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"DESIGNING A TAX SYSTEM FOR PAPUA NEW GUINEA"

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FOREWORD

The first study commissioned by the I.N.A. was "Tax Policy in Papua New Guinea". It was published as Discussion Paper No. 4 and the author was the distinguished British economist Professor Robert Neild of Cambridge University. Other Discussion Papers on taxation have followed, all by acknowledged experts - Professor Russell Mathews of the Australian National University; Dr. Rajah Chelliah, Director of the National Institute of Public Finance and Policy in New Delhi; and by Professor Richard Bird of the Institute for Policy Analysis of the University of Toronto.

Taxation has been a continuing concern to the I.N.A. for a number of reasons. Obviously, the national tax regime impacts on the business sector in a variety of ways and therefore its self-interest is involved. In this regard direct taxes on companies and persons and indirect taxes and licensing fees have an immediate effect on the business environment. More generally, to the extent to which taxes are an instrument of fiscal control, they constitute an important component of the spectrum of public policy issues which the I.N.A. was set up to investigate. But most fundamentally in a financial environment where taxation accounts for only about two thirds of all the government revenue raised, or to put it a different way, finances only just over half of all government activity, the search for a tax and expenditure system which will make Papua New Guinea more truly independent than it currently is, is clearly one of the most pressing of government priorities.

In his study Professor Neild stressed the need for further research into a number of tax related issues, but doubted that some necessary investigations - e.g. into the incidence of indirect taxes - was possible given the paucity of data on income distribution and family expenditure patterns. Since his work was published the government has commissioned a survey to ascertain some of this information for rural Papua New Guinea. But the pace is slow and the data may not be available during the time scale when urgent taxation decisions will have to be made.

Expanding the tax base and changing the structure of the tax system within a coherent tax philosophy is vitally important. The urgency is not just because the budget support provided by Australian aid seems set to fall in the foreseeable future, but also because the task of tax reform becomes more difficult the longer it is postponed. The existing tax system, whatever its merits or demerits, sets up a complex of vested interests resistant to change.

Whatever system Papua New Guinea adopts should guarantee revenue growth consistent with reasonable patterns of government expenditure. Only with an indigenous revenue flow can "reasonable" levels of such expenditure be gauged through the electoral process. The present situation with its large recurrent aid flow inhibits fiscal responsibility. The system, as with all tax structures, will have to balance the conflicting criteria of equity, economic efficiency, administrative simplicity and will also have to take note of a number of other matters related to the impact which the system has on the pattern and level of economic activity.

A peculiarity of the tax situation in Papua New Guinea is the large number of expatriates in the workforce and in business. Many of these are also subject to taxation in their home countries and most are transient. A key consideration, then, in the tax treatment accorded non-nationals is the effect which the total tax burden placed on them by this country and their country of citizenship would have on their willingness to work in Papua New Guinea.

At present, in the absence of the perfect data base, rather than redesigning the system, the government is marginally altering it year by year in accordance with its short term revenue requirements. That process of ad hoc adjustment has resulted in a tax system with little inner logic and, more worryingly, possibly little potential for future revenue growth.

Few recent extensions to the systems have constituted genuine extensions of the tax base. The informal sector still pays little taxation, yet it is largely from communities within this sector that demands for compensation are loudest. Often these demands are directed at the government for having used customary land to provide a service at taxpayers' expense. Even when the claim is directed at non-government agencies it is surely a measure of a community gain which demonstrates a taxable capacity.

The present study by Mr. David Collins of Macquarie University has been commissioned by the I.N.A. with those thoughts in mind. His brief was to look at the tax system in existence in Papua New Guinea in relation to likely future revenue needs, data sources and taxation administration capacity.

In his view data in terms of which to assess the system is likely to remain scarce, so to delay reform because of lack of information is pointless. To do so could delay indefinitely the process of reform. In his words:

"The process of expedient tax reform while waiting for information is likely to render more difficult the process of future tax reform. Taxes, once introduced, tend to be very difficult to drop and the usual result of expedient reform is that the performance of the tax system deteriorates. At present Papua New Guinea is in a favourable position for the implementation of tax reform. A comparatively small proportion of the total tax burden falls on nationals so that political opposition to tax reform is not likely to be as great now as in a few years time. In addition, the tax system is still relatively simple so that the process of redesign of the tax system will be much less complex now than it is likely to be in the future."

From this premise he discusses a number of principles of taxation placing particular stress on the criterion of "simplicity" of administration. An important factor in the Papua New Guinea economy is the large informal sector and he specifically agrees with Neild's observation: "That the general conclusion must be that possibilities of applying direct taxation in the countryside are uncertain and surely limited in the short run."

Above all he argues for a consistent tax structure based on a set of coherent principles and cautions against the sort of expedient approach to expanding the tax system which has led to the massive degree of evasion and avoidance characteristic of most developed economies.

Specifically, he advocates a generalised system of flat rate taxes for both direct (possibly with a threshold and incorporating a simple rebate pattern) and indirect taxes, all deducted at source. He suggests a shift towards more reliance on indirect taxes - wholesale, export, import, and services - partly as a means of bringing the informal sector as far as possible into the tax net and partly to eradicate the present bias in, and inefficiency caused by, the partial nature of such imposts. While he argues for a simple system of taxing income supplements such as housing, he is inclined to argue against the extension of the tax base to include capital gains at this stage. He opposes both a value added tax and a national retail turnover tax in Papua New Guinea on grounds of both cost and difficulty of administration.

Above all he calls for a systematic approach to tax planning, with a coherent set of principles underlying the system. The I.N.A. presents this Discussion Paper in the hope that it will provoke discussion of those principles, informing policy makers of the dangers in the ad hoc approach to tax planning currently being followed. It is hoped to convince government that it is both unnecessary and unwise to defer the process of fundamental tax reform until perfect data is forthcoming.

It would be quite inconsistent with his approach to implement his suggestions piecemeal. Our object in releasing the document is to provoke discussion of principles. If his are not acceptable, the government should avoid any further tax initiatives until it is satisfied that it understands and accepts the principles on which its own tax planning is based.

Some potential exists within the present system for increases in collections through more effective administration. This would require scarce manpower and would enshrine some of the ad hocery underlying the existing tax structure but it would be preferable to further attempts to extract added revenue from the current narrow base. In the long run that base would have to be expanded. The only alternative would be a substantial cut in government expenditure.

SUMMARY OF RECOMMENDATIONS

A. GENERAL RECOMMENDATIONS

(a) The tax system should be based on a set of consistent principles designed to balance (in a politically acceptable fashion) the criteria of -

- . economic efficiency - the extent to which decision making in the private sector is distorted.
- . equity - the extent to which the tax system conforms to community standards of fairness.
- . simplicity - with respect to both the public and private resources needed to sustain the tax/tax system.
- . fiscal flexibility - the efficiency of the tax as a means of revenue raising and as a tool of fiscal policy.
- . the tax system should also be designed so as to minimise possibilities for evasion and to minimise the substitution of tax deductions for explicit expenditure policies.
- . the system should be changed as little as possible with most change being confined to rates and rebates.

(b) The data required to design the perfect tax system will not be forthcoming for many years. In view of the increasing difficulty of tax reforms as the existing tax system builds up a network of vested interests, it is therefore preferable to implement necessary reforms at the earliest date.

(c) The comparative size of the informal and non-market sector in Papua New Guinea means that overseas models, especially the Australian one, may be irrelevant as a basis of comparison for a sensible Papua New Guinea tax system.

B. SPECIFIC RECOMMENDATIONS

(a) Personal Income Taxation

- . There are strong arguments for a single personal income tax system applying to all income earners.
- . The "best" such tax, in view of the criteria under A above would be a linear tax - a simple proportional tax levied on all "taxable" incomes above a designated threshold. "Taxable" income, as now, could be arrived at after deducting authorised (e.g. dependants) allowances from

actual income. The threshold, the rate or the size of deductions could be varied from time to time. At this stage capital gains taxation would be unwise, but income should embrace wages and salaries, salary supplements in kind, interest, dividends and royalties. All these incomes should be taxed at source.

- . Dependant rebates should be regularly indexed for inflation, tax rates on contract gratuities should remain as they are, and taxation of income in kind should be based on standard arbitrary valuations as at present and taxed at source.

(b) Indirect taxation

- . The base should be as broad as possible and the tax rate applied to the base uniform.
- . Value added taxes and retail turnover taxes require record keeping and financial expertise not consistent with Papua New Guinea norms and should not therefore be entertained.
- . A wholesale tax, collected at source with few or no exemptions would be best.
- . Such a wholesale tax should be levied on services as well as goods. The taxing of services could be effected through a tax on some index of activity in the financial sector which could be passed on to customers - e.g. a tax on assets or transactions - and possibly licence fees for providers of services. Such imposts could replace existing stamp duties and the like. A broad based service tax would not be possible.
- . Excises should continue and it may be possible to graduate such taxes on alcohol to reflect the alcoholic content of the taxed commodity.

(c) Taxation of the informal sector

This could be effected with various export and production taxes, withheld by marketing and exporting authorities. Again, the tax should be levied on a uniform rate.

(d) Import taxes

Without entering into the argument of whether tariffs should be used as a protective device, to the extent to which customs duties are used to raise revenue they should be uniform with respect to all categories of goods and to all categories of importer, including government agencies.

(e) Company taxation

- . Company profits should be taxed at source and dividends should be taxed as income by recipients, preferably at source by some sort of proportional withholding tax.
- . Using the tax system to discriminate between categories of companies is not efficient; subsidies are preferable.

DESIGNING A TAX SYSTEM FOR PAPUA NEW GUINEA

INTRODUCTION

This paper reviews tax policy in Papua New Guinea with a view to producing recommendations for tax reform. Any review of tax policy must confront the questions of whether current revenue is being raised in the "best" way and in what way should future expenditure needs be financed. Evaluation of the methods of raising the given amount of current revenue involves a comparative study of different taxes but involves no consideration of the desirable level of tax revenue. In reality, consideration of future financing techniques cannot meaningfully be divorced from the expenditures to be financed. It may be possible, by more efficient public expenditure techniques, to increase public output without increasing total public expenditure, a process which would reduce funding requirements. Thus tax policy and public expenditure policy should be seen as interdependent by the policymakers. The scope of this study is, however, restricted to taxation issues.

In evaluating the current Papua New Guinea tax structure, as one of the funding techniques open to the government, we are therefore looking at alternative ways of raising the same revenue. Evaluation of a tax should be undertaken in relation to the available alternatives and it is not valid to condemn use of a particular tax if no better alternative is available. Similarly, a proposed tax reform should be judged not against some absolute standard but against the existing tax system.

Tax reform is often opposed on the grounds that it will inevitably lead to increased tax burdens which are, in themselves, undesirable. Maintenance of the existing tax structure, it is argued, has the advantage that it restrains politicians from increasing the size of the public sector. This is a political, rather than an economic, argument and is not addressed in this paper. It should be borne in mind, however, that the desirable rate of public sector growth must be related to available financing techniques. Determination of public expenditure levels should not be divorced from considerations of funding. It is quite conceivable that, in Papua New Guinea, funding constraints discussed below could imply negative public expenditure growth at some future time.

THE STRUCTURE OF TAXATION IN PAPUA NEW GUINEA

Table 1 presents a breakdown of revenue in 1984 and 1985. The Papua New Guinea financial year runs from January to December.

Table 1
Sources of revenue, Papua New Guinea 1984-85

Internal revenue	1984 (actual) K million	per cent	1985 (budgeted) K million	per cent	Rate of growth per cent
Import duties	95.5	14.5	109.0	14.7	14.1
Excise duties	58.0	8.8	61.8	8.3	6.6
Export tax	11.2	1.7	15.8	2.1	41.1
Dividend withholding tax	4.1	0.6	4.9	0.7	19.5
Company tax	42.0	6.4	58.0	7.8	38.1
Personal income tax	123.0	18.7	142.0	19.1	15.4
Mineral Resources					
Stabilisation Fund	29.7	4.5	32.1	4.3	8.1
Loan interest, etc.	14.4	2.2	14.9	2.0	3.5
Other indirect fees, fines, etc.	42.4	6.4	45.2	6.1	6.6
Investment revenues	10.0	1.5	15.0	2.0	50.0
Total internal revenue	430.3	65.4	498.7	67.0	15.9
Aid					
Australian	225.9	34.3	243.2	32.7	7.7
Other	1.7	0.3	2.0	0.3	17.6
Total aid	227.6	34.6	245.2	33.0	7.7
Total revenue	657.9	100.0	743.9	100.0	13.1

Source: Ministry of Finance, Estimates of Revenues and Expenditures for the Year Ending December 31, 1985, Table 5, November 1984.

The most important source of revenue is foreign aid, almost all of which comes from Australia. The reliance on Australian aid poses a major problem for future tax policy as the current agreement between the two countries calls for Australian aid to decline by 2 per cent in real terms in 1984/85 and by 3 per cent in real terms in 1985/86. Longer term planning in Papua New Guinea is based upon an assumption that the real value of aid will continue to decline at 3 per cent per annum but this may well prove to be too optimistic from the Papua New Guinea point of view. A substantially higher proportion of revenue will, in the future, need to come from domestic sources.

In comparison with the experience of developed countries relatively small reliance is placed upon income-based taxes - company tax, personal income tax, dividend withholding tax (on dividends remitted overseas) and the Mineral Resources Stabilisation Fund (MRSF), into which go tax revenues from mineral resource sources. Indeed, since a substantial proportion of company tax and all MRSF revenue comes from foreign-owned companies and since over 80 per cent of personal tax revenue comes from taxation of expatriates, the Papua New Guinea domestic income tax base is small. The other major taxes are import duties, an export tax and excises.

CRITERIA FOR TAX EVALUATION

In evaluating a tax it is necessary to establish a set of criteria against which the system can be judged. Conventional tax analysis uses four main criteria -

Neutrality (efficiency). The extent to which decision-making in the private sector is distorted, non-deliberately, by the tax.

Equity. The extent to which the individual tax or the tax system conforms to community concepts of fairness in relation to the distribution of the tax burden.

Simplicity. The costs which the tax imposes in terms both of public administration costs and compliance costs borne by the private taxpayers, individual and corporate.

Fiscal flexibility. The efficiency of the tax as a means of revenue raising and as a tool of fiscal policy.

While there can be no objective ranking of these criteria, in developed economies the predominant criteria tend to be the first two.

There is an increasing public awareness of the distorting effects of partial taxes, although this is not the way the layperson would describe this effect. Concern with the effects of high marginal personal income tax rates on work incentives and on the rate of inflation, of payroll taxes on the demand for labour and of financial institutions taxes on the structure of the financial sector are all examples of an awareness of the potential non-neutrality of taxation. Probably the major community concern with taxation is its fairness, which is usually expressed in terms of ability to pay. Do individuals (or, possibly, households) with the same ability to pay attract the same tax liabilities (horizontal equity) and does tax liability rise with ability to pay (vertical equity)?

There is, certainly, concern with the other two criteria. For example, taxes which have attracted critical comments in Australia when subjected to the simplicity criterion are the departure tax (in relation to the apparent administrative costs per dollar raised) and the Bank Account Debits (BAD) tax in relation to the compliance costs imposed upon the banks. Nevertheless, in advanced economies the ability of the bureaucracy to cope with the administration of a tax is less of a problem than in developing economies. In the area of fiscal flexibility, advanced economies tend to experience no shortage of tax instruments for the purposes of short-term fiscal policy. There is, however, an increasing concern with the problems of revenue raising as public sectors continue to grow and limits appear to the revenue potential of some taxes. The apparent effect of high personal income tax rates upon the extent of avoidance and evasion suggests the existence of such a limit to personal income tax revenue potential.

As indicated above, there is no objective way in which these criteria (which are often in conflict) can be ranked in importance but it would appear that in a developing country such as Papua New Guinea the appropriate ranking may be very different from that deemed appropriate in a developed country such as Australia. It is clear that the most important function of taxation in Papua New Guinea is to raise revenue. There are real and very substantial constraints upon the ability to raise sufficient revenue to finance planned future levels of public expenditure (given assumptions about future levels of foreign aid and future willingness or ability to engage in deficit financing). These constraints relate both to the size of the tax base and to the administrative ease with which taxes may be collected. The size of the Papua New Guinea tax base is determined by, inter alia, the level of gross domestic product, the size of the expatriate population and the size of the informal (and so untaxed) sector.

The administrative ease of tax collection is an extremely important criterion for tax evaluation since there is no point in proposing taxes (for example, value added or net worth taxes) which the revenue authorities do not have the administrative ability to collect. Almost without exception, previous studies of the Papua New Guinea tax system have drawn attention to the comparatively low level of administrative ability of the revenue authorities at central, provincial and local levels. There is, in practice, likely to be a strong inverse relationship between the degree of administrative complexity of a tax and its revenue potential - the greater the administrative complexity, the lower (ceteris paribus) the revenue potential.

At the same time it is necessary to look critically, in the Papua New Guinea context, at the other tax criteria.

1. Efficiency. Certainly there are good reasons for attempting to implement a tax system which does not accidentally distort economic decision-making in the private sector. Taxes may be used deliberately to direct resources to areas of use different from those which would otherwise have been chosen. As long as it can be shown that this resource reallocation could not be achieved more efficiently by other techniques (e.g. by direct subsidy rather than by tax concessions) the efficiency (neutrality) criterion no longer applies. Again, it should be realised that no tax system or individual tax can be completely non-distorting. The search is for taxes which are comparatively neutral rather than completely neutral. Taxes which are highly non-neutral in an advanced economy with, for example, a developed manufacturing industry, may meet the neutrality criterion much better in a developing economy. For example, a general import levy would be much more defensible in Papua New Guinea than in an Australian context. One major neutrality consideration in Papua New Guinea is the impact of taxation upon the supply of expatriate labour.
2. Equity. In the context of the taxation system of an advanced economy, equity is usually seen as an important tax goal. In the Papua New Guinea system, it can be argued, equity should be treated as a very much less significant objective so that a well-designed tax system for Papua New Guinea may have a structure quite different from that deemed appropriate for a developed economy. The basis for this assertion lies in the extent to which Papua New Guinea tax revenue is raised from external sources.

The 1985 National Budget predicted that, of total internal revenue, personal income tax would yield 28.5 per cent (K142 million) and company income tax 11.6 per cent (K58 million). A high proportion of these taxes will be either borne by expatriates working in Papua New Guinea (in the case of personal income tax) or exported (in the case of company tax). Furthermore, a significant proportion of indirect taxes must also either be borne by expatriates or exported.

There seems little case for arguing that the personal income tax rate scale and system of allowances should, insofar as they apply to expatriates, be designed to achieve normal vertical equity objectives. Expatriates usually return to their countries of origin, with their own tax systems, in a relatively short period of time and it would be difficult to argue the case that short-term redistribution of income between different categories of expatriates through a progressive rate scale for example, confers any benefits on the host country. In evaluating a tax system, or indeed any national policy, it is the interests of the host country which must be considered. Apart from considerations of common justice and predictability of policy for existing expatriates, there is little justification for host countries assuming responsibility for equity and social welfare policies for expatriates. It should be stressed that this argument can be put while still acknowledging the very great contribution which expatriates can and do make in developing countries.

It is, in fact, doubtful if Papua New Guinea could have any real impact upon the longer term distribution of income amongst expatriates even if it so wished. In considering personal income tax policy towards expatriates, then, equity effects need not really be considered and attention can be devoted to the real issue of the revenue potential which depends to a considerable degree upon the effects of taxation on the supply of expatriate labour.

Insufficient information exists on expatriate labour supply elasticities. The general (not entirely disinterested!) opinion among expatriates working in Papua New Guinea seems to be that the relevant determinant of labour supply is income net of taxes and that supply is elastic (that is, relatively in response to changes in net income). If this were the case, an increase in the rate of taxation on expatriates would be accommodated either by a reduction in expatriate supply or by an increase in gross expatriate incomes (or by some combination of the two).

If expatriate labour supply were elastic, an increase in tax rates could lead to a simultaneous reduction in supply and in tax revenue, hardly a satisfactory outcome. If expatriate labour supply were inelastic (relatively, but not completely, unresponsive to changes in net income) a decision would need to be made about the desirable trade-off between expatriate labour supply and tax revenue.

If the increased rate of taxation on expatriates had to be accommodated by an increase in gross incomes payable by employers, a reduction in the demand for expatriates could occur, with consequences for revenues. There would be no net budgetary gain in relation to expatriates employed in the public sector because the increased revenue would be matched by increased expenditure requirements to finance the higher salaries.

In all, the scope for increased revenue from the expatriate work force in Papua New Guinea appears to be limited. The scope for increased revenue from indirect taxes on goods and services typically consumed by expatriates could be greater since the impact of indirect taxes tends to be less visible. Thus, their effects are less likely to be incorporated into expatriate labour supply contracts.

Evidence of the incidence of company income taxes is, in all countries, unsatisfactory. It is not possible to say what proportions of company tax are forward shifted (in terms of higher output prices), backward shifted (lower input prices) or unshifted (lower profits and, eventually, lower profit distributions). It would, however, be an unlikely set of competitive circumstances in which all of the company income tax liability was ultimately passed either forward to consumers or backward to input suppliers. Thus, it seems highly probable that at least some of Papua New Guinea's company tax is exported and the incidence of this component is, therefore, irrelevant to consideration of equity objectives in Papua New Guinea. The same argument applies to the Dividend Withholding Tax and to revenues directed to the Mineral Resources Stabilisation Fund, which are derived from mineral projects with a substantial degree of foreign ownership.

Thus the equity impact of at least 35 per cent, and quite probably much more, of total internal revenue can be ignored. The ability to adjust the distributional effect of the remaining taxes is severely constrained. The incidence of personal income tax upon nationals can be adjusted by changes in rate scale and/or allowances but only about 15 per cent of personal income tax revenue (about 4 per cent of total internal revenue) comes from this source. Indeed, even in advanced economies the usefulness of personal income tax policies in reducing

poverty is not great, although they are more effective tools in reducing perceived excesses in wealth. Expenditure policies are much more effective tools in the alleviation of poverty.

What scope exists for adjusting the distributional impact of other taxes in Papua New Guinea? The remaining major taxes used by the national government are import duties, excise duties, export tax and other indirect fees, fines and royalties. The major taxes used by provincial governments are the general retail tax, the alcohol retail tax and the land tax but, in total, 1984 provincial internal revenue raisings represent only 3.7 per cent of national revenue raisings (see Review of Inter-Governmental Fiscal Relations In Papua New Guinea, Volume 2, Table 28).

Where taxes are levied on intermediate goods or services (inputs) rather than on final consumption there is virtually no scope for adjusting their incidence. A tax on, say, steel, electricity or labour, will push up the input costs of so many different goods and services that its incidence (whatever it may be) must be taken as given. There is no practicable way in which its incidence can be adjusted. Papua New Guinea national taxes in the category include import duties on inputs and sales taxes on inputs. The overall tax incidence can be adjusted using taxes on inputs only by changing the relative importance of these taxes. In terms of practical policy, this implies (a) that the incidence of each of these taxes is known and (b) that differences exist in the incidence of the various taxes. Some research use is made of the household expenditure survey material due to be released soon, but the difference between the incidence of each of the major taxes may turn out to be not great.

There remain those portions of company taxes ultimately borne by nationals and of indirect taxes on final consumption ultimately borne by nationals. The ability to adjust these types of taxes is severely constrained by revenue raising requirements.

In conclusion there is little scope using existing taxes, and probably little potential scope, for adjusting the incidence of taxation on nationals. Attention should, therefore, be diverted away from equity to other tax criteria. Delaying tax reform in anticipation of more satisfactory tax incidence information is unjustified because of the low probability of such information becoming available in the immediate future. The equity objective should not be totally abandoned but there is no point in pursuing the unattainable.

3. Simplicity. It has already been argued that simplicity of administration of any tax is a crucial criterion in the Papua New Guinea context. Generally, simplicity is taken to relate to administration costs as a proportion of revenue, with a simple tax being one for which this proportion is comparatively low. In Papua New Guinea this criterion may be expanded to include the question of whether a particular tax can be administered sufficiently effectively for it to be capable of yielding significant revenue. It may well be desirable to use forms of taxation such as withholding taxes in which the bulk of administration is carried out by private institutions rather than by the revenue authorities. In other words, it may be necessary to increase compliance costs in order to reduce administrative costs and to raise useful amounts of revenue. Furthermore, a tax with relatively few collection points, for example an export tax, is likely to be preferable to a tax involving a higher degree of administrative complexity for the revenue authorities, for example a land tax.

4. Fiscal flexibility. As discussed above, revenue raising potential is arguably the most important criterion by which a tax should be judged in Papua New Guinea. Suitability for use as a fiscal tool of stabilisation policy is not a major concern since tax policies have not in Papua New Guinea been used to any extent as a fiscal tool for the purposes of fine tuning.

In summary, in evaluating possible tax instruments the most important criteria should be revenue raising potential and administrative feasibility. Neutrality issues are important particularly in relation to the use of partial, rather than general, tax measures and to the effects of taxes upon the supply of expatriate labour and entrepreneurial ability generally. Equity can be considered a less important criterion from the points of view of both the need to redistribute and the ability to redistribute the tax burden. Redistributive policies can almost certainly be more effectively achieved through the expenditure side of the budget. Extremes of poverty are less evident in Papua New Guinea than in most developing countries.

Bearing in mind the relationship between administrative complexity and revenue potential, in the Papua New Guinea context, it is possible to formulate some major requirements of a tax system whose main function is to raise revenue without undue distortion of resource allocation.

REQUIREMENTS OF A TAX SYSTEM

1. Taxes should be as simple as possible. They should be based on "easily identifiable and verifiable characteristics" (Bird 1983), and they should be readily comprehensible to tax administrator and taxpayer. The tax base should be clearly and simply defined. There should be as few exemptions and allowances as possible. There should be minimal discrimination between different taxpaying units (for example national and non-national companies). Rate structures should be as simple as possible. Flat rate taxes, in addition to being simple, have the further advantages that they obviate the need for indexation and facilitate consistency with withholding taxes. There should be as few tax collection points as possible and, where possible, the responsibility for revenue collection should be placed on private organisations.

2. The structure of taxes should be such as to minimise possibilities for tax avoidance and tax evasion. Tax evasion is the minimisation of tax liability by illegal means (for example, by failing to report income) while tax avoidance is tax minimisation by techniques which, while not against the letter of the law, are against its spirit. To reduce vulnerability to avoidance and evasion, taxes should have the following characteristics -

Taxes should, if possible, be deducted at source. Flat rates facilitate this process because they reduce the need for end of year adjustments by refunds or additional tax payments.

There should be a comprehensive definition of income to avoid the possibility of conversion of taxable income into non-taxable forms. Income-based taxes should include some direct or indirect reference in the tax base to capital gains.

Where valuation of some forms of income (for example, fringe benefits) is complex, simple rules of thumb for valuation should be adopted. This is already done with some fringe benefits, for example private use of employers' motor vehicles (assessed at K20 per week if fuel is also provided), accommodation provided by employers (between K2 and K17 per week depending on the standard of accommodation) and services of domestic staff (K12 per week in urban areas).

Taxes should be levied on an easily measurable base (e.g. a licence fee rather than a tax on turnover) in order to minimise opportunities for manipulation of valuation of the base and to minimise the need for administrative discretion.¹

Opportunities for exploitation of the tax unit (for example, by income splitting) should be minimised. Flat rate taxation is the simplest way of achieving this objective.

Where the cash economy makes income taxation difficult, consumption-based taxes will imply at least some level of taxation on otherwise untaxed units.

Consumption taxes should be as broad-based as possible to prevent substitution of untaxed goods or services for taxed ones.

3. Direct expenditures are preferable to tax expenditures. Individual and business taxpayers receive benefits from various kinds of taxation concessions and allowances which either reduce tax liabilities or have the effect of delaying those liabilities. These types of benefits could alternatively be provided by direct expenditures paid to the beneficiaries by way of subsidy and are often referred to as "taxation expenditures". Replacement of tax expenditures with direct expenditures has the following effects -

The tax becomes simpler to administer. It has been suggested that the staff of the Chief Collector of Taxes in Papua New Guinea are administratively more efficient than are Public Service staff likely to implement direct expenditures and that this justifies the extensive use of tax expenditures. Such a policy fails to take account of the opportunity cost of using tax staff to administer expenditure programmes. Given the severe constraints on tax staff in Papua New Guinea, one cost of administration of expenditure programmes through the tax system will inevitably be a reduction in the ability to collect revenue. Thus taxation expenditures, in addition to being

1. An anonymous referee has also pointed out that licences, as such, can be used to minimise tax evasion as in the newly introduced requirement that PMV licences can only be renewed on production of a current income tax return.

less efficient than direct expenditures, for reasons discussed below, are likely to be more expensive in terms of the overall effect on the budget balance. The recently introduced wage subsidy programme, administered through the tax system, is an example of the increased administrative burden imposed upon the tax authorities.

Direct expenditure costs are more easily identifiable, more predictable and more controllable than tax expenditure costs. Because the costs are more identifiable, and have to be specifically financed in the Budget, it is more likely that the direct expenditure programmes will be evaluated to determine their cost effectiveness in achieving their objectives.

Recognition of unintended and undesirable side effects of expenditures is facilitated.

Direct expenditures have a smaller adverse effect upon the efficiency of the allocation of productive resources. As an illustration of this point, take the example of the provision by employers of untaxed fringe benefits. Assume that company X provides, at a cost to the company of K25,000 p.a., housing to a top executive. If the corporate tax rate is 35 per cent the after-tax cost reduces to K18,750. Since income tied to a particular form of expenditure can be expected to have a lower real value to the recipient than untied income of equal monetary value, assume that the executive views the value of the housing as the equivalent of K20,000 in untied after-tax income. If he faces a 50 per cent marginal tax rate he would have to receive K40,000 in additional pre-tax income to compensate for the loss of this fringe benefit. In this example, the beneficiary of the arrangement is the employer (a reduction in after-tax costs of K1,250) but the economy incurs a deadweight loss, that is a reduction in the efficiency of resource use. Goods costing K25,000 p.a. are being provided to someone who values them at only K20,000.¹

4. Tax-induced distortions should be minimised except where they are deliberate. Taxes should be as broad based as possible. For example, consumption-based taxes should, if possible, tax services as well as goods.

1. I am indebted to Henry Goldstein for this example. Different tax rates would affect the size and direction of the distortion but the principle remains.

This has the added advantage that the broader the base the lower is the tax rate necessary to yield a given revenue and the less likely it is that the revenue base will be eroded by avoidance activities exploiting exemptions.

Taxes should be levied at uniform rates. This uniformity should apply both to the range of goods and services and to geographical areas, once again in order to prevent avoidance through exploitation of differences in tax rates.

The interaction of inflation and taxation should be minimised, possibly by automatic indexation or by the use of flat rates which imply automatic indexation.

Income-based taxes should include some reference (direct or indirect) to capital gains in the tax base. Although there is some circumstantial evidence that exploitation of untaxed capital gains is not, as yet, a major problem, the absence of reference to capital gains in the tax base will inevitably lead to increased avoidance levels in the future.

5. Year-to-year tax changes should, if possible, be confined to rates and rebates. Administrative procedures and definitions of tax bases should not normally be changed.

What types of taxes do these requirements imply?

A POSSIBLE TAX SYSTEM FOR PAPUA NEW GUINEA

1. Personal income taxation. Without reasonably up-to-date data and the ability to experiment with different rate scales and rebates yielded by computer programmes similar to TAXREV and INCTAX, written by the author to assist in analysis of Australian personal income tax, this discussion must be speculative. Nevertheless some broad indications of a reformed structure of personal income tax can be given. A reformed system could be formulated on the basis that total tax revenue should be approximately the same under the new system as it would have been under the old and that net incomes of non-avoiding or evading taxpayers would not fall significantly as a result of the change.

One possibility for a reformed personal income tax system would be a dual rate scale, a progressive one for nationals and another, higher and flat, rate for expatriates. Two major objections can be raised to this proposal -

There is a strong case for treating nationals and expatriates alike within one system rather than encouraging the belief that nationals should receive favoured tax treatment. A higher proportional, as well as absolute, tax contribution from nationals will be an inevitable component of future funding requirements. It seems quite perfectly possible that the point will soon be reached where increased tax rates on expatriates may lead to lower total revenue from them, although data on expatriate labour supply elasticities, upon which revenue estimates could be based, are not available.

Scope exists for transfer between expatriate and national status so that tax benefits aimed at nationals might in part leak to other groups not intended to benefit from these concessions. As explained above, accurate targeting of tax expenditure benefits based upon discriminatory allowances is very difficult.

There are, therefore, strong arguments for a single personal income tax system applying to all income receivers.

The personal income tax system which seems most likely to meet the bulk of the requirements discussed above is some variant of the "linear" tax. The linear tax is a single rate system but with a zero tax threshold. Purely as an illustration, such a linear tax schedule might be as in Table 2.

Table 2
Example of a linear tax

<u>Income</u> <u>kina</u>	<u>Marginal tax rate</u> <u>toea in kina</u>
0 - 1999	0
2000 and above	20

Such a tax is still progressive, since the existence of the zero rate step implies that, above the threshold, the average tax rate rises with income. The progressivity of the schedule can be adjusted by changing the threshold and/or the marginal tax rate. At the same time all taxpayers pay the same marginal tax rate with the following attendant advantages:-

- (a) A withholding tax, similar to the current pay-as-you-earn system for wages and salaries, could be applied to incomes from "moveable capital", in particular interest, dividends and royalties. If the withholding tax rate were the same as the "standard" tax rate, the marginal tax rate applied would be the appropriate rate for all taxpayers except those with taxable incomes below the tax threshold. It could be argued that the withholding tax rate on dividends should be lower than on other forms of income because of the alleged "double taxation of dividends". This argument is, in my view, generally overstated because it assumes that company taxation in the "classical" system is not in any degree forward or backward shifted. The available evidence concerning the incidence of company taxation is, as mentioned above, quite inconclusive. If it were decided to impose a lower withholding tax rate on dividends, that tax rate should be the final rate imposed on these dividends. These receipts and the withheld tax should not be included in any end-of-year refund calculations. However, in my view simplicity of administration should prevail over the equity considerations of any double taxation of dividends so that the same withholding rate should be applied to dividends as to other forms of income.

The implementation of the withholding tax on interest receipts would be relatively simple and the requirement imposed upon the withholding body to remit the tax to the taxation authorities at regular intervals (say every calendar month) would provide that body with a liquidity benefit as some compensation for administering the tax. The remittance interval could be adjusted to ensure that revenue was collected no later than it would be under the existing provisional tax system. The costs and resources involved, on the part both of the banks and the revenue authorities, in the current system of checking whether interest receipts have been declared would be saved and a significant amount of evasion, resulting from non-declaration of interest receipts, would be prevented.

- (b) The single rate would eliminate the benefits of income splitting and so could be expected to generate some extra revenue.
- (c) Under the current rate scale, inflation generates increases in real tax burdens proportionately much greater than the increases in real incomes. The linear rate scale would reduce (but not eliminate) this effect. Indexation of the tax threshold and dependants rebates would eliminate this effect completely but this is, of course, also true of full indexation of the current system.
- (d) If it were intended to introduce a more comprehensive capital gains tax than currently exists, although this would not at present seem necessary, the rate to be applied to capital gains could be the same as the "standard" tax rate (20 per cent in the example in Table 2) so that there would be no problems of "locking-in" or of inconsistency between the rates applied to capital gains and to other forms of income.

In addition to the linear tax rate, other recommended components of a reformed and simplified personal income tax would be -

The current dependants rebates should be maintained but automatically indexed for changes in the consumer price index in the previous year.

A broad range of fringe benefits should be valued on an arbitrary, and so comparatively simple, basis as was implemented recently in relation for example, to the employee's private use of a car owned by the employer.

The tax on these fringe benefits, calculated by applying the standard tax rate to the benefit valuation, should be withheld at source in the normal way.

The current tax treatment of end-of-contract payments should remain unchanged. Employees pay a tax rate of 2 per cent on gratuities of up to 25 per cent of their total taxed salaries and wages during their employment in Papua New Guinea. Continued operation of this

arrangement is supported on the basis that its abandonment would have a substantial impact upon the supply of expatriate labour.¹

There does not currently appear to be a great problem of untaxed capital gains in Papua New Guinea. Devices such as stamp duties and the 10 per cent surcharge on rental income provide some de facto taxation of capital gains. Thus, it is doubtful if an expanded capital gains tax would at this stage yield revenue sufficient to justify the diversion of scarce administrative resources from other uses. The linear tax rate would, however, make future capital gains tax implementation much simpler.

A high proportion of capital gains appears to come either from ownership of non-owner occupied accommodation or from appreciation of share values and a future capital gains tax should, perhaps, be confined to these sources. The current capital gains tax provision in relation to purchases undertaken with the intention of profit-making, a provision very similar to that contained in S.26(a) of the Australian Income Tax Assessment Act, should be dropped since it is unworkable.

In order to remove an excessive degree of unpredictability and to permit time for the necessary administrative reforms, the change in the system could be announced well in advance of its implementation. This might well have the effect that expatriate contracts were renegotiated to yield the same net incomes, by adjusting gross incomes. The net impact of these changes on company income tax revenue should not be great, and could go in either direction depending upon the actual rate scale adopted.

The advantages of such a reformed system would be substantial. It would be much simpler in administrative terms so that scarce skilled staff could be released for other revenue collection work. It would provide a relatively comprehensive income tax base. Periodic changes to the system, apart from those arising from the need to index for inflation, need only be made through the standard tax rate or the dependants rebates. Furthermore, it is probable that a reduction in avoidance and evasion would lead to increased revenue collection.

1. An anonymous referee has commented that to an extent, the end of contract gratuity of the contract employee is somewhat akin to the capital gain of the departing self-employed businessman. There is a strong case for consistent tax treatment of the two. Editor.

2. Indirect taxation. From the points of view both of neutrality and revenue raising two indirect tax requirements stand out -

the base should be as broad as possible, and

the tax rate to be applied to the base should be uniform.

The taxes which in developed economies best meet these requirements are the value-added tax (VAT) or the retail turnover tax but both are inappropriate in the Papua New Guinea situation. They would place excessive demands upon the tax administration and require, on the part of the taxpayer, a sophistication in record-keeping which is unlikely to be achieved. Furthermore, the degree of evasion at the retail level of these taxes, particularly the retail turnover tax, is likely to be great. There are, therefore, strong arguments for the imposition of a sales tax imposed at the wholesale level and at a uniform rate in all provinces on all goods sold in the formal sector. It is important for administrative purposes to minimise (and preferably avoid completely) concessional rates or exemptions and a uniform rate on a comprehensive base minimises the rate needed to achieve a given revenue. A uniform rate in all provinces is important in order to prevent avoidance by provincial border-hopping. A visiting Australian team has recently been engaged in drafting a model sales tax law to be implemented in all provinces. Although sales tax revenue will be earmarked for the provinces, it would be more efficient for collection to be undertaken by the Papua New Guinea Chief Collector of Taxes on behalf of the provincial authorities.

A major problem with the wholesale sales tax is that services (for example banking services, entertainment, tourism and transport) are not taxed because in almost all cases there is no concept of a wholesale value. There thus tends to be a discrimination against the production, distribution and consumption of goods. A wholesale sales tax might, for example, discriminate against the domestic production of timber for local use and in favour of the renting of video cassettes. It is, therefore, necessary to seek ways of taxing services in a way which might produce a very roughly neutral effect but which would not be subject to the administrative and evasion problems of a VAT or retail turnover tax.

One potential tax on services is a financial institutions duty (FID). One form this could take is a levy at a uniform rate on credits to all accounts with financial

institutions, including credit cards. Since the financial institutions are all to a greater or lesser extent computerised the collection costs would be minimised and, again, the length of the interval between tax remittances to the Chief Collector could be adjusted to provide some compensation to the financial institutions for their collection costs. An even simpler form of financial institutions duty could be a levy on some measure of the assets of financial institutions (for example, deposits) which the institutions could pass on to their customers through their general structure of charges. The FID proposal has great attraction in terms of administrative simplicity. One aspect of the introduction of the FID should be the replacement of stamp duties on cheques, bills of exchange and loans.

Taxes on other services should be based on easily identifiable characteristics, for example a flat tax licence fee, per PMV (public motor vehicle - a privately owned bus) or per hotel bed. It would not be possible to implement a broad-based services tax.

There is a strong case for special treatment of alcohol and tobacco, both of which are currently subject to some physical base (for example, per kilogram of tobacco or litre of beer) rather than upon a value base. The rate of an excise varies with the price of the excisable good but the amount of tax payable does not. The case for special treatment of tobacco and alcohol relates to -

- . medical and social problems relating to their consumption, which will simultaneously increase demands for public expenditure and reduce tax revenues;
- . ease of collection through a small number of collection points;
- . low price elasticity of demand which means that excises are a potentially valuable revenue source.

The rates of excise duty applying in the tax year 1985 are presented in Table 3.

Table 3
Excise rates, 1985

<u>Product</u>	<u>Rate</u>
Cigarettes	K22.56 per kg
Beer	67.2 toea per litre
Aerated water	15.0 toea per litre

The major objection to increasing excise rates on tobacco and alcohol is that the incidence is probably regressive. The comparatively poor probably spend a higher proportion of their total income on beer and tobacco than do the affluent and so the excise which they bear represents a higher proportion of their income. It is, therefore, a question of balancing the social and revenue effects of the increased excise against the distributional effects.

One way to avoid this trade-off in relation to the excise on beer while increasing revenue is to apply a differential excise rate according to the percentage alcohol content by volume. The current alcohol percentage on SP beer is 3.6 per cent and a dual rate could be implemented, the lower rate to be applied to beers with an alcohol content of no more than (say) 2 per cent. This lower rate could be the current rate of 67.2 toea per litre, with the second substantially higher rate to be applied to beer of above 2 per cent alcohol by volume. Thus beer drinkers choosing to drink the low alcohol beer would pay no more excise duties so that the increased tax becomes, in a sense, optional.

Such an arrangement would almost certainly yield increased revenue while addressing the social problem of high alcohol consumption.

The administrative costs of collection would be low since in Papua New Guinea there are only 4 breweries all of which are part of the one brewing group. All other alcoholic drinks are imported and consideration should be given to increasing the import duties on these.

The excise on soft drinks (aerated waters) was apparently introduced to produce more equal tax treatment of these drinks vis-a-vis beer. This implies that soft drinks are a close substitute for beer and that no other drinks are equally close substitutes. Neither of these assumptions is easy to support. The arguments put forward earlier for special treatment of beer and tobacco do not apply to aerated waters and there seems no reason for different tax

treatment of aerated waters compared with that accorded to fruit juices, fruit cordials, flavoured milk, tea or coffee. Sales of aerated water should be included in the sales tax base, rather than being subject to excise tax.

3. Taxation of the informal sector. It is clear that there is a substantial non-market component in Papua New Guinea gross domestic product. Activity in the non-market sector largely escapes both direct and indirect taxation. The national accounts estimate of non-market components relate to production by rural village households for final consumption in the rural villages and their production of direct assets for use in producing for their own consumption.

Conventional taxation techniques are totally unable to cope with this kind of activity. Furthermore, even when rural outputs such as coffee and copra do enter the market economy, substantial problems still exist in imposing direct taxation, both personal and company. It is difficult to disagree with Neild (1980) that "The general conclusion must be that possibilities of applying direct taxation in the countryside are uncertain and surely limited in the short run."

There are, however, two types of taxes which can be used as surrogates for income taxes on the rural sector - export taxes and product withholding taxes. If Papua New Guinea is a price-taker in the international markets to which it exports, taxes on exports cannot be forward shifted at all and so they represent a tax whose incidence is wholly on the domestic value added. Papua New Guinea's exports are largely concentrated in a few commodities - cocoa, coffee, tea, copra, palm oil, forest products, fish, gold and copper - and so the export tax represents a tax on the production and handling of these commodities.

Product withholding taxes can be implemented by withholding a given proportion (the tax rate) of prices paid by some marketing organisation to producers. The prescribed product withholding tax is currently levied at a rate of 10 per cent on alluvial gold sold to the banks. This particular tax has proved to be not without its problems. It is a tax which is relatively easy to evade and the inconsistency between the flat rate withholding tax and a progressive rate income tax has led to problems in the administration of tax refunds.

The two taxes can be seen as close substitutes with the major difference being that the export tax, since it is levied on FOB value, is also a tax on the internal transport and handling of the goods. It is important, if the purpose of the tax is to raise revenue, that a uniform rate should be imposed, unlike the current Papua New Guinea situation in which the rate of tax on timber, for example, is higher than the general levy rate. Discrimination of this type could be justified if it were based on evidence of different price elasticities of demand but it is extremely doubtful if this is the actual motivation for the discrimination.

A horizontal equity problem will almost certainly arise with taxes of this type which are seen as indirect substitutes for direct taxation. Some taxpayers will only be paying the export tax but others, in the formal sector, will be paying both export and income taxes. With a product withholding tax imposed at the same rate as the linear income tax this problem need not arise. For incorporated enterprises the withheld tax could be set against company tax liability.

It would be very much more difficult to take account of these equity considerations with an export tax because of the great difficulty of imputing export taxes back to the primary producers. On the other hand, considerations of administrative simplicity would favour the export levy and my view is that, in the Papua New Guinea context, administrative considerations (and so, revenue potential) should prevail.

4. Import taxes. Currently imports are taxed by customs duties, which vary according to the class of import, and by the general import levy of 4.0 per cent on the FOB value of a high proportion of imports.

Customs duties are used both as a protective device and as a form of revenue raising, evidenced by the fact that they are levied on some non-consumption goods of which there is no domestic production. It is difficult to defend this latter discriminatory use of the tariff and the revenue raised from this source could be more efficiently and simply raised from the general import levy.

The major exemption from the general import levy relates to imports for use in the public sector. This exemption is hard to justify. It is likely to lead to administrative

complexity and certainly leads to the public sector paying lower prices than does the private sector for the same goods. The effect of this price discrimination will be to encourage less efficient use of resources in the public sector than in the private sector since the efficiency of resource use is directly related to the price of these resources. The abolition of the import levy concessions for goods imported for use in the public sector would not directly affect the net public expenditure revenue situation (i.e. the budget surplus or deficit) but would reduce the administrative costs associated with the levy and, by increasing efficiency of resource use in the public sector, might well ultimately produce an improvement in the net budgetary position.

Customs duties on imports of consumption goods which are not competitive with local production can be seen as equivalent to a consumption-based tax. They are widely used to increase tax rates on imported goods, such as wine, video cassettes and television satellite antennae, which are seen to be consumed by affluent groups and the duties are thus seen to be progressive in impact. This analysis is probably correct. While it is not impossible to envisage a mechanism by which the incidence of taxes on these types of goods could be shifted to other, less affluent, people. The use of these discriminatory import duties should be limited to consumption goods, rather than goods which are used as inputs in some productive process. Further, these consumption goods should be very carefully selected to ensure that the tax incidence can be easily determined and is at least proportional, and preferably progressive, on Papua New Guinea nationals. For reasons discussed earlier, it is argued that the progressivity or otherwise of taxes borne by expatriates should not be a major policy consideration.

In summary, customs duties should only be used specifically to protect domestic enterprise or to tax specific consumption goods. On the other hand, the general import levy should be applied to all imports at a uniform rate.

5. Company taxation. Neild (1980) produced the most comprehensive review of company taxation in Papua New Guinea and it is not difficult to agree with the general thrust of his arguments. There are, however, two general comments that need to be made.

Firstly, Papua New Guinea would be wise to resist any pressure to move away from the "classical" system of company taxation, in which company profits are taxed at source and distributed profits, in the form of dividends, are subject to personal income taxation. Even if "double taxation of dividends" were seen to be a problem, the use of administratively sophisticated arrangements such as imputation or integration would be totally inappropriate, because of the administrative and compliance costs which they impose.

Secondly, the problems of administering expenditures through the tax system are clearly illustrated by the tax exemption of the first K50,000 of profit, granted to national companies, that is companies with 100 per cent national ownership. It was intended that only one exemption should be allowed to each company group. In practice, it is, apparently, a fairly simple matter to avoid this provision so that the costs of the concession are greater than expected and the benefits are not all being directed where intended. The surveillance procedures necessary to restrict the benefits to those originally intended would be difficult to implement.

The differential treatment of national and non-national companies seems to imply that non-national companies have a greater ability to pay tax than national companies at the same level of profitability and/or that the owners of non-national companies should pay tax at higher rates. It would be very difficult to argue the case for different ability to pay according to degree of foreign ownership. The argument that owners of non-national companies should be required to pay higher tax rates is difficult to sustain if those owners are resident in Papua New Guinea. No other type of income is subject to this type of differential treatment. If it is intended that owners resident overseas should bear higher tax rates, this could be more efficiently implemented by having a slightly higher rate of withholding tax on dividends remitted overseas. This policy would have the dual advantage that there would be an increase in revenue resulting from the abandonment of the K50,000 exemption and from the increased withholding tax rate (although in principle this increase in revenue should be directed towards a reduction in the overall rate of company taxation). There would also be a minor reduction in the administrative costs of company taxation.

The question of whether there should be discrimination against non-national companies is essentially a political one but it should be realised that such discrimination is likely to have an effect upon future foreign capital inflows into Papua New Guinea enterprises.

CONCLUSIONS

This paper has indicated some areas in which it would be possible to extend the tax base and rationalise the tax system without involving radical restructuring. The key to these proposals is the flat tax rate.

The flat rate personal income tax (with a threshold) permits the administratively simple implementation of withholding taxes which provide the prospect of increased revenue. Flat rate taxes on consumption, exports or imports provide, once again, a comparatively simple administrative task, minimise the degree of unintended tax-induced distortion of resource allocation and provide a potentially substantial revenue base.

The implementation of flat rate direct and indirect taxes would not necessarily imply large scale restructuring of the tax system in a way likely to induce uncertainty about the direction of future tax policy. On the contrary, once the simplified system had been implemented, changes in the foreseeable future should be restricted to tax rates and the tax base should be left undisturbed.

One of the major problems which complicates the process of tax reform in Papua New Guinea is the scarcity of information on the effects of tax reform - on the allocation of resources and distribution of income and on tax revenue. There is a temptation to delay tax reforms of a more fundamental nature until more evidence as to their probable effects become available. In the meantime the increased funding requirements tend to be accommodated by introducing pragmatic taxes whose longer term allocative and distributive effects have not been considered or by forgoing expenditures which would, on other considerations, be warranted. However, the approach to taxation policy formulation has major drawbacks.

Any future improvement in the availability of information is for the purpose of tax analysis likely to be limited. Thus, there seems little justification for delay of fundamental tax reform for this reason.

The process of expedient tax reform while waiting for improved information is likely to render more difficult the process of future tax reform. Taxes, once introduced, tend to be very difficult to drop and the usual result of expedient reform is that the performance of the tax system deteriorates. At present Papua New Guinea is in a favourable position for the implementation of tax reform. A comparatively small proportion of the total tax burden

falls on nationals so that political opposition to tax reform is not likely to be as great now as in a few years time. In addition, the tax system is still relatively simple so that the process of redesign of the tax system will be much less complex now than it is likely to be in the future.

There are, therefore, strong reasons for developing an integrated tax strategy rather than simply responding to short-run revenue requirements by introducing hastily-designed tax instruments. Papua New Guinea is favourably placed to implement an integrated programme of tax reform.

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