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A Contribution to the Debate about Proposed Tax Changes in Papua New Guinea

By Francis Odhuno

1. Introduction

On Monday, August 24, 2015, *The National*, one of the two widely circulating daily newspapers in Papua New Guinea (PNG), carried a front-page headline news story about the Tax Review Committee's proposal to:

- i. Increase personal income tax-free threshold from K10,000 to K15,000;
- ii. Reduce resident company tax rate from 30% to 25%; and
- iii. Increase Goods and Services Tax (GST) rate from 10% to 15%.

Since the publication of this story, hardly a day passed without newspaper reports commending or disapproving these proposals. For example, "GST increase wrong..."; "GST hike to balance services, revenue take"; "Tax increase grave injustice for people"; "... welcomes tax recommendations"; "... concern over tax system"; "... commends ... tax review..."; "... tax advice poor and shallow"; "New tax regime slammed"; were some of the news stories read much more widely during the week ending 28 August, 2015, courtesy of print and online editions of *The National* and *Post Courier* newspapers and the social media.

This flurry of news stories and letters to the editor prompted the Tax Review Committee to publish an advertorial in the Friday, 28 August, 2015 edition of the *Post Courier*, the other widely circulating daily newspaper in PNG. In the advertorial, the Committee sought to clarify that the proposed GST, corporate tax and personal income tax changes are only part of the broad directions of tax reform currently underway. Hence, the above recommendations are preliminary, and were only highlighted during one of the numerous stakeholder consultations. Thus, the suggestions remain open for further public debate.

When the debate continued into the following week, *The National* carried a front-page headline news story clarifying the Government's position that there will be no new taxes or any increase in the existing taxes, after all.

Since this topic is of broader interest within and beyond PNG, particularly at this very moment when it is under discussion in local newspapers, this article provides key takeaways from the contribution of the National Research Institute (NRI), as a public policy "Think Tank", to the

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discussion. In particular, it summarises NRI's stand with regards to the proposed GST and corporate and personal income tax changes.

2. Background

With partial funding from the Tax Review Committee Secretariat, the NRI hosted a Symposium on *Analysis of Taxation Policies and Reforms Affecting Businesses and Individuals in Papua New Guinea* on May 29–30, 2014 in Port Moresby. Fourteen research papers on various tax topics that were presented at that Symposium were prepared as part of a research project of NRI supported by funds provided by the Australian Department for Foreign Affairs and Trade (DFAT).

In preparing for the Symposium, NRI requested the authors of the papers to conduct deeper analysis of taxation and related issues accumulated over the past years to: (i) identify concerns with the current taxation system; (ii) describe what a good tax system should be like; (iii) consider options for reforms; and (iv) evaluate the pros and cons of those options.

The NRI reviewed the Symposium papers and summed up the discussions, the interpretations, and conclusions expressed by the presenters, discussants and other contributors and prepared a summary report of the proceedings of the Symposium. That summary report, which reflects the responsibility and judgement of NRI, formed the basis of its submission to the Tax Review Committee on 14 October 2014.

In that submission, the NRI made observations and recommendations on a wide range of tax and fiscal policy issues for the Tax Review Committee to consider. This article focuses on the proposed GST, Personal Income Tax, and Corporate Income Tax changes — the tax topics that have been the subject of recent discussion in the media.

3. Discussion

3.1. Goods & Services Tax (GST)

GST imposes a heavy tax burden on disadvantaged consumers, including very poor individuals, households and rural dwellers in the least-developed provinces and urban (informal) settlements. Yet, the goal of any tax policy should be to enhance the national welfare, especially when the country's natural resource revenues are not disappearing in the short, medium, or foreseeable future.

Nevertheless, considering that GST promotes competitiveness of domestic products and services with imported products and services, and considering also that it has the potential of raising

more revenue in a more sustainable manner, the NRI recommended that GST should not undergo major structural change.

Following the presentations and deliberations at the Symposium in 2014, it is believed that the current 10% GST is reasonable. A higher rate is not needed in the wake of projected strong resource revenue flows, although at the time of writing this article, the future is wrought with uncertainty that is threatening the confidence in the anticipated revenue from the PNG-LNG gas exports.

Nevertheless, the Government believes that the economic outlook is positive despite the fall in commodity prices, which is considered a temporary shock to the country's economy. A lower GST rate is also not justifiable given IRC's limited resources for collecting the tax; but there is the need to compensate the provinces where the tax is originally collected.

Hence, the NRI further recommended that the formula for redistributing the GST income should be adjusted to 60:20:20, so that:

- i. 60% of the internal GST revenue is retained in the province where it was collected;
- ii. 20% of the internal GST collection is put into a trust fund to support labour-intensive income and employment generating activities in the less well-endowed provinces; and
- iii. 20% goes to the National Government to be added onto the GST on imported products and services and, ultimately, into the consolidated revenue.

3.2. Corporate Tax

The NRI stated in its submission that successive PNG governments have been designing tax policies with the intention of attracting foreign direct investment (FDI) and stimulating economic growth. Yet, the 50% resident oil company tax and the 48% non-resident company tax rate, compared to the current 30% tax rate for resident companies, are too high for PNG, a developing country competing to attract FDI.

It is also possible that the 8% discrepancy between the 48% non-resident company tax and the 40% special tax rate for non-resident mining companies, which is inequitable, could be having negative effects on investment decisions. It is also inequitable that designated petroleum and gas projects pay 7.5–10% Additional Profits Tax while mineral resource projects do not (which leads to considerable revenue being forgone).

While the PNG government is encouraging investment in the construction and extractive industries

— especially in the housing, mining, petroleum, and gas sectors — this should not be to the detriment of other sectors. Moreover, the high degree of variance in tax rates within and across industries may be restricting participation of foreign investors rather than encouraging them to incorporate in PNG.

Therefore, in order to design tax policy with incentives that promote desirable investment behaviour and disincentives for undesirable behaviour, the NRI recommended that the following corporate tax reform options be considered:

- i. Reduce resident company tax rate from 30% to 25% in the medium term to make PNG's tax regime more internationally competitive.
- ii. Equalise the resident and non-resident company tax rates at 25% to remove the existing inequities.
- iii. Equalise the resident and non-resident mining company tax rates at 25% to remove the existing inequity.
- iv. Re-introduce the 7.5–10% Additional Profits Tax for mining companies to remove the existing inequity between resource projects.
- v. In the interest of fairness and simplicity, non-resident contractors and insurers should have 20–25% of their fees withheld and paid to IRC.

3.3. Personal Income Tax

Currently, a person's income tax liability is not calculated on an annual basis but according to their pay period — which may be weekly, fortnightly or monthly. The tax liability on wages withheld by employers, and which is remitted to IRC, is declared as "final tax", unless the individual employees have other non-wage income.

The problem with the current system, however, is that the burden of personal income tax falls only on 5 percent of the country's population, and less than half of that proportion pays 90% of the total personal income tax.

Moreover, the top marginal tax rate of 42% is too high, compared to the global average of 31% and the average in Asia of just 28.4%. But there are also problems with how the low- and middle-income earners — the people best placed to invest in micro and small enterprises — are taxed in PNG.

The current system of taxing unincorporated small and micro enterprises remains unfair to owners of micro or small businesses who also receive a salary or a wage because both their business incomes and salary or wage are aggregated to calculate the total tax liability. In contrast, a micro/small business run

by a person with no other income will face a lower marginal rate of tax.

Since the determination of personal tax consists first of the choice of the tax base and then the choice of the tax rate schedule, the higher marginal tax rates applicable to the combined income discourage potential investment by the middle class; it also discourages informal micro/small businesses from transitioning to a formal status. Hence, a level playing field is needed where unincorporated micro and small businesses are taxed in the same way, regardless of the owner's status in the formal workforce.

To achieve this, the NRI suggested that the Government of PNG would need to do the following:

- i. Abolish the personal income tax system and replace it with two separate and mutually-exclusive forms of income tax — (a) Wage Income Tax; and (b) Investment Income Tax.
- ii. Continue treating the Wage Income Tax as a "final tax" collected by employers in accordance with the previous section.
- iii. Introduce a new and separate tax scale for the Investment Income Tax so that wage income is not added to investment income in calculating tax liability.
- iv. Set the tax rate for the Investment Income Tax at the same rate as the corporate tax rate (25 percent as recommended in 3.2(i) above).
- v. Since a reduction in the burden on individuals who pay tax will only become feasible if the number of taxpayers increase, the government could limit the risk of tax evasion by also lowering the top marginal tax rates for individuals to 30%.
- vi. Introduce the same tax free threshold for both forms of taxation (It is proposed that this should be K18,000 per year).
- vii. Scrap the fringe benefits tax system, which is complex and difficult to administer, and tax in full, all fringe benefits within the Wage Income Tax system — allowing a minimum threshold of, say K20,000 restricted to housing, car, phone, home travel, and educational benefits only.

3.4. Tax Exemptions and Incentives

In the NRI submission, it was argued that, in general, tax exemptions and concessions in PNG appear to be inefficiently designed and to favour high-income groups who also often enjoy long tax holidays before they begin to contribute to government revenue; or effectively escape taxation altogether for a large subsequent number of years.

The more disconcerting irony is that the majority of these tax incentives and concessions are provided

in project-specific agreements that are not only confidential between the government and the company but also alter and override the general tax legislation, after greatly reducing the effective tax rate.

Ultimately, the tax-to-GDP ratio is usually lower than what it should be because the level of foregone revenue is significant — the Treasury ends up with less revenue and some ‘favoured’ companies receive the money.

In order to safeguard the potential loss of revenue that may be occasioned by the implementation of changes suggested for corporate and personal income taxes, the NRI recommended further that:

- i. The government could expand the tax base by removing tax exemptions and concessions so that the individual and corporate burden may be reduced without a reduction in tax collection.
- ii. Eliminate tax breaks — allowable deductions and exemptions — which allow companies in PNG to defer paying taxes but encourage the same companies to shift profits offshore. Non-general tax exemptions also distort investment flows towards industries/firms that are not necessarily the most profitable.
- iii. The fiscal arrangements for mining, petroleum, and gas companies should be incorporated into the general legislation and not varied for individual projects or over time.
- iv. Fiscal stability clauses should be removed and should never be used as they have not been effective in reducing perceptions of sovereign risk.

4. Conclusion

From the above discussion, it can be seen clearly that:

- First, the Tax Review Committee’s proposed changes, as reported in the recent media, are in agreement with the NRI suggestion only in respect of reducing corporate income tax from 30% to 25%.

- Second, the Committee’s proposal to increase the tax free threshold from K10,000 to K15,000 for personal income tax purposes is a step in the right direction; NRI had suggested the threshold for individual taxpayers to be increased to K18,000, and that the top marginal tax rates for individuals should be lowered from 42% to 30%.

- Third, the Committee’s proposal to increase GST from 10% to 15% is at odds with the NRI recommendation. The NRI submitted that the current 10% GST is reasonable and should not be adjusted, which is in line with peoples’ expectation as reflected in the majority of recent media reports about proposed tax changes. The argument is that the current temporary reductions in government revenue occasioned by the fall in world commodity prices should not be matched by increasing indirect tax collections in the form of increased GST rate, which will be permanent — since prices are usually sticky downwards.

- Fourth, the NRI believes that the across-the-board elimination of income tax preferences within a comprehensive reform of the tax system, rather than targeting certain exemptions and concessions, is certainly the easier way to achieve the country’s fiscal and economic goals.

- Finally, while this article has weighed in with sensible tax reforms, it is the Tax Review Committee’s prerogative to select which recommendations (if any) to submit to the Government, which, in turn, has the prerogative to accept or reject the Committee’s recommended tax reform proposals. The outcome will be known when the Committee’s final report will have been submitted to the Government later this year.

About the Author

Dr. Francis Odhuno is a Senior Research Fellow with the Economic Policy Research Program at the National Research Institute, Port Moresby.

Contributions to Spotlight should be addressed to the Director, NRI:

Email: nri@nri.org.pg

Fax: 326 0213

Post: P.O. Box 5854, Boroko, NCD 111. Papua New Guinea

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