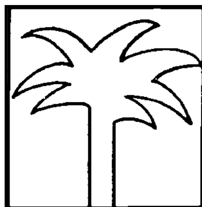

Taxation policy issues for Papua New Guinea[1]

Brian Brogan[2]

The Papua New Guinea tax system

The taxation system in Papua New Guinea has undergone few substantive changes since the early 1980s. Income tax on individuals and companies has remained high (relative to other developing countries of similar income levels) and fairly constant (as a proportion of total revenue, generating just over one-quarter of the total).[3] The mix of company and individual taxes within the total has also been consistent. The most important change in the tax structure has been the rapid rise in import taxes. They are now almost as large as grants, whereas they were only half as large at the beginning of the decade.[4]

This heavy reliance on customs duties, and increasingly on quantitative import restrictions, has contributed to an isolation of the economy and a decrease in its international competitiveness. Revenue from customs duties has not been large enough to cover the 50 per cent increase in government outlays, especially since grants have declined. Government borrowing increased, at least until 1988, and expenditures are expected to rise over the next few years.

Proposed mining developments should guarantee a flow of increased revenues. A well managed mining boom could result in long-term increases in national income. Present conditions suggest, however, that it will be close to the turn of the century before mining revenues do much more than replace declining aid and revenue losses arising from the closure of the Bougainville mine.[5] Therefore, reform of the taxation system is urgent.

At present, 40 per cent of internally raised revenue comes from company and personal income taxes and over 25 per cent from import duties. Over 50 per cent of personal direct taxes are paid by resident expatriates who constitute less than 10 per cent of taxpayers. A similar figure is likely for the company sector.

There are three reasons for the low collections from nationals.

- There are differential income distributions for nationals and expatriates.
- Nationals have a low involvement in the formal economy.
- A mixture of poor compliance and weak administration of the tax system lowers collection from nationals.

In a semi-subsistence economy, many cash earners do not feel obliged (or able) to pay taxes. Some compliance difficulties were overcome by the adoption of fortnightly tax deductions by employers and the elimination of the requirement to file returns for those receiving income only from employment. These reforms were recommended by a 1980 study by the Institute of National Affairs.[6] But further reform is necessary.

Tax administrators in Papua New Guinea have to negotiate a complex tax system with poorly trained and inadequate numbers of

1 This is a condensed version of a paper with the same title presented to the Papua New Guinea Tax Summit on 8 October 1991.

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3 R. Bird, *Taxation in Papua New Guinea: backwards to the future*, Islands/Australia Working Paper No. 87/15, National Centre for Development Studies, Research School of Pacific Studies, Australian National University, Canberra, 1987.

4 Most of the data on the tax structure are taken from the *Annual Reports* of the Chief Collector of Taxes (N. Bogan).

5 D. Parsons and D. Vincent, 'High stakes: mineral and petroleum development in Papua New Guinea', Islands/Australia Working Paper No. 91/5, National Centre for Development Studies, Research School of Pacific Studies, Australian National University, Canberra, 1991 (a summary of which appears in this *Bulletin*).

6 R. Neild, *Tax Policy in Papua New Guinea*, Discussion Paper No. 4, Institute of National Affairs, Port Moresby, 1980.

staff. In an establishment of 131 technical and 118 administrative and clerical staff, only 83 and 102 positions respectively were filled (as at December 31, 1989). Individuals in receipt of income in addition to wages lodging returns numbered 8,105 and there were 4,126 company returns. Despite these meagre resources, increased efficiency on the part of the Tax Office accounted for 21,000 of the 31,000 new taxpayers between 1986 and 1988. (The other 10,000 were due to employment growth.)

Taxation reform: the broad issues

Revenue buoyancy in the near future will be limited by: the shrinking personal income tax base as employment becomes increasingly localized; the lack of profitability in the non-mining private sector; constitutional limitations on national sales taxes; and lack of ready access to other indirect taxes. These limitations suggest that the following issues need to be addressed in an agenda for reform.

1 Inappropriate constitutional allocation of taxing powers

The constitution gives provincial governments the sole right to levy taxes on sales. This has been interpreted to permit the national government jurisdiction over customs and excise and taxes on exports. The possibility of the national government collecting taxes on behalf of provincial governments has not been ruled out, but this is nevertheless a barrier to an efficient regime of national sales taxes.

The importance of the informal sector in Papua New Guinea makes it appropriate for indirect rather than direct taxes to make up a substantial proportion of tax revenue. The allocation of sales taxing rights to provincial authorities has deprived the national government of a tax source that is both efficient on economic grounds and relatively simple to collect at a national level. The Papua New Guinea government has been forced to resort to indirect taxes such as imposts on imports—a second-best proxy for a general consumption tax in a country where a large component of the consumption basket consists of imported goods. Further, as exports are expected to be an increasing source of gross domestic product it can be expected that there will be a countervailing increase in imports.

A retail sales tax should not be within the jurisdiction of lower orders of government partly because of the problems associated with differential tax regimes along state, provincial and regional borders. In Papua New Guinea the courts have ruled that retail taxes may be imposed at the wholesale point, but importers and wholesalers are frequently located in a province such as Morobe (Lae) separate from the point of consumption, for example in Eastern (Goroka) or Western (Mt Hagan) Highlands. There is also the practical problem that the provincial administrations are less efficient than the National Tax Office.

2 The tax base should extend to informal and semi-formal sectors

Fewer than 35 per cent of citizens in the potential workforce are in formal employment Only two-thirds of those are in full-time formal employment. In addition, national policy proposes to reduce the proportion of expatriates employed in both public and private sectors, and national pay scales are substantially less than expatriate incomes. Action is therefore required to ensure that as the economy grows, and workforce and company ownership structures localize in accordance with government goals, the tax base is extended to enable tax revenues to grow at a rate consistent with fiscal needs. Such growth, however, must take account not only of aggregate revenue needs but also of efficiency in resource allocation and equity in the distribution of the tax burden. Nield made a number of suggestions to achieve these ends: a simple tax scale, as near as possible to proportional; the tax 'fortnight' for deductions and reporting rather than the previous annual returns (this has been adopted); and taxes on imports and exports and excises as proxies for a (constitutionally invalid) general consumption tax.[7]

3 The need to place minimum administrative demands on taxation authorities

In the interest of both administrative efficiency and extension of the tax base in Papua New Guinea, several generally accepted principles of taxation in developed countries may have to be flouted: vertical equity may have to give way to simple unified rates; the individual (person or enterprise) may have to give way to the traditional clan or group in certain circumstances as the tax unit; and the concept of no 'one-to-one' relationships between revenue sources for public goods and specific taxes may have to be jettisoned.

Efficiency criteria should be given priority over equity matters in tax planning because of the importance of growth at this stage of Papua New Guinea's development. Equity should be related to developing, not industrial country norms. Inter-clan (or inter-group)

7 Ibid.

rather than inter-personal equity not only makes sense in cultural terms, it affords an administratively feasible approach to taxing those outside the formal economy. The Tax Office is not complacent regarding the administrative improvements that have already been achieved and is continuing a program to improve the administration of the present system.

It may be desirable to extend the notion of user pays to government services such as local schools, health centres and roads, traditionally provided through the budget.

A successful tax system requires an efficient and honest tax bureaucracy, tax laws that are simple and consistently administered, a taxpaying public that understands and accepts the system and enough accounting and legal skills in the wider community to explain and operate the system. The impact of the tax system on macro- and microeconomic factors is of paramount importance in designing the system. The levels set for the various tax instruments have to reflect the broad macroeconomic strategy currently in place. In Papua New Guinea this means: encouraging national savings; stimulating (or at least not discouraging) investment; and creating an environment conducive to export development.

Such an approach to tax planning has the added advantage that it is administratively simple. If a tax system attempts to introduce too many sectoral objectives it is likely to create unanticipated and undesirable distortions. In a country at Papua New Guinea's stage of development, it is best to keep the broad goals of the tax system relatively simple. The system should be regarded as a means of revenue raising, hedged in by a minimal set of requirements relating to administrative convenience, elementary notions of tax equity and an overriding requirement to maintain economic efficiency.

Simplicity and consistency not only make for ease of tax administration, they lessen the burden on the taxpaying community by reducing uncertainty and lowering the costs of administration and compliance.

Frequent changes in the tax system are disorienting to the community. They make the assessments required for investors to gauge the viability of proposed investments difficult, they increase the risk associated with investing, and they give conflicting signals of government intentions to the private sector. The best incentive that can be provided to potential investors is the guarantee of a stable, honest and competently managed tax regime. Evidence for this proposition can be gained from the mining sector. Papua New Guinea gives few tax incentives to mining operations. The mining tax regime has, however, been stable since Independence. The general economic and geological environment, combined with a predictable and consistent (albeit tough) tax regime has been sufficient incentive to attract the world's leading minerals explorers and developers. What is starting to deter new developers in this sector is a trend towards general economic and social uncertainty combined with demands for a new tax/royalty regime. Favourable tax regimes do not attract investors but unpredictable regimes deter them.

Current international fashion is to move towards a mix of instruments that gives greater weight to indirect taxes. This would be desirable in Papua New Guinea but could present constitutional difficulties. Apart from a proliferation of licence fees and selected imposts on sales and production (which are likely to have distorting effects), the only indirect taxes with substantial revenue potential which are not already in use are taxes on imports and taxes on land. Import taxes (except for a low uniform customs levy like the present basic rate, and selected duties on a limited range of luxury goods) are a cause of domestic economic inefficiency because of their protective effects. They cause resource distortions and shelter the economy from international competition, inhibiting growth and leading to widespread inflexibility. They also raise the cost of intermediate goods and thus inhibit investment in the export industries on which Papua New Guinea depends. Papua New Guinea has probably gone as far down the import tax road as it should. By raising duty rates on Category C items (imports that compete with domestic production) to 30 per cent and placing some domestically manufactured goods in Category D (luxury items), it may have already gone dangerously far.[8]

Taxation reform: specific issues

The following are policy suggestions for implementing reforms that address the broad issues outlined above.

1 Improving administration of the existing system

Considerable progress has already been made with simplified taxation and customs schedules, simplified administrative procedures

8 *Report*, Review Committee appointed by the Minister of Finance (B. Brogan, Chairman), Port Moresby, 1986.

and improved training programs. When reforms of the tax system are under consideration, due weight must be given to the administrative burdens that they impose. Some 'second best' policy solutions may have to be maintained if the administrative cost of change is too high.

2 Simplifying and extending the personal income tax system

The difficulty of administering an equitable personal income tax system contributes to heavy reliance on indirect taxes. A large informal sector, a workforce that moves in and out of employment and a society not given to record keeping bedevils tax administration. This is compounded if voluntary tax compliance is not common. A judicious combination of sales, import, excise and land taxes, plus well-designed user charges (perhaps on a clan basis) for basic government services, may be the best way to bring the informal or semi-formal sector into the tax net, especially at the provincial level.

The treatment of non-monetary wage supplements in the cash economy (the most important of which are employer-provided housing, cars, schooling and telephones), and the tax treatment of expatriates are probably the most pressing issues in Papua New Guinea. Both these matters affect the vertical equity of the tax system and attempts to solve them might involve considerable administrative costs. Non-wage supplements are presently taxed by attributing to them an imputed income according to a standard scale. This is a sensible and administratively simple procedure.

Tax reform is complicated by the existence of two distinct income earning groups in the workforce: citizens and expatriates. The former mainly receive a straightforward salary, although in recent years fringe benefits have been added to senior citizens' salaries to address perceived inequities in their treatment *vis-à-vis* expatriates, especially in the private sector and government statutory authorities. Expatriates, in addition to the basic salary, earn a salary supplement nominally designed to reflect opportunity costs, paid on a recurrent basis as part of the expatriate's normal salary. This results in a bimodal income distribution which works against the adoption of a simple tax scale.

Expatriates also receive a package of fringe benefits. This may include housing, a car, telephone, children's education allowance, home leave and terminal gratuity. The gratuity, which is virtually tax free, is a substitute for superannuation. The 'in kind' income, most of which is now taxed to some extent, was originally designed to compensate for the inconvenience of living abroad but permits some tax avoidance. This package not only complicates tax reform, it imposes unnecessary strain on the wage system.

Tax reforms would be expedited if expatriate salary packages were restructured as follows.

- They should include a basic national salary which would be taxed at normal rates. Income in kind, not related to opportunity cost and the inconvenience of living abroad, would be seen as part of this 'national wage' and taxed as such.
- All expatriate supplements designed to adjust for opportunity costs and inconvenience and to compensate for loss of superannuation should be treated as a 'contract related' payment (all expatriates work on 3-year contracts) which should be taxed (at a rate to be decided) once per contract period or part thereof.

3 Simplifying and extending taxes on the business sector

To create a stable environment within which investors can carry out feasibility studies without fear of unexpected change, it is essential that business taxes be simple and consistent. Highly protective tariffs and complex tax incentives should be avoided. They distort resource flows, redistribute income away from consumers and exporters, attract mainly footloose industries and only rarely promote growth. Efficient and honest public administration and well designed macroeconomic policies do far more to promote social and economic growth.

Extensive tax incentives for business complicate tax administration and compliance for both government and business, encourage small businesses to avoid taxes, and hence increase the cost of collection and policing. Here macroeconomic considerations and administrative simplicity both dictate an uncomplicated rate scale.

There is scope for cooperation between local, provincial and national governments: business licensing fees could be introduced at a local or provincial level with a requirement on the provincial authorities to inform the national tax office of the name and address of all locally registered businesses. This would legitimise lower level revenue raising from business and also help to provide a database of businesses liable to national taxes.

4 Simplifying the tax system by refining the mix of direct and indirect taxes

The Papua New Guinea constitution has been seen as a barrier to a national expenditure tax system of any form, although it has not prevented taxes on imports, selected excises on production, and national coordination and collection of provincially-based sales taxes.

A prelude to any general consumption-based tax would be a concerted attempt to change the constitution. To achieve this, cooperation with provincial governments would be required and some alternative means found to compensate for the lost revenue (such as providing them with additional national grants or encouraging them to enter new fields of taxation).

About one-third of total national revenue is currently raised by indirect taxes, of which nearly two-thirds comes from import taxes. These import taxes have been imposed as a proxy for a general sales tax—mainly because of the administrative ease with which such taxes can be collected and partly because of the constitutional barrier to more conventional sales taxes. There is a rough logic in this: private consumption constitutes over 60 per cent of GDP while imports approximate 50 per cent, 60 per cent of these imports being consumer goods and fuel.

Despite their administrative ease and their rough logic, import taxes are an inferior approach to indirect taxation. They distort choices between domestic and imported goods and squeeze profit margins in export-oriented industries. In addition, like all turnover taxes, they 'cascade': that is, the tax imposed at an early stage of production (for example a customs duty on imported inputs) runs through all subsequent production stages unless there are complex systems of tax credits, duty drawbacks or exemptions for imports that are to be inputs to later stages of production. While such exemptions are both equitable and economically efficient, they are administratively complex and only rarely effective in the countries where they are applied.

Import taxes are nevertheless widely used in developing countries (often without the drawbacks described above) because they are simple to collect. If constitutional barriers to national sales taxes are thought to be insurmountable in Papua New Guinea, import taxes should remain but perhaps be modified. The basic levy should be extended to all commodities not specifically covered by other categories as a proxy for a general consumption tax (that is, all Category A goods (essential items) should be classified Category B (basic goods: items in widespread use as consumer goods or in the production of other goods)). This should be accompanied by a selected program of excises on the domestic production of import competing goods (for example, canned fish would be taxed as an import, canned meat as an excise or customs duty depending on its origin).

The rate applying to Category C goods (the protective rate of duty) should be gradually phased down to reduce distortions and all *bona fide* users of these goods as inputs to export industry should be entitled to duty drawbacks.

Category D items (luxury goods) should be subjected to higher rates than the current 50 per cent, to promote equity. This should be seen in the context of a simplification and rationalization of the income tax.

Whatever is done with import taxes they are second best alternatives to a general consumption tax. The latter, in a number of forms, is now common in industrialized countries and has been or is about to be introduced in a few developing countries (for example Brazil, Fiji and Tonga). Such taxes can range from simple turn-over taxes through to complete value-added tax (VAT) systems. They can be completely general or selective, flat rate or progressive.[9]

Turn-over taxes (in the absence of complex tax credit arrangements, which detract substantially from their administrative appeal) have the cascading characteristic referred to above. Like all consumption taxes, they are best administered in a society where most transactions occur in the formal sector through well managed enterprises. Inevitably, in a society with a substantial informal sector they become selective taxes on formal activities. In countries using simple turn-over taxes, exemptions are often given on equity grounds (for example basic food items) or to overcome administrative difficulties (for example service activities such as financial transactions). Occasionally exemptions are granted to particular categories of users (such as church groups and governments). Such exemptions produce economic distortions, open possibilities for corruption and detract from

9 *World Development Report 1988*, Part II, New York, Oxford, 1988 describes the characteristics of general consumption taxes.

the administrative appeal of broad-based general taxes.

The case for consumption taxes is part of a broader macroeconomic argument. Goods and services taxes are introduced in an attempt to induce savings as well as to improve the efficiency of resource flows and to simplify tax administration. No broad-based transaction tax should be introduced without an accompanying rationalization of personal and company income taxes, otherwise double taxation results.

Value-added taxes have considerable theoretical appeal. They are easy to collect (given certain institutional characteristics), self-policing and sector neutral, and they assist in promoting savings at the expense of consumption. From a practical perspective, their main advantage is that they are almost impossible to evade. The world's first VAT was introduced in 1967 in Brazil, a country with a notorious tradition of non-compliance with personal and company taxes. The next significant introduction was in the European Community where taxpaying was not a popular activity in some member countries. A VAT has considerable appeal in Papua New Guinea because it would widen the tax base and compel compliance.

Under a VAT regime, enterprises at each stage of production assess the tax payable on their sales, deduct the tax paid on inputs used in generating this revenue (including import duties) and remit the difference to the tax authorities. Thus the tax does not cascade and ultimately only the final consumer bears the tax although collections have taken place along the production chain; this is the only goods and services tax in which the final tax payment rests exclusively with the final consumer (usually, VAT is not collected on export sales). The tax is consequently sector neutral, and it does not discriminate in favour of local production (that is, it has no hidden protective dimension as does a general import levy).

Critics of a VAT focus on its alleged inequity: it taxes rich and poor alike. Economists say that a VAT should be part of a general package of tax reform, the other elements of which can address equity issues. In any case, equity should be seen in the context of the total fiscal impact of government, not simply the effects of their revenue raising activities through the tax system. Development specialists are inclined to put administrative efficiency and macroeconomic aspects of taxation ahead of equity as operational criteria in developing countries, arguing that too much emphasis on equity in the early stages of modernization will probably stifle development.

Unlike Fiji, which will soon introduce a VAT, Papua New Guinea has an informal sector which still occupies a considerable proportion (at least 75 per cent) of its workforce. This includes a large semi-cooperative productive sector within which goods and services are not bought or sold.

Most small enterprises are poor at record keeping. It would be difficult to administer a VAT in this context, although it could be argued that such a tax would be a considerable incentive to small firms to improve their administrative systems.

If introduced in Papua New Guinea, a VAT would initially have to be selective in sectoral scope to satisfy the demands of pressure groups. It could not be general because of the relative sizes of the subsistence and semi-barter sectors. Tonga acknowledged this problem by exempting subsistence output and a large part of agricultural and handicraft output from VAT. Transactions on urban consumer produce markets are also exempt. A further problem (which applies to any alternative indirect tax option) is related to Papua New Guinea's present wage fixing system. If a VAT led to a rise in consumer prices (that is, after offsetting price reductions induced by a decline in import duties and other excises), it would feed directly into the cost structure through wages. Without a fundamental reform of the wages system its introduction would discriminate against labour-intensive industries and squeeze profit margins in the export sector.

5 Appropriate means to extend the tax net

Land taxes are common in most countries but represent an untapped source of tax revenue in Papua New Guinea. It could be an ideal means of levying taxes on rural-based clan and sub-clan villagers. Revenue could determine the allocation of provincial services such as access roads, schools and aid posts. There should be a perceived link between willingness to contribute to government revenue and receipt of basic government services. The need to pay taxes may also generate positive side effects. In order to raise the cash to pay the tax (if it is to be in cash, not kind) groups would have to either use part of the land to raise cash crops or contract with other individuals or groups to use it in return for cash compensation. This would be in the long-term national interest.

User charges and land taxes should be given priority in attempts to target the informal and subsistence sectors. Both types of impost should be approached through provincial and lower level governments (perhaps with national matching grants). As a first step the group or clan could be the taxable unit rather than the individual, with local land owners assumed to be the chief beneficiaries of government services and facilities. Taxes could be directly related to local capital works and the recurrent costs of operating local health, education and other infrastructure facilities. If placed under provincial administration (with support from the national government), these taxes might encourage provincial governments to begin collating local land registers. In the long run these registers could form a foundation for more conventional approaches to the taxation of land.