance to taxpayers;
- Systematic verification of reported tax liabilities through risk-based desk and field audits; and
- Computerized matching of income reports.
For the self-assessment system to function effectively, the Review recommends taking into account the following preconditions developed by Ebril (2001) before introduction of self-assessments:

- A simple, clear, stable law.
- A good taxpayer service.
- Simple procedure, e.g. simplified tax return forms.
- Effective enforcement.
- Reasonable audit.
- Strict penalties.
- A good administrative review system.

Revenue Collection Systems

Recommendation (17): The IRC and PNGCS modernise their revenue collection, accounting and management systems.

The Review recommends modernisation, and especially automation, of the revenue collection systems and procedures of tax administration, particularly the flow of tax and accounting information among bank accounts, revenue administration and Treasury. Both the IRC and PNGCS have already introduced electronic modes of payments under the KATs system facilitated by the Bank of PNG.

Enforcement and Audit

Recommendation (18): The IRC and PNGCS review, upgrade, strengthen, and modernize their enforcement and audit functions.

The Review noted that there are no or limited audits of large corporate taxpayers, especially those in the extractive sector, because IRC does not have the capacity. To begin with, the Review recommends IRC take immediate steps to:

- Seek assistance from bilateral partners for specialised professional auditors to develop an audit strategy to immediately audit large corporate taxpayers and train IRC staff.

- This can be further supplemented by the OECD and UNDP initiative of the Tax Inspectors Without Borders (TIWB) which enables the transfer of tax audit

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41 L. Ebrill, Micheal Keen, Jean-Paul Bodin, and Victoria Summers, “The Modern VAT”. (IMF, 2001)
knowledge and skills to tax administrations in developing countries through a real time, ‘learning by doing’ approach.

For the medium to long term, the Review recommends that both IRC and PNGCS build their enforcement capacity and modernise their audit functions to improve compliance.

The Review recommends the use of information technology in assessing, profiling and detecting the risk of non-compliance. This includes the development of systems for risks analysis and selection of cases for audit and investigation. Adopting a risk analysis based approach to curbing tax evasion and smuggling is advantageous and as it helps enforcement activities of gathering additional revenue and penalizing evasion.

Audits are critical as they assist increase compliance. They are used to: (i) detect and redress individual cases of non-compliance; (ii) promote voluntary compliance by increasing the probability of detection and penalties for non-compliant taxpayers; and (iii) gather information on both the health of tax system and the evasion techniques used by taxpayers.

Additionally, audits provide a good opportunity for the tax administration to educate taxpayers on their legal obligations or book keeping requirements, thereby improving future compliance.

The Review recommends strengthening of audit capacity. Improvement in audit planning, gathering and collection of information, methodology and techniques of conducting the audit and training of new auditors are priority areas.

Tax Appeals and Dispute Resolution System

Recommendation (19): The IRC and PNGCS review and modernize their appeals and dispute resolution system and management.

The diagnostic review verified that the dispute resolution systems under the ITA has not been reviewed, refreshed and updated since its inception in 1959. The Review specifies best practice conditions for a credible appeal process.

The Review also notes that disputes by aggrieved taxpayers starts with an administrative dispute settlement mechanism of an objection which is handled by senior and more experienced officers. If the objection is disallowed than the next

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recourse for the taxpayer is to appeal to a quasi-judicial Tax Review Tribunal\textsuperscript{44}. The Taxpayer has further recourse to the courts if his appeal is dismissed.

The Review recommends that the following consideration be taken into account:

- Tax disputes processes should encompass both the administrative and the judicial process.
- The IRC and PNGCS should establish independent tax and customs review tribunals.
- There must be options for binding advanced rulings and arbitration.

**Information Technology**

**Recommendation (20): The IRC and PNGCS to continue investing in the development and implementation of a comprehensive ICT Governance framework.**

The Review notes that IRC has, since early 2014, undertaken a massive IT modernization program through SIGTAS. SIGTAS is the acronym for Standard Integrated Government Tax System. According to IRC SIGTAS represents a major investment and is anticipated to automate most of IRC’s existing work by processing how it processes taxpayer information.

The diagnostic review confirms that introduction of SIGTAS hardware and software profoundly alter the operating landscape for administration and operational matters.

PNGCS, on the one hand, presently automates its core operations and functions on the ICT platform of ASYCUDA ++. It is currently in the process of upgrading to ASYSCUDA World.

The diagnostic review confirms that 80 per cent of all declared Customs ports are connected to the Customs ICT network and ASYCUDA. The business process of trade facilitation, revenue and data collection is 100 per cent automated with 80 per cent of cargoes processed without Customs intervention.

The Review commends IRC and PNGCS for their promising inroad and embracing of modern ICT platform as a core business enabler.

In noting this, the Review recommends that both should work towards leveraging optimal value from ICT, including SIGTAS and ASYCUDA systems.

\textsuperscript{44} (Note: IRC has a quasi-judicial system of Tax Review Tribunal presided by a one man tribunal chairman who was appointed in late 2014. Prior to that the post was left vacant for an extended period).
Part. 3 – Independent Diagnostic Recommendation for IRC and PNGCS

Recommendation (21): The Review recommends that IRC and PNGCS to incorporate the recommendations by the independent diagnostic review into their strategic and operational plans. These recommendations can be found in Appendix B.
CHAPTER 3: PERSONAL INCOME TAXATION

Introduction

For developing countries, the taxation of personal income is not the most important means of raising revenue. In this context, PNG is an oddity in that personal income taxation contributed around 8 per cent of nominal GDP in 2014, which is higher than most other countries in the region. As discussed in Issues Paper No. 8: Personal and Retirement Income Taxation, this reliance on personal income taxation is reflected in the overwhelming feedback received by the Review that the current level of taxation imposed on personal incomes is too high.

Issues Paper No. 8 made a number of proposals for the reform of personal and retirement income taxation and should be referred to a fuller discussion of the issues and proposals for reform. The proposals in the Issues Paper were structured as a series of consultation questions. These proposals were directed at addressing concerns that personal income taxation had not recognised changes in income since marginal tax rates were adjusted in 2008 and the tax free threshold increased to K10,000 in 2012.

In response to Issues Paper No 8 submissions were received from Kalakune Laeka, Consultative Implementation and Monitoring Council, Bank of South Pacific, Sales and Administration staff of Ela Motors, Oil Search Limited and PricewaterhouseCoopers.

When considering tax reform options, policy makers have to consider the interaction between the tax system and economic growth. Taxes generally influence economic activity and have efficiency and distributional impacts as well. For example, personal income taxes can discourage workforce participation and savings, both of which are important for economic growth. Work by the OECD (2010) concluded that while personal income tax is not as harmful to economic growth as corporate income tax, there is scope for making personal income taxes more growth friendly, predominately by shifting the tax burden from income to consumption.

The role of income tax is to provide governments with revenue to pay for public goods such as healthcare, education, infrastructure and law and order. Direct taxes on income, such as personal income, are often preferred by governments because the tax paid is directly related to the income earned by the taxpayer. It allows governments to adjust tax so that fairness and other policy objectives are met. Thus personal income tax will usually require those earning more income to pay more tax because they have a greater capacity to pay. Similarly, the personal tax system should also ensure that taxpayers with a similar capacity to pay share the same tax burden.
In recommending reforms to the personal tax system the Review has considered the submissions and feedback it has received on its earlier Issues Papers. The Review has argued that the focus of reform should be on delivering tax relief to lower and middle income earners as well as simplifying the administration of the tax system for both taxpayers and the tax administration regime itself.

### Tax Free Threshold

**Recommendation (22):** The Review recommends that the current tax free threshold of K10,000 be increased to K20,000 as budget conditions allow. As an interim step the threshold should be raised to K15,000. The cost to revenue of a threshold of K20,000 is estimated to be approximately K560 million assuming no other changes to marginal tax rates. Increasing the tax free threshold to K15,000 is estimated to cost K283 million.

Wage and salary increases since 2012 has seen a significant number of low income taxpayers become subject to tax. Without change to the tax free threshold, the average tax paid by wage and salary earners will increase as wage levels rise (‘bracket creep’)

The 2014 group employer survey data shown in Issues Paper No 8 indicates that 36 per cent of employees earned less than K14,000 and contributed less than 2 per cent of the reported PIT receipts.

The tax free threshold also has an important role in overall fairness in the income tax system as it provides greater tax relief, as a percentage of income, to lower income earners. Increasing the threshold to K20,000 will have substantial benefits in reducing the income tax burden on taxpayers as well as removing about 40 per cent of taxpayers from the income tax system.

However, a tax free threshold of K20,000 will come at a large revenue cost that may not be immediately affordable. Still it should remain an objective of reform that aims to support low income earners. As a more affordable interim step, the tax free threshold should be increased to K15,000. A K15,000 threshold will still have important simplification benefits as it could remove up to a third of current taxpayers from paying income tax and will improve the administrative simplicity of PIT.

- Increasing the tax free threshold therefore will deliver on the reform objective of directing tax relief to lower income earners, although tax relief in the absence of any other changes, is provided to all income groups because all taxpayers get the benefit of the tax free threshold.

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45 Bracket creep is movement between salary range caused by salary and wages movement including inflation.  
46 Of these employees, most earn more than K10,000 but there are many employees that currently earn less than the tax free threshold yet are still subject to tax. This is a result of the final assessed tax being calculated on fortnightly income, irrespective of whether the income for the financial year exceeds the tax free threshold.
Submissions

Submissions received by the Review were broadly supportive of increasing the tax free threshold, but two (2) submissions commented that the tax-free threshold is insufficient to provide tax relief to low and middle income earners and that further reductions in marginal tax rates are needed.

Reduce Marginal Tax Rates and Income Tax Band

Recommendation (23): The Review recommends that:

- lowest marginal tax rate should be reduced from 22 per cent to 20 per cent to provide tax relief for low and middle income earners;
- income tax bands should be collapsed to four (4) as a future objective;
- as a first step the marginal tax rate of 30 per cent that now applies at K18,000 should be removed, reducing tax bands from the current six (6) to five (5); and
- the Review does not recommend any change to the top marginal tax rate at this time. It should be considered as part of reform to the corporate tax rate.

The Review previously canvassed in its Issues Papers the desirability of reducing the tax burden on wage and salary earners through a combination of (a) an increase in the tax free threshold and (b) reductions in marginal tax rates.

Table 2 below shows the current marginal tax rates applying to personal income.
Increasing marginal tax rates provide a linear path where average tax increases with income. This was discussed in Issues Paper No. 8 which illustrated that average income tax paid has changed only slightly between 2002 and 2012, notwithstanding the personal income tax reforms during this period. In effect, the changes made to thresholds and rates during this period addressed bracket creep caused by increases in income rather than substantial reform made to PIT. This caution is understandable as the contribution made by PIT to government revenue collections is significant and therefore major reductions in tax rates or increases in thresholds will have significant budgetary implications.

The Review looked at overseas experience to determine the appropriate approach to marginal tax rates. PNG has more tax bands and higher marginal tax rates compared to developing economies in the region. However, its tax free threshold is significantly higher in per capita terms than other countries in the region\(^47\). Yet such comparisons, while useful, need careful evaluation given the data gaps and differences in local circumstances.

The current PIT tax rates create a ‘cliff face’ for those earning low and middle incomes as marginal tax rates start at 22 per cent at K10,000 increasing to 35 per cent for incomes above K33,000 (as illustrated in the following chart). Wage and salary earners approaching the K10,000 income band go from 0 per cent tax to 22 per cent tax and those at K18,000 go from 22 per cent to 30 per cent tax rate when they earn extra Kina.

\(^{47}\) For the purposes of this work the Review looked at Tonga, Solomon Islands, Samoa and Fiji.
The sharp increase in marginal tax rates acts as a disincentive for employees to seek higher incomes or for workers to move from the informal to the formal economy. One means of addressing this is to adjust the existing marginal tax rates by moving them so they apply at higher income bands. Alternatively, a simpler method is to remove one or more of the existing income tax bands in the tax schedule.

Significant tax relief can be achieved through a combination of an increase in the tax free threshold and a reduction in the 22 per cent marginal tax rate to 20 per cent. This will reduce by approximately K1100 the annual PIT paid by a workers earning between K15,000 and K18,000.

Reducing the Number of Tax Brackets

The Review has also considered whether the existing six marginal tax brackets should be reduced. In Issues Paper No 8, this topic was discussed with the proposal that the number of marginal tax brackets could be reduced to four. Fewer income tax brackets may reduce complexity although it was also important to maintain the progressivity of the income tax system (those who earn more pay more tax). Submissions received by the Review generally agreed with the reduction of the number of tax brackets, arguing that lower taxation was needed to encourage participation and to reduce the tax burden.

The administrative benefits associated with fewer income tax bands are likely to be limited as employers will still have to calculate tax payable whether there are six (6) or four (4) tax brackets. However, the removal of bands does have the advantage of reducing the effect of bracket creep as the gaps between income bands are larger and therefore provides greater scope for incomes to rise before the next marginal tax rate applies.

There are two (2) main challenges associated with having fewer tax brackets. The first is that without additional adjustments, removing a tax bracket will reduce overall revenue collection for the government. The second is that tax brackets are
used to make the personal tax progressive in that higher income earners pay more tax. So removing a tax bracket can make income tax more or less progressive depending on which tax bracket is removed.

It is accepted that while reducing tax brackets will result in a reduction of revenue from PIT, reform of the personal tax system will see a greater reliance placed on indirect charges and taxes such as the GST. In terms of the distribution of benefits, PIT reforms should focus on low and middle income earners. This can best be achieved through the removal of the K18,000 income band thus reducing the existing number of tax brackets to five (5).

- A move to four (4) bands could subsequently be considered when the threshold is raised to K20,000. This would involve harmonising the marginal tax rates at the K70,000 and K250,000 and relocating that rate at a new threshold, perhaps at K150,000 or K200,000.

The removal of the 30 per cent marginal tax rate that now applies to incomes in excess of K18,000 will provide a degree of protection from bracket creep for low income earners as they will need to earn more than K33,000 before the 35 per cent tax rate applies.

**Top Marginal Rate**

In Issues Paper No. 8 the Review acknowledged the desirability of a reduction in the top marginal tax rate but argued that that the immediate focus for policy makers should be to reduce income tax for low and middle income earners. The Issues Paper also suggested that the top marginal tax rate is best considered in the context of corporate tax rate. Moreover, recent academic thinking suggests that the work participation of high income earners are less influenced by marginal tax rates compared to low and middle income earners.\(^{48}\)

PNG’s top marginal tax rate is not inconsistent with the top marginal tax rate in a majority of OECD countries.\(^{49}\) While PNG may not have many economic similarities to most OECD countries, the performance of its personal income tax system is similar to OECD economies in its revenue collection outcomes. The key distinction appears to be that in PNG the top marginal tax rate applies at a high multiple of the average wage. Hence only a small proportion of taxpayers face the top marginal tax rate.


\(^{49}\) http://www.oecd.org/tax/tax-policy/tax-database.htm#pit
Submissions

In response to the Review’s consultations on marginal tax rates several submissions were received. One submission argued that the current marginal tax rates impose a high tax burden on middle income earners and that the marginal tax rate applying between K30,000 and K150,000 should be 30 per cent. This would represent a significant reduction in tax, particularly for employees earning more than K70,000. Another submission focussing on the employees earning less than K30,000, argued that even a 15 per cent marginal tax rate would leave very little capacity for employees to save after cost of living expenses are considered. However, other submissions suggested that reforming the top marginal tax rate was a lower priority to reducing tax for low and middle income earners. It was noted that for high income employees, employers structure remuneration packages to take account of the effect of the top marginal tax rate on after tax income.

By itself, adjusting the top marginal tax from 42 to 40 per cent rate will have a small revenue consequence meaning a loss of approximately K27 million. However, more significant changes, such as adopting a 35 per cent top marginal tax rate, results in a substantial reduction in income tax receipts, in the order of K220 million.

Moreover the current top marginal tax rate for personal income approximates the effective tax rate on company earnings of 41.9 per cent. Usually it is argued that misalignment of the top rate and the corporate tax rate can encourage the transfer of income between personal or corporate tax entities to the lowest taxed entity.

In any proposal to reduce the top marginal tax rate, there are important policy trade-offs to consider, such as whether the tax benefits should be shared more broadly or limited to certain income levels. While there are arguments that can be made for and against reducing the top marginal tax rate, the Review has concluded that given the current alignment, change to the top marginal tax rate is better considered in conjunction with change to the corporate tax rate.

Recommended changes to PIT

In making recommendations for changes to marginal tax rates, the Review has endeavoured to take account of the policy objectives of providing tax relief, introducing more simplicity into the tax system and to maintain the role of personal income taxation as an important contributor to the budgetary needs of government. These are judgement calls and further work will be required to fine tune the final tax rates and the thresholds at which they apply. As a starting point the following table shows a five band tax system could be implemented that provides tax relief for low and middle income earners and also take account of the Review’s recommendations to remove some rebates. The estimated cost of this package is about K504.3 million.
Table 3: Reviews’ Proposals for Revised Marginal Tax Rates

| Current (2015) | | Proposed | |
|----------------|----------------|----------------|
| Tax brackets (K) | Rates (%) | Cumulative tax (K) | Tax brackets (K) | Rates (%) | Cumulative tax payable (K) |
| 0 – 10,000 | 0 | 0 | | | |
| 10,001 – 18,000 | 22 | 22 toea for each kina over 18,000 | 0 -15,000 | 0 | 0 |
| 18,001 – 33,000 | 30 | 1,760 plus 30 toea for each kina over 18,000 | 15,001 - 33,000 | 20 | 20 toea for each kina over 15,000 |
| 33,001 – 70,000 | 35 | 6,260 plus 35 toea for each kina over 33,000 | 33,001 – 70,000 | 35 | 3,600 plus 35 toea for each kina over 33,000 |
| 70,001 – 250,000 | 40 | 19,210 plus 40 toea for each kina over 70,000 | 70,001 – 250,000 | 40 | 16,550 plus 40 toea for each kina over 70,000 |
| 250,001 and above | 42 | 91,210 plus 42 toea for each kina over 250,000 | 250,001 and above | 42 | 88,550 plus 42 toea for each Kina over 250,000 |

Non-Resident Tax Rates

Recommendation (24): The Review recommends that non-resident tax rates be aligned with resident tax rates.

The Review proposed in Issues Paper No. 8 that the non-resident\(^{50}\) tax rates be aligned with resident tax rates. The Issues Paper argued that there would be simplicity benefits and that it was unlikely that there would be significant revenue implications due to the deductibility of non-resident wages costs for corporate employers. That is, revenue from higher effective marginal tax rates on non-resident employment income is offset by lower corporate tax receipts from companies due to deductions for the wage cost of non-resident employees. The following table shows the current resident and non-resident tax rates.

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\(^{50}\) Definition of Non Resident is a person who does not satisfy the requirements of Section 4 of Income Tax Act, 1959. A non-resident does not have access to the tax free threshold and other tax concessions or benefits may be available.
Table 4: Resident and Non-Resident Marginal Tax Rates

<table>
<thead>
<tr>
<th>Taxable Income (K)</th>
<th>Tax Rate on excess</th>
<th>Non-Residents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Taxable Income (K)</td>
</tr>
<tr>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>10,000</td>
<td>Nil</td>
<td>10,000</td>
</tr>
<tr>
<td>18,000</td>
<td>1,760</td>
<td>18,000</td>
</tr>
<tr>
<td>33,000</td>
<td>6,260</td>
<td>33,000</td>
</tr>
<tr>
<td>70,000</td>
<td>19,210</td>
<td>70,000</td>
</tr>
<tr>
<td>250,000</td>
<td>91,210</td>
<td>250,000</td>
</tr>
</tbody>
</table>

Submissions

Submissions to Issues Paper No. 8 supported the alignment of resident and non-resident tax rates. Submissions also noted that the remuneration packages of non-resident employees take account of income tax rates in PNG compared to their country of residence. Thus their after tax salary position is kept whole and wages are grossed up to equalise any adverse tax outcomes. Submissions also agreed that the tax treatment of non-residents is unlikely to cost revenue because any increase in personal income tax is offset by reductions in corporate tax as described above.

While separate non-resident tax rates are traditionally a feature of PIT, the Review concludes that there will be simplification benefits associated with uniform tax rates and thresholds being applied to residents and non-residents. It will also improve the attractiveness of PNG for highly skilled workers that have consequential spinoff benefits for the economy as a whole. The Review has not closely modelled the revenue consequences of alignment. However, given the close proximity of the corporate tax rate to the 40 and 42 per cent personal income tax rates, it seems logical that the revenue consequence should be minimal.
Changes to the Taxation of Redundancy Payments

Recommendation (25): The Review recommends:

- the removal of the 30 person rule in section 46CA of the ITA and the requirement to seek the Commissioner-General’s approval to be entitled to concessional tax treatment for redundancy payments;
- The existing concessional cap for redundancy payments should be increased to K100,000 and that all payments are included in the cap and taxed at the concessional rate of 15 per cent;
- Long service leave payments should be included in the cap unless the current concessional treatment of long service leave provides a lower tax outcome for the long service leave payment.

The starting point for tax policy analysis is that all income should be taxed similarly. Concessional tax treatment of redundancy benefits is usually justified on the grounds that these payments are needed to provide income support during periods of unemployment. However, if this argument carried any weight, concessional tax treatment would be applied to all payments made at redundancy such as accumulated leave. Yet this is not the case as some, such as long service leave, have specific tax provisions.

Submissions received in response to Issues Paper No.8 conceded that taxing redundancy payments as ordinary income was not realistic and somewhat unfair in the circumstances where government income support is not available to those made redundant. It was also recognised that tax concessions play a role in maintaining the progressivity of increasing marginal tax rates. Issues Paper No.8 therefore proposed the removal of the 30 person threshold that underpins the current approved redundancy provisions and explored whether the concessional cap should be broadened beyond ex gratia payments. It also proposed two alternative approaches to implementing tax concessions.

The first is to maintain a cap under which all redundancy payments would be taxed at existing concessional tax rate of 15 per cent. The second is to have the amount to be concessionally taxed determined by the length of service, akin to the current tax treatment of superannuation benefits.

In proposing a Kina cap or length of service to determining the amount to be concessionally taxed, the Review was mindful that safeguards are to prevent the concessional treatment of termination payments being abused through contrived redundancies. The original 30 person rule in Section 46CA was introduced as an integrity measure for that reason. However, the 30 person rule can result in unfair
outcomes where some terminated employees have their ex gratia payments concessional taxed while others not.

Submissions

The Review received submissions that supported the continuation of the concessional tax treatment of redundancy payments. One submission supported the idea of a standard cap but argued that the cap would need to be more than the suggested K50,000. This was so that employees with lengthy service were not discriminated against. The submission also acknowledged the attractiveness of the alternative of using length of service but noted that this may be unfair in situations where such an employee changes employment and is subsequently made redundant. Another submission argued that a standard cap would discriminate against employees with lengthy service where the termination payment reflected that length of service.

Both of the approaches discussed would maintain the progressivity of the taxation of redundancy payments as if they had been taxed over a longer timeframe. This is a particular issue in PNG because tax liability is assessed and finalised for wage and salary earners on a fortnightly basis. Also while a standard cap could be seen to discriminate against those with a lengthy career, it can be addressed by ensuring that the cap is of a sufficient amount to accommodate most employees.

The Review is attracted to simplifying the law and removing anomalies that are created by Section 46CA. The least complicated approach is to apply a standard cap to all payments. The cap would cover ex gratia payments as well as payments for annual leave and other entitlements. To address the risks of the cap being inappropriately used, the existing integrity rules in Section 46CA would continue to apply.\(^{51}\)

For long service leave, the current arrangements provide for concessional tax treatment for payments accruing before 1993. There may be employees by the nature of their lengthy service and their income that would be better off having their long service leave payment taxed according to the existing arrangements for such payments. In light of this pre-existing entitlement, the Review proposes that long service leave payments be included in the cap unless the existing arrangements for long service leave provide a lower tax outcome in respect of the payment of long service leave.

In conclusion the Review recommends amendment of section 46CA by removing the 30 person requirement and the requirement for the approval of the Commissioner-General. The Review’s recommendation is for a concessional cap of at least K100,000 covering ex gratia payments and leave entitlements.

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\(^{51}\) This includes the eligible taxpayer requirements, excluding the 30 person threshold and the Commissioner-General’s approval.
With respect to the tax rate that should apply to redundancy payments, some
submissions to the Review argued that these payments should not be taxed or be
taxed at very low rates, say 5 or 10 per cent. However, a concessional rate of 15 per
cent will generally result in an income tax outcome that in most redundancy
situations is better than if the sum had been taxed as salary over a year. While a
lower rate will provide a more advantageous outcome for those made redundant,
the Review has not been able to conclude that a rate lower than 15 per cent is
justified.

On balance the Review recommends a tax rate of 15 per cent should continue to be
applied to payments made under the cap. The amount that exceeds the cap would
be taxed at the relevant marginal rate using the existing formula.\(^{52}\)

**Medically Caused Retirements**

The Review also consulted on the issue of whether payments for medically caused
retirements should be taxed more lightly. Submissions that considered this issue
supported concessional tax treatment. This is consistent with the submissions the
Review received in its blue sky consultations.

The argument in favour of concessional tax treatment is that medically caused
retirements can place employees into a similar financial hardship position as if they
were terminated. Further, blue collar workers are more likely to face the risk early
retirement due to medical grounds compared to office workers. Therefore the rate
of tax on the payment of entitlements (excluding any superannuation payments)
should be concessionally taxed along the lines of redundancy payments.

The Review has considered this issue but it received little new information in
response to Issues Paper No. 8. Matters that would need development include the
integrity measures particularly as the boundary between bona fide medical
retirements and other retirements may be blurred. Another consideration is how to
determine an appropriate taxation regime given that some payments may already be
subject to concessional tax treatment. Consequently the Review has not made a
formal recommendation at this time.

\(^{52}\) This involves dividing the excess amount by 26 to create an incremental amount. Tax is then calculated with
reference to the tax on normal pay and the tax on the normal pay plus the incremental amount. The difference
in tax is then multiplied by 26 to arrive at the amount of tax owed.
Changes to Rebates

Recommendation (26): Remove education and salary and wage rebates. The dependant rebate should be retained but removed once the K20,000 tax free threshold is implemented.

The Review also recommends the election expenses rebate should continue.

The Review foreshadowed that as part of the reform of the personal income tax system, most rebates should be abolished and the savings used for reducing the income taxes. The Review also argued that the rebate on election expenses should be maintained due to the importance of encouraging PNG citizens to participate in public life and use democratic principles by seeking election to the national parliament.

Submissions

Proposals for the dependant, education and election expenses rebates attracted attention in the submissions received. In summary, there was concern about the proposal to abolish these rebates and there were doubts about the reported low use of the dependant rebate in particular. Submissions also argued that it was unfair to propose the abolition of rebates normally used by taxpayers but maintain the election expenses rebate.

Dependant Rebate

The dependant rebate is a refund of the tax that is otherwise payable. It is deducted from the gross tax calculated on the taxable income and is provided in respect of a maximum of three direct dependants (spouse, children and certain invalid relatives). The maximum annual rebate of K450 applies to the first dependant and K300 for the second and third dependants, resulting in a total tax rebate of K1050 per annum.

For example, an income earner earning K18,000 per annum would normally pay K1,760 in personal income tax per annum, or around K68 per fortnight. If they claimed three dependants then their annual tax liability would fall to K710, a saving of K40 per fortnight. This is a similar outcome for the taxpayer having a tax free threshold of K15,000.

As shown in Table 5 below, data obtained from the IRC indicate that the dependant rebate becomes more significant for employees earning more than K25,000 per annum. At income levels below K25,000 the average taxpayer claims for 1 dependant, whereas above K25,000 the average taxpayer claims 2 or more dependants. Between government and private sector employment, private sector employees claim more dependants than government sector employees, particularly for income levels below K25,000 per annum. The reason for the difference in the
average number of dependants between the income levels is not known. It may be due to taxpayers on lower incomes just starting out in the careers and thus more likely being unmarried. If this is the case then it would have the effect of lowering the average number of dependants for lower income groups. However, the average dependant rebate does not appear to reduce, by much, the tax paid by low income workers.

The difference between government and private employment is likely to be more nuanced. It is uncertain whether this reflects that private sector employees are better informed of their entitlements or due to other factors unique to private sector employment. For instance private sector employment is likely to cover a broader geographic area than the public sector. It may be the case that employees in rural areas are more likely to be supporting larger families than government employees living in the main cities.

Table 5: Average taxpayer claim for the dependant tax rebate

<table>
<thead>
<tr>
<th>Income band (K)</th>
<th>Private sector</th>
<th>Government sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Range of the average number of dependants claimed</td>
<td>Range of the average number of dependants claimed</td>
</tr>
<tr>
<td>0-9,000</td>
<td>0.13-0.73</td>
<td>1.15-1.37</td>
</tr>
<tr>
<td>9,000-18,000</td>
<td>0.56-1.09</td>
<td>1.58-1.78</td>
</tr>
<tr>
<td>18,000-25,000</td>
<td>0.99</td>
<td>1.86</td>
</tr>
<tr>
<td>25,000-70,000</td>
<td>1.76-2.37</td>
<td>2.04-2.24</td>
</tr>
<tr>
<td>70,000-250,000</td>
<td>2.34-2.61</td>
<td>1.73-2.41</td>
</tr>
</tbody>
</table>

Submissions to the Review remarked that the allowance is well used and indeed should be expanded to include a broader definition of dependant to reflect the extended family obligations including those particular to PNG. This is hard to reconcile with the data in Table 5. However, one submission reflected that the dependant rebate is already sufficiently broad in its application but that it may be underutilised due to a lack of understanding by employees. If this is the case it could explain the data shown in the table.

The Review reflected on the submissions received and agrees with the suggestions made in some that the data suggesting low utilisation of the rebate is most likely due to a lack of understanding by taxpayers of their entitlements. It is unlikely that the low utilisation is due to employees having few dependants to support. It may also be that the rebate initially claimed at the commencement of employment is not subsequently updated as the employee’s number of dependants increase.

While the Review recognises that dependants can include wantok obligations, it is not convinced that, if the dependant rebate is to be retained, it needs to be
extended to apply to a broader group of dependants. Few submissions provided evidence on why the rebate should cover a broader range of family and social commitments. Most of the information provided to the Review pointed to a lack of awareness of the rebate rather than it being too narrow in its application. But its lack of use is concerning and supports the Review’s earlier suggestion the rebate appears ineffective in providing tax relief to low income earners.

There are two options available to government in addressing the issues discussed in this section. The first is to provide general tax relief of a sufficient level that the dependant tax rebate is no longer necessary. The second is to continue to provide the rebate but invest in taxpayer education so that the availability of the rebate becomes well known.

The current dependant tax rebate provides tax relief for all taxpayers who claim it but for low income earners, as a percentage of income, the rebate provides the greatest relief. Nevertheless, the Review questions whether it is appropriate for the budget to be providing a tax rebate (which is worth at a maximum K1050) to all taxpayers, particularly high income earners. High income earners do not need the support of the budget and providing them with a K1050 rebate at a time of tight budgetary finances is not sound policy.

The Review’s tax reform proposals include the recommendation of increasing the tax free threshold to K20,000. Because a tax free K20,000 threshold will have significant cost to the budget, an intermediate step of increasing it to K15,000 is recommended. With a tax free threshold of K20,000, the dependant rebate is no longer justified. But with a K15,000 tax free threshold, there is an argument for retaining the dependant rebate for the immediate future. In the context of a tax reform switch to indirect taxes some low income workers may still need the rebate. In combination with a K15,000 tax free threshold a worker claiming 3 dependants will be in the same situation as if the tax free threshold had been increased to around K18,000.

Wage and Salary Expenses Rebate

The assessment of fortnightly final tax includes a standard reduction in tax of K200 per annum for wage and salary expenses. However, a rebate is available for losses or outgoings that exceed K200 in a year, calculated as rebate of 25 per cent of those losses or outgoings. Data obtained from IRC suggest about K477,000 was refunded in 2013 with the highest amount in 2004 and the lowest amount in 2012. Information available from the IRC indicates that most taxpayers do not lodge amended income tax returns to claim their wage and salary rebate.

Submissions to the Review did not oppose the removal of the wage and salary rebate and the Review has not been able to find evidence that removal of the wage and salary rebate will cause hardship for taxpayers. With the recommendations to increase to the tax free threshold and make changes to marginal tax rates, taxpayers
will pay less tax under the reform proposals. The abolition of the wage salary expense rebate will remove another layer of complexity from the tax system.

**Education Expenses Rebate**

Issues Paper No. 8 proposed the removal of the education rebate of the costs of sending children to primary or high schools within or outside PNG. The rebate is limited to the lesser of 25 per cent of the net education expenses incurred or K750 per dependant child. Data provided to the Review and discussed in the Issues Paper noted that the rebate is used by few taxpayers. Issues Paper No. 8 also commented that recent years the trend had been towards reduced utilisation of the rebate. The Government has recently introduced free education but that by itself does not explain why the rebate has been trended down since 2004 rather than being more closely aligned to the more recent changes in Government education policy.

**Submissions**

Submissions received have assisted in understanding of the low utilisation of the education rebate. They noted that for many taxpayers, private school fees were usually funded either fully or partly through salary sacrifice arrangements with their employers. Thus provided the salary sacrifice arrangements stayed in place, the removal of the educational rebate was unlikely to impact negatively on most taxpayers. However, one submission made the point that not all employers are prepared to offer remuneration packages that cover school fees and that therefore the removal of the rebate will impact on those employees who still use the rebate.

The low utilisation of the rebate tends to support the suggestions in submissions that education expenses are being funded through allowances paid directly to educational institutions on behalf of employees by employers, or by salary sacrifice arrangements. In that regard the Review is not proposing any change to the current arrangements for salary sacrifice or the treatment of education allowances paid directly. In light of the low utilisation of the allowance and the Review’s other proposals to reduce personal income tax, which will offset the loss of the rebate for those who currently use it, the Review recommends the abolition of the education rebate.

**Rebate on Election Expenses**

Costs associated with seeking election to the National Parliament of PNG are an allowable deduction against income under Section 96 of the ITA. Any expenditure that is reimbursed by another party must be included in assessable income. The taxpayer can alternatively seek a rebate of salary and wages tax under Section 214.

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53 See Section 40(3) of the ITA.
(1)(a)(ii) of the ITA. The rebate allowable is limited to 25 per cent of the election expenses incurred.

In Issues Paper No. 8 the case was made for treating the election expense rebate differently to other rebates arguing that the rebate on election expenses should be maintained due to the importance of encouraging PNG citizens to participate in the country’s democracy.

Submissions

Submissions responding to Issues Paper No. 8 have not supported the argument that election expenses were different from other expenses incurred in earning an income. The submissions argued that if other rebates were to be removed so should the election expenses rebate.

The Review understands the strength of the comments made in submissions. However, running for elected office does entail significant costs and in circumstances where there is an uncertain outcome. To some extent this is a different situation to other wage and salary expenses where nexus between costs incurred and income earned may be less closely associated. The ITA also requires that any disbursements provided to offset election expenses be included in the taxpayer’s assessable income.

PNG is not alone in providing deductibility for such expenses as it is common across most democracies, even those where election expenses are partially funded by the public such as in Australia. If the rebate were to be removed then the ability of citizens to seek election to the National Parliament would be subsequently curtailed by the costs involved. It may also undermine the electoral system through encouraging sponsorship of election costs. Consequently, the Review recommends that election expenses continue to be deductible.

Accommodation Allowances

Recommendation (27): The Review recommends:

- Adjusting the taxable component of housing allowance over the next 5 years so that 50 per cent of the value of the allowance is included in an employee’s assessable income.
- As a first step, for very expensive properties and those with rents in excess of K5,000 per week, the amount added to taxable income be increased to K1400 per fortnight.

Issues Paper No. 8 noted that comprehensive income tax would treat the value of any fringe benefit as part of an employee’s assessable income. This provides for consistency between income that is received by way of salary and is taxed and income that is received as an untaxed employer provided benefit. In PNG certain
fringe benefits are concessionally taxed in that only a proportion of their value is included in taxable income. The question for the Review is whether this is justifiable in policy terms and if so what value should be included in assessable income.

Housing or shelter is usually considered part of basic needs to be provided in society, along with food and clothing. Housing, in particular, plays a role in most countries as a part of the stock of assets that contribute to the feelings of wealth. It can also be argued that housing plays a role in ease to which labour moves from one geographic area to another. To the extent that housing is funded by mortgages, it also provides the mechanism for monetary policy to influence economic behaviour.\(^{54}\)

From the perspective of tax policy the treatment of housing should not encourage either over or under consumption. It is better to lower overall personal income tax rather than achieve this for only those employees who can access housing benefits. Further, if housing ownership or provision is to be promoted it should be through means other than the tax system. There is also the debate whether these tax concessions are unintentionally adding to the demand for rental accommodation and increasing property prices and rents as a consequence.

Housing benefits have become an important feature of employee remuneration. The value of allowances has increased markedly in recent years as the value of housing has climbed and the challenges of supply and demand particularly in major urban centres of PNG continues to be a significant cause. This has seen the taxable value of the allowance detach from its value to the employee. There may be some justification for existing housing concessions if the allowance was required to attract highly mobile labour that might otherwise not be available. However, the Review has no evidence before it to support that conclusion.

**Submissions**

Several submissions disagreed with the Review’s views on the housing allowance. These submissions argued that the concessional treatment of housing allowances was essential to provide employees with suitable affordable accommodation and any increase in assessable value of the allowance would increase housing costs for employees. Similar views were expressed in other submissions on the grounds that housing is expensive and therefore the allowances, necessary. While there was some recognition of the costs associated with the allowances and the loss to government revenue, the point was made that any change to the housing allowance should not make PNG less attractive for highly skilled workers.

One submission encouraged the Review to look at the taxation of housing allowances as an opportunity to simplify the tax law. It was suggested that rather than the taxable component being referenced to the value of rent or housing a percentage of

\(^{54}\) Zhu M. Housing Markets, Financial Stability and the Economy. International Monetary Fund 5 June 2014.
the value of the allowance, say 50 per cent, be included in taxable income. The Review is attracted to this suggestion as it would provide a straightforward means of taxing the allowance, without reference to rents or home values, while having the taxable component set at a level which is more closely aligned with the value of the allowance.

While the Review understands that changes to the taxation of housing allowances will increase the after tax costs of accommodation, the concessional treatment of these allowances is not sustainable. Concessional tax treatment of housing allowances encourages rising housing costs as those who ‘consume’ housing do not face the true cost and this in turn will see housing allowances increase. Another consequence is that revenue lost through the tax subsidies provided for housing allowances results in the revenue being recovered from higher taxes elsewhere or resulting in a reduction of government services.

For example, if an employee rents a high value flat at K6,000 per fortnight in Port Moresby and receives an allowance to cover the cost, only K700 is added to their fortnightly taxable income, notwithstanding that the value of the allowance paid is K6,000. That is, less than 12 per cent of the allowance is taxable. For an employee renting a low cost flat in the same area who also receives an allowance to cover the rent, if it is assumed that the prescribed maximum rental values apply, only 8 per cent of the allowance is taxable.

The Review considers there is merit in adopting a simple percentage as the amount of housing allowance to be included in taxable income. The Review appreciates that time will be required for employees, employers and the housing market to adjust to changes in the way in which these allowances are taxed. Consequently the Review recommends that over the next 5 years the percentage of housing allowance to be included in taxable income increases until it reaches 50 per cent. This will still represent a significant tax concession to those renting or buying a property.

Until such time as the Review’s recommendation on housing allowances is implemented an interim measure, to address very high value properties, should be introduced. These properties are currently well above the existing top tier of the prescribe value schedule. The Review concludes that a sensible point to position this additional tier is for housing where the fortnightly rental or property value is approximately double the current top tier. This top tier would attract a taxable component of K1400 per fortnight, an increase from the current K700 per fortnight. This is still a significant tax concession but will represent a first step in a longer term change:

- High cost housing in relation to employer owned accommodation is any unit of accommodation which would fetch K1,600,000 or more if sold on the open

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Oil Search, 4 September 2015
market, and in any other case is any unit of accommodation whose market rental is K5,000 per week or more.

The change can also be shown as an additional tier in the existing table of prescribed values.

Table 6: Revised prescribed values of employer provided accommodation

<table>
<thead>
<tr>
<th>Type of housing</th>
<th>Value of taxable benefit per fortnight</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Area 1 (a)(b)</td>
</tr>
<tr>
<td>Very high cost house or flat*</td>
<td>K1400.00</td>
</tr>
<tr>
<td>High cost house or flat</td>
<td>K700.00</td>
</tr>
<tr>
<td>Medium cost house or flat</td>
<td>K400.00</td>
</tr>
<tr>
<td>Low cost house or flat</td>
<td>K160.00</td>
</tr>
<tr>
<td>Mess/barrack accommodation</td>
<td>K 60.00</td>
</tr>
<tr>
<td>Government mess/barrack accommodation</td>
<td>K 7.00</td>
</tr>
<tr>
<td>Citizen employees in approved low cost housing scheme</td>
<td>K 0.00</td>
</tr>
</tbody>
</table>

(a) Employees provided with accommodation outside PNG by their employer are deemed to reside in Area 1, and are subject to tax on the taxable benefit value for private high cost housing.
(b) Area 1 in the table is any area located in, or within 15 kilometres radius of the boundaries of Goroka, Lae, Madang, Mount Hagen and Port Moresby.
(c) Area 2 in the table is any area located in, or within 15 kilometres radius of the boundaries of Alotau, Bulolo, Daru, Kainantu, Kavieng, Kerema, Kimbe, Kiunga, Kokopo, Kundjawa, Lorengau, Mendi, Popondetta, Poggera, Rabaul, Tabubil, Vanimo, Wabag, Wau, and Wewak.
(d) Area 3 is any place in PNG not included in Area 1 or 2.

*Very high cost housing in relation to employer owned accommodation is any unit of accommodation which would fetch K1,600,000 or more if sold on the open market, and in any other case is any unit of accommodation whose market rental is K5,000 per week or more.

The objective of including 50 per cent of the value of housing allowance in assessable income would result in the prescribed values in Table 6 being removed. If need be the percentage of allowance included in taxable income could be adjusted to take account of the Government’s policy objective of encouraging home ownership. The current Government first home owner schemes are directed at lower cost housing which in most instances under the current arrangements would fall within the definition of low cost housing.\(^\text{56}\)

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\(^{56}\) Low cost housing in a city like Port Moresby is where a house is valued K400,000 or less and the rental is K1000 per week or less.
Taxation of Retirement Benefits

**Recommendation (28): Objective of the taxation of retirement benefits should be aligned to the Taxed, Taxed and Exempt\(^57\) model of taxation.**

PNG has a limited retirement benefits framework as superannuation is confined to the mandatory and voluntary savings of those who are employed in the formal economy. It also excludes the important role that family and community play in supporting those who have retired.

There are several models that are used to explain the taxation of retirement benefits and these were explored in Issues Paper No. 8. PNG has a hybrid model similar to Australia where contributions to retirement funds, fund earnings and the payout of benefits are subject to a combination of tax concessions, exemptions and taxation at the contributor’s marginal tax rate. For the stages of contribution, accumulation and payout, PNG’s approach to taxation of retirement does not neatly fit the traditional taxation models as it has elements of the Exempt, Taxed and Taxed (ETT) and Taxed, Taxed and Exempt (TTE) respectively. It is a complex system as shown in the following table.

<table>
<thead>
<tr>
<th></th>
<th>Contributions</th>
<th>Earnings</th>
<th>withdrawals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee mandatory</td>
<td>Taxed at marginal rate</td>
<td>Taxed at 25 per cent</td>
<td>Tax free (E)</td>
</tr>
<tr>
<td></td>
<td>(T)</td>
<td>(T)</td>
<td></td>
</tr>
<tr>
<td>Employee voluntary</td>
<td>Tax free (E)</td>
<td>Taxed at 25 per cent</td>
<td>Taxed at varying rates depending on the length of time in the fund. (T)</td>
</tr>
<tr>
<td>pre-tax (capped)</td>
<td></td>
<td>(T)</td>
<td></td>
</tr>
<tr>
<td>Employee voluntary</td>
<td>Taxed at marginal rate</td>
<td>Taxed at 25 per cent</td>
<td>Tax free (E)</td>
</tr>
<tr>
<td>after tax (capped)</td>
<td>(T)</td>
<td>(T)</td>
<td></td>
</tr>
<tr>
<td>Employer</td>
<td>Tax free (E)</td>
<td>Taxed at 25 per cent</td>
<td>Taxed at varying rates from 2 per cent to 15 per cent depending on length of time in the fund, and whether a RSA is used. (T)</td>
</tr>
</tbody>
</table>

Ideally, taxation of retirement benefits should follow the ETT or the TTE model rather than both. As discussed in the Issues Paper, the ideal model for the taxation of retirement benefits is the Exempt, Exempt and Taxed (EET) model as this maximises retirement savings and then treats those savings as ordinary taxable income when they are used at retirement. Given the existing and growing pool of retirement savings accumulating under the existing tax rules, the Review recommends that objective of the taxation of retirement benefits should be aligned to the TTE model of taxation.

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\(^{57}\) Tax Tax Exempt means contributions from employees are taxed, and superfund earnings are taxed and retirement earnings are tax exempt.
The Review has considered whether alignment with either the TTE or ETT model is feasible. The tax on withdrawing retirement benefits is only applied to the concessionally taxed contributions (employer contributions and any voluntary salary sacrifice amounts) and fund earnings on the member’s account. Any after-tax contributions can be withdrawn tax free. Further, for employees with at least 15 years of contributions, concessional amounts are only taxed at 2 per cent. Withdrawals are thus lightly taxed approximating the TTE model.

At the contribution stage only an employee’s compulsory contributions and after tax savings to superannuation are taxed. The employer and salary sacrifice contributions are made tax free. Given this, it is unlikely that any voluntary contributions would be made by employees beyond their compulsory obligations. Therefore while there are taxed elements at the contribution stage, a larger proportion of the funds contributed to licensed superannuation funds are made tax free. However, the more even mix of taxed and non-taxed contributions makes the ETT model less of a good fit with the current taxation of superannuation.

Submissions

In consultation and in submissions, arguments were made for the reduction in tax on superannuation. Submissions reasoned that reductions in taxation would increase the pool of savings available in retirement. Submissions also raised issues about the objective of superannuation that went beyond tax matters.

The taxation of superannuation is not simple and this is evident from some of the submissions where the taxation of superannuation has given rise to some misunderstandings. This is not surprising as the tax treatment of contributions and payouts is a confusing mixture of taxed, untaxed and concessionally taxed components. Instead of the taxation of superannuation being high, the existing tax concessions reduce the impact of taxes on superannuation savings. Further, Superannuation Funds earnings receive a 5 per cent concession on the corporate tax rate and do not pay tax on capital gains so the effective rate of taxation on fund earnings is lower than the stated 25 per cent tax rate. Therefore the argument that superannuation currently is over taxed is not supported by the evidence.

Improvements in transparency and simplification benefits may be realised if the taxation of superannuation was moved closer to the TTE or ETT model and the current clutter of taxed, concessionally taxed and untaxed components clarified. Such a move could improve confidence in superannuation as a vehicle for retirement savings and therefore encourage a higher level of savings than is currently the case.

The Review is not recommending changes to the taxation of superannuation at this time because further work is necessary but is important to provide certainty if retirement savings are to be encouraged. This can be best achieved by a comprehensive review of superannuation that includes aligning the life cycle of taxation of contributions, earnings and withdrawals to the TTE taxation model. The
need for this review is now urgent given the growing importance and significance of superannuation savings for PNG. Such a review could also address changes needed to enhance the level of retirement savings while encourage more retirees to take their superannuation as a stream of regular payments rather than as a lump sum.

Definition of Tax Resident

Recommendation (29): The ITA should be amended to make the tax definition of residency for individuals clear, simple and consistent with tax treaties. This would use presence in PNG for 183 days in any 12 month period, supplemented by a place of abode and government employee tests.

The definition of the place of residence of an individual is used to work out how their income is to be taxed. If the person is a resident, then all (world-wide) income is taxed; non-residents are only taxed on income sourced in Papua New Guinea. Different rates of tax apply to non-resident individuals, who do not benefit from a tax-free threshold. Furthermore, certain locally sourced income of non-residents – such as interest and contract income – is subject to a final withholding tax; whereas residents are taxed on net interest (although there is a withholding tax) and net contract income.

Issues Paper No. 8 asked whether the tax definition of ‘resident’ (based on Australian law) should be changed. A simpler definition better suited to local administration (especially under self-assessment) could produce similar outcomes. In practice most residence questions are settled by asking whether the person is in the country for more than half the year of income or is applying a tax treaty rule which has a similar test.

However, the definition of resident in the current law potentially requires working out if a person resides in PNG which may require analysing the intention or purpose of the person’s presence; family and business and employment ties; maintenance and location of assets, and social and living arrangements. The issue may also turn on whether they are domiciled here because of their birth or intention to stay in PNG. It may also be necessary to consider whether the person has a permanent place of abode, raising questions about intended and actual length of stays out of the country, continuity of that stay; whether there is an established home overseas, or a local residence while overseas. There is also a superannuation rule, of limited application, which effectively says that government employees working overseas are residents.

New Zealand has a streamlined rule (section YD 1 Income Tax Act 2007) which relies primarily on a clear 183 day test, supplemented only by a permanent place of abode rule and a clear rule for government employees as follows:

Box 1: Core New Zealand residence tests
A person is a New Zealand resident if they are personally present in New Zealand for more than 183 days in total in a 12-month period.\(^{58}\)

... a person is a New Zealand resident if they have a permanent place of abode in New Zealand, even if they also have a permanent place of abode elsewhere.

... a person who is personally absent from New Zealand in the service, in any capacity, of the New Zealand Government is treated as a New Zealand resident during their absence.

Submissions

Submissions received by the Review generally supported the status quo on the grounds that the existing definition of residence is working and that making changes was a low priority. Another submission expressed concerns that changing the definition could cause inappropriate tax outcomes. However, the Review notes that adopting simpler rules will make it easier for administrators and taxpayers to determine their liability to PNG income tax. Including a place of abode along with 183 day rule will address the concerns that the change will produce unintended tax consequences.

Other Issues

The Review does not consider a rental withholding tax as necessary.

Issues Paper No. 8 described how rental income paid to an individual is taxable under PIT arrangements. Taxpayers who own rental property are required to disclose rental income and deduct relevant expenses in their income tax return. However, there are significant concerns that many landlords leasing out their commercial and residential properties are not declaring rental income to the IRC. The Review described the experience overseas of withholding taxes being imposed on tenants, reflecting that implementing such an approach in PNG would be difficult.

Recent changes in the 2015 PNG National Budget make it mandatory for landlords to provide a Taxation Identification Number (TIN) on lease documents. This will help the IRC to match the stamp duty lease information with IRC’s lodgement and assessment information. Further, variations for housing allowances are now only approved by the IRC on provision of a stamped lease agreement that also includes the landlords TIN.

The Review believes that these recent developments will ensure that the extent of non-compliance by landlords of not disclosing rental income will reduce. The alternative of a withholding tax presents a number of difficulties as it would impose a significant compliance burden on the IRC in circumstances where the revenue return is unknown.

\(^{58}\) The New Zealand rule asks whether the person is resident for 183 days in any 12 month period, which is better than the current approach in PNG which applies that test for each financial year. Half years crossing over the end of a financial year would not trigger residency under current laws.
Submissions

The Review did not receive any submissions on this matter.

A number of issues were canvassed in Issues Paper No. 8 that on reflection, the Review decided not to recommend any changes at this time. The issues canvassed in the Issues Paper are briefly discussed below.

Fringe Benefits

Issues Paper No. 8 sought feedback on the taxation of fringe benefits. The paper explained the operation of the current fringe benefit taxation arrangements and the IRC’s administrative rules. One submission commented that the IRC’s current rule of requiring taxpayers to take at least 60 per cent of their income as salary is too restrictive. It suggested that the IRC should adopt a 50/50 rule given the high cost of living in the major cities such as Port Moresby.

Taxation of Investments

Issues Paper No. 8 sought comments on the taxation of investment income. Of the submissions received, only one submission directly commented on the issue, arguing that the current rate of taxation on dividends is too high and should be reduced.
CHAPTER 4: CORPORATE AND INTERNATIONAL TAXATION

Introduction

Relative to developed countries Papua New Guinea relies a lot on corporate taxes – collecting some K2.693 billion in 2014 - though the level of collections is broadly consistent with other developing countries. Export focussed economies, like Papua New Guinea, are exposed to international competition for investment and jobs.

The effective rate of company tax is important to decisions about where to invest within this region. But this needs to be kept in perspective:

- If the investment relates to assets in Papua New Guinea (such as natural resources), decisions are less sensitive to the effective company tax rate.
- Taxation, though important, is not a first order issue for many investors in Papua New Guinea. Other issues such as law and order, corruption, transport and electricity infrastructure are much more important to the investment environment. Of course company taxes contribute to revenues funding efforts to address these issues.

Nevertheless the effective rate of corporate tax is important in attracting job-creating investments from the big players – foreign and local corporates, and wealthy individuals with capital to invest.

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PNG has a statutory corporate tax rate of 30 per cent for resident companies. As dividends paid by resident companies are subject to a withholding tax of 17 per cent the effective tax rate on the distributed profits of a resident company is 41.9 per cent.

Dividend withholding tax is reduced to 15 per cent in many treaties, which implies an effective tax rate of 40.5 per cent in treaty cases. If the investor does not distribute profit but takes the investment as a capital gain, the effective rate of tax is only 30 per cent. Furthermore, if the investment is privileged with tax incentives (common in mining, tourism and agriculture) the effective rate is lowered further.

The existing corporate income tax base is being eroded. Despite the significant economic benefits of cross-border trade and investment, globalisation has made it easier for companies to move profits to low tax countries. The Review makes recommendations to address these tax planning strategies. However, there are limits to what can be done and so corporate income taxes and therefore other less mobile tax bases such as a resource rent tax and ultimately a property tax should be developed to reduce reliance on company taxes over time.

Issues Paper

Issues Paper No.2: Corporate & International Taxation discussed:

- corporate tax rate settings, including the higher non-resident rate and various withholding taxes;
- improved administrative arrangements for large corporate entities to improve business certainty and the broader tax system – including self-assessment and simplifying depreciation;
- integrity settings sufficient to protect PNG from profit shifting;
- international collaboration and treaty negotiations; and
- export taxes in the fisheries and other hard-to-tax sectors.

Comprehensive submissions responding to the Issues Paper were received from Oil Search Ltd, PricewaterhouseCoopers, Exxon Mobil PNG Ltd, KPMG, Bank South Pacific, Deloitte, and the National Research Institute.

Tax Rates

**Recommendation (30): Reduce Corporate Tax Rate to 25 per cent in the medium to long-term.**

PNG’s company tax rate of 30 per cent is at the high end of the range of regional corporate tax rates.
As a capital importing country, Papua New Guinea needs a regionally competitive corporate income tax rate to promote investment and growth – which will in turn grow the tax base. On the other hand this needs to be balanced against the reality that corporate income tax partly captures economic rents from (immobile) natural resources.

It is noted that company tax collections will be sensitive to economic changes, but based on 2014 collections, a reduction of the corporate income tax rate to 25 per cent would cost in the order of K450 million. Base-broadening measures such as ongoing removal of inefficient tax incentives, plugging gaps in the base by introducing a capital gains tax and enhancements to tax compliance by the IRC could, over time, be used to fund a more competitive corporate income tax rate. However, in the longer term alternative, more sustainable bases – such as resource rent taxes and property taxes and consumption taxes – need to be adopted.

If the company income tax is reduced then this reduction should extend to the general income tax rate applied in the natural resource sector. The alignment of the general income tax across all sectors including the resource sector must not be associated to the discussion on resource rent tax. For example, if an effective resource rent tax was not introduced in the mining sector then it may be appropriate to maintain a higher corporate income tax rate, given its role in collecting a portion of the resource rents in the sector.
Recommendation (31) The Tax Rate of Non-Resident Companies (i.e. branches) should be the same as the effective rate on Taxable Income of dividend-paying resident subsidiaries (41.9 per cent). For mining companies, the current 40 per cent rate should be maintained until the effective rate falls below 37 per cent.

The effective corporate tax rate for non-resident taxpayers who invest through a branch or through a local subsidiary need to give a similar tax outcome, otherwise the tax system will distort the way foreigners invest in PNG.

A non-resident can directly invest in Papua New Guinea as a foreign company. It does this by establishing a division or branch in PNG. Branches do not pay dividends to their head office, so dividend withholding taxes do not apply to branches. Currently the non-resident company pays corporate tax rate at a rate of 48 per cent.

If the company operates through a local subsidiary, that subsidiary will pay company tax (currently 30 per cent) and remaining profits then distributed to the offshore parent company will be subject to dividend withholding tax (generally at the rate of 17 per cent). The effective tax rate is 30 + ((100 – 30) x 0.17) per cent = 41.9 per cent.

The resource sector and finance sectors typically use branches in structuring their investments. Branches are less common in other industries. If a mining company operates as a non-resident through a branch in PNG the tax rate is 40 per cent. The CIT rate for mining companies is 30 per cent and the dividend withholding tax rate is 10 per cent. The effective tax rate from combined CIT and dividend withholding tax paid on a distribution is 37 per cent.

The non-resident corporate tax rate should be reduced to 42 per cent under 30 per cent CIT rate and 17 per cent dividend withholding tax rate conditions. This will mean that non-resident branches are treated similarly to subsidiaries. Then the non-resident corporate tax rate should be progressively reduced to align with changes in the CIT and dividend withholding tax rates. Eventually it would be reduced to 36.25 per cent (reflecting the proposed 25 per cent CIT rate and a 15 per cent dividend withholding tax rate).

For mining companies, the current 40 per cent rate should be maintained until the effective rate falls below 37 per cent. Non-resident tax rates for the oil and gas sectors should then be reduced consistently with reductions in the effective rate reflecting the reduction of CIT and dividend withholding taxes.

The aim is to eventually align tax on investor capital (from CIT and dividend withholding) across all sectors to remove distortions in capital allocation.
**Recommendation (32):** All dividends (including mining and petroleum dividends) should be subjected to a consistent 15 per cent withholding tax rate, subject to treaties.

Dividend withholding tax is a final tax for both resident and non-resident investors. Dividend withholding taxes contributed K205m to revenue in 2014.

Withholding taxes play an important role in collecting tax on dividends paid by local subsidiaries to their non-resident parents. They are relatively easy to administer, and given the challenges in administering transfer pricing rules, withholding taxes can ensure some source country taxation on hard-to-tax subsidiary-parent transactions. For these reasons there are sound reasons for maintaining relatively high withholding tax rates on non-residents – even though sometimes they apply to tax-sensitive foreign capital.

Dividends paid by the petroleum companies out of assessable income from petroleum are currently exempt from dividend withholding tax. Originally a 50 per cent rate of corporate income tax was imposed on such income with no withholding tax on dividends. Consequently this resulted in an effective tax rate of 50 per cent. In the 1970s the corporate tax rate for petroleum operations was reduced to 35 per cent and then further reduced to 30 per cent. However, there were no corresponding changes made to the dividend withholding tax as compensation.

**Submissions**

The Issues Paper sought feedback on reducing the general dividend withholding rate and possibly harmonizing interest and dividend rates. Submissions had mixed views and comments. Some considered that withholding tax rates should be reduced to be consistent with the rates in tax treaties while others believed a reduction should only be effected if no further treaties are to be negotiated. Some suggested that withholding taxes should still be maintained until the IRC was able to implement current transfer pricing rules.

Other submissions recommended reducing the dividend withholding tax rate, arguing current rates are an impediment to investment in PNG. Furthermore, the submissions also argued that reductions in dividend withholding tax rate would increase distribution of profits to the shareholders.

The Review considers withholding tax rates on interest and dividends should be aligned. Aligning the rates will form a useful part of broader simplification and harmonisation. In addition, the current disparity between the dividend and interest
withholding tax rates may marginally contribute to a preference for debt financing. Furthermore, consistent with the position taken on incentives generally, the concessional dividend withholding tax arrangements for mining and petroleum should be wound back.

<table>
<thead>
<tr>
<th>Table 8: Dividend Withholding Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends paid by resident companies</td>
</tr>
<tr>
<td>Dividends (Mining)</td>
</tr>
<tr>
<td>Dividends (Petroleum)</td>
</tr>
<tr>
<td>Interest</td>
</tr>
<tr>
<td>Royalties paid to non-residents:</td>
</tr>
<tr>
<td>- other than associates</td>
</tr>
<tr>
<td>- associates</td>
</tr>
</tbody>
</table>

**Foreign Contractor (Withholding) Tax**

**Recommendation (33): The Foreign Contractor (Withholding) Tax be retained at a flat 12 per cent rate and the legislative design should no longer link the tax to the non-resident corporate tax rate.**

The review examined withholding tax levied on payments to non-resident contractors temporarily working in PNG. The tax applies to construction work or certain professional services. It is levied on 25 per cent of the gross value of the contract (a deemed profit margin), taxable at the 48 per cent non-resident corporate rate, which is an effective rate of 12 per cent — such rules are not uncommon, for example, New Zealand has a flat 20 per cent withholding tax for non-residents in specified industries.

The IRC can allow assessment on the actual net profit or loss. However, most foreign contractors pay the withholding tax and don’t seek to be assessed on an actual profits basis. This suggests that either the current 12 per cent rate is on the generous side, or administrative costs of assessment processes are prohibitive.

Withholding tax revenues have become increasingly buoyant — see Figure 2 below.
Submissions

One submission expressed broad satisfaction with the mechanisms for calculating the current withholding tax stating that if the Review considers that not enough revenue is collected, then changes should be made to the deemed profit margin. Another had a similar view, but recommended that its calculation must be linked to the non-resident company tax rate. Others argued that the rate is too high compared to other tax jurisdictions and therefore the rate must be reduced. One recommended doing away with the formulaic approach to calculating the withholding tax and reducing the rate to 10.5 per cent.

The Issues Paper also sought feedback on potential removal of the discretion to allow foreign contractor to be assessed on an actual profit basis, a provision that operates as a matter of law (i.e. upon application) subject to certain conditions. Most submissions agreed with the idea, but one argued that the IRC does not have resources to undertake international enforcement activity.

Conclusion

There is no compelling case to change the rate of the foreign contractor withholding tax. In fact the 25 per cent deemed profit margin seems generous. The low numbers who self-assess suggests the effective rate could, in fact, be increased. For these reasons the Review considers the 12 per cent rate should no longer be legislatively linked to the non-resident tax rate.

The process of designing self-assessment rules (discussed below) consideration should be given to ways to permit final assessment of foreign contractors (withholding) tax to be made on an actual profits basis, without the need to seek
approval from the IRC. The treatment of workers who move in and out of the country raises obvious difficulties under self-assessment, but if a satisfactory procedure can be developed then it should be implemented. The Review suggests that this is an area that the IRC can further look into.

Self-Assessment

**Recommendation (34): Introduce Self-Assessment as soon as practicable.**

The Review notes there are a number of prerequisites before full self-assessment can operate in the IRC.

The current tax law supports an ‘administrative assessment’ system of assessing tax. The IRC examines tax returns lodged by taxpayers to calculate the amount of tax payable, and then notifies the taxpayer of the tax liability. This contrasts with a ‘self-assessment’ system where returns are accepted at face value and the revenue authority may subsequently verify the accuracy of the return. A tax liability arises on lodgement of the return, with payment of tax made within a specified time period.

Administrative assessment is resource intensive, less effective in detecting unreported income, taxpayer education and assistance is in adequate and often less tax is collected because of insufficient focus on the highest revenue risks. There is often a high level of disputation.⁶₀

Self-assessment recognises the underlying reality that the IRC will never be able to accurately determine the tax liability of each taxpayer. Rather, the taxpayer (with assistance and guidance from the IRC) is in a better position to determine his or her own tax liabilities. Under self-assessment, the IRC’s role moves more to that of an educator and facilitator in helping the taxpayer to understand his/her obligations and, secondly, an auditor and enforcer to ensure returns are being lodged and in accordance with the law. A practical effect is that payment of assessments will be brought forward to the extent that the current assessment process delays determination of liability.

Issues Paper No. 2 argued a strong case for moving towards such a system for the larger corporate taxpayers at least (the case is less clear for personal income tax, which is supported by a strong final withholding tax system in any event). The IRC, through its administrative practices, has already begun to give effect to a partial self-assessment system

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Full self-assessment would require a range of preparatory work as outlined in Issues Paper No. 2, referred to in Attachment A.

Submissions

All submissions support the introduction of self-assessment. Some propose applying self-assessment to all taxpayers, whereas others suggest that self-assessment be applied to only medium and large companies. Another submission suggested a phased approach in the implementation of the self-assessment system.

Conclusion

The Review also notes that as far back as the 2000 Tax Review a self-assessment system was recommended. The IRC is beginning to give effect to a partial self-assessment, and this will be facilitated by a new IT system. Full self-assessment will require a range of additional actions but these are consistent with renewal of the tax administration proposed elsewhere.

Transfer Pricing

**Recommendation (35): Strengthen and Simplify Transfer Pricing Rules.**

Transfer pricing rules address international profit shifting, by requiring income and expenses from international transactions between related parties to be determined on an arm’s length basis.

PNG’s transfer pricing rules are based on Australian rules as they existed prior to amendments in 2012 and 2013. Significant deficiencies in the repealed Australian rules were highlighted in a 2011 court case. The repealed law:

- was found to be ‘transaction based’, not allowing the court to look at the totality of arrangements existing between the related parties;
- differed in some respects from the transfer pricing rules contained in treaties, another undesirable inconsistency; and
- did not require the court to have regard to international guidance material, the driver of international consistency in transfer pricing regimes around the world.

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61 F C of T vs SNF: [2011] FCAFC 74
Submissions

Submissions mainly from accounting firms pointed to a lack of capacity in the IRC to enforce the transfer pricing rules. They stated that priority should be given to building capacity in dealing with transfer pricing rather than upgrading the rules. A general theme was that the transfer pricing environment in PNG is relatively benign. Most did not specifically comment on whether technical deficiencies existed – apart from one which said it did not believe there is any real reason to consider updating or changing the existing rules.

Some submissions suggested that changes should be done in conjunction with the improvements in the IRC’s administrative infrastructure and an increase in the recruitment of transfer pricing specialists by the IRC. Assistance from transfer pricing experts would be an easy 'win' particularly in the mining sector, noting however, that it is preferable for the IRC as part of its capacity building initiatives to maximise skills transfer in this area. One submission made the point that PNG’s rules should align with international standards so multinational firms get symmetrical treatment of cross-border pricing issues.

The NRI had a general view that transfer pricing rules should always be kept current and further suggested modifications for small businesses.

Conclusion

It is initially surprising that profit shifting by multinational enterprises has not been observed much, because a relatively high corporate tax rate implies large benefits from shifting profits to lower tax jurisdictions. One explanation may be that the extensive availability of tax incentives or generous thin capitalisation rules has diminished the need to shift taxable profits from PNG.

The Review considers there are potential deficiencies in the current laws which mean that profit shifting rules might not apply consistent with international norms. This increases the possibility of double taxation or ‘double non-taxation’ of cross-border activity.

Furthermore:

- current transfer pricing rules are not suited to a self-assessment environment as the law is written to apply following exercise of discretion by the IRC62;

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62This is part of the rationale for the 2012 and 2013 changes Australia made.
• current law – based on old Australian law – is written in an overly complex style which compounds the difficulties of skilling administrators and practitioners alike. Clearer rules are needed for a self-assessment environment. OECD has published a more appropriate model of simplified draft transfer pricing legislation for developing countries; and

• modifications for small and medium enterprises as suggested by NRI should also be considered in the design of revised rules.

The underlying theme in the submissions that local expertise in administering these relatively complex rules needs to be ramped up, is understood. But if the legislation retains significant defects multinational enterprises can only be expected to comply to the extent required by law.

It is clear that these rules need to be upgraded in the medium term and as a priority element of implementing full self-assessment.

**Thin Capitalisation**

**Recommendation (36):** the Review recommends that:

- the standard 2:1 gearing ratio for thin capitalisation should apply in all cases – including in the mining and petroleum sector; and
- the Thin Capitalisation rules be reviewed in the medium term, once outcomes of the OECD Base Erosion and Profit Shifting Project are known.

There is no reason at present to extend the thin capitalisation rules to banks as they are required to comply with BPNG minimum capital requirements.

Thin capitalization refers to the practice of funding (or ‘capitalising’) a branch or subsidiary with excessive amounts of debt rather than equity capital. In other words, equity capital in the branch or subsidiary is ‘thin’. A thinly capitalized subsidiary of a multinational group can then claim significant interest deductions onshore and shift profit offshore, reducing local income tax.
According to the OECD, academic research demonstrates thin capitalisation is strongly associated with multinational groups. Multinational groups use more debt than comparable widely held or domestically owned businesses. Furthermore this is a big issue for developing countries which are more prone to debt shifting than developed countries.  

Thin capitalisation rules are designed to ensure a fair share of tax is received from companies operating in PNG, by disallowing interest deductions to the extent that the amount of debt held by a company exceeds 200 per cent of the company’s equity (a ‘gearing’ ratio of 2:1).

While thin capitalisation rules apply broadly, there are separate rules for mining and petroleum industries that allow debt of 300 per cent of equity. (a 3:1 ‘gearing’ ratio).

Also the rules do not apply to the finance sector. Banks and insurance companies present special issues because they raise debt finance in order to write new business. Interest expense is therefore much more closely tied to their ability to generate income compared to groups operating in other sectors. Moreover financial sector businesses are regulated by the Bank of Papua New Guinea which sets minimum equity capital requirements. Where thin capitalisation rules apply to the financial sector it is common to apply more generous debt to equity limits.

The Issues Paper raised the question of whether there was a need to introduce a debt/equity ratio for the financial sector and whether the gearing ratio for mining and petroleum should be the same as for all other sectors. There is clearly an international trend to tighten deductions for interest. For example, Australia and Canada have reduced their thin cap ratios to 1.5:1 (from 3:1 in Australia and 2:1 in Canada), and countries such as Germany, Portugal and Belgium have introduced rules that impose a limit on interest deductions as a share of total earnings. These types of reforms are often in response to concerns that interest payments, especially to related parties, are used for tax planning.

The Review is not aware of any other countries that have different gearing ratios for extractive industries.

Submissions

Submissions by accounting firms and Bank of South Pacific considered there is no need to extend the thin capitalisation rules to the financial sector as it is already subject to minimum capital requirement prescribed by BPNG. If the thin capitalisation rules apply to the financial sector it is common to apply more generous debt to equity limits.

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63 OECD (2014) p 16
capitalisation ratio was extended to financial sector, then a submission recommended the gearing ratio applicable should at least be 15:1. Another was broadly in favour of extending the thin capitalisation rules to the financial sector, provided they can access a higher gearing ratio and that the rules do not duplicate restrictions already put in place by the BPNG.

Conclusion

The Review finds no case for more generous thin capitalisation rules for the mining and petroleum sector and recommends the gearing ratios for these sectors be the standard 2:1 gearing ratio.

The minimum equity capital requirements for financial institutions cover the regulatory field excluded from the thin capitalisation rules and so long as this remains, the case for special thin capitalisation rules for this sector is not strong. Existing legislative arrangements need not change.

Base Erosion and Profit Shifting (BEPS) Project

The Review also notes that OECD (2014), analysis is of the fixed ratio rules which link interest deductibility to the level of equity in an entity through debt to equity tests (which applies in Papua New Guinea). It found this test is relatively easy to administer because information on the level of debt and equity in an entity is available. The test also provides a reasonable level of certainty to groups in planning their financing. However, a number of major drawbacks are identified. First the debt:equity ratio still allows companies considerable flexibility on the rate of interest charged on the debt. It also allows entities with higher levels of equity capital to deduct more interest expense making it relatively easy for a group to manipulate by increasing the level of equity in a particular entity. For this reason, the OECD is unlikely to propose a fixed ratio debt to equity test as the best approach to addressing profit shifting. The OECD process outcome remains unknown so it would be appropriate to review the current thin capitalisation rules once the BEPS process reaches a conclusion — even though PNG’s rules are relatively recent.

Recommendation (37): Negotiation of new tax treaties should be put on hold for the time being.

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64 ‘Financial institutions’ are defined to mean the Bank of Papua New Guinea and a bank or financial institution licensed under the Banks and Financial Institutions Act 2000.

65 OECD (2014, P 13)
When the BEPS project concludes, renegotiation over time of existing treaties may be required. Alternatively PNG should also consider the merits of entering into the multilateral instrument being developed as part of the BEPS process.

PNG has a manageable network of nine tax treaties which help avoid some forms of double taxation but operate to limit source taxation rights. They improve certainty in taxation arrangements for foreign investors — although the extensive use of fiscal stability clauses in natural resource agreements tends to limit the significance of this benefit. Plus there is no evidence they increase inbound investment to countries with the income level of PNG.

A number of submissions to the Review argued for the need to negotiate more tax treaties, providing certainty to investors and a more appealing investment environment. Issues Paper No. 2 examined the pros and cons of expanding the treaty network and sought the views of the community.

Submissions

Most submissions rated negotiation of new treaties as a lower priority. The resources of the IRC should be directed towards resolving outstanding technical matters relating to objections, requests for amendments, etc. It was noted for example that reduced withholding taxes are already provided for in the domestic law, ‘treaty shopping’ poses problems and tax treaties have the general effect of reducing local tax collections.

In contrast, some others argued a more comprehensive treaty network would play an important role in facilitating investment, trade and movement of technology and personnel. One suggested negotiations with the US and Japan should be looked at, with priority given the importance of the two countries as source of both investment and foreign aid funding.

Conclusion

Looking at the limited additional benefits flowing from tax treaties, and the significant opportunity costs to Treasury and the IRC of negotiating and maintaining a larger treaty network there are more significant priorities facing the PNG’s tax system at this time.

The development of a multilateral instrument as part of the BEPS process, which would readily enable signatories to update their existing treaties, could provide PNG

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66 Under the double tax agreements (DTA)
with an opportunity to update its treaty network, such as incorporating anti treaty shopping provisions also being developed as part of the BEPS process.

**Depreciation**

**Recommendation (38):** The Review recommends the following simplification package:

- the depreciation schedule should be (a) simplified by adopting fewer rate bands and (b) published on the IRC’s website;
- depreciation thresholds for small value assets should be increased to at least K3000. Plant or articles with a value between K3000 and K10,000 should be pooled and depreciated as a single asset; and
- eliminate the various depreciation concessions, including accelerated depreciation.

Expenses of a capital nature are not usually written-off immediately, but for assets which waste over time the tax system generally allows a proportion of the value of an asset to be deducted annually (‘depreciated’) over time. The rate at which an asset is depreciated generally follows the effective life of an asset. The IRC is required to make an estimate of the useful life of the depreciable assets and it does this by publishing a Schedule of Rates. Assets can be depreciated using either the prime cost method (that is, the same deduction is available in each year) or the diminishing value method (the amount of the deduction decreases each successive year).

In addition to the standard regime, PNG has a number of depreciation-based incentives. Notably certain classes of assets qualify for ‘accelerated depreciation’.

**Issues Paper No. 2 on Corporate and International Taxation.**

Issues Paper No. 2 discussed the following issues in detail:

- **Updating depreciation schedules.** The effective life schedules used to calculate the depreciation of assets are rarely updated.
- **Further simplifying depreciation schedules:** Assets, for example, could be classified into three or four broad categories
- **Further options to streamline schedules:** such as allowing the use of accounting depreciation rates or allowing self-assessment for low-risk companies.
- **Write off of low-value assets.** The law currently provides for the immediate expensing of assets valued under K1,000 for the mining, petroleum and gas sectors. A number of submissions argued not only for an extension of the immediate write off to all sectors but an increase in that threshold. Applying a higher threshold to smaller businesses only is also an option.

- **Remove existing concessions:** to streamline and simplify depreciation.

- **Black hole expense rules.** These expenses are capital expenses that are neither deductible (because under the general rules they are capital outgoings) nor depreciable – for example costs of establishing a business, or changing a business structure.

### Updating and Simplifying Depreciation Rates

Views on the urgency of updating and simplifying depreciation schedules whilst, varied, overall, most were supportive of doing so. One accounting firm, however, stated that this issue was a low priority because taxpayers were often self-assessing depreciation anyway, without specific reference to the schedules.

One submission did not recommend using accounting depreciation rates because while those rates are used by taxpayers whose accounts are audited, many taxpayers are not required to comply with the accounting standards and could use whatever depreciation rates they choose.

The Review considers the depreciation schedule should be simplified and updated by adopting fewer standard rate bands. The current depreciation schedule has not been updated for decades. It runs to 14 pages and is quite detailed with 15 different rates for the prime cost method. As it is not published on the IRC’s website and therefore, it is not surprising that many taxpayers are self-assessing.

The Solomon Islands also has a very simple depreciation regime, refer below.

**Figure 3: Solomon Islands Depreciation Rates**

<table>
<thead>
<tr>
<th>Item</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings, building fixtures, bridges, wharves</td>
<td>5%</td>
</tr>
<tr>
<td>Vehicles, vessels, aircraft, plant &amp; machinery</td>
<td>25%</td>
</tr>
</tbody>
</table>
One of the simplification options raised in submissions is to model the depreciation system on that applies to PNG mining and petroleum projects. There are two asset classes – short life and long life – each with separate depreciation rates. The resource sector has simplified depreciation rates (similar in effect to Solomon Islands but more generous). Assets with a normal useful life of 10 years or more are depreciated on a straight line basis over 10 years. Other assets are usually written off over 4 years (or less).

Submissions also suggested raising depreciation thresholds for small value asset treatment (to K5,000 and another suggested K2,500). In addition, one recommended having a default category (e.g. 10 per cent) for assets that may not fit clearly into one of the existing depreciation classes.

The Review makes no final recommendation about the final number of bands and particular rates, as to some extent this depends on revenue costs. However, the Review strongly suggests that the IRC updates the existing depreciation schedules so that it accounts for current practices. Both Solomon Island and PNG resource sectors provide examples of the general direction for change. In the case of PNG the depreciation rates should also be published by the IRC on its website.

The Review also recommends that depreciation thresholds for small value assets be increased to at least K3,000. Plant or articles with a value between K3000 and K10,000 should be pooled and depreciated as a single asset.

The simplification of depreciation schedules together with pooling of low value assets and assignment of appropriate thresholds would be especially beneficial for small to medium enterprises – this is further highlighted in the chapter on small business.

Some submissions cautioned against changing the more significant tax concessions (i.e. accelerated depreciation) which could reduce capital investment.

The Review has considered the broad question of the extensive number of incentives provided by PNG’s tax system. It is strongly recommending a review of ALL incentives.

While accelerated depreciation incentives perhaps do the least damage to the efficiency of the tax system and growth potential, they do add costs by unnecessarily complicating PNG’s tax rules.

The Review recommends that as part of a package of simplification measures, including streamlining rates and raising the small value depreciation threshold, the
various depreciation concessions, including accelerated depreciation should be rationalised.

Most submissions stated that rules giving certainty to the treatment of ‘black hole’ expenses (capital expenses which are not deductible or depreciable) were a good idea. On the other hand, the flavour of the submissions was that this issue is not causing major practical difficulty. The Review agrees that a depreciation style for black hole expenses should be introduced at some stage, but this is potentially a longer-term issue.

Training Levy and Double Deduction for Training

Recommendation (39): The training levy and the double deduction for training should be abolished.

Issues Paper No. 2 extensively discussed these two features of PNG’s tax system that are designed to encourage businesses to invest in the training/up skilling of employees:

- Businesses with a payroll of over K200,000 are liable to pay a training levy of 2 per cent of the gross payroll. The levy applies only if a business has spent less than 2 per cent of its payroll on training or skilling its staff. Once expenditure on qualifying training reaches 2 per cent of payroll no levy is payable. The definition of a “qualifying training expense” is generous and includes the salaries of apprentices, salaries of staff at approved training courses and the expenses of training staff at approved training courses. Revenue collected is negligible, but of course the underlying policy intent of the measure is not to raise revenue.

- An incentive to invest in training is available in the form of a double deduction for expenditure on the salary and wages of registered apprentices, the salary and wages of employees attending a Government Training Institute or other prescribed place of tertiary education, the salary and wages of full time training staff and also for tourism staff training costs.

Submissions: Training Levy

Most submissions proposed abolishing the training levy. A common point was that it imposes a significant compliance cost on employers and does not achieve its intended goal of promoting staff development; companies already have an incentive to do this because a well trained workforce adds value to the business. There was
also criticism that the training levy laws were designed in another era for a traditional business model in mind that no longer reflects the modern commercial environment with new work practices including labour outsourcing, contracting, large-scale projects with multiple entities, and access to online training modules, etc. Submissions also argued that the levy requirements are readily met by companies or, in other cases, simply ignored with limited enforcement action taken against them.

Conclusion: Training Levy

The case for abolishing the training levy is compelling. There is no evidence that it is achieving its objectives (there are inherent commercial incentives for developing staff) and plenty of anecdotal evidence that it is adding significant compliance costs and administrative complexity.

Submissions: Training Levy

Those submissions that addressed this issue, tended to favour the continuation of a double deduction as an incentive to staff training, although without extensive considerations. The NRI recommended abolition.

Conclusion: Double Deduction

The case for abolishing the double deduction is also compelling. For similar reasons as for the training levy, the incentive is unlikely to be promoting substantial additional training.

Other Issues

1) The scope and definition of the management fee withholding tax should be maintained.

First enacted in 1989, the management fee withholding tax was introduced to address transfer pricing practices (whereby businesses inflate ‘management fee’ payments to related entities offshore to shift profits to a lower taxing jurisdiction).

As a result of changes made in the 2005 Budget, “management fee” now extends to technical fees, because management fees were being re-characterised as technical services to avoid the withholding tax. However, the underlying policy intent, to assert source taxing rights in instances where there was a risk of transfer pricing activity between related entities, remained.

As the law currently stands, the regime only applies to “taxable management fees” as defined by sections 68AD and 155M of the ITA. These sections have the effect of
limiting the deductions available from the payment of such fees to associated entities.\(^6\) These provisions therefore act as an additional integrity measure, to protect against transfer pricing between related entities.

For similar reasons, management fees and technical fees are subject to withholding taxes around the world (Singapore is one example).

**Submissions**

Some submissions proposed that the withholding tax should not be applied as an anti-avoidance provision when income tax law contains general transfer pricing rules to ensure that profits are not shifted out of PNG. One company considered the underlying policy is sound and it is a useful mechanism to stop profit shifting. However, it said its effectiveness is limited and needs tightening to remove any ambiguity. Another submission also argued the Budget amendments have resulted in the widening of its impact far beyond its original policy intent.

**Conclusion**

The review considers it is legitimate to impose a withholding tax on management and technical fees — as many countries, including countries with strong tax administrations, do.

2) **Definitions of Debt and Equity**

A ‘substance over form’ approach is used in defining ‘interest’ ‘debt’ and ‘equity’ in thin capitalisation rules and is appropriate. In other words, a financing instrument is treated not by its legal form (for example, whether it is a share or not) but by its underlying economic substance.

Over time, international finance arrangements have increasingly made use of ‘hybrid instruments’ (having characteristics of both debt and equity). These instruments can be used to minimize or eliminate the imposition of tax on income in any jurisdiction. To avoid these instruments being used to frustrate the policy intent of the thin capitalisation rules, an effective debt/equity test is needed.

The Review examined the question of whether this approach should continue to apply outside the thin capitalisation regime, but notes the decision in the 2015 Budget to confine this approach to thin capitalisation to avoid unintended consequences.

\(^6\) That is, these provisions do not apply and therefore the withholding tax does not apply, in relation to payments that the Commissioner General is satisfied are not made to an associated entity.
3) Membership of the Global Forum on Transparency and Exchange of Information on Tax Matters

In a globalized economy, where taxpayers are increasingly operating across borders, collaboration between governments is vital in assisting tax authorities to address offshore tax evasion. Issues Paper No. 2 raised the question of joining multilateral efforts to collaborate in cross-border tax cooperation. It also considered issues relating to joining the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which would provide the legal basis to exchange tax information with much broader range of jurisdictions and allow PNG to ask other jurisdictions to collect taxation debts on its behalf.

Submissions

While acknowledging the importance of joining the Convention some stated that there were higher administrative priorities. Some suggested that PNG would be asked by other countries to provide more than it will seek from elsewhere. There were contrary views that exchange of information between countries is important as it could potentially increase tax collections and provide better insights in tax structuring into PNG.

Conclusion

The Review considers that targeted engagement with the international community is important for an internationally exposed trading economy like PNG. It will be important to keep this engagement focused and proportionate to the priorities under this reform.

The Government announced its support for PNG’s membership of the Global Forum on Transparency and Exchange of Information on Tax Matters in the 2015 budget. It noted that Membership to the Forum could be a precursor to signing up to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

4) International Tax Integrity Rules

The Review agrees with the position taken in the submissions: that is, that there is no compelling case for these measures at this time. As well, development in the Base Erosion Profit Shifting project should be monitored and any legislative consequences carefully considered.

Issues Paper No. 2 identified a range of additional integrity rules common in many jurisdictions. It noted the case for new integrity rules would need to be particularly strong given capacity challenges facing IRC in effectively administering existing integrity rules.
A number of integrity frameworks applied in other jurisdictions were identified:

- **Controlled foreign company (CFC) rules**: To prevent a resident deferring the payment of tax through holding income offshore in a company controlled by the resident.

- **Transactions with 'secrecy' jurisdictions/'tax havens'**: Measures to encourage these jurisdictions to share information to identify tax avoidance or evasion – for example, denying deductions for payments made to parties in that jurisdiction.

- **Earning stripping rules**: Restrict deductions for interest payments over some proportion of a company's income, and complement thin capitalisation rules. Recently the IMF said 'such measures are relatively easy to apply, and can be especially attractive for developing countries in protecting their tax base from base erosion'.

- **Minimum Tax**: protect revenue by charging tax on something such as turnover, book earnings or assets that is less prone to manipulation than 'taxable income'. Over 30 countries have implemented such minimum tax regimes though they vary from country to country.

**Submissions**

All submissions considered that introduction of new integrity frameworks is not a priority. The CFC rules are by nature complicated and difficult to enforce. Its Introduction would add unnecessary complexity to the tax law. Additional integrity frameworks are not necessary if reform efforts are focused on strengthening transfer pricing rules to prevent profit shifting.

One of the accounting firms stated that the priority is enforcement of existing transfer pricing and anti-avoidance measures. However, policy makers should continue to monitor BEPS developments with a view to legislate it in the future once issues are properly understood and a framework for compliance is in place.

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68 International Monetary Fund, 2014, Spillovers in International Corporate Taxation, IMF Policy Paper, 9 May 2014
CHAPTER 5: MINING AND PETROLEUM TAXATION

Introduction

The Review terms of reference includes reviewing the taxation regime applying in the mining and petroleum sector. The sector was last reviewed in the 2000 Tax Review.

Over the past decade, PNG’s mining and petroleum sectors have been significant contributors to the economic growth of the country. These two sectors account for around 75 per cent of exports and 20 per cent of gross domestic product. The sectors have also been an important but volatile source of revenue for the country.

Fiscal arrangements for mining and petroleum sectors have four main elements:-

- Royalties.
- Corporate income tax (CIT) including withholding taxes.
- A rent based tax (such as the additional profits tax applying to gas projects).
- State participation.

A key finding of the Review consistent with IMF advice, is that the tax arrangements for the mining and petroleum sector are very generous compared to other resource rich countries and do not reflect the maturity of PNG’s mining and petroleum sector. This is due to project specific arrangements and general tax incentives that have eroded potential government revenue.

Another finding of the Review was that a resource rent tax would best provide the optimal return for non-renewable resources (particularly when commodity prices are high) — while ensuring PNG remains a competitive investment location. Extraction of natural resources permanently depletes PNG’s inventory of resources and so it is very important to get tax and other policy settings right.

Therefore, the key changes proposed are:-

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69 Petroleum refers to Oil and gas

“There are few areas of economic policy—making in which returns to good decisions are so high—and punishment of bad decisions so cruel—as in the management of natural resource wealth. ... And amongst the most important decisions are those relating to the tax treatment of oil gas and minerals.”

IMF 2010
• to reduce the level of State participation for future projects, in exchange for extending a revamped Additional Profits Tax (APT) applying to all future mining and petroleum projects. (APT currently only applies to gas projects);
• to apply a resource rent tax in the form of a Rate of Return Additional Profits Tax with:
  o a single tax rate of 35 per cent; and
  o different hurdle rates of return establishing where the APT starts to apply for Mining, Oil and Gas.
• aligning income tax rates (including withholding rates) for mining and petroleum, with other sectors and rationalizing certain mining and petroleum tax concessions; and
• a change in the valuation method for royalties.

The changes to the level of state equity interests and extension of resource rent taxation across the sector should apply prospectively to all new projects. In assessing the Government’s take from the sector, it is important to view the different fiscal reforms as a package. Some of the changes to fiscal mechanisms (taxes, charges or options) will increase revenues while others will reduce revenue. However, the net effect is that the overall fiscal package will increase the Government take.

It might be argued that the current concessions should not change at a time when commodity prices are low. However, the Review considers its proposals will put in place a sector-wide fiscal regime for the long-term — for all times, when commodity prices are low and when they are high. Changes will be sustainable, because they provide a return for resources for the long haul. Concessionary incentives introduced when resource prices are low are tested when prices rise sharply. If these concessions prevent reasonable revenue collections — especially in good times — there will be pressure to reverse the arrangements.

Furthermore the proposed APT resource rent tax automatically adjusts to changes in project profitability. It is inherently more stable than inflexible arrangements such as royalties, etc. If conditions are good, a tax regime based on resource rent collects a reasonable share of profits for the government and if conditions are bad it collects little or no revenue, giving the investor the best chance of achieving its required hurdle rate.
Background

Mining and Petroleum taxation was discussed in Issues Paper No. 1: *Mining and Petroleum Taxation*. This Issues Paper was developed through work undertaken by the International Monetary Fund in March 2013. The paper described the Mining and Petroleum sector, tax revenue trends and current fiscal policy settings. It raised a number of questions for feedback. The detailed analysis contained in the Issues Paper, combined with input from submissions, form the bases of the decisions in this Report.

Eight submissions were received responding to Issues Paper No. 1 from Kepsey Puiye, Ernst and Young, Harmony Gold (PNG Services) Ltd, PNG Chamber of Mines and Petroleum, Oil Search Ltd, Exxon Mobil PNG Limited and the Department of Mineral Policy and Geo-Hazards Management.

The Review also hosted a Tax Symposium in conjunction with the National Research Institute. The main objective of the tax symposium was to bring together international tax experts with a wide range of stakeholders to discuss the future direction of taxation reform in PNG. For the academia, there involvement was to assist the Review in validating conceptual framework, analysis and ultimately guiding policy recommendations of the Review.

The Review also commissioned Craig Emerson Economics Pty Ltd to prepare a comparative fiscal analysis of the various resource rent options identified in Issues Paper No: 1 and recommend the most optimum option for PNG.

Importance of Mining and Petroleum Taxes

The Mining and Petroleum Sector is a very important sector to the overall PNG economy.

Revenues from the mining and petroleum taxes are volatile due to global commodity price fluctuations. Despite this volatility, they constitute a significant proportion of total revenues. For example in 2014, the revenue generated from the mining and petroleum sector was around 8 per cent of the overall tax revenue collected (see Figure 4).
Resident mining companies are subject to the standard company income tax rate of 30 per cent. Non-resident mining companies pay 40 per cent. There is currently no resource rent tax on mining profits. The State has the right to state equity (up to 30 per cent) and mineral royalties (5 per cent). Dividend, interest and contractor’s withholding tax apply, but at concessional rates. Most mining companies have negotiated concessionary rates of import duties. Mining companies also have a concessionary stamp duty rate for the transfer of mining information and concessionary rates on the transfer of an exploration or development licenses.

Further, mining companies can access incentives such as double deduction for exploration expenditures. Exploration expenditure from areas outside the project area may be pooled and deducted at 25 per cent declining balance, subject to certain restrictions. Thin capitalization debt:equity ratios (3:1) are more generous than the 2:1 ratio generally applying to the other sectors. Indefinite carry forward of tax losses, while a 20 year limit applies to other companies. A tax credit is available for infrastructure projects.
Table 9: Petroleum and Gas Fiscal Regime

<table>
<thead>
<tr>
<th>Fiscal Instruments</th>
<th>Petroleum projects</th>
<th>Gas projects</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty and development levy</td>
<td>2%</td>
<td>2%</td>
<td>On wellhead value.</td>
</tr>
<tr>
<td>Petroleum income tax</td>
<td>50% (old field), 45% (std) or 30% (incentive)</td>
<td>30%</td>
<td>Depreciation: Exploration (25% DB), Long Life (10 years SL) and Short Life (25% DB).</td>
</tr>
<tr>
<td>Ring fencing for tax</td>
<td>Per project</td>
<td>Per project</td>
<td>May include pipelines and processing facilities. Exploration in the country deductible with a limitation.</td>
</tr>
<tr>
<td>Uplift for depreciation under income tax</td>
<td>No</td>
<td>Only for PNG LNG Project</td>
<td>From 0 to 50% depending on R factor at year 11.</td>
</tr>
<tr>
<td>State participation</td>
<td>Up to 22.5%</td>
<td>Up to 22.5%</td>
<td>Option can be made when development is decided. Revenues to budget only if SOE transfers dividends.</td>
</tr>
<tr>
<td>Additional profits tax (APT)</td>
<td>None (repealed in 2003)</td>
<td>Reduced 2-tier APT for gas projects only. Thresholds: 7.5% and 20%. APT rates: 7.5% and 10%</td>
<td>Original two-tier APT from 2001 to 2003: Thresholds: 15% and 20%. APT rates: 20% and 25%</td>
</tr>
<tr>
<td>Other taxes</td>
<td>Taxation of subcontractors and personnel. No withholding tax on dividends or interest.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*DB stands for declining balance and SL stands for Straight Line*

State as the Resource Owner

The Independent State of PNG (‘the State’), on behalf of its people, owns the nation’s mining, petroleum and gas resources. PNG’s mineral and petroleum resources are a finite and non-renewable resource and their extraction permanently depletes PNG’s inventory of resources.

The State in issuing exploration and development licenses, grants to private firms access to prospective ore bodies or reserves. Further, it allows the private firms potentially to gain surplus profits in the form of resource rents.

Maximizing Mining and Petroleum Tax Revenue

Maximizing government tax revenue in the mining and petroleum sector is achieved by taxing resource ‘rent’. Resource rent is the profit remaining after all costs have been deducted. These costs include exploration and development costs, cash operating costs and the minimum return needed by an investor to proceed with a project. This minimum return is also known as the investor’s hurdle rate.
Resource deposits that are of higher quality and closer to final markets are more likely to generate a resource rent than those of lower quality and more distant from markets. The higher an investor’s hurdle rate, the lower the resource rent available from a project. A project’s risk profile will influence an investor’s hurdle rate – higher risk will translate to higher hurdle rates. Many things influence risk including the potential investor’s assessment of a country’s attitude towards regularly changing its fiscal regimes. If legal and administrative arrangements of a country are stable over time, an investor’s hurdle rate will tend to be lower, leaving more of a project’s proceeds as resource rent for sharing between the State and the investor.

**State Equity Participation**

<table>
<thead>
<tr>
<th>Recommendation (40): State equity participation rights in new projects should be 5 per cent.</th>
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</table>

The PNG Government has the right to acquire a share of designated petroleum or mining projects. The State can acquire up to 22.5 per cent of a designated petroleum project, and up to 30 per cent of a mining project, on ‘sunk cost’ basis. This means the State can acquire a share in a project by paying its share of the project’s historic cost (including exploration cost), and sharing ongoing future costs.

Submissions from the mining and petroleum industry sought to maintain the present state equity participation arrangements.

The Chamber of Mines and Petroleum argued that state equity was accepted and well understood and generally a positive influence in the mining regulatory environment. The Chamber clearly is more comfortable with a level of State equity, compared to the alternative of a resource rent tax (such as APT): “The substitution of State equity, which industry believes shows evidence of substantial PNG government commitment to the shared success of its mining ventures, with a complex and unwieldy tax which can only distance the government from the industry will be viewed negatively.”

On the other hand Oil Search, who is already subject to an APT and was comfortable with current arrangements on its gas projects with a combination of State equity and APT. It noted: “APT is a conceptually sound instrument available to the State to achieve desired progressivity in State take, as it is based on post tax rate of return which incorporates all variables including the time value of money.”

Issues Paper No.3 discussed various drawbacks associated with State equity participation. Some of the drawbacks are.
• State equity has a critical shortcoming if the project turns out to be unprofitable. Financing the State’s equity investment requires the PNG Government to borrow on international finance markets and pay interest on the debt. This exposes the State to substantial losses if a project that appeared likely to be profitable at the time of issuing a development license turns out to be unprofitable.  

• The decision to take up an equity interest is a complex one that is made more difficult by the project sponsor knowing more about the financial viability of the project than the State.

• State participation in projects introduces conflict between the commercial goal and the non-commercial roles of the State, creating the temptation to grant concessions to projects even when these are clearly not in the State’s broader interest.

• Often there is a disconnection between dividend flows and loan obligations arising from financing the State’s equity participation. In many cases, the dividends are received by a State nominee that has little responsibility to meet the loan obligations and, as a result, these revenue streams may be misused or over-committed (when they are needed, in part, to repay debt).

• The budget process becomes less effective and less transparent if dividend flows are effectively taken ‘off budget’. That is, the dividend flows are not subject to the scrutiny of the Government’s budgetary process. This can occur if the State nominee has the first call over dividend revenues either to support State participation in the project or, more generally, other activities of the nominee.

Notwithstanding the drawbacks discussed above, the Review recognizes there are expectations related to landowner equity participation in resource projects. Providing the opportunity for these important stakeholders to have a say in the sensitive development of their customary land should ensure projects can operate more efficiently and minimize disruptions.

**Choice of Rent Tax**

Recommendation (41): For any new projects, Additional Profits Tax must be in the form of a Rate of Return model and at a single rate of 35 per cent.

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70 The Review engaged Craig Emmerson Economics Pty Ltd to model State equity versus resource rent tax options. This modelling confirmed that State equity can be as effective as an APT in collecting rent from profitable projects but underscored the risks to the State budget if the project turns out to be unprofitable.
A resource rent is the extra revenue a project is able to gain as a result of the right to extract resources, over and above the ‘normal’ return that would otherwise be available to the capital invested in the project.

The general features of a resource rent tax are that:

1. It does not tax ‘normal profits’. Normal profits describe the return needed to make the investment worthwhile. The normal profit will be informed by what the investor could have expected to get from diverting labour and capital to other purposes.
2. A resource rent tax is designed to apply to profits over and above normal profit. It is the profit that comes from the exclusive right to extract the resource. The taxation of the resource rent is appropriate because it does not change the investor’s incentive to invest; and
3. A resource rent tax is self-executing and progressive, taking a larger share when profits are high and automatically adjusting to take a lower amount or not apply when profits are lower. In addition, a progressive regime could attract investment for marginal projects (increasing government revenue), just as a heavy early fiscal burden on a project could deter investment altogether.

Issues Paper No.1 discussed several resource rent tax methods and these were:

- R-factor taxes are payable when a project has paid back its initial cash outlays but with no allowance for an investor’s hurdle rate.
- Sliding royalty is a royalty based on value or volume and the rate increases progressively.
- Income tax surcharge is based on net cash flows after the payment of royalties and company tax, but with no allowance for an investor’s hurdle rate.
- An additional profits tax (APT) is a tax on net positive cash flow once the investor has received a specific rate of return.

PNG has historically applied an APT to some designated mining and petroleum projects. Currently, APT only applies to gas projects including the newly operating PNG LNG Project. For designated gas projects the APT is applied at progressive rates such that: (a) a tax rate of 7.5 per cent applies at an APT threshold rate of 17.5 per cent; and (b) a tax rate of 10 per cent applies at a threshold rate of 20 per cent. In the past, PNG has also applied APT rates to mining and petroleum projects of 20 per...
cent, 25 per cent and 50 per cent; with threshold rates of 15 per cent, 20 per cent and 27 per cent. The APT has since been removed for mining and petroleum products (other than gas projects).

With the exception of an APT for Bougainville Copper Limited, no APT has been payable by any petroleum or mining company. This is because the APT threshold rates have been set very high and have not been triggered.

The Review recommends maintaining APT but changing the method of calculation to a single Rate of Return form of APT. The proposal is based on its ability to capture only resource rent and also takes account of time value of money. Companies are not subject to resource rent tax until they have covered their costs plus a rate of return.

The application of the Rate of Return APT is simple because it applies a single rate as opposed to the current system based on a two-tiered APT model. At its theoretical extreme resource rent taxation rates tend to be 100 per cent, but in reality much lower rates apply. The resource rent tax in Australia applies an APT tax rate of 40 per cent. The Review proposes to apply a single tax rate of 35 per cent.

**Different APT Rate of Return**

**Recommendation (42): For any new projects, different APT Rate of Return threshold can be applied for mining, oil and Gas. These threshold rates will be included in legislation after further consultation.**

A resource rent tax is designed to tax the returns above an investor’s hurdle rate. The APT rate of return is used to carry forward and uplift the negative cash flow in the projects early years to be offset against positive net cash flow in its operating years.

The Review explored the possibility of a single rate of return across mining, oil and gas. It accepts the industry’s view that this is not the best approach. It considers that separate rates should be legislated for mining, oil and gas that are as close as possible to the typical investors hurdle rates.

The Review recognizes that it will be necessary to consult further with industry to establish separate legislated rate of return for the mining, oil and gas sectors.
Corporate Income Tax Rates

The review recommends (see the Corporate Income Tax (CIT) discussion) reducing various corporate tax rates and withholding tax rates to create alignment across sectors. This will be complimented by the broader application of a resource rent tax.

Ad hoc decision making, over time, has led to different CIT and withholding rates applying to different sectors. These different rates reduce economic efficiency and unnecessarily complicate tax decision making and tax administration. For example the rates of income tax on oil or gas projects can differ and this in turn requires a decision, based on the application of the oil and gas ratio test.

The Chamber of Mines and Petroleum was strongly against the alignment of the tax treatment of the different sectors for the sake of alignment. They consider that there are fundamental differences between mining, petroleum and gas projects and given these differences, it is appropriate the sectors be taxed under distinct and separate tax regimes.

However, these different rates can result in the PNG economy being less productive than it could be. CIT, dividend, interest and royalty withholding taxes are taxes on capital. Different tax rates for the resource sector distort the allocation of new capital investment in Papua New Guinea. At a time when diversification of the economy is critical, different tax rates between sectors are sending the wrong signals to investors. And scarce investment resources may be allocated away from more productive activities.

Hence, the Review recommends aligning the income tax rates. The specific recommendation is contained in the chapter on Corporate and International Taxation. The current rates are contrasted against the Review’s proposed changes in Table 10 below. The Review acknowledges the budget position may influence the timing of the reform.
When budgetary circumstances permit, the following changes to tax rates are proposed to change so corporate tax rates, as well as interest and dividend withholding tax rates, on all businesses are aligned.

- The general CIT rate is currently 30 per cent. Over time, the CIT rate is recommended to be reduced to 25 per cent. CIT rates for mining and petroleum should be the same as the general rate applying to all businesses.

- Dividend withholding tax is recommended to be 15 per cent, subject to treaties. It is also recommended that interest withholding taxes be standardized to 15 per cent. This means that interest withholding taxes will increase for mining and petroleum companies.

- Investors in PNG resources typically invest via branches of non-resident entities. A non-resident tax rate applies in these cases. The general rate of tax on non-resident companies is 48 per cent which is the effective tax rate once CIT and dividend withholding tax is paid on a distribution to a foreign parent. It is proposed to reduce this rate to 42 per cent (where a 30 per cent CIT rate applies and a 15 per cent DWT applies). Then progressively to 36.5 per cent (where a 25 per cent CIT rate applies and a 15 per cent DWT applies).

- Non-resident tax rates for the oil and gas sectors should be reduced consistent with the reduction of CIT and dividend withholding taxes. The CIT rate for mining companies is 30 per cent and the dividend withholding tax rate is 10 per cent. The effective tax rate from combined CIT and dividend withholding tax paid on a distribution is 37 per cent. The non-resident mining rate should remain at 40 per cent, but be reduced when the effective rate falls below 40 per cent so that eventually it aligns with tax on investor capital (from CIT and dividend withholding) across all sectors.

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71 Of the five oil fields currently producing in PNG, one is subject to a 45 per cent rate and the others are liable to the old 50 per cent rate.
The Chamber of Mines and Petroleum argued to retain the existing rates. It also notes that not all jurisdictions grant foreign tax credits on dividend withholding taxes. Levying a dividend withholding tax may result in different tax outcomes for projects from different jurisdictions where a policy goal of the Government should be to ensure a level playing field for all investors. First, it is true that most home countries do not provide credits anymore — but the trend is to exempt these dividends from home taxation. Second, it is not clear to the Chamber as to why it is that PNG revenue policy settings ensure a level playing field for all investors, when this is properly an issue for the investor countries to address.

**Exploration Licenses: Competitive Bidding**

Currently in PNG, mineral exploration licenses are awarded on a ‘first come, first served’ basis with license holders having the right to apply for a mining lease. Presently exploration licenses issued are valid for two years. They may be renewed every two years subject to meeting the regulatory requirements.

The Chamber of Mines and Petroleum supports maintaining the current system of awarding exploration licenses. It argues that it has worked well for the country and should not be changed.

For petroleum licenses however, PNG has an open door policy. This involves a bidding process that accords with a ‘work program bidding’ auction model. However, the Review believes it is unclear as to whether in practice the bidding process is competitive and transparent.

The Chamber of Mines and Petroleum has acknowledged the problem with the current system of petroleum license issuance, but suggests that any improvements must be based on a structured work program bid system and not on cash bidding.

The current system of awarding exploration licenses is allowing land to be ‘banked’. It would appear that exploration licenses are obtained without any real evidence genuine intent to actually undertake exploration. Furthermore, ‘land banking’ arises when licenses are then on sold to other interested parties for a fee to share, or take over, the exploration license outright.

In the Issues Paper therefore, the Review discussed changing the current system to a competitive bidding process. Competitive bidding is a process where the exploration right is awarded based on certain criteria such as work program, technical and financial capabilities. The suggestion had two broad objectives which are to minimise speculation in mining licenses trading and to ensure that companies applying for licenses are reputable and have a genuine intent to undertake exploration.
Throughout the review process, an alternative mechanism for dealing with land banking became evident. As a result, the Review agrees to maintaining the current system of license issue in exploration in mining and petroleum but recommend addressing ‘land banking’ through the introduction of a capital gains tax on the sale of exploration licenses. This is mentioned in Chapter 7 on Capital Gains Taxation.

**Exploration Expenses: Double Deduction**

**Recommendation (43): Remove double deduction for exploration expenses.**

The Income Tax Act 1959 allows double deduction for exploration expenses in the mining and petroleum sector. This means that if you spend K100 on exploration activities, the law allows for a deduction of K200 from the assessable income.

The Chamber of Mines and Petroleum does not support the removal of the double deduction. The Chamber argues that the provision is still required by resource projects because it supports project viability through off-setting some of the additional or higher costs associated with operating in PNG. Similar views were also expressed by Newcrest.

In contrast, other submissions have raised concerns about the provision of tax incentives to the mining and petroleum sector. The submissions argued that there is a sense of ‘unfairness’ about the concessional treatment provided to some of the largest taxpayers especially in the mining and petroleum sector.

Perceptions about the tax system are important. A broad perception that certain taxpayers or certain groups of taxpayers are getting special treatment can erode attempts to build trust and confidence in the tax system and encourage voluntary compliance.

Furthermore, the overall direction of the Review is to expand the tax base and reduce incentives and distortions. This will lead to a system where the allocation of resources is more efficient and productive.

**Exploration Expenditure: Annual Income Taxable Cap**

**Recommendation (44): Remove the 10 per cent annual income taxable cap limitation on deducting exploration expenditure**

The removal of the 10 per cent annual taxable cap limitations on deducting exploration expenditure must be combined with the repeal of the double deduction provision.
The Review notes that the removal of the limitation will remove the delay in the depreciation of the exploration expenses, encouraging exploration in a manner consistent with sound tax and economic principles.

Chamber of Mines and Petroleum is in support of the proposal and suggests that PNG move to this level of deduction to remain competitive. A view in general supported by the Industry.

Pro-rating of Depreciation Deductions

**Recommendation (45): Depreciation deductions should be pro-rated in the first year of production.**

Mining companies can depreciate using a 25 per cent declining balance method (sections 73-78 of the ITA 1959). Under these provisions, a company may take a full year’s depreciation deduction in the first calendar year of commercial production, even when commercial production was for a small part of that year.

This results in differing tax treatment according to what time of the year a project commences. To address this, it is proposed that the depreciation rules be modified to ensure that depreciation in the first year of commercial production of a project is pro-rated.

The Chamber of Mines and Petroleum do not support the proposal because it argued that limiting the capital allowance did not raise any additional revenue but adds to compliance cost for no purpose.

On the other hand, Oil Search Limited supports the proposal arguing it is an established global practice to pro-rate depreciation in the first year of operations.

Royalty Calculation for Petroleum licenses

**Recommendation (46): The field gate valuation method should be used to calculate royalties for new petroleum licenses.**

The Review considers the field gate basis for determining the royalty and development levy should be replaced as the deductions of the costs between the wellhead and the field gate remain a complex, time consuming, and controversial issue. The field gate (or delivery point) is the point at the outlet of the field storage before entering the transportation system (or the point of export for an offshore field), as defined and agreed when the field development plan is approved.
The wellhead valuation concept was originally used in the oil and gas industries of many countries. The complexities of this approach were not initially anticipated. Only Australia and the USA are still implementing a pure wellhead system in spite of the uncertainties associated with it. By contrast, Canada and the UK have modernized their approach to royalty valuation. India has also streamlined its approach to royalty determination.

The Review notes the Chamber of Mines and Petroleum view that the use of the wellhead value in determining the royalty rate is more equitable than the field gate value. Specifically, they note that the field gate value does not take into account any costs in producing the mineral or gas.

**Fiscal Stability**

<table>
<thead>
<tr>
<th>Recommendation (47): If fiscal stability agreements are offered;</th>
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<tbody>
<tr>
<td>▪ The benefits of these agreements should be restricted to key rates of tax and duty and to major deductions, such as capital allowances, explicitly listed in the agreement.</td>
</tr>
<tr>
<td>▪ The agreements should be symmetrical (that is no one-way bets) and should not contain most-favoured project rules.</td>
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<tr>
<td>▪ The agreements should be time limited.</td>
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</table>

As part of a package of measures, the premium requirement can be discontinued for new projects.

Fiscal stability agreements guarantee that agreed arrangements for taxes, duties or fees etc, will not change in relation to a project. It does this through a contractual arrangement with the Government. Issues Paper No 1, sets out the pros and cons of these agreements – which are more common in developing countries, than developed countries.

The *Resource Contracts Fiscal Stability Act 2000* authorises the State to enter into a fiscal stability agreement with developers of long-term resource based projects. The term of the agreements are limited to the lesser of the time it takes to produce a foundation volume or quantity for gas agreements, 20 years or, the financial period for mining and petroleum agreements.

All investments run the risk of an unexpected change in government policy, such as an increase in tax rates. But because natural resource investments typically require high sunk costs over a long period, investors in this sector try to contractually reduce tax risks by entering into a fiscal stability agreement with the Government.
As the Chamber of Mines and Petroleum explained: *Investors and their shareholders should have the right to understand the investment regime in which they invest at the time they are investing and to know that, subject to normal business risks, they are likely to be able to see their interests returned, including the principal, without the threat of expropriation through taxation either in part or full.*

Issues Paper No. 1 broadly made the point that fiscal stability is more likely to be achieved if the community perceives it is getting a fair share of the revenue from non-renewable resources. Notwithstanding the policy costs (discussed below) these arrangements are likely to remain part of the tax landscape for some time in recognition of the long-term nature of investment risks.

Governments enter into fiscal stability agreements to increase the chances of attracting investment. But this comes at a cost to the Government. These agreements limit the Government’s freedom of action to change tax policy or negotiate project terms, if circumstances change or more information comes available. They generally restrict this policy freedom for significant periods of time. The agreements can also add complexity to administration.

This cost to government is explicitly recognised by the 2 per cent premium on all resource operations. This premium does not apply to the LNG PNG Gas Agreement. There is an argument that charging a premium may add to perceptions that the government could arbitrarily increase taxes on those projects without fiscal stability agreements. The Chamber of Mines argued that the premium is effectively a penalty or financing charge on a project imposed by the government. While fiscal stability is important the Chamber argued it should not be achieved at a cost to projects.

**The One-Way Bet**

Some fiscal stability agreements are a one-way bet; protecting the project from adverse tax or duty increases but passing on to the project the benefits of general reductions in tax rates and other beneficial changes. The Chamber of Mines argued that the one-way bet style of stability agreement should apply, at least to similar projects: *if the State reduces tax rates applying to similar projects that are then competing either in the market for the commodity goods produced or for ongoing capital it may also render the initial investments unsustainable.* However it is difficult to see how in most circumstances a previously *profitable* project would become *unprofitable* if, following a general tax cut, there is no change to after-tax returns for the project.

But there are more significant policy reasons why the one-way bet approach should be avoided. This approach inhibits future reforms of the tax system, which may have wide economic benefits. Consider for example if the 50 or 45 per cent tax rate potentially applying to certain petroleum projects were to be reduced to a general 30
per cent — but as part of a fiscal package a withholding tax on dividends is to be implemented. The withholding tax increase may not be possible if the stability agreement has a ‘one-way bet’. Projects with a fiscal stability agreement may make a ‘windfall gain’ from reduced tax but still retain the exemptions. If large taxpayers are involved there could be significant revenue consequences, which can effectively inhibit future tax reform.

**Most-Favoured Project**

Another variation is to include ‘most-favoured project’ clauses in fiscal stability agreements, which provide that the project will be eligible for any benefits granted to another project under a future agreement. These clauses can constrain government decision making for other projects, because they mean that each new project has to take account of the fiscal stability undertakings in past projects. Or, more likely, new contracts will be negotiated without due consideration of the fiscal implications of the most favoured project clauses in other contracts.

The Review has reservations about the routine provision of fiscal stability agreements. Fiscal stability is more likely to be achieved if the government is getting a fair share of the revenue from non-renewable resources and that should be the main policy focus. But if offered, the benefits of these agreements should be restricted to key rates of tax and duty and to major deductions, such as capital allowances, explicitly listed in the agreement. The agreements should be symmetrical (that is no one-way bets) and should not contain most-favoured project rules. The agreement should be time limited. As part of a package of measures, there is merit in discontinuing the premium requirement for new projects.

**No recommendation is made on the following issues.**

**Landowner Commercial Interest in Projects**

At present there is an expectation that the State will facilitate the participation of landowners in resource projects. The landowners’ share in projects is two per cent for petroleum projects and five per cent for mining projects, free carried by the State, and is controlled by a State nominee company managed by the Mineral Resources Development Corporation Ltd.

In addition, the Issues Paper No. 1 discussed the option of granting landowners the right to acquire 20 per cent of the project on pure commercial terms without any assistance from the State.
Submissions

The Chamber of Mines and Petroleum did not support the proposal. It considers that landowners do not have the financial capacity to buy into projects or the ability to fund such investments on commercial terms. It is also mindful that where landowner expectations are not met it is likely this will result in disruption to the project.

Oil Search Limited also argued that equity participation on commercial terms would not work. It claims that landowners cannot organize that level of finance. It assumes the proposal will create expectations that can’t be met and the State will ultimately have to provide the finance.

It is extremely rare for landowners or local communities to acquire equity interest on commercial terms. The Review did not find any similar successful international experience.

Hedging of Gains and Losses

A hedge is used to reduce any substantial losses/gains suffered by an individual or an organization. A hedge can be constructed from many types of financial instruments, including stocks, exchange-traded funds, insurance, forward contracts, swaps, options, many types of over-the-counter and derivative products.

Gains and losses on hedging transactions can cause difficulties for the taxation of the mining and petroleum sectors. These arrangements are often very complex and can involve multiple offshore entities. These transactions can give rise to significant losses (and also significant profits) which may impact on the tax collected from mining and petroleum companies.

Issues paper No. 1 proposed a separate taxation treatment for the hedging gains and losses to avoid the corporate tax being impacted by these transactions.

The Chamber of Mines and Petroleum opposed the taxation of hedging gains or losses outside the project ring fence. It argues hedging is an integral part of resource project operations and artificially separating the hedging activity is uncommercial. Further, it will add complexity to the taxation of projects, and potentially add to tax costs.

Oil Search Limited considers hedging is undertaken to manage risk within an organization and claims that if hedging gains and losses were kept outside of the tax ring-fence, then the symmetry that hedging is looking to achieve would be lost and taxpayers would pay tax on gains they would not otherwise have made.
**Tax Grouping**

Tax consolidation, or combined reporting, is a regime which treats a group of wholly owned or majority-owned companies and other entities (such as trusts and partnerships) as a single entity for tax purposes. This generally means that the head entity of the group is responsible for all or most of the group's tax obligations (such as paying tax and lodging tax returns).

In PNG, a taxpayer can conduct two or more mining or petroleum operations within a single legal entity, but due to the operation of the tax ring fences, cannot share tax profits and losses between the ring fences.

Due to the size and scale of petroleum and mining operations, there is typically a very substantial upfront capital cost to put the necessary infrastructure in place. This creates a large pool of depreciation deductions that are available once the project begins to produce income. As a result, it can often be several years before the tax ring fence will pay tax. If these losses/deductions could be used at an earlier stage (i.e. by offsetting taxable income in other ring fences owned by the same taxpayer group) this will increase the overall net rate of return across the portfolio of projects.

Oil Search Limited raised concerns that the current tax ring fence approach creates unnecessary complexity for taxpayers. Typically, petroleum companies will seek to own interests in a number of licenses in a relatively small area. This allows the petroleum company to share infrastructure between the fields in the various license areas. However, due to the complexity of the tax system, petroleum companies are then required to perform an arbitrary split of these expenses between the licenses and in some cases, the fields within a license.

Therefore Oil Search is strongly in favour of tax grouping provisions especially where an entity is undertaking multiple projects in PNG.

However, any extension of such rule will have significant revenue implications and add complexity to the tax system. It will significantly weaken the strong ring fencing rules underlying PNG’s mining and petroleum tax system, therefore the Review does not favor this proposal.
CHAPTER 6: TAX INCENTIVES

Introduction

The Review’s terms of reference included an examination of the advantages and disadvantages of tax incentives.

Tax incentives (such as tax holidays) have been widely used in PNG, but appear to have had little success. It is unclear how much incentives currently cost in terms of foregone revenue and there is confusion as to the basis upon which they are granted in the first place.

Negotiating incentives imposes transaction costs on new investments, and inhibits diversification of the country’s economy. Those sectors which get the incentives can achieve highly competitive effective tax rates. But for those investors who are not accorded incentives miss out on tax privileges. PNG then becomes (too) costly thereby depressing economic activities and keeping its economic base narrow.

Rather than introducing specific tax incentives to help encourage certain businesses, and/or certain sectors, the Review suggests focussing on making PNG’s overall tax system more competitive, transparent, simple and fair. Reducing corporate income taxes, for example, would be more effective in encouraging investment across a broader (economic) base than retaining *ad hoc* incentives. There is much to be said for eliminating incentives to pay for more competitive company tax rates.

But to some extent, incentives are likely to remain a feature of PNG’s tax system. For any or all remaining tax incentives, there should be better and open public reporting of their cost (foregone revenue). If incentives are to be provided in the future then a clear and transparent framework must be put in place. The framework must include the process including justification for granting tax incentives, the policy basis on which the incentives are granted, the legislative framework under which such incentives will be applied as well as the rules and / or guidelines for the ongoing reporting and monitoring of those tax incentives. The Review suggests the establishment of an Economic Development Board (EDB). Such a Board would set the overall policy framework to assess PNG’s current and future economic priorities and strategies including of the country’s natural resources and the guidelines to assess the business case for every new incentives and trade off effects therein.

The damage to the revenue base that erodes the resources for the real drivers of investment decisions — infrastructure, education and security — is compounded by the lack of transparency and clarity in the provision, administration, and governance of tax incentives in developing countries. OECD 2014
Background

A ‘tax incentive’ is concessional tax treatment used to achieve some type of policy goal – usually promoting the growth of a particular industry, or sector of the economy. Tax incentives result in eligible taxpayers paying either less tax than they would have or paying tax later than they would have under ‘standard’ tax rules. The reduction or deferral of tax enhances the rate of return on an investment.

2000 Tax Review

The 2000 Tax Review raised concerns about the extensive use of tax incentives. Many incentives were ‘extraordinarily inefficient’ policy instruments because much of the revenue given up does little or nothing to advance the targeted activities. Incentives evolved on an ad hoc basis and have yet to be critically analysed to determine their effectiveness. The 2000 Review underlined the additional complexity that widespread incentives add to tax rules.

The 2000 Review furthermore recommended that the recommendations from a 1999 National Investment Policy be implemented. Attachment B of Issues Paper 5 sets out these recommendation that have not been substantively progressed.

No whole of government approach, or ongoing evaluation of incentives

Principles for analysing incentives used by the Department of Trade, Commerce and Industry are outlined in Volume 2 of a 1999 National Investment Policy. However, these principles or guidelines are only used by that Department. There still remains no whole of government approach to the issuing of incentives. Since 1999, there has been no efforts done to review and assess the ongoing effectiveness or otherwise of existing incentives.

Issues Paper No. 5

The Review provided an overview of current tax incentives in Issues Paper No. 5: An Examination of the Advantages and Disadvantages of Tax Incentives. The paper found that while tax incentives may have a policy role, they have many disadvantages.

This report should be read in the context of the more detailed discussion in Issues Paper 5. This report takes account of the many comments received from ‘Blue Sky’ consultations and submissions on the Issues Paper received from the National Research Institute, PwC, Oil Search Ltd and Ms Pauline Bre.
Tax Incentives in PNG

Issues Paper No. 5 lists 36 tax incentives which are currently in use for business generally or specific sectors (namely manufacturing, tourism, agriculture and the extractive sectors). There are also an unknown number of project-specific incentive packages which are generally non-transparent. Incentives include income tax exemptions or tax holidays, exemptions from various other taxes, reduced rates of tax, accelerated depreciation investment allowances, and financing incentives such as interest income exemptions, and reduced withholding taxes.

While the Review sees considerable merit in focusing tax reform efforts on improving the tax system as a whole (including broadening the base and lowering rates), it also recognizes that, as with other tax systems, PNG’s system is likely to accommodate some specific incentives.

Given the relatively highly number of incentives currently available, the Review now considers that there is urgent scope for PNG to develop a framework to better guide how it determines and manages its overall incentives regime.

There are two (2) dimensions for the Review’s framework for tax incentives:

1. An institutional framework:
   - How does PNG ensure a whole of government and a whole of economy consideration of each incentive?
   - How does PNG facilitate ongoing reporting and monitoring of tax incentives?
   - How does PNG consolidate the legislative framework underpinning tax incentives?

2. A tax policy framework:
   - How does PNG best utilize limited incentives to achieve their policy goals without distorting investment choices and forgoing revenue?

During the consultations the Review was made aware of more incentives that are in existence.
Part 1: Institutional framework

Currently there is no clearly defined process for assessing and granting of tax incentives. Policy ideas for new incentives may arise as part of the general deliberations of Ministers, or at departmental level or from lobbyists.

The Review has been unable to identify any clear government policy framework governing the granting of tax incentives in PNG. The most appropriate document is the National Investment Policy (Volume 2) approved in 1999. The Medium Term Fiscal Strategy specifically considers tax incentives and identifies the need to ‘restrict taxation exemptions and special arrangements’ with a particular focus on eliminating special tax concessions for all new resource projects.

Processes for a whole of government consideration of tax incentives have eroded over time. Consequently decision making on tax incentives have been ad hoc and do not take a whole of economy perspective.

In addition to the tax policy issues (discussed in Part 2 below) and fiscal policy, decisions to grant tax incentives should take into account PNG’s development priorities. This would include perspectives such as the prevailing macro-economic, trade, investment, and industry policies.

A whole new approach is needed and should be determined in the short to medium term.

Establishment of a Centralized Economic Development Board

Recommendation (48) An Economic Development Board (EDB) be established to coordinate PNG’s economic development priorities including oversight of tax and other incentives (such as grants). The EDB would also conduct an urgent review of PNG’s existing tax incentives.

Establishing a centralized EDB will provide institutional mechanism and structures to spur sustained economic growth.

The first fundamental step is to review and rationalize Ministerial powers in respect of vetting and making decisions on Foreign Direct Investment or Investments made by corporations already operating in Papua New Guinea.

All these powers are presently vested in each individual Minister which makes it unwieldy to administer. It is a very cumbersome and bureaucratic process, time consuming, costly, fractured and divisive, lacks transparency and has been a significant deterrent to investment and sustainable economic growth.
This will be streamlined and replaced by:

- Establishment of a centralized EDB under the ministerial purview of the Prime Minister.

Composition of this board must consist of representatives from the private sector, public sector and civil society.

This board will set the policy framework to identify economic priorities, strategies to unlock the value of the resource endowment, guidelines to evaluate the business case for every new investments and the trade off and value addition to PNG and many other important economic, social, environmental and inter-generational considerations.

Furthermore, when the EDB is properly constituted it must, as an initial first step, engage reputable groups such as the Boston Consulting Group, to conduct an elaborate mapping of all the country’s resource endowment and formulate strategies of how to unlock the value of the sustainable resources.

- Enabling laws will be necessary to enable establishment of the Economic Development Board and ensure a transparent Economic Expansion and Tax Incentives laws is enacted to stipulate uniform laws and regulations for non-tax and tax incentives in support of economic expansion.

Process for granting new tax incentives and reviewing of existing ones

The Review considers that an Economic Development Board should be established to develop a clear institutional framework and administrative body with a mandate for the carriage and formulation of National Strategic Economic Development Plans. Such a body could comprise a good mix of public sector, private sector and civil society members with experience and standing in the community.

The Board would provide an effective institutional and administrative mechanism for designing policy choices and decisions in identifying and selecting priority economic sectors:

- To enable better utilization, deployment and mobilization of public and private resources and to incrementally grow and expand the prioritised economic sectors and to do so sustainably;
- To provide a robust and disciplined process to build sound foundation for PNG to gradually diversify from non-renewable sectors to renewable sectors;
- To promote targeted policy interventions.
As with the last point, the EDB can play an important role in ensuring that PNG’s tax incentives regime effectively contributes to broadening PNG’s economic base.

Submissions

One submission noted that a framework already exists in that the National Executive Council (NEC) grants or approves tax incentives. The submission acknowledged that improvements are needed in administering and governance of applications for tax incentives, but the submission acknowledged that NEC should remain the ultimate arbiter on whether or not an incentive is ultimately awarded.

Process for reviewing existing Tax Incentives

The EDB would also have the role of reviewing existing incentives. In the main priority should be given to estimating the cost to revenue for a particular incentive. There is merit therefore in examining:

- Rural Development Incentives. This incentive has not been fully utilized by businesses because of the lack of infrastructure and other problems related to the remoteness of the prescribed areas. The ensuing effect is that those areas do not get the development support they deserve.
- Tax Credit of Banks.
- 20 per cent income tax rate for new primary production projects.
- The concessional tax treatment available to various classes of fishing licenses.

Elsewhere in this Report the Review has recommended removal of some existing incentives including the double deduction for staff training (and the training levy) and the double deduction for exploration expenditure.

Part 2: Tax Policy Framework

Policy Principles of Tax Incentives

Recommendation (49): Tax incentives should be granted sparingly. However, when considering the merits of new or existing incentives the following policy principles should apply.
### Box 5: Policy principles for tax incentives

**Principle 1**: As a starting point, tax incentives should be used only rarely with a preference for creating a tax system that is fair, simple, transparent and more competitive.

**Principle 2**: Consideration of tax incentives should be made with a clear sense of how the tax system is best placed to achieve the desired policy outcome. If the outcome being sought is simply to reduce costs, then consideration should be given to providing a direct subsidy or grant.

**Principle 3**: Consideration of an incentive should have regard to limited administrative capacities. Incentives that require complex determinations to be made or ongoing monitoring that requires a significant commitment of resources, should be avoided.

**Principle 4**: Project-specific and taxpayer-specific incentives should be avoided.

**Principle 5**: Where a tax incentive is to be used, it should be appropriately targeted.

**Principle 6**: Any tax incentive should only be for a set period of time (for example, 5 years). Any extension of the incentive should be subject to analysis of the effectiveness of the incentive.

**Principle 7**: If a tax incentive is to be used, the least harmful option should be preferred. For example accelerated depreciation is less harmful than tax holidays or reduced rates.

**Principle 8**: Taxpayers using a tax incentive should (if necessary) be required to report to the IRC, the value of that incentive on an annual basis. This should be a condition of accessing the incentive.

**Principle 9**: The granting of any tax incentive needs to support the broader development priorities of the country.

**Principle 10**: Any other criteria used to assess whether an incentive is provided should be made publicly available, consistent with maintaining the overall transparency of the process.

### Submissions

One submission argued that all preferential tax breaks and incentives be removed to promote a level playing field for all taxpayers. A former tax administrator noted that tax incentives “*have proven difficult to administer and add to the complexity of the tax system. They create an unfair playing field, do not usually serve its public policy purpose, create distortionary effects and provides ways for clever crafted tax planning and tax avoidance. Administratively, it detracts the limited resources of the revenue administrations*.” Other submissions saw the value in incentives stating incentives can encourage investment in socially desirable projects, can assist in infrastructure provision where the State is not able to provide it, even where the incentives gives rise to a windfall gain, it was argued that this cash flow benefit can promote further productive expenditure.
Tax Incentives Cost Revenue

Tax incentives cost revenue, which in turn limits options to reduce taxes generally or expand potential government spending which could make the economy more competitive. Issues Paper No. 5 explored the costs of these incentives. Under current administrative arrangements, it is very difficult to obtain good data on the revenue costs of many incentives. But the following examples are illustrative:

- In recent years the infrastructure tax credit scheme has fluctuated between K50 million and around K100 million. A more expansive national infrastructure credit scheme ramped up the costs of infrastructure credits to around K200 million in 2015.
- Research and development concessions had a (combined) revenue cost of around K66 million for 2013 and 2014, with a backlog of claims costing potentially K2.4 billion in the pipeline.

Effectiveness of incentives is unclear

Without routine evaluation of the effectiveness of tax incentives the Committee cannot say whether incentives have met their objectives. Intuitively the R&D concession seems not to have led to a major change in intended behaviour, with the incentive simply providing a windfall gain for firms that were going to undertake the activity anyway. Another example may be the extensive incentives directed to tourism. The tax system is unlikely to be a significant reason why tourists do not choose PNG as their holiday destination. Rather this is more likely to relate to issues such as law and order and cost of travel.

Advantages and Disadvantages of tax incentives

The Review was asked to examine the advantages and disadvantages of tax incentives. The considerable drawbacks of tax incentives have not been adequately recognised by policy makers.

Many countries use the tax system to incentivise particular activities. This may be to;

- encourage activities that produce benefits for society that the private market does not fully take into account (“positive externalities”). Incentives for training for research and development are often justified on this basis.
- make a country more competitive, allowing it to compete for foreign direct investment against its neighbours. Related to this, submissions argued tax incentives compensate businesses for other costs of doing business in the
country such as poor infrastructure, crime problems, corruption, or unnecessary red tape.

But policy makers should first be convinced that an incentive would achieve the desired policy goal. Often tax incentives do not lead to a change (or only a limited change) in the intended behaviour, with the incentive simply providing a windfall gain for firms that were going to undertake the activity anyway. PNG’s research and development concessions, for example, seem to have had limited impact on the level of R&D. International evidence suggests that there is no clear link between tax incentives and foreign investment or economic growth generally.

Even if policy action is appropriate, depending on the issue, there may be more direct means for policy makers to address the problem. For example, if the problem higher costs of doing business, a more effective means of assisting taxpayers may be through budget expenditure (eg on infrastructure) or more directly through grants. These may have similar outcomes to a tax incentive. But they have better budgetary cost controls — and come without the extra costs that flow from long-term damage to the policy design of the tax system.
Table 11 lists policy concerns with tax incentives provided through the tax system.

**Table 11: Tax Incentives**

<table>
<thead>
<tr>
<th>Principle of good tax policy</th>
<th>Problems with tax incentives</th>
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<tbody>
<tr>
<td>Revenue: A good tax system should raise sufficient revenue to ensure that the government can deliver services that meet the community’s needs.</td>
<td>Tax incentives cause a loss in current and future revenue. Also granting exemptions to one group of taxpayers creates pressure from other taxpayers for the same exemption (“exemption creep”).</td>
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<tr>
<td>Competitiveness and efficiency: A good tax system should promote economic growth and thus drive more jobs, higher incomes, more services, lower prices and less poverty.</td>
<td>Tax incentives are inefficient, because they create different tax treatments between and within sectors. This distorts the allocation of workers or investment to different activities. Furthermore, tax incentives mean that, if the government is to achieve its revenue target, taxes must be higher for other activities, which has the potential to harm economic efficiency and compliance, and causes inequities. They also limit a Government’s ability to reduce overall tax rates, benefitting a broader range of taxpayers and increasing the competitiveness of the tax system overall.</td>
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<tr>
<td>Fairness: A good tax system should be fair: it should create a level playing field for businesses and it should ensure that taxpayers each pay their fair share.</td>
<td>Incentives for a particular sector, or taxpayer, mean that other taxpayers have to bear a higher revenue burden. This creates an unfair competitive advantage over other firms in the same sector. For individuals, incentives generally advantage higher income earners more – they are also better placed to obtain the tax advice often required to access concessions.</td>
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<tr>
<td>Simplicity: A good tax system should be simple enough for taxpayers to understand and meet their tax obligations. It should also minimise the administrative costs for government and for the taxpayer.</td>
<td>Special tax treatment complicates tax administration and compliance. These complications often arise because of the need to monitor the incentives due to concerns with abuse. The administration and compliance difficulties are especially likely where the tax administration is also weak. The inability of PNG to effectively implement the R&amp;D incentive, as highlighted above, is an example of this. Complexity is a particular concern in PNG. Discussions with IRC and PNGCS have confirmed that significant resources need to be devoted to administering incentives. Tax incentives can also complicate the affairs of taxpayers as it encourages tax planning.</td>
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<tr>
<td>Trust in and accountability of government: A good tax system including a reliable tax administration should build trust and confidence in government and should be transparent and encourage greater government accountability and integrity.</td>
<td>Tax incentives can create opportunities for tax abuse and corruption. An example of such abuse can be transfer pricing between related parties to ensure profits are made in exempt activities and deductions in fully taxable activities.</td>
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**Tax holidays are the most harmful tax incentive.** They tend to attract footloose firms that leave as soon as the incentive expires, without lasting employment benefits. When discussing tax holidays provided by the Pioneer Status Act, the National Investment Policy noted that:

*The incentive failed to meet its intended purpose as businesses granted the incentive ceased operating on expiry of the incentive period.*
Furthermore a tax holiday may actually be of little use in promoting investment in new enterprises which are often unprofitable in the early years and unlikely to benefit from the incentive.

In addition, tax holidays are often poorly targeted unless linked to any level of investment, which is what they are trying to promote. This can be contrasted to other incentives such as accelerated depreciation and investment allowances which, by their nature, require some investment by the taxpayer.

In general accelerated depreciation is the preferred (and least harmful) form of tax incentive. It is less costly for revenue collections than income tax holidays, investment allowances or tax credits and generally provides less scope for tax abuse.

As a second-best alternative, investment allowances and investment tax credits are more cost effective than income tax holidays. As indicated above, unlike tax holidays, these credits/allowances require actual investment by the business. They also allow better targeting of particular types of investment, and their fiscal costs are more transparent and easier to control.

Border tax concessions on import duties, excise and import GST also have drawbacks. If not appropriately targeted they can generate an unfair competitive advantage to those firms receiving the incentive and may be open to abuse or leakage into the domestic economy (with goods being on sold for lower prices or used for purposes other than which the incentive was provided).

Incentives that are targeted to one taxpayer or project produce a tax system open to negotiation on a taxpayer by taxpayer or project by project basis. This should be avoided. It significantly increases the complexity of the tax system, reduces transparency and undermines the ability of the system to generate revenue. As noted in the 1999 National Investment Policy, ‘company-specific negotiations...not only create inefficient monopolies but are also seen as the major disincentive to investing in PNG.’

Submissions

One Submission argued against project specific agreements on constitutional grounds. In the author’s view project specific agreements usurped the Legislature’s power to enact laws and the “Executive arm should not tread on that law-making power by using its contractual power and bind the State without proper debate and discussion in Parliament.” The other submissions also reflected concerns about the lack of transparency that project specific arrangements involved. Industry wide
arrangements were preferred. If a project specific concession was provided it should be legislated in the tax laws.

**Annual Tax Expenditure Statement**

**Recommendation (50)** an annual Tax Expenditure Statement should be published. As a first step a list of the incentives and those who benefit from the incentives should be published.

As with the direct Government expenditure programs it is important that tax incentives are managed in a transparent manner and are subject to ongoing monitoring and evaluation.

While some limited reporting of incentives is provided for each year as part of PNG’s Budget documents, more can be done to improve transparency. A number of jurisdictions around the world report the type and cost of their tax incentives. This promotes the overall transparency of the tax incentives regime and provides a clearer picture to Government of the revenue consequences of providing the incentive.

As a first step the Government could publish description of expenditures and description of groups who benefit, without cost estimates. Over time the Treasury could estimate the revenue costs for say 20 per cent of the incentives with the aim of reviewing all incentives over a five (5) year period.

**Submissions**

Submissions noted that it was difficult to comment on the effectiveness of incentives in the absence of publicly available data. There is no evidence one way or the other that incentives have worked in this country. Another submission stated that the requirement in Principle 8 of reporting annually to the IRC was punitive and unnecessary and that the costs should be able to be estimated through IRC data. If the data is readily available to the IRC then the Review agrees this may be a better course. The main point is that the proponents of incentives and authorities need to agree on a data collection strategy as part of the decision to provide an incentive.

**Consolidate all Tax Incentives in the Tax Law**

**Recommendation (51):** All tax incentives should be consolidated in the tax law.

The legislation granting tax incentives is dispersed over many Acts and should be brought together in the tax law. The dispersion of incentive laws over various Acts
makes tax administration and industry policy more complex and sometimes it is not clear that the incentive rules are effectively changing behaviour.

The Department of Trade, Commerce and Industry recommended amalgamating all incentives (focussing on investment incentives) into a single piece of legislation. This approach also has some international support (see for example, OECD 2012 p3 and IMF 2014, p 51). A similar approach is to incorporate all incentives into a new section of the relevant tax legislation.

Where the incentive is found outside the tax law (for example, in PNG, in relation to aid organisations) one option would be to remove the provision and place it in the tax legislation. This would address, for example, the uncertain legal basis of tax exemptions provided outside of the operation of the income tax laws.

Submissions

One submission stated that the idea was impractical, but if the incentives are to be consolidated, these should form a schedule to the ITA and the Department of Treasury should have carriage of the drafting of the new law as opposed to the Department of Trade, Commerce and Industry.

**Infrastructure Tax Credit Scheme**

**Recommendation (52): Suspend Infrastructure Tax Credit Scheme for new projects pending audits for the value of money forgone.**

Under the ITC scheme, eligible companies receive a tax credit for funds expended on approved infrastructure projects – this means that tax payable by the company is reduced by the expenditure and, as a result, there is no cost to the company.

The scheme was first introduced in 1992 as a means of utilising mining and petroleum companies as contractors to build infrastructure without the need for an appropriation from Treasury. This would ensure that communities impacted by the resource project would be able to receive tangible benefits from the extraction of resources in their land.

The scheme recognised that:

- the National and Provincial Governments lacked the skills and capacity to deliver infrastructure, particularly in remote areas where mining and petroleum activities took place; and
- that resource companies were well placed in these areas to deliver such projects given their management and construction capacity.

The scheme has been expanded since its introduction. Key features of the regime are:
• it has been extended from the mining and petroleum sector to the tourism and agriculture sectors;
• The amount that can be expended under the scheme in any income year is limited to the lesser of the amount of tax payable or:
  o for the mining and petroleum sectors (in general) – to .75 per cent of assessable income;
  o for the primary production sector – to 1.5 per cent of assessable income
  o for the tourism sector – to 1.5 per cent of assessable income;
• companies working on the PNG-LNG project can access an additional 1.25 per cent (making 2 per cent in total);
• unused credits can now be carried forward for two years; and
• while initially focused on the construction of infrastructure, the scheme was subsequently extended to maintenance – a response to the recommendations of the 2000 Tax Review.

Submissions

Many submissions called for the scheme to be extended to other sectors. These included the financial sector and state-owned entities on the grounds of insufficient funding through budget appropriation. The Higher Education Office suggested the scheme be expanded to institutions of higher education.

Another submission argued that infrastructure tax credits should be seen as incentives providing tangible benefits to remote communities. The review notes this may be true, but they do represent a priority call on the Budget which needs to be carefully managed.

Rationale for Suspension

Over almost 20 years since the introduction of the ITC, there has been no substantive review of its operation. There is an urgent need to review the ITC in order to ascertain whether the tax credit provisions in the ITA are being adhered to and whether the policy objectives are being achieved.

Generally, there is a significant lack of reporting in relation to the ITC expenditures and monitoring of approved projects. The absence of a standard format for reporting ITC expenditures has resulted in a lack of consistency in the provision of the information by developers. This creates difficulty for the collation of tax expenditure data.

The appraisal process has suffered from a lack of technical capacity and funding within DNPM. These processes relate to policy screening, cost appraisal and approval
of the projects by the Project Appraisal Committee. Monitoring and evaluation of these projects has been compromised for decades.
CHAPTER 7: CAPITAL GAINS

Introduction

Individuals and businesses make capital gains whenever they sell assets for more than they paid for it. These assets may include property (houses or buildings), financial assets (shares, etc), mining and petroleum tenements, or intangible assets.

Capital gains are just another form of income, but in PNG most capital gains are untaxed. Many other countries tax capital gains in some form, either with an explicit capital gains tax or by treating capital gains as part of ordinary income.

If capital gains were to be taxed, the system would be fair. Investments would be driven by economic priorities – not tax avoidance. Plus extra revenue would, in time, allow PNG to fund lower rates of personal or corporate income tax.

Not taxing these gains allows wealthier investors (which includes individuals) to escape income tax. Currently non-residents can sell their PNG investments without paying any tax on the gains and some of these gains can be very large.

A capital gains tax also reduces income tax avoidance. Tax planners can convert taxable income into untaxed capital gains. For example, shareholders may decide not to pay dividends (which are taxable) but instead retain the profits and increase the value of their shares. Once these shares are sold, the shareholders receive capital gains (which are not taxable). So a tax system without capital gains tax distorts investment choices towards assets that offer returns as capital gains, and away from taxed investments. For example investment in property for capital gains is tax advantaged compared with investments that pay interest (such as bonds or loans) and thus are taxed.

By distorting investment of economic resources, the income tax system can lead to second best investment decisions which in turn can slow PNG’s productivity and growth in living standards.

Not taxing capital gains may also be contributing to other distortions such as speculation on exploration/prospecting licenses. That is, holding onto the licenses without undertaking genuine exploration.

There is long-term revenue potential from taxing capital gains. This is particularly true in relation to gains from the transfer of mining, oil and gas interests.
A capital gains tax will represent new arrangements for both taxpayers and the IRC, so it is recommended that the new rules be gradually phased-in. Initially the rules should only apply to those areas where revenue is likely to be significant, and taxpayers are reasonably sophisticated, namely real property, including the disposal in whole or part of mining and petroleum entities or licenses.

The Review recommends that some gains should be exempt from the tax, for example, family homes. Gains on all customary land should also be excluded from this tax.

The Review has broad recommendations on the design of the tax, but inevitably there are detailed questions on the design of the tax that needs to be addressed in the development of the rules. The Review suggests an Advisory Committee be established to assist in the design of these rules.

**Issues Paper**

Issues Paper No. 4 *Taxing Capital Gains* developed the case for taxing capital gains income. It examined some design issues but noted the design of such a system would require more detailed consideration, to ensure that it was appropriate for PNG’s circumstances. The Paper:

- noted that the design should be right for the country;
- analysed systems for taxing capital gains in other countries;
- explored transitional issues, including options for avoiding the retrospective taxation of past gains; and
- explored some of the key design questions of any system to tax capital gains such as;
  - who should be subject to a tax on capital gains,
  - which assets should the tax apply to,
  - when gains should be taxed, and
  - the rate of tax.

**Taxing Capital Gains**

Not taxing capital gains is a significant structural defect in the tax system. A number of formal submissions were received in relation to taxing capital gains. Individuals also provided views in the regional consultation forums, particularly in Lae.
The Review thanks these companies and citizens for their perspectives on the proposal.

The Review believes the design of capital gains rules could benefit from more substantive consultation with the community. This could be achieved by developing the rules with the assistance of a technical advisory group.

Taxing capital gains can be complex. Therefore it is important that its design should be simple to implement and administer. Critical to this is taxpayer education and up skilling of IRC staff. Sometimes this will be at the expense of other tax principles such as efficiency and fairness. The tax should be implemented incrementally, to help absorb the changes.

The Review concluded that the introduction of capital gains tax, should remain a mid-term priority until systems and governance processes necessary for the introduction of the tax and appropriate resources (people and skills) are also in place. The Review believes a carefully crafted implementation is vital.

However, the longer the implementation of the tax is deferred, the revenue benefits which could support tax reductions elsewhere and make the overall tax system more equitable would also be delayed.

**Capital Gains should be taxed**

**Recommendation (53):** Introduce a capital gains tax initially to apply only to certain real property, including the whole or partial disposal of mining and petroleum entities or licenses.

**Taxable Persons**

**Recommendation (54):** CGT to apply to residents and non-residents and to all taxable entities including: individuals, companies, superannuation funds, and trusts.

**Rate of Capital Gains Tax**

**Recommendation (55):** A 15 per cent CGT rate should apply to all taxable capital gains.

As a starting point, for capital gains tax to apply efficiently there would be no difference between the rate of tax on capital gains and the individual and corporate
tax rates. However, the progressive rates for individuals, a 25 per cent superannuation fund rate and a 30 per cent corporate rate complicate this.

Some submissions to the Review argued that a lower rate of tax should apply to capital gains to reflect additional risks associated with capital income — effectively as an incentive to capital investment. But the Review notes that if revenue from capital gains is used to fund reduced corporate rates, the positive incentive effects for investors would be even greater.

The Review proposes a single rate for the taxation of capital gains of 15 per cent. This would be an internationally competitive rate which would be similar to the rates applying to other income from investments such as interest and dividends. Having the similar rate would prevent avoidance from converting capital gains to interest or dividends.

This rate is concessional for corporate investors, superannuation funds and high income earners who face higher marginal tax rates and are expected to make the vast majority of capital gains. There are risks that taxpayers may still try to convert ordinary income to capital gains to take advantage of the lower capital gains rates. But this reform has to be seen as an advance on the existing situation where such gains are untaxed.

**Tax Base**

**Recommendation (56): CGT to apply to PNG-sourced gains, including foreign gains relating to PNG real property and the disposal in whole or part of mining and petroleum entities or licenses.**

There are two main approaches to taxing foreign gains. The first is to tax only gains sourced in PNG. The alternative would be to tax residents on their worldwide capital gains, exempting gains taxed by a foreign jurisdiction, or provide a credit for the foreign tax against capital gains tax in PNG. The risk of not taxing foreign gains is that it could bias against decisions to invest in PNG. But in the interest of simplicity, the Review recommends that the tax should be initially applied on PNG-sourced gains.

Non-residents will be taxed on PNG-sourced gains and gains on indirectly held real property in PNG (for example, gains on the sale of shares in a foreign company which in turn owns PNG mining or petroleum interests). Submissions noted the potential impact of double tax agreements on capital gains tax. In particular some treaties (e.g.

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73 Similar rules apply in the existing stamp duty laws Division 10A, Stamp Duties Act.
the UK treaty), do not have capital gains rules. This will require some analysis and potentially treaty revision, because investments may be restructured through these treaty countries to avoid the capital gains tax. Withholding taxes may need to be considered to ensure collection of non-resident capital gains.

**Recommendation (57)** Eventually the CGT should apply to all assets (with some exclusions), but initially it should apply only to PNG real property interests, including interests in mining and petroleum resources.

The Review considers that to begin with the introduction of capital gains tax it should be limited to certain classes of assets.

As discussed previously, this would mean that the regime would apply to areas of greatest revenue potential, to a limited number of sophisticated taxpayers who are able to understand their obligations.

Once the initial phase is concluded, capital gains tax should be extended to apply to all assets, other than certain identified exclusions (as opposed to specifying a class of assets that are subject to the capital gains tax — which has greater potential for taxpayers to change the legal character of assets to fall outside the tax).

**Exclusions from the base**

The Review considers that capital gains tax should be excluded from the following:

- main residence;
- customary land;
- depreciable assets;
- trading stock; and
- personal assets such as a car and furniture.

**Customary Land**

The National Research Institute took the view in its submission that there should be no exemption for customary land. NRI noted that land ownership is vested in tribal or clan segments and co-landowners cannot alienate their customary land. NRI further argues that informal land transactions are prevalent, but informality is not a reason to exempt customary land transactions. Furthermore, incorporation and registration of land groups is being encouraged in PNG. As the registered land can be leased NRI argues that capital gains should be taxable.
Listed Company Shares

Two submissions recommended that shares listed on the Port Moresby Stock Exchange (POMsox) be excluded from a capital gains tax applying to non-residents, in other words extending a 1999 concession contained in section 36B of the Income Tax Act 1959. It was argued that imposing a capital gains tax would hinder the liquidity of the Stock Exchange as capital gains taxation acts as a disincentive to the disposal of shares.

Another submission however, argued that capital gains tax should apply to POMsox listed shares noting that there would be little sense from an economic perspective, in excluding shares and bonds, potentially two of the largest classes of capital investments from the capital gains tax.

The Review agrees with the second view. Therefore, it recommends that in the first year, capital gains taxes should apply to shares in land and resource companies — otherwise a significant part of the capital gains tax base would be excluded and the intent of phase 1 of the tax would be undermined.

It is expected that in the first phase of implementation of the tax, the gains are relatively small and given the proposed concessional rate, are unlikely to inhibit investor interest significantly.

Taxable Event

**Recommendation (58): Capital gains and losses should be taxed when the asset is sold, or otherwise disposed off (‘realisation’ basis).**

Capital gains and losses should be recognized on a realisation basis – that is, when the asset is sold or disposed of. The alternative of taxing capital gains on an annual basis as they accrue would require annual valuations which would be costly for the economy and would cause cash flow problems.

Capital losses Quarantined

**Recommendation (59): Capital losses can be offset against current year capital gains. Residual losses can be carried forward and offset against capital gains in a later year.**

Many capital gains tax systems only allow capital losses to be offset against capital gains. As explained in Issues Paper No. 4 many systems ‘quarantine’ capital losses – that is, they ensure that such losses can only offset against current or future capital
gains (and not other forms of income). This is because capital gains are taxed on a realisation basis. The timing of the capital gains or losses is up to the taxpayer. Without quarantining, taxpayers can accelerate the recognition of losses and claim them against income tax while deferring the recognition of gains.

**Rollovers to Defer CGT**

**Recommendation (60):** Tax will not be imposed in relation to specific disposals but deferred (or ‘rolled over’) until the person getting the asset sells it.

Rollovers are an integral part of capital gains tax systems. Typically, rollover arrangements apply to certain re-organisations of company groups, certain involuntary disposals (such as the compulsory acquisitions of property) or transfer of asset on the breakdown of a relationship such as a marriage. These should be developed through consultation in the law design process.

**Transition**

**Recommendation (61):** The tax will be prospective and only tax gains relating to the period after commencement of the CGT regime.

There are two common approaches to the introduction of capital gains tax; excluding gains made prior to introduction; or excluding gains derived from assets held prior to introduction.

In considering these transitional issues, the objective should be to maximize the long-term efficiency, fairness and simplicity of the tax system, while minimizing the short-term complexity and administrative challenges.

South Africa, the UK and Canada all adopted the approach of only taxing gains that accrue on existing assets after introduction. To exclude gains that accrued before the introduction of taxing capital gains, the initial value or acquisition cost of the asset should be its market value at the time the reform measure is introduced.

The review notes this approach will necessitate the keeping of records.

The Issues Paper No. 4 stated that where the market value of assets is generally available information, such as for listed shares, the IRC could publish these ‘official’ values as at the valuation day. For significant assets, such as private businesses or large property developments, taxpayer could provide a professional valuation to the IRC. The cost of obtaining a valuation would be recognised in the overall acquisition
cost of the asset. Simpler rules could assume constant gains over the holding period, or deem the original cost of the assets to be adjusted for inflation.

The alternative approach to prevent retrospective tax is that only gains made on the sale of assets acquired after the commencement of capital gains tax are subject to the tax. In other words, an asset has to be sold after the commencement date twice to attract the tax. This avoids the valuation issues described above.

The issues about using this approach is that revenue benefits are deferred significantly and exemption for pre-CGT assets can reduce the efficiency benefits of taxing capital gains. This approach can also be seen as unfair because those who own assets at the time of commencement escape tax, whereas new owners and future generations pay the tax. Complex integrity rules are needed to prevent people from trying to convert taxable gains to exempt pre-CGT assets.

Both approaches were advocated by submissions made to the Review. The Review believes that the valuation issues associated with taxing gains accruing after commencement are manageable and so recommends taxing gains accruing after the commencement of the tax on capital gains.

Box 4: Revenue

A tax on capital gains would improve the sustainability of revenues. However, it will take some time for revenue collections to mature. Even if the transition is on an accruals basis as recommended, initially taxable gains will be minor, reflecting that gains are only assessed from commencement.

Revenue from taxing capital gains can be difficult to predict, but international experience suggests that the revenue impact of including capital gains in the tax base often exceeds the predictions, and far exceeds administration costs. Capital gains tax collections can also be ‘lumpy.’

One-off transactions can also generate significant gains, particularly where a country has a strong resource sector. For example, a single sale of mining interests yielded Mozambique USD224 million (1.5 per cent of GDP) in the form of capital gains taxes in 2013 enabling a supplementary budget.

Increased revenue from the direct collection of capital gains tax will trigger an increase in personal and corporate income tax (‘ordinary’ income), because the incentive to convert income to capital gains is reduced or removed. Furthermore, the positive broader revenue impact will increase over time, by reducing tax distortions and encouraging more productive investment.

Ultimately, the revenue impacts of taxing capital gains would depend on key design issues, including the transitional issues discussed in this chapter. However, even a conservative system for taxing capital gains is likely to be significantly revenue positive.
Stamp Duty

One submission noted: “the existing operation of stamp duty already acts as a de facto CGT on certain transactions. This assumes that a buyer of an asset calculates what they are prepared to pay on a stamp duty inclusive basis and hence the presence of a stamp duty reduces net proceeds to a seller. The continued operation of stamp duties in PNG therefore supports a lower rate of CGT than the standard company rate; especially given stamp duty is applied against the value of the asset transferred and not the gain made.”

Issues Paper No. 10 discussed stamp duty noting that the duty on the transfer of mining tenements, exploration licenses and petroleum licenses and associated rights including mining information for both exploration and development licenses is limited to K10, 000. This is a small amount - given the typical value of such leases – and equates to a notional maximum value of K200, 000 on the basis of the standard stamp duty rates. If an effective capital gains tax (even at a lower rate than the corporate income tax) is introduced the rationale for this duty needs to be reviewed and this will depend on the final design of the tax on capital gains.
CHAPTER 8: MICROENTERPRISE, SMALL BUSINESS & INFORMAL ECONOMY

Introduction

Small businesses face many challenges. Their focus is often on the daily survival of family. There are often cash flow problems with daily takings quickly spent to meet numerous expenses such as using the takings to pay for vehicle repair. One notable challenge they face is proper accounting and recording keeping. Understanding tax laws and procedures is difficult. Smaller businesses simply cannot afford tax agents or accounting help.

The Review proposes simpler tax rules for smaller businesses with sales of less than K250,000. The sector is dominated by retail trade, hospitality, motor vehicle repairs and petrol supplies, transportation and construction activities.

The Review also looks at the informal economy. The informal economy in PNG is significant and is growing. These (mainly small) businesses do not pay income tax. There is scope to improve the fairness of the tax system and tax revenues by encouraging these businesses to participate in the tax system. The Review looked at the challenges for the tax system of large scale informality. Certain features of small businesses make them ‘hard-to-tax’. Many do not engage with the IRC. They do not file tax returns or directly pay tax. In fact many do not know that they are required to pay tax.

Importance of Small Business

It is important to include smaller businesses in the tax system. They provide relatively low tax revenues, but the IRC still needs to make sure they pay the right amount of tax otherwise (a) they may choose to stay small, just to remain lightly taxed; (b) they could unfairly compete against other businesses; and (c) the perception that the sector does not pay their fair share of tax thereby undermining confidence in the overall tax system.

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74 Strictly the rule is based on ‘turnover’. Turnover is the gross proceeds of business without deduction of expenses, including proceeds from the disposal of business assets.

75 See Piatti M, et al (2014) at pp 4 – 6 where they discuss various measures of the size of Papua New Guinea’s ‘shadow’ economy as a percentage of GDP.
Taxing Smaller Business

Tax laws potentially apply to all types of small businesses: from informal micro businesses, small sole traders and partnerships, up to medium enterprises. These businesses may be incorporated (those who pay company tax) but most will be unincorporated sole traders or partnerships (personal income tax). In fact, many low income businesses do not pay income tax and are not required to register for GST.

Issues Paper No. 7 Microenterprises, Small Business, & the Informal Economy 76 discussed ways to make tax easier for small businesses and ways to address the informal economy. These issues were raised in Blue Sky consultation. Formal responses were received from John D Conroy, the Consultative Implementation and Monitoring Council, the International Finance Corporation, and the National Research Institute.

Fitting the Tax System to suit Smaller Businesses

Currently, running a small business has very similar tax obligations as a big business. Business taxpayers need to register with the IRC, they need to understand tax rules, keep accurate records, file returns, pay tax and assist in any tax audits. The compliance burden is disproportionately higher on smaller business as they often do not have the resources, systems or technology to manage these obligations efficiently. These costs are relatively higher for small businesses compared to larger competitors and are a disincentive for compliant tax behaviour. Many small business operators may decide that the costs of strictly complying with tax rules (and other regulations) exceed the potential benefits.

Tax costs therefore, need to be reduced to match the size of the business.77 Simpler tax requirements will also make it easier for informal businesses to join the tax system. Similarly for the IRC, small business tax administration should be streamlined. Simpler rules would improve the efficiency of the economy, would assist in growing future revenues, improve perceptions of the fairness of the tax system and potentially improve government accountability.

Income tax for businesses (large and small) is based on ‘accounting profit’. One way to reduce these costs for small businesses is to either (a) make working out ‘accounting profit’ easier; or (b) use a simpler substitutes for ‘accounting profit.’ Both of these strategies have been proposed in the report.

76 The Issue was first discussed in Issues Paper No 3: The Case for Reform and Broad Reform Directions.
77 The NRI noted that small business should keep a wider range of records for bankers and insurers.
New Rules for Small Business with turnover of less than K250,000

**Recommendation (62):** The new rules apply to businesses with a turnover of less than K250,000 AND the new tax rules would not apply to companies and professionals.

The Review proposes a reduction in costs for smaller businesses by finding cheaper ways to calculate accounting profit for tax purposes. Businesses with turnover of K250,000 or more, must collect GST. This in turn requires records (record keeping) which can also be used to work out accounting profit. Therefore, the GST registration threshold of K250,000 is a natural dividing line for the simplified tax system.

Furthermore, companies are generally required to keep good accounting records for company registration purposes and professionals are required to keep good accounts for clients as part of their professional standards. These groups are excluded from the new tax rules. There are pragmatic reasons for excluding them as well – a different tax rate applies to companies and professions tend to operate on very high margins.

**Introduce simplified accounting rules for small businesses**

**Recommendation (63):** Introduce simplified accounting rules for small businesses along the lines of Samoa’s legislation but with a K5,000 cap on depreciation and a shortened four (4) year record retention period.

Currently, accounting rules are used to work out accounting profit which, in turn, is the basis of taxable income for business. This makes tax calculations for small business more complex than it needs to be. It requires income or expenses which relates to two tax years be allocated between the two years according to accounting rules. This can be changed so the income (or expense) is returned (claimed) in the year received (paid). Trading stock rules can be simplified so all purchases are deducted in the year received. Depreciation can be simplified by writing off most assets when purchased.

This approach was discussed extensively in the Issues Paper No. 7. The paper discussed the rules currently used in Samoa and Australia. The Samoan rules provide a template for modifying accounting profit for the purposes of calculating taxable income as follows:

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78 The IFC noted that businesses with turnovers just above the GST threshold may have limited capacity to maintain accounting records. It discussed the possibility that the GST simplification arrangements discussed later in this Report could potentially apply to higher turnover levels.
36. **Simplified tax accounting for small business** — (1) The taxable income for a tax year of a person conducting a small business is computed in accordance with this Act subject to the following modifications:

(a) the assessable income, and expenditures and losses of the business are accounted for on a cash basis;
(b) the rate of depreciation of the depreciable assets ... is 100 per cent;
(c) ... a deduction is allowed for the cost of trading stock acquired during the year;
(d) the period for retention of records ... and amendment of assessments ... is 2 years.

37. **Cash-basis accounting** — A person accounting for income tax purposes on a cash basis derives an amount when it is received by the person and incurs expenditure when it is paid by the person.

The only departure from the Samoan law, is that the Review is attracted to the idea of putting a limit (say K5,000) on the value of assets which can be depreciated at 100 per cent. There may also be a need for rules relating to small businesses transitioning from the simplified accounting rules to the standard system.

**Submissions**

The National Research Institute (NRI) agreed with the above approach, but believes that 100 per cent write offs were appropriate — revenue implications are small because few of these businesses would make major acquisitions in a year. International Finance Corporation (IFC) believes this proposal alone would not be sufficient to reduce small business costs because most micro and small businesses have difficulty in keeping records of accounts. This proposal may be useful for businesses with slightly higher turnover, within the normal income tax system (smaller medium sized businesses). Capped depreciation requires some thought regarding revenue implications. The Review agrees that this proposal will have limited effect on businesses without record keeping.

**Time limit for Retaining Records**

The time limit for retaining records is reduced for small businesses. This probably reflects a desire to reduce record keeping, but needs to be balanced against the time frame in which the tax administration might need records for audit or other purposes. A four year retention period from assessment recognises the general amendment period is 3 years from assessment, with some allowance for cases with unlimited amendment.

These changes could be implemented relatively quickly.
Administrative Guidance on Acceptable Profit Margins

Issues Paper No. 7 discussed the possibility of the IRC publishing likely profit margins, to give businesses some guidance on the expected net profit from each kina of sales. Businesses significantly outside of the benchmark financial ratios could expect the IRC to understand their specific position better.

This guidance would be based on tax returns and other data. It could be supplemented by consultation with local accounting expertise. The IRC has indicated to the Review that this guidance could be developed for key sectors once sufficient data is available from its new IT system.

Submissions

Both NRI and IFC had serious doubts about the administrative guidance because the literacy and record keeping of small businesses means such guidance is not likely to have any real effect. IFC also had doubts about the data collection capacity to develop such ratios. The Review agrees that while these ratios may be of use in audit case selection (and could be published as part of transparent administration) they would be unlikely to assist small business compliance. No recommendation is made on this issue.

Flat Tax + Turnover for Small Business

Recommendation (64) Develop a flat tax + turnover proposal (with an option to opt out) for small business.

Issues Paper No. 7 discussed a combination flat tax + turnover tax for small businesses (with turnover below K250,000) designed to achieve a tax level similar to the standard personal income tax.

The conceptual outline of flat tax + turnover tax for a low profit margin business, could be applicable to a retailer. The proposed flat tax + turnover tax tries to achieve a similar tax outcome to the current personal income tax after allowing for dependant and other rebates. (The personal income tax outcome is shown as blue squares in Figure 5 below.

In Figure 5, red triangles represent the possible tax for a retailer (which is assumed to earn around 10 - 15 toea net profit for each kina of sales). The flat tax + turnover tax applies to businesses with turnovers below K250,000.

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79 This is not a proposal. It is just a conceptual guide, based on current rates of personal income tax. Much more work has to be done.

80 The standard income tax rules apply to businesses with sales over K250,000.
• A very low flat tax applies to the smallest businesses – such as street traders. Alternatively the tax could be set at NIL, recognising the tax free threshold.

• A tax based on a percentage of sales (‘turnover tax’) for larger businesses with sales up to K250,000.

Microbusinesses

Issues Paper No. 7 discussed a low flat tax for microbusiness. A central question discussed was whether the tax-free threshold should be reflected in such taxes. In practice this would mean the flat tax level would be set at NIL. It discussed the alternative possibility of a very low flat tax similar to a business license for all microbusinesses. On balance the Review considers it necessary for an incremental approach to implementing this tax and initially at least, the flat tax component should be set at NIL tax. A very low flat tax (e.g. K100-K200), similar to a national business license, might be justified but would entail significant implementation costs and so may need to be deferred.

Turnover Tax

Small businesses with turnover greater than the microbusiness cut-off turnover could use a tax based on turnover for up to K250,000 as discussed in the Issues Paper. The turnover tax would broadly replicate outcomes under income tax. A lower rate of tax would probably apply to retailers, with a higher rate applying to other (higher margin) businesses.
Submissions

The NRI prefers a more comprehensive change to the personal income tax system with two mutually exclusive forms of personal income tax (a) a wage income tax with (b) investment income tax. All small micro businesses above an K18,000 a year tax-free threshold would be subject to corporate tax rates. The NRI made the point that the turnover tax should not mimic the personal tax arrangements, it instead suggested the alternative of record keeping requirements and the possibility of instalment payments. The submission by John D. Conroy contains a useful critique of some aspects of the NRI arguments and rationale.

IFC noted the primary objective of flat taxes is not to raise revenue but to familiarise small businesses with the requirement to pay tax. Lump sum taxes are difficult to collect from hard-to-tax micro-businesses. IFC pointed to the difficulties in the collection of small amounts and the need to develop collection at the local level. The Review notes these issues, partly addressed by use of a nil rate for subsequent review based on experience in implementation.

IFC considers that a presumptive turnover tax is likely to be the most effective in reducing business compliance costs. IFC also discussed the issues associated with designing a turnover tax, which will be a helpful reference in the implementation phase.

Alternative presumptive tax for special classes of economic activity

Recommendation (65): Develop an alternative presumptive tax to separately tax special classes of economic activity that are clearly identifiable and for which likely taxable income is reasonably predictable.

An alternative presumptive tax would separately tax certain classes of economic activity that are clearly identified and for which the likely taxable income is reasonably predictable. In particular taxi and PMV transport, and (possibly) restaurants and trade stores could be the subject of a separate tax.

Typically the resulting tax would be:

- Taxis – a flat tax per taxi
- PMVs – a flat tax per PMV or a tax based on engine capacity.
- Trade stores – tax based on floor space in the shop. (The turnover tax is an alternative solution.)
- Kaibar – tax based on seating or space. (The turnover tax is an alternative solution.)

If the flat tax + turnover tax proposal was introduced, these special taxes could nevertheless be introduced as an alternative especially for activities such as taxis and PMVs.

An important issue is whether the rules would be appropriate where one person owns many taxis or trade stores. Another issue would be how the rules would apply when a taxi is owned by one person and driven by another on a profit sharing basis. Consideration should be given to requiring a taxi, PMV or trade store that has paid their tax to display a certificate so IRC staff can visually check tax status of small businesses operating in public.

Submissions

The NRI argued that this type of tax is best administered and collected with vehicle licensing. They suggested that a retail tax based on floor space should be treated as an advance before the business is licensed. Again IFC’s submission gives some useful background on issues for the system design.

Way Forward

The flat tax + turnover tax and the specific industry taxes should be developed after studying industry profitability. Some indications could be obtained from tax returns of those who file, tax audit results, applications for government assistance and bank loans. These should be supplemented by public and industry consultation. The study should identify the appropriate unit of tax for the specific industry tax (taxi license, PMV engine capacity, and so on).

Once profit per kina of sales for each industry is estimated, the tax is worked out by ‘fitting’ the flat tax + the turnover tax to the personal income tax payable (after rebates etc are allowed). This will usually mean a different treatment for retailers (who usually earn smaller profits per kina of sales) and others.

Designing these taxes will require careful analysis so as to develop the detailed policy, significant taxpayer education and an audit strategy. These proposals therefore are recommended for the medium term.

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81 This in turn hinges on the likely turnover per taxi or per store. If the likely turnover of say a certain number of taxis was greater than K250,000, then the standard tax system would apply to owners of that number of taxis.
Relationship to Income Tax

The flat tax + turnover tax and the specific industry tax replace income tax on small businesses. They are in addition to any existing licenses and permits such as business names fees, trade license fees imposed by provincial governments and urban authorities, industry licenses, company registration fees or certification of foreign enterprises.

Reduced Record Keeping and Reduced Form Filling

For the flat tax + turnover tax and specific industry taxes, businesses would be required to keep a cash book recording daily sales and other proceeds, including credit sales. PAYE record keeping would not change. In dealing with the IRC it would only be necessary to certify the turnover for the year.

In addition to the record keeping savings, one advantage of these flat taxes for business is that they will be able to budget for their tax and possibly pay as they go, so they can better manage their cash flow. There is more certainty that small businesses have paid the right amount of tax and it is less likely that they will be subject to audit or penalty tax.

Opting Out

If a person thinks the standard arrangements would be a better deal than the flat tax + turnover tax then he or she could opt to return to the standard system — provided they keep complete tax records. To prevent ‘cherry picking’, once someone opts for the standard system they would not be permitted to use the simplified tax for five years.

Recommendation (66): Payment of GST and Salary and Wage Tax should be combined and payment periods be increased to three monthly.

The Issues Paper also raised the possibility of streamlining payments and filing of returns by small businesses. Each month small businesses send salary and wages tax, with a group employer form to IRC, within seven days after the end of the month. Many small businesses are GST payers (voluntary GST registered), and they must lodge a goods and services tax return form, together with the payment within 21 days of the end of the month. By combining these requirements and making the payment period 3 monthly, both small business costs and tax administration costs
could be reduced. Submissions raised questions about the ability of small businesses to keep records for a longer period. This should be monitored, in the implementation phase.

Submissions

NRI cautioned that small businesses may face cash flow problems if they fail to manage cash over a longer cycle. The Review considers the option to engage the banking sector to assist in facilitating payment arrangements. IFC stated that frequency of filling is one of the main reasons for high GST compliance costs. IFC reported that from its interviews with small businesses: “cash flow has been a problem for [small business] when filing monthly coupled with delays in IRC providing rebates. Therefore filing bi-monthly or every three months would address the issue of cash flow whilst reducing compliance burden for small business”. But they noted that small businesses may have problems in keeping records for long periods.

Create a Position in IRC to Drive and Coordinate its Engagement with Small Business Sector

Recommendation (67): Create a position in IRC with the primary role/function to drive and coordinate the IRC’s engagement with the PNG small business sector.

As part of this process, the whole of small business interaction with the IRC should be redesigned and a formal strategy adopted. Forms and information material need to be written specifically for this sector. IT solutions which can streamline the process and simplify access for taxpayers to pay (including payments through mobile phone banking channels) should be explored. In the opinion of the Review outreach to small taxpayers and compliance support services are overdue. Education campaigns and local support services are required to support a small business compliance strategy. A challenge is there are many potential taxpayers and tax understanding is critically low. The Review is not recommending a change to the functional organisation of the IRC, but a cross-function position. This will oversee the IRC’s engagement with PNG’s smaller businesses to drive change and for that change to be effective.

Submissions

NRI suggested the IRC should consider greater use of the website to put reliable learning resources on the website with Q&A on popular social media like Facebook.

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82 While these changes are raised in the context of a discussion about small businesses with a turnover of less than K250,000, (ie voluntary registration) it is feasible that the threshold for combined filing and payment could be higher.
Private tax services and civil society should also be encouraged to support taxpayer education.

**Strategy to improve compliance from PNG’s hard-to-tax sector**

**Recommendation (68): A formal strategy be developed to help improve compliance so as to increase tax from PNG’s hard-to-tax sector.**

The Review recommends a more strategic approach to be developed to improve the tax efforts in the hard-to-tax industries. Currently, the main way this sector pays tax is through the GST on business inputs purchased from formal suppliers and from GST paid on their consumption items.

There is potential to improve confidence in the tax system and mobilise important revenue by including more ‘hard-to-tax’ cash businesses in the income tax base. This does not mean the subsistence economic activities which are not taxable, but those enterprises including illegal enterprises that choose to stay remote from the IRC and earn taxable income. During consultation, the Review heard complaints that the IRC needs to be more aware of the extent of abuse in this areas.

Simplifying tax calculation and record keeping removes a barrier to businesses formalising their tax arrangements. But this alone is not enough. Issues Paper No. 7 discussed some possible incentives, along with possible enforcement strategies to encourage informal businesses to participate in the tax system. The Review strongly recommends that a whole of government approach to addressing the informal economy is needed, and a formal strategy be developed and adopted by the Treasury Department.
Undertake study of Tax Morale

**Recommendation (69): A Study of Tax Morale in PNG should be undertaken.**

Enhanced education awareness and enforcement can help, but attitudes to voluntary tax compliance must be better understood. These attitudes are entwined with fundamental aspects of the tax bargain between citizens and the state. People’s intrinsic motivation to pay tax is referred to as *tax morale*.

Issues Paper No. 7 summarised material presented at a 2014 National Research Institute seminar: Piatti et al 2014(a), 2014(b). While this material looked at economy-wide tax compliance, the findings were particularly relevant to small businesses. The Review contributed funding to this seminar.

It was noted that countries with strong institutions and governance tend to have higher levels of voluntary compliance and lower tax evasion:

- As a multi-ethnic society, PNG has much work to do to gain the necessary state legitimacy which would promote voluntary compliance.

- High levels of corruption undermine trust in the state and it increases the challenges in tax administration.

- Income inequality is problematic in PNG, and it is getting worse. Inequality affects willingness to comply with the tax system. A potential response would be to increase public services to low income citizens — and this has the side benefit of tackling tax evasion.

- Younger people tend to have lower tax morale than older people and this could be an ongoing challenge given PNG’s rapidly growing young population.

- Increasing the IRC resourcing can yield better tax performance. A respectful and fair treatment of taxpayers (this is in the IRC values statement) will be reciprocated by taxpayers and lead to respect for the tax system cooperation between the IRC and taxpayers. Hard core and malicious evaders should be targeted by a solid law and order structure.

- The National Identity Number (NID) – An option suggested by IRC was to tap into the NID system which keeps track of all citizens doing business and capture them into the tax system. Doing so would validate and cross reference IRC’s Tax Identification Number (TIN) system. The current National Identity project (NID) is managed by Department of National Planning & Monitoring.
The Review recommends the IRC implements this proposal in the mid to long term period.

There will be limits to what can be done about tax evasion by small business and other sectors without improving PNG institutions and governance. While this is a matter for a whole of government response, in the tax area more extensive research into taxpayer attitudes could at least track developments in this regard.

The academia recommends that:

- Surveys along the lines of the Taxpayer Opinion Survey (TOS) be conducted regularly;
- A panel data set be used to monitor tax morale annually, tracking the same taxpayers over time. This would offer the opportunity to assess how taxpayers react to internal and external shocks or changes;
- Testing compliance strategies with field experiments in collaboration with academic researchers. For example what level of supervision/audit is optimal? Does friendly and respectful communication and treatment of taxpayers positively affect and result in tax compliance? How does the provision of information change compliance? What are the real effects of informing new taxpayers about important tax issues? How useful is preparing new taxpayers to be more compliant? etc.

The Review believes that there will be a significant payoff from investing in understanding tax morale in Papua New Guinea, which in turn leads to a far more sustainable tax system.

**Hard-to-tax Economy**

The Review considers more strategic attention needs to be given to improving the tax effort in hard-to-tax industries, to fund the goods and services required by the community. The Review believes this should be done sooner than later.

Given the significance of the informal economy in the PNG, there is potential to raise more revenue by adding more businesses to the income tax base. However, even if the revenue potential of income tax were not significant, a taxpaying culture at all levels enhances community confidence in the overall tax system. The benefits can be advantages.

Simplifying tax calculation and record keeping removes a barrier to businesses formalising their tax arrangements. But this alone is not enough.
Issues Paper No. 7 discussed some possible incentives, along with possible enforcement strategies to encourage formalisation of businesses. For example:

- simplifying the on-Tax business registration processes need to be simplified;
- opportunities to enhance financial inclusion of small businesses should be promoted;
- third party reporting and cross matching system be further developed; and
- consider the selective use of export taxation.

A submission by John D. Conroy emphasized that enforcement strategies need to be considered on a selective basis. At this stage of its development, Conroy argues that PNG needs more informal enterprises. He proposed that increasing financial inclusion of businesses after their formalisation, will become easier. The Review agrees that enforcement has to be well targeted, particularly so that they do not unfairly tax very low income earners.

**Business Payments Withholding Tax**

Issues Paper No. 7 sought feedback on the practical application of the business payments withholding tax. During consultations there were discussions on aspects of certificates of compliance but the Review understands these are being addressed by the IRC. There is no case therefore for change from the current approach on the basis of the evidence and information received.

**Simpler GST System for Voluntary Registrants**

The Issues Paper No. 7 discussed possible ways to simplify GST for certain low turnover businesses (also raised in Issues Paper No. 9 Goods and Services Tax.) Submissions broadly supported simplifying GST for voluntary registrants, and all pointed out the need for good data to develop any such arrangements. Good and reliable data may become available as the IRC’s SIGTAS system is implemented. While simplifying GST may be worthwhile, until such time that data is available, the Review does not consider this as a priority issue.
CHAPTER 9: GOODS AND SERVICES TAX

Introduction

The Review’s terms of reference includes the reviewing of the design, operation and efficiency of the Goods and Services Tax (GST) in PNG.

GST issues were discussed in detail in the Review’s Issues Paper No. 9: Goods and Services Tax. Several submissions were received both in response to the Issues Paper as well as through the ‘Blue Sky’ consultation phase.

GST is a significant contributor to PNG tax collections, contributing some 11 per cent of the overall tax revenues in 2014. GST is a broad-based tax on the final domestic consumption of goods and services. Although it is collected throughout the supply chain by businesses, the system of tax and input tax credits (ITC) is designed so that businesses are not taxed and the final incidence of taxation is intended to be upon the final consumer.

The broad base of the GST distinguishes it from consumption taxes on specific goods such as excises, which are often also used for social policy reasons. For example, tobacco excise has an important role in moderating the health risks from smoking.

Consumption taxes have a different range of economic impacts than income taxes and tax systems are usually designed to include a variety of tax types in order to spread the economic impacts and to avoid any disincentives that might arise from a reliance on one specific type of taxation. For example, income taxes are generally thought to provide a disincentive for people to take on more work while narrow based consumption taxes influence the decisions made to consume one good over another.

Personal income tax raises 34 per cent of total tax revenue and is only paid by 5 per cent of the population, i.e. those in formal employment. This is a narrow base tax which is both inequitable and unsustainable. One of the key themes of the Review is to increase the revenue from GST in order to share the tax burden more equitably whilst broadening the overall tax base.

The GST is only intended to apply to domestic consumption. Under this arrangement exports are zero-rated in order to maintain the international competitiveness of PNG products. Conversely, imports are taxable although business imports will attract an ITC like any other business transaction. This approach to the international tax of trade is known as the “destination principle”.

One of the key integrity features of the GST is that each supplier throughout a supply chain charges tax on the value they add. This is achieved through the system of ITCs. This arrangement provides strong incentives for businesses to only deal with other businesses which have adequate records and provide the correct documentation so that ITCs can be claimed. The use of zero-rating for supplies to various sectors has seriously undermined the operation of this system and presents a severe compliance risk.

There is a general perception that poor compliance is an overall problem with the GST. However, the Review has not been able to estimate the size of this. This relates both to the unavailability of accurate national accounts data as well as the administrative difficulties of the IRC. The zero-rating arrangements also compound this problem as credits are not easily allocated to the final supply.

**Background**

GST was introduced 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 whilst maintaining Government revenue. The tariff reform was part of PNG’s broader trade liberalization commitment as a result of its membership of Asia Pacific Economic Cooperation (APEC) in 1993 and the World Trade Organization (WTO) in 1996.

At the time of introduction, the rate was set at 10 per cent with certain classes and supply of goods and services either exempt or zero-rated. The registration threshold was set at K100,000 gross annual turnover. Thirteen years later in 2012, the registration threshold was increased to K250,000.

GST revenue (net of refunds) is shared between the national and provincial governments on the basis of 40 per cent to the national government and 60 per cent to provincial governments. This Review did not consider revenue sharing issues related to GST.

The Review notes that although PNG’s GST system was originally designed to be simple and broad-based, administrative incapacity to effectively administer the tax and the number of amendments to zero-rate certain supplies have actually made the system more complex, unfair and open to abuse.
**GST Rate**

| Recommendation (70): The Review recommends that the rate of the GST be increased to 15 per cent. The increase to revenue is estimated to be approximately K750 million per annum. |

An increase to the GST rate will raise significant revenue. If consumption patterns do not change, raising the rate to 15 per cent (an increase by 50 per cent) would increase total revenues by a similar amount.

However, in practice there may be reduced aggregate consumption as a result of the GST rate increase. While income tax reductions will provide extra post-tax income for workers in the formal economy to offset the impact of increased prices, those who do not currently pay income tax may not be able to maintain their consumption at current levels. Thus the actual revenue impact will be lower than the increase in the GST rate. It is not possible to cost this with the data available to the Review.

As an alternative, the increase in the GST rate could be done by a two-step process with one increase to 12.5 per cent from 1 July 2017 and a further increase to 15 per cent from 1 July 2018. This would give more time for the economy to adjust. It should be noted that there is a compliance cost for business each time rates are change so it would be undesirable to plan for more than two increases.

In developed economies, compensation can be provided through pension (or similar) systems for low-income earners. However, this approach is not available in PNG and in the absence of broad transfer system, well targeted social policy programs are the best option. In order to compensate for the increased GST, the Review suggests the Government continue its Tuition Fee Free education, Free Primary Health Care and funding for Low Cost Housing Scheme to improve the living standards of low-income earners.

**Submissions**

Several submissions have commented on the appropriate rate for the GST. Not surprisingly there were different views. A few supported an increase, particularly if it is linked to reductions in income tax, others suggested reducing the rate either across the board or for particular goods and services.

There were concerns raised about the impact of an increase on low-income earners and particularly people from the rural areas. There is no doubt that raising the rate will increase prices but the Review believes that for many low-income earners the impact will be small.
This recommendation is part of a package which includes significant changes in income tax particularly for those in the lower-income bands. These income tax changes will provide extra income and this will flow through into the economy, including to the villages through remittances from family members working in the towns.

**Zero-rating of Supplies to Resource Companies and Others**

Recommendation (71): The Review recommends that:

- the current zero-rating of supplies to resource companies, aid programs and charitable organisations should be removed immediately and replaced with a standard treatment whereby relevant supplies by those sectors are zero rated;
- the tax concessions granted to aid organizations, designated air bodies or persons under the out-dated PNG DFAT administration laws be reviewed to reflect current policy intent; and
- the process to approve charitable organisation status be done by another Government agency, other than the IRC.

The current arrangement where supplies made to resource projects, aid projects and non-profit bodies are zero-rated creates a significant compliance problem. It is also rather unusual. The only real benefit of this approach is a reduction in the compliance cost and a minor cash flow benefit for these businesses. This comes at a cost of significant non-compliance, administrative difficulties for the IRC and PNGCS and additional compliance burdens for honest businesses throughout the supply chain.

International best practice is for any particular good or service to have a consistent tax treatment under the GST. Varying the way a particular good or service is treated because of the nature of the recipient of the supply only serves to add complexity and increases non-compliance.

The supply of minerals and other resources to international customers should be zero-rated, in line with the destination principle. In fact, they already are! Repealing the current arrangements will mean that these businesses will need to pay tax inclusive prices for their supplies and then claim their ITCs themselves. This change

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83 Defined by GSTA section 21(1)(e) as religious, charity or community organisations approved by the Commissioner and carrying on a non-profit activity.
84 GST Act, section 19
85 GST Act, section 21(1)(c), (d) and (e)
will not alter the ultimate incidence of GST but rather will move the onus and costs of compliance onto the provider of the zero-rated good or service. It will also remove a large number of intermediate suppliers from the refund system and, finally, will mean that domestic supplies of resource products will be taxable – as they should be.

Similar arrangements\(^{86}\) apply to the supply of crude oil to domestic refiners and this could also be considered for repeal. The Review is not aware of any evidence of a compliance problem with this provision. However, the repeal would be consistent with the intent to rationalise the use of concessions in the GST system to improve the administration.

**Submissions**

In their submission, the PNG Chamber of Mines and Petroleum argued against change to the current approach. The Chamber\(^{87}\) stated that they were unaware of any abuse and argued that the “key purpose of zero-rating supplies to resource companies is to encourage compliance by the contractors...[but if contractors would be] in a GST payable position...opportunities for further abuse are opened up”. The Review is not persuaded by this argument and notes that international experience, and indeed local experience in other sectors, is that large companies will require smaller companies to register if they wish to do business so that the large company can claim its ITCs. This is actually a key design feature of the GST system whereby the relationship between businesses and the need for each to claim their appropriate ITCs acts as a powerful aid to compliance. In the PNG resource sector this interdependence has been removed. The Review further notes that pushing the compliance responsibility and costs onto the smaller companies unfairly allows the larger company to minimise its own compliance responsibilities while maximising its benefits.

Another submission pointed out that tax concession to aid organizations, designated aid bodies or persons as contained in the PNG DFAT administration laws are out-dated and requires a review to reflect the current policy intent of Government and method of aid to PNG. The Review agrees with this view.

The same submission argued that charities enjoy a wide range of tax incentives, including concessional GST treatment. Currently, the Commissioner General of IRC

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\(^{86}\) GST Act, section 21(1)(f)

approves an organization’s charitable status and the IRC is not best placed to decide if a charity meets social welfare objectives. It suggested that recognition of charities be done by another Government department, especially the Department of Community Development. The Review agrees with this proposal.

Remove Discretionary Exemptions

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<th>Recommendation (72) The Review recommends the existing arrangements for providing discretionary GST exemptions should be repealed as soon as possible.</th>
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The GST Act contains arrangements\(^{88}\) whereby specified goods and services can be exempted from GST, or subject to a reduced rate, by the Head of State acting on advice. The Review understands that this provision has been used mainly for resource related projects; however, it is difficult to understand the rationale behind these exemptions.

Because of the basic design of the ITC system, GST is not actually paid by businesses and the actual burden of the tax is carried by the final consumer. The benefit to the business from an exemption is thus small but, similar to the resource issues discussed above, the cost to the system in complexity and compliance is high.

It should also be noted that the drafting of the legislation to allow these exemptions is unclear. Sub-section 25(8) of the GST Act provides the mechanism whereby the supply of any good or service may be made “exempt from” GST. Sub-section 25(9) further provides for a “reduced rate” of GST. These provisions are contained in section entitled “Exempt Supplies” but they do not use the language typical of exempt supplies which is a technical term for supplies for which no GST is charged and no ITC is available. There is significant doubt as to what the legislation actually means and the Review understands that many supplies are treated as zero-rated rather than exempt.

The Review has been examining incentives as a separate issue.\(^{89}\) Irrespective of other decisions on incentives, the Review recommends that the discretionary exemptions provisions of the GST Act be repealed as soon as possible.

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\(^{88}\) GST Act, section 25(8) and 25(9)

\(^{89}\) Issues Paper No.5: An examination of the advantages and disadvantages of tax incentives
Improve GST Remittance between PNGCS and IRC

**Recommendation (73):** The IRC, PNGCS and Treasury should work with BPNG to develop arrangements to expedite the remitting of GST collected to the National Goods and Services Trust Account.

The Review understands that the existing arrangements for transferring GST collected on imports and in the provinces to the IRC is subject to ongoing delays. The current system relies on payments via commercial banks to BPNG and then to the National Goods and Services Trust Account.

The processing delays have caused problems for the IRC in accessing funds to pay GST refunds in a timely manner. Delays in paying refunds can in turn cause problems for businesses and lead to an undermining of confidence in the tax administration. This can discourage compliance and potentially compromises the integrity of the GST system.

The Review recommends that PNGCS lead a project with the IRC, Treasury and BPNG to examine the problem and devise a new system to facilitate the timely transfer of funds.

Educational Institutions

**Recommendation (74):** The concession which allows educational institutions to claim ITCs should be repealed.

Despite educational services being exempt supplies, section 31(16) of the GST Act allows educational institutions to deduct ITCs for certain educational materials (such as text books and writing materials) received by them. As educational supplies are exempt supplies this means that educational institutions become eligible for refunds. As they generally have no other GST liabilities, many educational institutions have used third party brokers to claim their refunds and these brokers operate on a commission basis – sometimes their fees can be up to 40 per cent of the refund. This leads to an incentive to over claim refunds.

Following the implementation of the Tuition Fee Funding program, educational institutions have a more secure funding base and the original intent behind the ITC policy no longer seems relevant.

Because of the growing compliance problem, and in line with our other recommendations, the Review considers this to be an important integrity measure.
Medical Services

The supply of medical and related services by a hospital, a registered medical practitioner, registered dental practitioner, optician or nurse, or an aid post orderly is exempt from GST. Section 21(1)(a) of the GST Act, however, zero-rates medical supplies.

A submission by the Pacific International Hospital argued that medical services should be GST-free as it is a public good. The submission further argued that “private health-care providers, who rely heavily on direct fees, are at a competitive disadvantage with public and Church-run health care systems under the current GST regime as they have to charge patients more to recover their costs”. The submission argued that it is costly for Papua New Guineans to seek overseas specialist medical services and that the Government must support private health care providers to lower their costs. It further argued that that there is no definition of medical supplies in the GST Act and this is open to abuse.

The Review considers that it is a standard international practice to exempt medical and related services. Australia is the only country where medical services are GST-free (or zero-rated). PNG’s system where medical supplies are zero-rated is actually a concessional treatment. The Review therefore does not recommend any further changes and also agrees that there is a need to define what constitutes ‘medical supplies’.

GST Deferral Scheme

Recommendation (75): The legislation to allow a GST deferral scheme for imports should be brought forward as soon as possible, noting however that this scheme should not be implemented until adequate automated data exchange is in place between the IRC and PNGCS data systems.

GST paid on imports by registered businesses will almost always be offset by an ITC so that the net tax impact is nil. However, GST is due at the time of importation and the ITC cannot be claimed until the next settlement. The timing difference can lead to a cash flow burden for businesses, particularly if the import is of expensive capital equipment.

GST deferral systems are common around the world. In order to ensure compliance, these are usually only available on a discretionary basis. In Australia, for example, GST deferral is only available to businesses which:
are registered for GST;

- lodge their tax statements online and monthly; and
- make their tax payments electronically.

Businesses which are not up to date with tax returns or payments or who have been convicted or penalised by a court for specific offences relating to tax and related matters may be excluded from the deferral scheme.

The success of a deferral scheme depends on timely and accurate data exchange between IRC and PNGCS. Without this the compliance risk is severe. The Review understands that IRC and PNGCS are working on data exchange between their systems but this has not yet been achieved to an adequate level. Nevertheless, the Review recommends that legislation be put in place to allow the scheme to operate but that it should not actually commence until data exchange issues are resolved.

Submissions

Submissions from the Chamber of Mining and petroleum and Oil Search have advocated a GST deferral scheme.

**GST Refunds Risk Management**

**Recommendation (76): The IRC should take immediate steps to establish a GST refunds risk management policy and operationalize it to detect, deter and prosecute GST refunds fraud.**

It is well recognized 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 and the administrative challenges have facilitated GST refund fraud. A significant amount of GST revenue is lost annually through fraud and abuse of exemptions, zero-rating and withholding arrangements.

A GST refund risk management policy should be put in place to manage risk. Risk assessment should be automated and clearly defined risk profiles should enable proper screening and faster refunds processing of low-risk clients. The IRC should prosecute dishonest taxpayers and agents and publicise their names as a deterrence measure to others.
Other Matters Considered

GST Registration Threshold

The Review examined the existing GST registration threshold. This is set at K250,000 and is relatively high by regional standards but consistent with international recommendations.

The Review considers this to be appropriate and believes it should be retained at that level.

Simplified System for Small Businesses

The Review is aware of the UK Flat Rate VAT system for businesses below the registration system, i.e. voluntarily registered. This system is based on a flat rate of tax being remitted on turnover. The flat rate is calculated on an industry basis taking account of the average proportion of ITCs and GST payable. So, for example, a retailer would be eligible for a higher proportion of ITCs than an accountant and would therefore pay a correspondingly lower rate of total turnover as net GST. Businesses receiving supplies from a flat rate supplier would still be eligible to claim the ITC at the standard rate. See the Review’s Issues Paper No. 9, Goods and Services Tax (GST) for further information.

This approach is similar to the turnover approach for income tax canvassed in the Review’s Issues Paper No.7: Microenterprises, Small Business, & the Informal Economy.

A confounding issue for PNG is that the current system of zero-rating for end use, such as resource projects, would make the calculation of reasonable turnover/ITCs very difficult.

Nevertheless, the Review believes there could be merit in further examination of this option if there was also interest in the turnover approach for income tax. The two taxes could be combined into one overall rate. At this stage, this is a possible project for the future.
CHAPTER 10: EXCISE TAX

Introduction

The Review’s terms of reference includes reviewing the definition, objective and design of excise tax in PNG.

Excise issues were considered in Issues Paper No. 6: Excise Tax. Several submissions were received both in response to the Issues Paper as well as in the earlier phases of the Review’s consultations.

Excise tax is an indirect tax, i.e. a tax on particular goods that is ultimately/indirectly paid for by a consumer. Examples of goods subject to excise tax include tobacco, alcohol and vehicles. Excise rates are either:

- *ad valorem* which means the tax is calculated on the value of the good, e.g. as percentage of a price; or
- *specific* which means the tax is set as a rate per some unit, e.g. an amount per litre of petrol.

There are number of reasons why excise taxes are used:

- they may be imposed on goods where a change in the price as a result of tax has minimum impact on the demand for that good. This is desirable because taxes should have as little unintended impact on consumption choices as possible;
- they may be imposed on harmful goods as a means of reducing the broader economic, social or environmental costs associated in consuming the goods, e.g. tobacco, alcohol or petroleum products;
- excises on luxury items can enhance the fairness of the tax system by ensuring those with more wealth pay more tax; and
- excise taxes can be relatively easy to administer, relative to the amount of revenue that can generate. This is an important consideration where administrative capacity is limited.

The key finding from the Review is that PNG relies proportionately heavily on income taxes (notably personal and corporate income taxes) and relatively less on indirect taxes. Thus, the Review proposes to shift the tax burden from narrowly-based income taxes towards indirect taxes such as excise tax as part of its efforts to broadening the tax base.
In summary, the key proposals are:

- simplifying the excise tax regime by focusing on key traditional products;
- applying excise tax to telecommunication services;
- updating the indexation arrangements; and
- rationalising the Customs and Excise Tariffs.

Background

Excise taxes are a form of indirect tax that targets specific goods or activities. This contrasts with other forms of indirect taxes such as the GST which seeks to tax consumption more broadly.

There are over 140 separate items that attract excise tax in PNG, with many being variations of the same product. The specific items are discussed in the Excise Tax Issues Paper.

PNG uses both the specific and ad valorem methods for calculating excise rates.

- For alcohol products, the excise base rate is based on the alcohol content of the product – that is, the higher the alcoholic content, the higher the excise.
- For tobacco products sold in cigarette form, excise is applied at a specific rate per 1000 cigarettes. For other tobacco products, excise is applied per kilogram of tobacco.
- For petroleum products, the excise base rate is applied per litre.
- For other excisable items, an ad valorem method is used, with rates varying between 15 per cent and 120 per cent.

Excise rates for tobacco and alcohol products are indexed to maintain their value. The rates are adjusted twice a year (1 June and 1 December). Prior to recent changes made in the 2015 Budget, the same indexation arrangements applied (from 2006) to both alcohol and tobacco products. The increase was capped at 2.5 per cent or the lesser of Consumer Price Index (CPI) expressed in percentage. CPI figures are determined by the National Statistical Office.

As a result of changes in the 2015 Budget, different indexation arrangements now apply to tobacco products. For income years 2015 and onwards, tobacco products are now increased by a flat 5 per cent every six months.
Importance of Excise Tax

Figure 6: Excise Tax Revenue (2000-2013) divided into Local and Import Excise

Figure 6 highlights an overall trend of increasing excise revenues over time. The consistently greater collection from locally manufactured excisable goods reflects the significance of excise collected on locally manufactured alcohol and tobacco products.

Excise tax revenue receipts are an important source of tax revenue for PNG, with K814.4 million being collected in 2013. This represents 9.48 per cent of overall tax revenues.

Clarify Excise Schedule

**Recommendation (77): Repeal and replace Schedule 1 of the Excise Tariff Act 1956.**

The Excise Tariff Act was initially enacted in 1956. The Act has been subject to numerous amendments over time where items were either removed or included in the process. There is no proper record of a comprehensive list of excisable goods reflective of these amendments over the years.

Research undertaken by the Review revealed that a library in Australia kept a very good record of various amendments to the Excise Tariff Act 1956. The Review discovered that the current excise schedule is not comprehensive. There were certain excise items that existed in the excise amendments found in the library in Australia which were not in the current schedule. The reason for their removal is unclear. One good example is aerated water.

It was brought to the Review’s attention that this creates confusion as to what goods are legally subject to excise, their precise description, the correct tariff item number and the rates applying to them.
Therefore, the Review recommends an urgent need to repeal and replace Schedule 1 in its entirety. This will provide certainty to both PNGCS officers and taxpayers. The amendment will simplify the excise schedule.

**Simplify Excise Regime**

**Recommendation (78):** Streamline the schedule to concentrate on key traditional Excise products – tobacco, alcohol, petroleum products and vehicles.

There are over 140 separate items that attract excise tax in PNG, with many being variations of the same product. These can be split into five broad categories of goods:

- Tobacco;
- Alcohol;
- Petroleum;
- Vehicles; and
- ‘Other’ goods (a combination of goods deemed to be luxury items such as jewellery, televisions, cameras etc. ... and other ‘harmful’ goods such as firearms and goods associated with gambling).

Traditionally, excise was used to raise revenue with the tax levied on high volume, relatively price inelastic goods for which there were few substitutes. Today, excise policy is largely driven by the correction of negative externalities. The most common forms of goods subject to excise are tobacco, alcohol, motor vehicles and petroleum products. Excise tax is used to capture the cost of the negative externalities in the price paid by the consumer.

Therefore, the Review recommends simplifying the excise tax regime to focus on the key traditional excisable products - tobacco, alcohol, petroleum products and vehicles. The Review argues that the policy rationale in the imposition of excise on these products is very clear and justified.

Simplifying the regime will enable Customs administration to free–up its already constrained resources to deal with only a few companies and products. In doing so, will better serve the taxpayers efficiently and effectively.

The simplified regime will also assist Customs to concentrate their efforts to minimise revenue leakage and improve taxpayer compliance with the tax law.
Other Goods: Arms, Ammunitions and Gaming Machines

Recommendation (79): Remove excise from the goods category except for firearms and gaming machines.

The Review proposes removing the “other goods category” except arms, ammunitions and gaming machines. Details of the items are specified in Table 12 below.

Table 12: Other goods category within the Excise Tariff Act 1956

<table>
<thead>
<tr>
<th>Rate</th>
<th>Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>30%</td>
<td>• Perfumes</td>
</tr>
<tr>
<td></td>
<td>• Photographic Film (not X-Ray)</td>
</tr>
<tr>
<td></td>
<td>• Microwave ovens</td>
</tr>
<tr>
<td></td>
<td>• Video recording or reproducing apparatus</td>
</tr>
<tr>
<td></td>
<td>• Still image video cameras</td>
</tr>
<tr>
<td></td>
<td>• Small clothes dryers</td>
</tr>
<tr>
<td></td>
<td>• Hair dryers</td>
</tr>
<tr>
<td></td>
<td>• Televisions and other video equipment, including cameras</td>
</tr>
<tr>
<td></td>
<td>• Answering and dictating machines</td>
</tr>
<tr>
<td></td>
<td>• Audio hi-fi equipment without recording capability</td>
</tr>
<tr>
<td></td>
<td>• Lenses for photographic equipment</td>
</tr>
<tr>
<td></td>
<td>• Binoculars</td>
</tr>
<tr>
<td></td>
<td>• Articles for funfair, table or parlour games, except for gambling or coin or disc operated</td>
</tr>
<tr>
<td></td>
<td>• Roundabouts, swings, shooting galleries</td>
</tr>
</tbody>
</table>

| 40%   | • Natural or Cultured Pearls                                         |
|       | • Diamonds (other than industrial diamonds)                          |
|       | • Previous and semi-precious stones                                  |
|       | • Synthetic or reconstructed previous or semi-precious stones        |
|       | • Dust and powder of natural or synthetic previous or semi-precious stones |
|       | • Silver, semi-manufactured                                          |
|       | • Base metals clad with silver                                       |
|       | • Gold, semi-manufactured                                            |
|       | • Based metals or silver clad with gold                               |
|       | • Platinum (other than unwrought platinum or platinum in powder form) |
|       | • Palladium, rhodium or iridium unwrought or in powder form          |
|       | • Base metals, silver or gold clad with platinum                     |
|       | • Waste and scrap of precious metal or of metal clad with precious metal |

The goods as shown in Table 12 are often seen as luxury goods with the aim of establishing a progressive tax on the spending of the wealthy. These types of taxes are distinguished by their ad valorem nature where it is designed simply to raise revenue. However, these goods are consumer items which are becoming accessible to more and more people so the notion that they are luxury items is becoming less relevant. The inclusion of these goods also complicates the excise arrangements.
Information from PNGCS notes that the annual revenue generated from these goods is less than K5 million. The revenue amount generated varies annually depending on trade. The revenue forgone in comparison to the overall tax revenue collections is very small and may not be worth the administrative burden. Other policy changes can provide far more than the amount that would be lost if this change is implemented.

However, for social policy reasons the Review believes the excise on firearms, ammunition and gaming machines should be maintained.

**Goods of the Same Class**


A submission supported the removal of the reference to Customs Tariff Items in Schedule 1 of the Excise Tariff Act 1956 in making the schedule simple for taxpayers and customs administration.

Excise tax is usually imposed on goods that are locally manufactured and customs duties apply to imports. However, in PNG, the excise tax law extends to some imported goods, notably motor vehicles. In order to simplify the administration and to improve transparency, it is worth considering moving items that are exclusively imported from excise legislation to the customs legislation.

The Excise Tariff Act would apply to goods solely produced locally, whilst the Customs Tariff Act would focus on imported goods. New Zealand and Australia treatment of goods of the same class is similar to this system.

A system of this nature will greatly assist PNGCS administration where importation including goods of the same class will be dealt with by single Act as oppose to the existing system where you cross reference with multiple legislations.

**New Items to be subject to Excise**

**Betelnut**

| Recommendation (81): Treasury to work with PNGCS and relevant authorities to devise options for the control of betelnut which might include taxation options. |

Betelnut is a nut commonly grown in the coastal areas of PNG. Its consumption dates back thousands of years. Traditionally, betelnut was consumed in the villages for leisure and on certain occasions.
Today, betelnut has commercial value and in fact it is a growing industry in PNG. It is very difficult to quantify its value but anecdotal evidence suggests it is in millions.

However, international studies including the World Health Organisation (WHO) have revealed that betelnut chewed with lime has significant public health problems. In PNG’s urban centers, consumption and trade of betel nut causes environmental and social problems. An effort by National Capital District Commission to regulate betel nut has been a major challenge.

Betelnut is grown all over PNG’s coastal regions and is widely chewed and predominantly traded in the subsistence and the informal economy. The Review notes that it will be difficult to establish a practical means of applying excise. Nevertheless, it may be useful to further consider how this could be achieved and whether other forms of regulation might provide a more effective means of controlling this. It would be useful to examine this further in conjunction with the relevant authorities.

Telecommunication Services

**Recommendation (82): Apply excise tax on telecommunication services.**

Several submissions in response to Issues Paper No. 6 have opposed the proposal to apply excise on telecommunication services. The submissions argue that the application of excise tax on telecommunication services will further increase the already expensive telecommunication costs in PNG.

Introducing excise tax on telecommunication services was a recommendation by IMF in relation to the Philippines as a means to increase overall excise revenue receipts without the need to significantly increase other excise taxes such as those on petroleum, tobacco, and alcohol.

The proposal to apply excise tax on telecommunication was based on three objectives:

- abnormal profits to the operators because of limited spectrum;
- positive externalities benefiting existing users as the networks expand; and
- complex pricing schemes by the operating companies that make the tax base difficult to define.

In the Asia-Pacific Region, Bangladesh, Cambodia, Sri Lanka and Pakistan have specific charges on telecommunication in addition to GST.
Applying excise tax on Telecommunication services could be seen as proxy for a tax on rents where telecommunications services are provided by few operators. It has a wide coverage by extending taxation into the informal economy where mobile phone use is prevalent and has been increasing. It could be used as a means to tax informal activities where a significant portion of economic activity is undocumented and tax evasion is widespread.

The proposal is restricted to ‘voice’ calls. The broadening of the scope to include ‘SMS’ and ‘Data’ must be long term and subject to a study on the revenue and economic effects.

Issues Paper No.6 discussed introducing excise tax at a very low rate per call. However, the Review is concerned that the ultimate cost will be passed onto consumers. Hence, the Review is proposing that the excise tax is based on annual turnover. Turnover is generally the gross amount of income received by a business. This is to minimise the excise tax impact on the end user.

The Review was unable to obtain any information on annual turnover sales figures from relevant telecommunication companies. Treasury should consult on the design features of the proposal with the relevant authorities before it is implemented.

Excise Indexation

**Recommendation (83): Amend the law to ensure:**

- excise indexation continues on a six monthly basis;
- the 2.5 per cent cap on indexation of alcohol be removed and indexation be by the CPI rate alone;
- excise on petroleum products be indexed on the same basis as alcohol; and
- tobacco indexation be the higher of 5 per cent or the CPI.

Indexation of excise rates is used to manage the impact of inflation which erodes the value of revenue collections over time. This is only an issue for specific rates which apply to tobacco, alcohol and petroleum. Ad valorem rates automatically take account of inflation as they are based on the value of a product. As we have previously highlighted, excise collections have grown strongly over time but when these are adjusted for inflation the picture does not look as promising as Figure 7. The Review estimates that if excise rates had been indexed at the CPI rate since 2000, the collection in 2013 would have been around K750 million more than the actual collection of K814 million.
Currently excise indexation only applies to alcohol and tobacco. Alcohol products are indexed every six months (1 June and 1 December) at 2.5 per cent or lesser depending on CPI movements determined by the NSO. Tobacco products are indexed every six months at a 5 percent flat rate.\textsuperscript{90} The higher rate for tobacco reflects the health issues associated with its use. The Department of Health recommended that tobacco excise indexation be set at 30 per cent per annum to move towards the minimum tax of 70 per cent of the retail price.\textsuperscript{91}

Unfortunately, the CPI has averaged 6.9 per cent per annum since 2000 so the current indexation is not keeping up with inflation and the real value of the excise rates is decreasing each year. Further, indexation does not apply to petroleum products at all.

The Review is convinced that a new indexation arrangement should be put in place which will cover all products with a specific excise rate, i.e. tobacco, alcohol and petroleum products.

Noting the health impacts of tobacco, the Review recommends that excise indexation occur every six months as follows:

- Tobacco products – the higher of 5 per cent or the CPI.
- Alcohol and petroleum – the CPI.

This will be an important step to maintain the real value of excise over time and will assist in paying for some of the other excise reductions.

\textsuperscript{90} The legislation to implement the 5 percent flat rate for tobacco has not actually been passed at the time of the release of this report.

\textsuperscript{91} National Department of Health (2014), Tobacco Taxation Submission, available at taxreview.gov.pg
Reduce Excise tax on Motor Vehicles

**Recommendation (84):** The Review recommends that:

- Treasury to work with the transport authorities to determine if there should be restrictions on the importation of second hand vehicles on environmental and safety grounds, and, if so, the appropriate criteria for such restrictions;
- once a decision has been taken whether to restrict imports of second hand vehicles, the differential rates between all categories of new and second hand vehicles should be removed; and
- vehicle excise for all categories should be reduced to half their 2014 rate in equal steps over a ten year period.

Vehicles and fuel should be considered as part of the same package. The impact of vehicles on roads and the environment relates both to the characteristics of the vehicle and its usage. Fuel used relates directly to the overall use of the vehicle.

Excise rates on motor vehicles are high by regional comparison and this provides a significant barrier for people wishing to purchase a vehicle. In 2013, excise on motor vehicles raised some K167 million. Conversely, excise on fuels, especially diesel, appears rather low, raising only about half that amount.

Several submissions argue that excise tax on ordinary vehicles is very expensive and makes ownership beyond the reach of many ordinary PNG citizens. More access to vehicles will be an important aid to development and should be a policy aim although this will require more attention to other matters such as safety, road maintenance and general traffic controls. Some submissions have also suggested a ban on second hand vehicle models that are more than five years old on environmental and safety grounds.

Vehicles are no longer a luxury good. They are becoming a necessity because of poor road infrastructure and an inefficient public transport system. The Review supports an excise reduction to make it more affordable for ordinary citizens to own cars. Reducing vehicle excise will also reduce costs for businesses and promote growth. This reduction will be balanced to some extent with an increase in diesel excise.

The Review also considered restrictions on vehicle models that are more than five years old for safety and environmental reasons. If such an approach is adopted, it is arguable whether five years is a reasonable criteria. Generally, newer cars will have better environmental performance than older vehicles, but not all cars of a particular age are equal. A better approach might be to set a limit based on distance travelled...
by a vehicle. For example, restrict imports of vehicles with no more than 50,000km travelled. This may open the possibility of evasion through manipulation of odometers but this may be a relatively minor problem.

If import restrictions are made, there should be provisions to allow for the importation of vehicles which do not meet the standards. Examples could include vintage cars or special purpose vehicles such as cranes.

Treasury should consult with the transport authorities to decide if, and on what basis, an import ban should be applied.

Once a decision is taken to restrict imports, the classification between used and new vehicles should be removed and standardized. The excise collected on used vehicles in 2013 was K29.5 million. Removing the differential excise rates between new and used vehicles would assist people who can’t afford a new vehicle. This will come at an approximate annual cost of K7 million.

The excise rates on all vehicles should be reduced progressively. A large one-off decrease would cost too much and would also reduce the value of vehicles in the second hand market thus, undermining existing owners’ investments. A reasonable approach would be to reduce vehicle excise for all categories of vehicles to half their current rates over a ten year period. This would require reductions of 3 per cent per annum in each year for the standard rate of 60 per cent which applies to most new vehicles. This should also apply to second hand vehicles. The cost of this is estimated at K6 million annually and would accumulate over time. The revenue loss would be recouped by increases in the number of vehicles imported and the increased consumption on fuel excise.
**Fuel Excise**

**Recommendation (85):** The Review recommends that:

- Treasury undertake further work to determine appropriate arrangements for business use of diesel; and
- an additional K0.06 be added to the diesel excise rate at each indexation period until the petrol and diesel rates align.

There is no reasonable justification for the current differential excise rates for petrol and diesel. Petrol excise is K0.61 per litre and diesel is K0.06. Neither rate is currently indexed. A reduced rate of K0.03 applies to diesel for fishing vessels.

The differential rate presumably relates to conditions at the time that diesel excise was imposed. Diesel was predominantly used in heavy commercial vehicles and agricultural machinery and petrol was used in light vehicles especially private cars. That is changing with the production of more light vehicles with diesel engines. The excise is a strong incentive for private motorists to choose diesel vehicles and that category will only grow over time.

A number of submissions have opposed increasing excise tax on diesel. The submissions have argued that it will further add to business cost which will pass on the burden to consumers.

Other countries have mechanisms to provide excise-free or reduced diesel to selected users such as farmers or other business users. In some parts of Europe, dyes are used to mark excise free diesel and it is an offence to be found with dyed fuel in ineligible vehicles. Australia has a system of providing fuel tax credits at the same time as GST returns and in a similar fashion to ITCs. New Zealand has no excise on diesel but all diesel vehicles are subject to a mass-distance charge whereby registration is effectively issued for a certain number of kilometres rather than time based. The charge takes into account road maintenance and other externalities of vehicle use. Neither, the Australian or NZ model seems practical for PNG at present.

The Review recommends that diesel excise be aligned with the petrol rate over the next 6 years. This time frame will allow sufficient time for vehicle owners to adjust to the change. It will also allow for the Government to further consider what arrangements, if any, should be put in place for businesses using diesel. The concessional rate for fishing vessels should remain until a decision is taken on a more general approach to business use.
Indexation should apply to diesel excise (see above) and an additional K0.06 per litre should be added at the time of each indexation until the petrol and diesel rates are aligned. This is expected to take 6 years.

**Excise rates for tobacco**

**Recommendation (86): The Review does not support the proposal for a reduced rate of excise for domestic tobacco used in cigarette manufacture.**

The rationale for excise imposition on tobacco is based on the negative externalities associated with smoking. The Department of Health has recommended that tobacco taxation should be increased to 70 per cent of the retail price. Tobacco is already subject to a higher rate of indexation than other excisable goods but this is not keeping up with inflation (see above).

A confidential submission has suggested that a lower excise rate could be provided for domestically grown tobacco used to manufacture cigarettes. This is similar to the system operating in Fiji which has lower excise rates applying to tobacco products containing locally grown products.

The Review notes that such proposal would conflict with the overall health objectives of tobacco taxation. The Review further notes that whilst the development of a domestic tobacco growing industry may create additional employment, it may also lead to increases in the illicit tobacco trade as leaf is diverted from farms. This was a significant issue in Australia which eventually led to the closure of the domestic tobacco industry. The Review does not support this proposal.

**Illicit Trade of Tobacco**

**Recommendation (87): PNGCS should improve on its efforts to restrict illicit tobacco trade and report to the Government from time to time on any additional steps that might be required to manage this problem.**

There is a widespread illegal tobacco trade in the country. This is evident in the streets and markets of PNG. A submission claims that any further increase in excise on tobacco will lead to an increase in the illegal tobacco market.

The Review acknowledges that the issue needs addressing. This is because a significant amount of potential excise revenue is foregone due to the illegal trade in tobacco. A report by KPMG\(^\text{92}\) has estimated that illegal tobacco represents 11 per

\(^{92}\text{KPMG (2015), Illicit Tobacco in Papua New Guinea, KPMG LLP, London}\)
cent of the total cigarette market in PNG and that the informal tobacco market (‘brus’) represents 58 per cent of total tobacco consumption. The informal tobacco sector is not regulated and therefore not illegal.

However, the illegal trade in cigarettes is a world-wide phenomenon and there is a wealth of international experience in methods of dealing with this. The geography of PNG is a challenge as smuggling overland from Indonesia appears to be one of the main channels and the border is very difficult to police. PNGCS will need to continue to monitor the problem and report to the Government on any additional steps required.

The Review does not consider the illegal trade any justification for reducing, or slowing the growth, in the tobacco excise rates. This would only lead to increased consumption and further health problems.
CHAPTER 11: OTHER INDIRECT TAXES

Introduction

The Review considered other indirect taxes in Issues Paper No. 10 Other Indirect Taxes. These taxes are listed below. Whilst these taxes may raise less revenue than GST and income tax, they nevertheless are important to the overall tax revenue. In 2014, K318 million was raised from Other Indirect Taxes.

List of other indirect taxes and revenues:

<table>
<thead>
<tr>
<th>Tax</th>
<th>Annual Revenue (K million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Departure Tax</td>
<td>6</td>
</tr>
<tr>
<td>Stamp Duties</td>
<td>137</td>
</tr>
<tr>
<td>Betting Tax (Gaming Machines)</td>
<td>162</td>
</tr>
<tr>
<td>Bookmakers Turnover Tax</td>
<td>13</td>
</tr>
</tbody>
</table>

Source: IRC data, Final Budget Outcome 2014 and NGCB 2015

The Review also consulted on environmental taxes and noted that these currently do not apply in PNG. In many cases other forms of regulation may provide for better environmental outcomes than taxation. The Review also noted that the establishment of the Climate Change and Green Growth Trust Fund by the Government of PNG and the international associated agreements on carbon trade that PNG is a signatory to, may result in the development of environmental taxes in PNG.

Departure Tax

A departure tax of K30 charge is levied on international passengers departing PNG by air or sea. The rate has not been adjusted since its introduction in 1988. Most countries around the world have raised their rates and undertake regular reviews.

Departure taxes are used by many countries and are usually intended to provide some recovery of the costs of passenger processing. The current departure tax is too low by regional standards with only Solomon Islands and New Zealand having a lower charge and PNG’s current rate is not consistent with increases in the costs of passenger processing.

Stamp Duties

Stamp duties are levied on a variety of transactions, mostly real property transactions including sales, leases and mining interests. They also apply to marketable securities, gifts and settlements, bookmakers and lottery tickets.
Stamp duties are relatively simple to collect but are generally considered economically inefficient due to the way they distort decision-making on use of resources. This is a particular problem with real property.

The Review has not recommended any changes to stamp duty. However, the Review notes that the best alternative could be a broad-based system of property taxation and capital gains taxes. Further work on Land and Property Taxation is recommended to examine these options.

Gaming Taxes

There has been significant growth in gambling tax revenues in recent years. The largest source is the betting tax applied to gaming machines which has almost doubled over the last decade from K94 million to K164 million. Turnover tax on bookmakers has shown similarly high growth but is small in comparison. Bookmakers are also subject to stamp duty and it may be worth considering ways to combine the stamp duty and turnover tax, although this would require careful consideration of the existing cost sharing arrangements between the national government and provincial governments.

The betting tax arrangement shares the gross profit from gaming machines between the operators and the Government through a formula. Under this arrangement, operators and owners retain 35 per cent of the profit and 46 per cent is betting tax which is general revenue. The remainder is hypothecated with 14 per cent to the Community Benefit Fund and 5 per cent provided as the operating costs of the National Gaming Control Board.

The growth in revenue suggests that more people are gambling. This may become a significant social problem in the country. However, international experience suggests that taxes are not an effective means of dealing with problem gambling rather social support programs provide a better and lasting response to addiction.

The Review therefore has not made any recommendations to change the overall structure of betting taxes on gaming machines themselves. However, the Review recommends that the current hypothecation arrangements should be replaced with appropriate funding through the budget process.

The Review has also identified some potential areas of gambling which are currently untaxed and where the government could consider imposing taxes, particularly on lotteries. The Review is aware that these lotteries are also facilitated by communication devices such as mobile phones.

There would also be benefits in examining taxing arrangements for internet based gambling – particularly that conducted by international operators. The Review
understands that no one entity has data and research-based material nor do social service arms of the government have this in their priority list. The Review is unaware of the extent to which this currently occurs. However, international experience suggests it is most likely to grow over time and this has the potential to erode the current gambling tax base.

Increase Departure Tax

**Recommendation (88):** The departure tax should be increased to K60 for all tickets sold from 01 July 2016 onwards. This is estimated to raise K7 million annually based on current outgoing passenger levels.

Changing the rate should be reasonably simple but there will be a need to provide some lead time for airlines and travel agents to adjust their systems – the Review believes three months would be sufficient. Applying the increase to tickets sold after a specified time would be the simplest approach and would avoid the need to adjust fares already purchased.

The original purpose of the tax is unclear but departure taxes are usually collected to offset the costs of passenger processing, e.g. airports, security, etc. A new rate could be calculated using an inflationary adjustment or by reference to the actual costs incurred in providing specified services. However, the Review believes a simpler suggestion is to make a modest increase of the rate to K60. This is well below an inflationary adjustment which would suggest a rate of around K180 plus a flat rate adjustment would avoid the complexity of collating actual costs.

Finally, the suggested rate of K60 retains PNG’s relative ranking within the region and is comparable to the rates in Vanuatu, Samoa and Tonga.

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate in Local Currency</th>
<th>Kina 93</th>
</tr>
</thead>
<tbody>
<tr>
<td>Solomon Islands</td>
<td>SBD 40</td>
<td>K14.56</td>
</tr>
<tr>
<td>New Zealand</td>
<td>NZD 12.50</td>
<td>K22.68</td>
</tr>
<tr>
<td>PNG Current</td>
<td>PGK 30</td>
<td>K30.00</td>
</tr>
<tr>
<td><strong>PNG Recommended</strong></td>
<td><strong>PGK 60</strong></td>
<td><strong>K60.00</strong></td>
</tr>
<tr>
<td>Vanuatu</td>
<td>VUV 2500</td>
<td>K63.35</td>
</tr>
<tr>
<td>Samoa</td>
<td>WST 65</td>
<td>K71.51</td>
</tr>
<tr>
<td>Tonga</td>
<td>TOP 55</td>
<td>K72.33</td>
</tr>
<tr>
<td>Australia</td>
<td>AUD 55</td>
<td>K112.01</td>
</tr>
<tr>
<td>Fiji</td>
<td>FJD 200</td>
<td>K266.50</td>
</tr>
</tbody>
</table>

93 Currency conversions via xe.com as at September 2015.
Simplify Bookmakers Turnover Tax

**Recommendation (89): The current stamp duty on bookmakers should be removed and replaced by an increased rate for the turnover tax.**

IRC data shows that stamp duty has been relatively stable over the last four years while turnover increased significantly in 2014. The Review was not able to determine the cause of the significant increase. However the Review assumes this could be due to large bets which pays proportionally less stamp duty.

The data needs further verification but on average stamp duty has raised 56.4 per cent of the total tax on bookmakers. This implies that a new rate of turnover tax would be 9.2 per cent to maintain revenue neutrality.

The current arrangements include revenue sharing with the national Government receiving revenues from the stamp duty and provinces receiving the turnover tax. This broad arrangement should stay in place but will need to be adjusted so that the national and provincial shares are maintained.

**Clear Delineation of Ministerial Responsibility**

**Recommendation (90): The Review recommends for a clear delineation of Ministerial responsibility in the control and taxing element of the Gaming Control Act.**

The Gaming Control Act contains both taxing and control functions. The inherent incentives of each may be difficult to reconcile and this may be contrary to good policy. In order to promote budget disciplines and transparency, the Treasurer should be responsible for the taxing elements and this would require clear
delineation of responsibilities for gaming control which currently rest with the Prime Minister.

**Taxing Lotteries via Mobile Phones**

**Recommendation (91): Taxing arrangements should be implemented for mobile lotteries as soon as practical.**

The Stamp Duties Act provides for a duty of K0.05 per ticket and the Gambling Control Act provides for regulations to be made for taxing lotteries.

There is a mobile phones based lottery which has been operating since 2012 but the Review understands there is no tax or charge imposed. There is no data available on the social effects of this form of gambling, particularly as it relates to underage use and/or abuse of the gaming or lottery feature on mobile phones. This appears to be a significant oversight and the NGCB is considering how to implement a tax on this lottery.
CHAPTER 12: EARMARKING OF REVENUE

Tax earmarking involves committing specific tax revenues to specific expenditures.

Issues Paper No. 3 on The Case for Tax Reform and Broad Reform Directions discussed the earmarking of taxes for specific purposes. The Issues Paper commented on the benefits of transparency associated because taxpayers can see what their taxes are funding, particularly the appeal of a regular allocation of a proportion of a tax or charge to support spending programs.

Recommendation (92): The Review recommends that:

- Existing ‘ear-marking’ of tax revenue should be replaced with funding through the normal budget processes.
- Stop further ear-marking of revenues for new proposals.

Submissions

Most submissions to the Review supported the allocation of a proportion of taxes raised being allocated (‘earmarked’) for specific purposes – such as tobacco excise being used to support smoking related health improvement programs.

Good budgeting requires the Government to allocate spending according to current priorities. However when taxes are earmarked to specific uses, the government’s annual spending decisions are locked in, and cannot be reallocated. This can result in tax revenue being earmarked for programs when the revenue could have delivered greater social benefit if directed elsewhere – including through lowering existing taxes.

Furthermore, earmarking can complicate decisions about setting tax rates, because the rate is set according to funding requirements of the agency receiving the earmarked tax. A good tax policy requires lower tax rates.

Particular examples of earmarking of tax revenue were identified by the Review. Further examples exist in relation to non-tax revenues. The following tax arrangements were earmarked:

- The National Roads Authority’s Road Fund receives two-thirds of the excise on locally manufactured diesel (K0.04 per litre) for road maintenance work.
- Betting tax arrangements provide that 14 per cent of the gross profit from gaming machines is hypothecated to the Community Benefit Fund and 5 per cent to the costs of operating the National Gaming Control Board.
Earmarking of Revenue

The Road Fund has not received its anticipated funding due to higher levels of imported diesel replacing domestic production. This highlights another problem: earmarking funds in this way does not guarantee receipt of a particular level of funding.

In limited circumstances, earmarking may be useful but only if there is a close connection between the taxes being raised and their subsequently use. For example, a levy for entry to a national park that raise revenue that is subsequently used to fund the park’s activities may be desirable, but only because it is in fact a user charge rather than an earmarked tax.

Earmarking of tax revenue for a specific purpose is not good fiscal policy and should be avoided. The main purpose of the tax system is to raise revenues and which can be allocated according to the Government’s priorities through a transparent Budget process. Extensive earmarking can undermine the established budget processes. It can also distort government decision-making in setting tax rates and it is usually complex to administer.
CHAPTER 13: LAND AND PROPERTY TAXATION

Introduction

The Review undertook preliminary work on Land & Property Taxation following the overwhelming and sustained interest and concerns, shown by numerous stakeholders from all levels of community, including ordinary citizens from rural and urban areas, landowner groups, businesses, civil society groups, research agencies and scholars. The Review acknowledges the substantive nature of interest and the sensitivities of land ownership and usage in PNG. Therefore, it warranted a structured approach to reviewing this area of tax and potential reforms therein.

The Review also acknowledges the growing significance of reform in this area and increasingly in the context our country’s current and future socio-economic development.

The preliminary research and analysis indicates that land and property taxes remain an untapped revenue resource for the Government of PNG. While revenues from land and property tax are small compared to income tax and GST, with appropriate policies and effective administration, a property tax has the potential to yield 2-3 per cent of GDP.

The discussion on land and property taxes would necessarily involve the consideration of a long term direction that PNG needs to take because there are significant administrative impediments that would need addressing across a range of structures and jurisdictions in PNG.

Land and Property Taxes

This tax is most commonly an annual tax levied on land, improvements such as buildings, or both.

For a long time land tax was unpopular across the world. Possibly because of organised opposition by landowners and the fact that they are so visible and valuations can often be contested, so citizens do not like them.

There are many types of tax on property, but recurrent taxes on property (land tax) is most likely what PNG should focus on. Property taxes are a good local level tax; only payable by residents of local area and property values reflect to some extent the
services provided by the local level government. Property tax is visible tax and assists accountability of a local government – an opportunity for PNG to consider in the context of federal fiscal relations.

**Current Situation**

Use of recurring taxes on land and property in PNG is limited and except for the NCDC, reliance on land and property taxes as revenue sources in other parts of PNG has been declining over the years. A consequential link effect is that levels of grants now being sought by the provinces from the National Government has been increasing.

Rapid urbanisation in PNG is increasing property values so property tax is a good tax base opportunity. Property taxes are useful in rural areas too as they promote efficient use of land by imposing a tax-cost that makes the owners think about how to use them most efficiently.

The lack of effective tax regulation and administration of property and land in PNG may have contributed to the extent of corruption PNG has experienced in this area over the past 3 decades.

In principle, land taxes are relatively simple and implementing them means understanding (i) the value of the land and the owner; or (ii) the name of the person to whom to send the tax bill. In PNG, both of these are problem areas especially as they relate to issues regarding community based ownership of land. Furthermore, very little record keeping and documentation of land and property may have caused even more complexities in directly addressing the issue of land taxes in PNG.

PNG’s rapidly and uncontrolled urban growth has caused dangerous levels of parallel increase in settlements on the fringes of cities and towns. The ensuing effect is a burden on services and infrastructure and the quality thereof. The Review notes that there are prevailing social and cultural sensitivities, so the question or issues for the government is answers to the question – should a small land tax be applied to the users of fringed land?

The keeping of (i) up-to-date land registers; and (ii) current valuations is an administrative protocol that would need addressing. Both of these areas would require careful, long-term attention before a land tax can be introduced. Moreover,
there is the question of how this should be done in the short-term to introduce a land and property taxation if is introduced in the medium-term.

Way Forward

A fundamental prerequisite to any reforms related to land in PNG (tax or otherwise) is a properly thought through and researched-based strategy, a factual synthesis and thorough understanding and appreciation of land in the PNG context (state, freehold or customary) and the social, cultural, economic and political dimensions. The Review proposes establishment of a committee to begin a scoping process, from which the remaining sub-entities of the umbrella policy strategy be designed and the policy and sub-policies implemented.

Furthermore, it is imperative that a concurrent task be looking at the effects of changes in land tax on the existing arrangement under the Organic Law. Consequently, this would need to be a medium to long-term tax reform initiative.

An across-all-systems reform in land and property tax administration review in PNG is overdue by three decades. There should however be clear guidelines on demarcation of roles and responsibilities, noting that the provinces will need national government support in terms of manpower, skills, resources and (technical) training in the first instance.

Recommendations

The Review regards the following reasons as valid and pertinent;

- There was a time loss of seven (7) months in the Review timeline. This was caused by circumstances beyond the control of the Review, hence the TOR was not fully completed;
- The substantive nature of the work is needed to assess this area of tax reform (from data collection and analysis to assessing existing structural frameworks at various levels of government at both national and provincial levels); and
- The sensitivities of ownership, use and cultural significance of land in PNG and the ensuing need for any review to be mindful of this factor.

Therefore, the Review recommends that the Government approve a Phase Two of the Review to cover the Land & Property Taxation and this be undertaken in early 2016.
CHAPTER 14: NON-TAX REVENUES

Introduction

The Review has commenced work on Non-Tax Revenue component of the Review TOR. Non-tax revenues have the potential to provide a stable and reasonable source of revenue for the government. Non-tax revenues come from various sources including dividends, interests, royalties and sale of fixed assets. The focus of this chapter is: fees for government services or goods, regulatory charges or licenses; rents charged for use of public assets and penalties and fines. These fees and charges are administered by various government departments and agencies. Whilst these can be reliable source of government revenue, they do not constitute a large proportion of taxes compared to income tax or GST.

Non-tax revenue encourages the efficient use of scarce public resources. Government continuing to provide free or underpriced costs of goods and services encourages over consumption and increases the “handout mentality”, leading to high expectations and low quality and supply of basic services to communities. The Review views that a well-designed fee or charge system for goods and services can cause a better and efficient system of public resources.

Current Situation

The Review’s initial position is that in the medium term, PNG needs to install a robust and transparent administration system to help address some of the major weaknesses in its institutional frameworks at both the national and provincial government levels.

To illustrate, the Non-Tax Revenue Division (NTRD) of the Department of Finance has some responsibility of oversight of the government’s non-tax revenue but the Division is severely under-funded and under-skilled. Furthermore, there is a lack of overall policy framework to guide the legality and level of fees or charges applied. Over the decade, fees and charges have been set and introduced on ad hoc basis. Some fee levels have remained unchanged for 40 years. There is inadequate monitoring and reporting and there is no central database on non-tax revenues which in turn complicates the administration of non-tax revenue receipting, recording and reporting systems. Furthermore, the levels and or retention of some fees and charges clearly circumvent the budgetary process.
Table 14: Non-tax Revenue Collections 2011 - 2014

<table>
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<tr>
<th>DEPARTMENT/AGENCY</th>
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<th>2012</th>
<th>2013</th>
<th>2014</th>
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<td><strong>239,575,382.00</strong></td>
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*Source: IFMS Reports, Non-Tax Revenue Division Files, Department of Finance.*

**Strategy for Reform**

For PNG to address these problems and concerns, a fundamental aim must be to have in place a functioning, efficient and robust non-tax revenue administration regime which is capable of supporting the Government’s overall revenue and fiscal management objectives and which can lead to more efficient allocation and redistribution of Government resources for community services.
A Clear Regulatory Framework and Procedures for Non-Tax Revenues

Having in place a clear regulatory framework and procedures for non-tax revenues will enhance the government’s revenue raising capacity. It will improve transparency and accountability, reduce fragmentation and breach of budget protocols and instill a one-discipline for all system compelling all departments and State Owned Enterprises (SOE) to follow budget appropriations protocols. The current Public Finance (Management) Act 1995 design provisions are adequate, however, the Review believes, adherence to same in terms of efficient and effective reporting, auditing and financial management has been lacking for a number of years.

Features for inclusion in Regulatory Framework and Procedures

The Review believes the following features should necessarily be included in the scope of the design of the Regulatory Framework and Procedures:

- a clear approval process for non-tax-revenues (new & existing fees and charges);
- central processing unit to vet all non-tax revenues proposal and ensuring effective management protocols;
- a compulsory annual review of performance of non-tax revenue management and administration including enhanced reporting requirements of all fees and charges;
- compelling each department, agency and SOE to remit the collections of all fees and charges into the Consolidated Revenue Fund (CRF);
- no initial retention by departments, agencies or SOEs;
- consistent publications of all fees and by who (i.e. Department, Agency, SOE); and
- a compulsory strategic review every 5 years (relevance and level of government fees and charges) including the adoption of a sunset clause;

Parties to the newly established Regulatory Framework and Procedures

The regulatory framework and procedures adopted in 2014 by the Government of Samoa is a possible model which PNG can adopt. Once the Government designs and adopts the new system, it will be advantageous to urge the provinces to follow a
similar system suitable for their needs. Furthermore, in transitioning to the new regulatory framework, the government would benefit even further by sourcing technical assistance to review the existing fees and charge to value add which would hasten NTDR’s current review process including validating importance and value of this much needed revenue in the short-term for the government.

Recommendations

The Review regards the following reasons as valid and pertinent:

- There was a time loss of seven (7) months in the Review timeline. This was caused by circumstances beyond the control of the Review, hence the TOR was not fully completed;
- The substantive nature of the work is needed to assess this area of tax reform (from data collection and analysis to assessing existing structural frameworks at various levels of government at both national and provincial levels);

The Review recommends that the Government approve a Phase Two of the Review for the work commenced on Non-Tax Revenue to continue in 2016.
CHAPTER 15: CUSTOMS TARIFF

In 1986, the Bogan Review covered the area of Tariff Policy and Administration in PNG. It was intended that this review would be a major overhaul of the country’s tariff structure. This resulted in the release of the 1997 White Paper on the Tariff Reform Program and the introduction of Tariff Reduction Program (TRP) in 1999. The TRP is aimed at encouraging a more efficient and productive private sector through greater exposure and participation in international trade. As well, the introduction of the Value Added Tax, now the Goods and Services Tax, was designed to ensure that there would be no concern over revenue losses arising from the TRP, while at the same time introduce a more modern and efficient approach to the design and collection of indirect taxes.

In the lead up to the 2003 Budget, the Manufacturers’ Council of PNG sought a temporary suspension of the TRP as commenced in 1999. The Government responded by undertaking a review of the TRP in 2003. This Review recommended that the existing schedule of the TRP should remain in place and that tariff reductions be continued beyond 2006.

In 2007, another review was undertaken to recommend the future direction of tariff policy for PNG. This review recommended for further tariff reductions, so as to achieve more uniform and lower tariff rates, through scheduled reductions. The 2007 Review also recommended that adjustments be made to intermediate goods of export industries not produced locally and remaining tariffs on other goods for which there is no domestic production except in specific cases where there are sound and valid reasons for not doing so.

In the course of the this Review consultations, several local manufacturing businesses argued that the TRP in reducing import rates is giving local manufacturing companies unfair competition from imported products in such areas as quality and eventually shelf prices at the consumer level. Some businesses argued that if nothing is done in addressing their concerns about the TRP, many including long term PNG businesses will be affected, some even forced to close.

The Review has assessed the arguments raised by submissions and comments during blue sky consultations and is strongly of the view that the issues and concerns raised have merit. The Review is of the view that since the inception of the TRP in 1999, there has not been a substantive study or an impact assessment of the TRP to ascertain the cost-benefits.
This Review had initially approved to outsource an independent expert to undertake an impact study however, this did not occur to circumstances beyond the control of the Committee and Secretariat.

Therefore, it recommended that the Government immediately suspend the current TRP until an impact proper study is done and furthermore that this be done in Phase 2 of the Review in 2016. Peak industry bodies and many other sectoral groups have argued the Review that the study must be done in full and the cost-benefit of the TRP be totally research-based.

Recommendation

The Review recommends that the Government immediately suspend the current TRP until an impact proper study is done and furthermore that this be done in Phase 2 of the Review in 2016.
CHAPTER 16: AUTONOMOUS REGION OF BOUGAINVILLE

The Review did some preliminary work on the Autonomous Region of Bougainville (AROB). Although the Terms of Reference does not specifically cover AROB, the Review is cognizant of Autonomous Bougainville Government’s (ABG) unique constitutional position with distinct provisions on revenue matters. This also encroaches on the area of fiscal federalism and poses exclusive challenges with organic law implications in the sharing of powers between the ABG and the National Government. The Review noted that the Autonomy arrangements relating specifically to revenue sharing, taxation and fiscal self-reliance provisions of the Bougainville Peace Agreement need to be revisited to assist the ABG optimize revenue collections.

The current revenue sharing arrangement sees 100 per cent of personal income tax and 30 per cent of inland GST collections in AROB paid to the ABG. Other provisions for company tax and customs duties have not been implemented due to lack of statistics of companies based in AROB paying those taxes.

ABG has limited taxing powers. Company tax, GST and customs duties remains under the control of the National Government. It however has the power to vary the rates of personal income tax by no more than five percentage points from the National Government.

ABG can set its own revenue regime with other taxes like liquor licensing fees, gaming taxes, property tax, motor vehicle registration, road users tax and other taxing powers available to provincial and local level governments. The Bougainville Peace Agreement suggests that ABG has control over local excise and export taxes, however this does not seem to have been incorporated into the Organic Law.

ABG also has control over non-tax revenues, including revenues from fishing activities, activities within its Exclusive Economic Zone, postage stamps and concessions at seaports and airports.

The Review noted that there is significant lack of knowledge of the terms of the National Constitution Laws regarding AROB by the National Government agencies responsible for fiscal and revenue issues of ABG.

The ABG has raised concern that the current tax administration arrangements between the IRC and the ABG are not efficient and effective due to administrative
capacity constraints. Assistance required under the MOU is staff capacity building, joint enforcement activities, taxpayer education and awareness and sharing of resources and information. This is an area where the IRC should look into as proposed in the Review’s recommendations on Tax Administration.

Recommendation

That Review recommends that the Government approve a Phase Two of the Review to examine the revenues of Provincial and Local Level authorities, including AROB as a special case.
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APPENDIX

A. Revenue Administration Maturity Level

### Strategic Planning: Maturity Level. 1  Key words: "Focused on day-to-day work"

The revenue administration's vision, mission statement, and goals are unclear & not documented. Only a few individuals, primarily at the senior leadership level, understand what the administration aspires to achieve. Activities are not aligned to the strategic objections and the mission and the organization rarely achieves benchmarks toward its mission and vision.

The revenue administration has no formal strategic plan and does not have in-house capacity (staff skills, tools) to develop a plan. Leaders view the strategic plan as something required by external stakeholders. Staff have limited understanding of the role of strategic planning and do not contribute to discussion about strategy. The administration's programs and services lack clear alignment with its mission and objectives. New programs are often ad hoc reactions to current events unrelated to each other and rarely integrated.

The revenue administration does not have performance targets or indicators to adequately measure performance at an organizational level, and is reluctant to set targets because of a lack of tools, capacity, or time to collect performance data. Leaders and staff focus only on measuring and achieving externally imposed targets (e.g., project targets) or individual targets. The administration has no benchmark for measuring its success and there are often disagreements about whether the organization is successful and how it can improve.

The revenue administration does not have systems, processes, or tools in place for performance data use. There are no mechanisms to check if data is reliable or correct. Data, when it exists, are often set aside, rarely used, and not analyzed, and there is no compliance or accountability around collecting, using, or ensuring the quality of data. Data is collected because it is required by external stakeholders and there is no internal demand for data. Leaders prefer to make decisions based on "gut feeling" or past experience. Staff lacks capacity to analyze or apply data to their jobs. Even if data are available, the administration is unable to use it effectively. The administration often misallocates resources as a reaction to current events.

Managers and staff feel that implementation is more important than planning. Attempts to develop work plans or action plans often fail because there are no planning processes or tools, and few staff has experience or interest in this area. Projects are implemented with minimal short- or long-term planning, and may exceed budget, if a project budget was set, and are not implemented on schedule.

### Strategic Planning: Maturity Level.2  Key word: Qualitative

- The revenue administration has a specific vision and mission statement that is formally posted or documented. Few staff know the mission and see a connection between it and their day-to-day tasks. Leaders sometimes use the organizational mission and vision to direct goals and activities and aim to develop a process that will help them more consistently align goals and activities. The administration is sometimes able to achieve benchmarks toward desired goals and objectives when activities are aligned.

- The revenue administration has a strategic plan or, at a minimum, has had some discussions around a strategy, but does not have a formal process to develop, update, or monitor activities against the plan. The strategic plan is driven primarily by senior management, with little input from staff, and
few staff are aware of the plan. Leaders develop a strategic plan to guide the organization toward the mission, but the plan is rarely referred to and changes are not implemented as a result of the plan, but rather as a reaction to events. Programs are not closely linked to mission or strategic objectives.

- Leaders have set some performance targets, but the targets are not measureable. There are no key performance indicators or plans to collect and monitor data. Only a few staff are aware of performance targets and understand how their individual targets contribute to the administration’s targets. They are rarely asked to provide input or feedback on targets. The performance targets that exist are primarily related to revenue collection with minimal attention to other priorities in the plan such as service delivery. The administration is still unable to measure progress towards those targets.

- The revenue administration is starting to develop systems and/or tools to assist in using data. However, it is still unclear if the data being collected is applicable or reliable. Data are being collected and standard operating procedures for compliance, quality control, and accountability on collecting and using data are in the process of being developed. Leaders understand that there is value in using data to guide decision-making, and do refer to it from time-to-time. Some staff are being trained to analyze and use data in their job functions, but the data being used may be incorrect or not applicable to providing an accurate analysis of the project or task being measured. Although the data are being used sporadically, when it is used correctly, the organization is able to identify and avoid negative outcomes or mistakes.

- Some staff have planning skills and have introduced planning tools to the organization. These are occasionally used to develop a work plan or action plans, but the plans are rarely integrated, linked to the strategic plan, or implemented. Staff that use work plans are better able to manage costs, where there is budget responsibility, and schedule, and can identify problems early on.

### Strategic Planning: Maturity Level.3 - Key word: Strategic

- The revenue administration’s vision and mission statements are posted in multiple locations and integrated into orientation materials and other guidelines. The vision and mission statements have been communicated to all staff in seminars and using other methods. All staff understand how they contribute to it, and can communicate it to external stakeholders. The administration consistently uses a formal process to align strategies and activities to the mission, and it achieves benchmarks toward its mission/vision.

- The revenue administration has developed a strategic plan using formal processes and tools to translate it to action plans and work plans. Leaders and staff are involved in implementing the strategic plan and monitoring progress towards strategic objectives and mission. The plan is widely known within the organization and it is consistently used to guide operational and program decisions. The strategic plan contributes to better alignment between programs and operations, and the organization is achieving some strategic objectives.

- The revenue administration has established performance targets, key performance indicators, and a formal performance monitoring plan. Staff are aware of these targets, understand how their performance contributes, and are collecting performance data to measure progress towards these targets, though data are not always reliable. Leaders and management consistently review performance data, using dashboards and other tools, and check progress toward strategic objectives. The organization is able to objectively demonstrate its success, and sometimes uses performance data to improve areas where performance is weak.
The organization has formalized the development of systems, processes, and tools to collect data and has formalized mechanisms to ensure that the data, when it is collected, is both applicable and reliable. There is an internal demand for data, but it is primarily driven from the top. Leaders are using data to inform and guide decision-making. There are documented standard operating procedures for data collection that outline guidelines for data collection, quality control, and accountability, but these are only occasionally followed by staff. The administration has been successful in using data to avoid making mistakes and, as a result, there has been an increase in positive outcomes.

The revenue administration has formal planning processes and tools, and has built staff capacity to use these tools. Staff have been specifically assigned to compiling and providing senior management with an analysis of the indicators. Leaders and staff work together to develop an annual work plan based on the strategic plan. Action plans are developed for most projects and are integrated. New project proposals that are not provided for in the strategic plan and subsequent work plans are approved when they are in conformity with the plan. Managers are required to implement these, and are consistently able to manage costs and schedules effectively.
## SUMMARY ON DIRECTIONS FOR REFORMS IN PNG CUSTOMS SERVICE

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<tr>
<th>Area</th>
<th>Findings</th>
<th>Key Recommendations</th>
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<td><strong>Strategy</strong></td>
<td>Embedding the Customs Service Plan</td>
<td>• Formalised and consistently communicated strategy initiatives according to the Customs Service Plan to better connect divisions and regions and gain organisational alignment on strategy delivery.</td>
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<td>Investing to rebalance the strategic focus</td>
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<td>• Secure necessary investment and resources to rebalance organisation focus and efforts to address gaps in border control, trade facilitation and improving efficiency and effectiveness of revenue administration activities.</td>
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<td>Delivering against the modernisation agenda</td>
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<tr>
<td><strong>Governance &amp; Structure</strong></td>
<td>Alignment of organisational and functional structure</td>
<td>• Progress the organisational restructure to transition to an independent statutory authority and develop clear and detailed organisational structures and reporting lines.</td>
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<tr>
<td>Development of corporate governance protocols and practices</td>
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<td>• Consistently communicate and embed key corporate governance policies and processes such as risk management and the whistle blower program</td>
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</tr>
<tr>
<td>Formalising detailed organisational structures</td>
<td></td>
<td>• Progress the organisational restructure to transition to an independent statutory authority and develop clear and detailed organisational structures and reporting lines.</td>
<td>Medium</td>
</tr>
<tr>
<td><strong>Leadership</strong></td>
<td>Enabling leadership development initiatives</td>
<td>• Actively pursue leadership development initiatives and identify future organisation leaders for succession and organisation continuity</td>
<td>Medium</td>
</tr>
<tr>
<td><strong>Stakeholders</strong></td>
<td>Improving engagement and communication with external stakeholders</td>
<td>• Formalise and progress stakeholder consultation forums on a routine/regular basis</td>
<td>High</td>
</tr>
<tr>
<td>Promoting an effective service culture</td>
<td></td>
<td>• Formalise, communicate and embed the compliance strategy</td>
<td>High</td>
</tr>
<tr>
<td>Developing stakeholder feedback avenues and dispute resolution pathways</td>
<td></td>
<td>• Develop a stakeholder feedback avenue and supporting processes which are impartial/objective and transparent</td>
<td>Medium</td>
</tr>
<tr>
<td>People</td>
<td>Ensuring clarity of roles and description</td>
<td>Communicate and create awareness to encourage stakeholders to pursue grievances through the resolution mechanism, as legislated</td>
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</tr>
<tr>
<td>Addressing staff remuneration needs and welfare issues</td>
<td>As part of the organisational restructure under the approved statutory authority status, review and update role descriptions and promote role clarity across individuals and division/regions</td>
<td></td>
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<tr>
<td>Addressing experience gaps through staff training and skills development and creating succession plans</td>
<td>Create formal succession plans and appropriate oversight mechanisms to ensure succession is managed proactively</td>
<td></td>
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<tr>
<td>Managing staff levels and recruitment challenges to meet operational needs</td>
<td>Progress current recruitment initiatives and formalise a structured on-boarding/induction process and develop appropriate training and plans to address skills c/capacity gaps</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Processes</td>
<td>Updating and disseminating up to date internal policies and procedures</td>
<td>Progress initiatives to upgrade policies and Standard Operating Procedures (SOP) and ensure their effective and structured roll-out across the division and regions</td>
<td></td>
</tr>
<tr>
<td>Aligning and addressing gaps in the legislative framework</td>
<td>Undertake a review of current legislation administered by Customs and identify revisions required to support Customs in effectively executing its mandate</td>
<td></td>
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<tr>
<td>Investing in the development of the PCA function</td>
<td>Actively invest in the development of the Post Clearance Audit (PCA)</td>
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<tr>
<td>Ensuring timely and accurate reconciliation and administration of revenue</td>
<td>Address delays and issues noted in the reconciliation and administration of revenue collection</td>
<td></td>
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<tr>
<td>Processes</td>
<td>Addressing clearance of cargo delays and costs</td>
<td>Formalise the analysis and actions as a result of cargo time-release studies and address these to develop further improvements in trade facilitation</td>
<td></td>
</tr>
<tr>
<td>Addressing unreconciled entries in ASYCUDA</td>
<td>As a matter of urgency, progress actions to address unreconciled/‘hanging’ entries in ASYCUDA</td>
<td></td>
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<tr>
<td>Systems</td>
<td>Building resilience and</td>
<td>Address identified gaps in the</td>
<td></td>
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<tr>
<td>TOR provided by TRC</td>
<td>Findings/Discussion</td>
<td>Key Recommendations</td>
<td>Comments</td>
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</table>
• The question is how well this is perceived and understood through the various levels of the organisation and portrayed in all activities.  
• Sighted the overall IRC Work Plan for 2014, but not any divisional work plans. However, did sense from the interviews conducted that there is general awareness of the divisional work plans and the need to achieve targets which this has been filtered to staff to some degree. | • Greater marketing and explanation of the vision and mission statements would ensure this is ingrained into the lower levels of the IRC workforce to achieve the goals of the organisation. | One of the expected outcomes of the Diagnostic Review TOR is to identify and recommend short term remedial measures and long term reform including solutions. Generally this has not been addressed in the Report. |
| **Organisation and functional structures**              | • Organised since 2010 along functional lines rather than on tax types or roles which is neither efficient nor appropriate for present needs. | • Recommended proposed structure also based on functional lines is attached as “Attachment A”.  
• The proposed |
| IRC is currently considering developing a new structure that far better suits their current operational needs. This is driven at pace by the introduction of SIGTAS and made far more possible by the statutory restructure status granted in September 2014. |
| IRC Executives have the new structure in their minds and not formalised yet. Deloittes believe the thrust is proper. |
| Deloittes are aware that in IRC’s original request to NEC for statutory authority, two options of governance were suggested. The two options were for (1) independent Board approach (2) for a Commission approach. NEC was not in favour of Board approach, thus authorising the Commission approach which has been in existence since September 2014. Deloittes are aware of the apparent closure of this consideration from a Government perspective but subject to TRC, can comment further in the Final Report. |
| This structure also tries to avoid the previous fascination on dedicated assistant commissioners being solely responsible for defined functions and outcomes but rather can promote collaboration between several of them within one “pillar”. |
| Initial consideration for/or such Board if implemented would require a mixture of public sector, tax professional, civil society and business sector representatives; oversight outcomes only and not be involved in day to day operations or management of IRC, refrain from advising IRC on the management of individual tax matters or cases or allowing itself positioned in some part, as a port of call or arbiter for taxpayers regarding individual tax matters; its prime governance role should be one of equity for taxpayers, as a link to community values and functional areas are referred to as “pillars” to represent their role of key support to the overall IRC mission of nation building. The term “pillar” would be interchangeable with several other descriptions. The term “division” to be discontinued as the word implies a silo-like separation. |
• Deloitte are aware of suggestions from other quarters for IRC to establish a Large Business Unit (LBU). However, do not consider the timing is right in IRC’s transformation to adopt the approach fully since to do it require too many high level technical resources and this will impact on other key operational activities and turnaround times. This was experienced in 2013 and 2014 were over a dozen technical officers were quarantined for two “training audits” on large taxpayers and consequently many advising and assessing functions fell into disarray.

• Provincial and regional offices are not adequately supported technically, logistically and human resources. In spite of these shortcomings, the staffs enjoy their work. Staff may only be knowledgeable in GST from the old structure and not income tax and other taxes or no technical knowledge at all. These offices lack ICT equipment. If they do, do not have ICT services e.g. email. These offices do not have sufficient motor vehicles to perform their jobs. These offices to have accommodation for managers with close view and also play a role in monitoring or advising all potential areas are being covered by IRC actions.

- Deloittes note IRC has plans to increase manpower at Lae office (to around 30 and Kokopo (to around 20/25) and the setting up of regional offices including IT assets.

- Political considerations aside, Provincial and regional offices to be located at secure locations.

- All provincial and regional staff to have structured training and mobility between IRC sites.

- All larger provincial and regional offices to be allocated two vehicles for effective taxpayer coverage purpose. To this
proximity to the office. Services from HQ in terms of staff issues and taxpayer queries leave a lot to be desired. Staffs are broadly aware of SIGTAS innovations occurring at HQ but have limited understanding of it and what it would mean if SIGTAS was directly available at their office. Lodgements and receipts couried to HQ weekly not efficiently recorded or receipted resulting in unnecessary additional work for taxpayers and IRC (provincial staff). Visits from senior HQ staff only limited to review of work plans and little time spent on local environment factors or staff development.

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<tr>
<th>Institutional or corporate governance framework</th>
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<td>IRC has implemented a number of improvements to their Commission governance. They have introduced an extensive series of documented policies and frameworks ranging from such matters as Commission Governance and Administrative Orders to Codes of Ethics and ICT Acceptance User Policy.</td>
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<td>Given these constraints, Deloittes recommend that the procedures manuals for technical work areas include excerpts of applicable section of the ITA. These would assist with review and decision making process by staff, enhancing their own understanding and knowledge of the law as applied to their respective tasks performed.</td>
</tr>
</tbody>
</table>

Deloittes acknowledge the cost involved.
- Provincial centres to enter into MOU with Provincial Governments or Post PNG to provide counter type payment and lodgement services or to share local intelligence.
available to the IRC, which if it was would give wider and easy access for use.

- General instructions for various Sections of IRC were not sighted which cover technical aspects and knowledge on application of the law. These instructions should also be readily available for access by the various section within IRC and key staff within, but are not readily available to all.
- (more comments on HR Division – page 46)

| Organisational leadership and management protocols and ethos | The IRC is populated in its senior ranks, i.e. Assistant Commissioner and above, with people who are strongly committed to its achieving better operational performance generally and across a far wider tax base. These officers are typically long term employees, averaging two decades of service with IRC, have been promoted through the ranks over a lengthy period of time, and collectively, are well credentialed to perform the technical and regulatory roles of the IRC across the breadth of the remit.

  - It is not so obvious, however, that commitment, aspiration and technical competence is not fully shared across the IRC nor does it
- Deloittes suggest the leadership management adopt more aggressive approach, prepared to risk demanding substantially higher performance standards, and dealing assertively with staffs who do not wish to adapt to these higher expectations. This cannot be done in isolation of the internal systems changes needed to enable people to successfully fulfil their work requirements.
  - The middle management staffs acquire both a substantially improved work ethic and enhanced capabilities. To large extent, this needs to accompany the process changes that will be driven by SIGTAS. However, it can ill-afford not to an aggressively pro-active approach to this task, nor is it clear that it can
<table>
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<tr>
<th>Interface and relationship with the Ministry and Department of Treasury</th>
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| • IRC – IPA relationship on IRC capturing all new businesses registering at IPA.  
   - Deloittes note the fact that IRC has been operating and continue to operate well below establishment embedding serious structural and strategic weakness which Department of Treasury and Finance and Government have not recognised over many years.  
| • Government agencies to work together for the common good. |
| Internal systems and processes |
| • Deloittes overall impression on inspecting and observing IRC operations at HQ was of untidy, even sloppy work places, inefficient processes and in some cases complete wonderment that any procedure could be completed in a timely manner.  
  - Deloittes have evidence on IRC totally unable to streamline or consolidate its taxpayer file management and security making file security and taxpayer information open to theft, copying, alteration and destruction contravening the secrecy provisions of the various Acts.  
| • Deloittes note IRC would greatly benefit from the introduction of a Total Quality Management process improvement program on principles of Customer Focus, Leadership and Teamwork, Systems Thinking And Continuous Improvement.  
  - Deloittes expect further Implementation of SIGTAS all incoming  
| • Issue raised in the 2000 Tax Review |
- Deloitte have noted in the recent past little importance attached to the way official correspondence generated from across IRC has been dealt with in the mail room based on their own experiences in 2013 to now.

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<tr>
<th>Technology framework, systems and capabilities</th>
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<tr>
<td>• The introduction of SIGTAS software and the accompanying implementation project represent a most significant shift in IRC’s role in tax administration for PNG, and indeed, even the tax system’s legal framework.</td>
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<td>• Deloitte believe IRC needs to concentrate harder in future on reverse flow as it is irritant and cost to taxpayers and IRC e.g. the late payment penalties automatically imposed for salary and wages tax from SIGTAS around February 2014.</td>
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<tr>
<td>• The introduction in early 2014 of the ability for taxpayers to make payments via electronic funds transfer (EFT) into IRC’s bank account at BPNG has been well received by the taxpayer community.</td>
</tr>
<tr>
<td>• Deloitte note IRC should also be introducing now, even as an interim step, a redesigned structure to optimise the benefits of SIGTAS and expect taxpayer interface with the system.</td>
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<tr>
<th>Broad staff competency, training and development</th>
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<td>• This aspect is mixed but also complex. There is some evidence of sound core</td>
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</tbody>
</table>
| **(technical and management), staff retention policy and succession plans and priorities** | **competency management in some operations, but its effectiveness varies greatly according to such issues as its staffing (work ethic, capability and numbers) and organisational design.**  
  
  - The present senior leadership group is generally long serving. Whilst this has the advantage of bringing sound corporate knowledge and memory to the IRC, it is exposed as many of this group of people approach retirement.  
  
  - This problem is exacerbated by the fact that the IRC has not until recently, pursued an active strategy of recruitment and training and development. |  |
|---|---|---|
| **General taxpayer services and interface with taxpayers and or agents** | **The consistent theme that emerged was that IRC officers generally displayed a lack of urgency, little grasp of commercial reality and insufficient internal coordination when dealing directly with taxpayers and tax agents.**  
  
  - The responsiveness of IRC officers to contacts from this stakeholder group were roundly seen as poor, though it was felt that compared to other public service agencies the IRC was one of the best performers. | **Deloittes note IRC would greatly benefit from the introduction of a Total Quality Management process improvement program on principles of *Customer Focus, Leadership and Teamwork, Systems Thinking And Continuous Improvement.*** |
## Phone, counter and email & other issue

**Phone**
- Long serving officers deliberately avoid answering phone queries. This results in numerous attempts having to be made to initiate contact on current tax matters. When calls were answered, the caller as told the case officer had “just stepped out” or a similar statement, notwithstanding the call was made in core business hours.
- IRC phone queries of this stakeholder group there was wide frustration with different IRC officers from the same area calling separately about the same issue & tax type, some times less than a week apart.

**Counter**
- For counter queries, the feedback was that whilst the capacity to deal with counter queries has improved markedly in Port Moresby HQ over the past year, officers were still at times abrupt or awkward in dealing with those making queries. At provincial offices the manner in which those making the enquiries were received far better, but generally the officers had very limited technical skills and despite their best efforts could only...
refer to HQ. One bright spot was the new IRC cadet and graduate staff accepting ownership of issues and trying to solve them in a timely manner.

**Email**
- The introduction of email has been broadly viewed as a genuine view in the right direction as it has made it much easier to provide copies of lodged documents and to engage in technical or process related discussions. However, some thought staffs need to receive training in email etiquette, especially as to enabling an “out of office “message.

**Other issue**
- The other issue raised was the frequency of officers not being aware of their own organisations public communications e.g. the announcement of streamlined COC processes at HQ but staff in that section not adhering to the publicised changes for some clients attending their counter.

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<p>| General interface with tax practitioners and Chief Financial Officers of large corporate taxpayers | One positive feedback was on IRC initiative that was desired by larger business taxpayers was the introduction of key client or client relationship role where a senior technical officer was appointed as one-stop shop for all their queries and issues. |
| Competency and capability levels in areas of tax | Not covered |</p>
<table>
<thead>
<tr>
<th><strong>collections and compliance by large corporate taxpayers including resource companies</strong></th>
<th><strong>Capability and efficiency in enforcement and compliance including legal capacity (enforcement through litigation)</strong></th>
<th><strong>Taxpayer appeals and objection processes including the quasi-judicial functions of the tax review panel</strong></th>
</tr>
</thead>
</table>
| **The Legal Services area of IRC has since the 2010 restructure has been restricted to formal litigation work internal legal advice and only rarely is now involved in matters of law interpretation or application on specific taxpayer cases (most of such responsibilities has been transferred to Policy & Advice Division).**  
- It has been severely understaffed for several years.  
- Its intended functions have been hampered also by the fact that, at the same time, the flow of prosecution referrals from operational divisions for tax compliance failures has all but dried up, again due to resource constraints.  
- It has suffered a further short term impact through the resignation earlier this year of the Commissioner for Services, who oversaw this function. | **Deloittes consider this as a priority area to re-staff and hopefully the new Authority status will allow it to do so by offering market commensurate conditions for qualified lawyers. If this is achieved, it can also resume a more active engagement with tax law interpretation issues (as the structure proposed by Deloittes), to the overall benefit of the IRC’s quality and efficiency outcomes.** | **Feedback in this area was that there appeared to be inertia in dealing with business taxpayers and tax professionals and that in many cases it seemed technical officers, had**  
- Stakeholders felt existing IRC officers should be offered much better technical training opportunities and as an organisation must be better funded to compete |
| **Tax advising functions including preparation and issuance of tax rulings** | • Policy and Advise Division was rated the worst performer by a number of stakeholders including internal stakeholders  
  
  • The full TOR was not covered | • Stakeholders felt existing IRC officers should be offered much better technical training opportunities and as an organisation must be better funded to compete in the market for qualified personnel.  
  
  • It was hoped that the recent statutory status will assist with terms of appropriate remuneration, plus also in being freer to dismiss ‘deadwood’ staff. |
|---|---|---|
| **Tax audit functions including systems and processes** | • Stakeholders who had encountered audits the feeling was in some cases there have been recent improvements in communication and timeliness of the conduct for audits. The overall process still left much to be desired. E.g.  
  
  • Initial notice period of a | • Stakeholder group supportive of appropriate and extra technical training opportunities in particular frontline and client-facing.  
  
  • Audit personnel to undertake reviews of bank accounts over the last 2 to 3 year period to determine business activity to monitor the TIN requirement in late |
detailed audit taking place being too short, often only being a week or two in advance of the audits scheduled meeting.

- The number of the years included in initial audit activities is unreasonably large, often four or five, whereas one or two would be sufficient to establish if there are issues or liabilities.

- A number of larger, compliant and highly visible taxpayers have been audited frequently for SWT or GST whereas those outside the tax net are never troubled by IRC.

- Failure to properly conclude audit process.

- Amended assessments, especially for GST and SWT audits, being issued at the conclusion of audits without any prior explanation or notification of how they were arrived at.

2014 for those with a business account to quote a TIN registration number. This will address present criticism on compliance activities focusing too much on taxpayers who have always participated in the tax system.

Efficiency and robustness of the assessing division canvassing a sampling of company, partnerships and individual tax assessment systems and processes including capability and competency

- Deloittes have confirmed that IRC has been applying a de-facto assessment approach to company and many other returns lodged.
  - This approach has been driven by scarcity of skilled technical staff, the need to clear backlog of unassessed returns and the drive to maximise

- Deloittes believe the time is right to introduce self-assessment and in their view does not require major legislative programme.
The adoption of self-assessment will allow for technically skilled staff to be deployed to key compliance and advising roles.

Process time of assessment of income tax return and the notice of assessment expected to improve to a week after lodgement under SIGTAS implementation program late 2014. This process portrays anticipated restructure.

<table>
<thead>
<tr>
<th>Efficiency and robustness in collection and enforcement of Group Tax; Company Tax, GST, Stamp Duty and other taxes</th>
<th>GST</th>
<th>GST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Difficulty in tracking taxpayers who should be complying and are not.</td>
<td>Suggestions noted to address this could be via more taxpayer awareness, direct door to door locking, improved systems of tracking and following up non-lodgers and government agencies working together and sharing data to be more efficient.</td>
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<tr>
<td>Indications of no proper systems in place to track non-lodgers.</td>
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<tr>
<td>There is possible disparity with payable GST returns lodged at and payments being receipted. GST payments are made at the main cashier and the returns lodged at GST office.</td>
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<tr>
<td>GST being self-assessment, it can be argued that GST is not properly recorded/and or reported in returns lodged. Corrections can be made by IRC in liaison with taxpayer.</td>
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</table>
- Deloitte noted more effort is needed in bringing taxpayers into GST net and increasing revenue collection in this area.

- No comments on Group Tax; Company Tax; Stamp Duty and other taxes.

<table>
<thead>
<tr>
<th>Efficiency, robustness and timeliness of collection (timeliness and swiftness in receiving and encashment of checks), cashier responsibilities and duties, issuance of receipts acknowledging payments, and accounting processes and systems including capability and competency</th>
</tr>
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<tbody>
<tr>
<td>- Deloittes identified lack of attention by cashiers’ to input correct initial received date details for returns and remittances lodged at provincial offices and courier to HQ.</td>
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<table>
<thead>
<tr>
<th>Efficiency and robustness of the GST collection and refund system</th>
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<tr>
<td>- Stakeholders bemoaned the time taken by IRC to process GST refunds or offsets, and also other tax refund.</td>
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<tr>
<td>- The delays in both GST section staff verifying GST credit and then the further delay in Accounts Section actually processing the refund or the offset.</td>
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<tr>
<td>- Delays in lodged GST returns, especially ones disclosing a credit balance, being input into the system so progressive</td>
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<tr>
<td>Efficiency of the systems and processes of debt management</td>
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- Refunds cheques issued for amount less the full amount due to insufficient funds for refund.
- Offset or transfer Transactions showing as “refund” on the statement of account when it was transferred to another account costing the taxpayer considerable amount of time following up to clarify and resolve the matter.
## C: List of Consultants

<table>
<thead>
<tr>
<th>No</th>
<th>Names</th>
<th>Organisation</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Patrick Colmer</td>
<td>Economic &amp; Public Sector Program (EPSP)</td>
</tr>
<tr>
<td>2</td>
<td>Neil Motteram</td>
<td>Economic &amp; Public Sector Program (EPSP)</td>
</tr>
<tr>
<td>3</td>
<td>Michael Rawstron</td>
<td>Economic &amp; Public Sector Program (EPSP)</td>
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<tr>
<td>4</td>
<td>Craig Emerson</td>
<td>Monash University, Australia</td>
</tr>
<tr>
<td>5</td>
<td>Diane Kraal</td>
<td>Monash University, Australia</td>
</tr>
<tr>
<td>6</td>
<td>Peter Mullins</td>
<td>International Monetary Fund (IMF)</td>
</tr>
<tr>
<td>7</td>
<td>Larry Walters</td>
<td>International Monetary Fund</td>
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## D: Submissions to the Review

<table>
<thead>
<tr>
<th>Author</th>
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<tbody>
<tr>
<td>1  Adam Smith International</td>
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<tr>
<td>2  Amos Yalkiabo</td>
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<tr>
<td>3  Ano Tunamba</td>
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<tr>
<td>4  Anoko Sasi</td>
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<tr>
<td>5  Association of Superannuation Funds of PNG</td>
</tr>
<tr>
<td>6  Bank of Papua New Guinea</td>
</tr>
<tr>
<td>7  Bank South Pacific Limited</td>
</tr>
<tr>
<td>8  BC Enterprises</td>
</tr>
<tr>
<td>9  Bialla Oil Palm Growers Association</td>
</tr>
<tr>
<td>10 Chris Smith, Chartered Accountant</td>
</tr>
<tr>
<td>11 Clement Korken</td>
</tr>
<tr>
<td>12 Clement Yang</td>
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<tr>
<td>13 Consultative Implementation &amp; Monitoring Council</td>
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<tr>
<td>14 David Caradus, Partner, PricewaterhouseCoopers</td>
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<tr>
<td>15 Deloitte Touche Tohmatsu</td>
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<td>16 Department of Finance</td>
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<td>17 Department of Health</td>
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<td>18 Department of Trade, Commerce and Industry</td>
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<tr>
<td>19 Dike Kari</td>
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<tr>
<td>20 Ela Motors Sales and Administration Staff</td>
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<tr>
<td>21 Elim Kiang</td>
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<tr>
<td>22 Ernst &amp; Young</td>
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<td>23 Exposa Tax Consultants</td>
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<td>24 ExxonMobil PNG Limited</td>
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<tr>
<td>25 Francis Marai</td>
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<td>26 Francis Nipuru</td>
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<tr>
<td>27 George Kuno</td>
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<tr>
<td>28 Glen Andrew</td>
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<tr>
<td>29 Harmony Gold (PNG Services) Limited</td>
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<tr>
<td>30 Hon. Sam Basil, MP</td>
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<td>31 International Education Agency of Papua New Guinea</td>
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<td>32 International Finance Corporation</td>
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<td>33 Investment Promotion Authority</td>
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<tr>
<td>34 JAJ &amp; Associates</td>
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<tr>
<td>35 John D. Conroy</td>
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<tr>
<td>36 Kalakune Laeka</td>
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<tr>
<td>37 Kapi &amp; Clarke Chartered Accountants</td>
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<td>38 Kepsey Puiye</td>
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<td>39 KPMG</td>
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<tr>
<td>40 KTK Accountant and Advisors</td>
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<tr>
<td>41 Martin Thompson (Apiculture Industry)</td>
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<td>42 Michael Wap</td>
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<td>43 Mission Aviation Fellowship (MAF)</td>
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<td>44 Moses Moti</td>
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<td>45 National Gaming Control Board</td>
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<td>46 National Research Institute</td>
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*Note: the list above does not include submissions marked as ‘confidential.*
## Appendix E: Consultations

### Regional Forums

<table>
<thead>
<tr>
<th>No.</th>
<th>Province</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Lae, Morobe Province</td>
</tr>
<tr>
<td>2</td>
<td>Madang, Madang Province</td>
</tr>
<tr>
<td>3</td>
<td>Kokopo, East New Britain</td>
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### One-on-one Meeting

<table>
<thead>
<tr>
<th>No.</th>
<th>Organisation/Agency</th>
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<tbody>
<tr>
<td>1</td>
<td>Adam Smith International</td>
</tr>
<tr>
<td>2</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>3</td>
<td>Bank of Papua New Guinea</td>
</tr>
<tr>
<td>4</td>
<td>Business Council of PNG</td>
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<tr>
<td>5</td>
<td>Chamber of Mines &amp; Petroleum</td>
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<tr>
<td>6</td>
<td>Consultative Implementation &amp; Monitoring Council</td>
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<tr>
<td>7</td>
<td>Deloitte Touche Tohmatsu</td>
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<tr>
<td>8</td>
<td>Department of National Planning &amp; Monitoring</td>
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<td>9</td>
<td>Department of Finance</td>
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<td>10</td>
<td>Department of Mineral Policy</td>
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<td>11</td>
<td>Department of Petroleum &amp; Energy</td>
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<td>12</td>
<td>Department of Policy and Geohazard Management</td>
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<td>13</td>
<td>Department of Trade, Commerce &amp; Industry</td>
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<td>14</td>
<td>Department of Treasury</td>
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<td>East New Britain Chamber of Commerce &amp; Industry</td>
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<td>ENBP IRC</td>
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<td>ENBP PNG Custom Services</td>
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<td>18</td>
<td>Fiji Revenue &amp; Customs Authority (FRCA)</td>
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<td>19</td>
<td>Governor of Oro, Hon. Garry Juffa</td>
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<td>20</td>
<td>Governor of West New Britain, Hon. Sisindran Muthuvel</td>
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<td>Inland Revenue Authority of Singapore</td>
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<td>Institute of National Affairs</td>
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<td>Internal Revenue Commission (IRC)</td>
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<td>IRC Northern Province Manager</td>
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<td>Lee Holland(Oil Search Limited)</td>
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<td>31</td>
<td>Mark Bell &amp; John Mooney (representing ABG)</td>
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<td>Mr. Maurice Brownjohn</td>
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<td>Real Estate Industry Association</td>
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<td>48</td>
<td>Rural Industries Council</td>
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<td>Tourism Promotion Authority</td>
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