CPA CONFERENCE – KOKOPO 17th June 2016

TAX REVENUE AS AN ENABLER OF ECONOMIC GROWTH - WHAT ARE THE CHALLENGES?

The Role of Tax and Tax Legislation – Paul Barker

Economic activity and employment in PNG, and in all market economies, are largely driven by the private sector. In PNG's case this entails a relatively small number of large businesses, well under 50,000 SMEs, and the majority working in rural or urban micro enterprises or semi-subsistence agriculture. Formal sector employment is estimated to be fluctuating around or just below 500,000, so the vast majority of adults in the labour force of around 5-6 million (if there's a population of around 10 mill) are self employed, notably in agriculture, or in micro enterprises.

Most wages are relatively low, at around K12,000 in the formal sector (in 2014), and K22,700 in the public sector (largely teachers etc), although the private sector mean is higher, pulled up by the small number of higher salaries. The private unregulated sector wages average nearer K5,000 per annum and in an INA survey, urban informal incomes were found to be higher, at around K15,000.

Role of Govt under the concept of the 'Social Contract" is the provision of enabling environment for business and investment and provision of security and human resources/welfare support for households. In return, or to pay for this provision of needed infrastructure, law and order, education, health and other services and providing a suitable regulatory environment, businesses and households provide taxes (or sometimes inputs on kind, like the former community workdays in PNG).

How much public expenditure and the level of taxes depends partly on calculations of what provides the best combination for economic and social development, which in turn is determined partly by social and political perspectives on the level of utilities and services expected of the State, as against provision by households, or businesses themselves. (e.g level of public or private health/ education/ security/ transport etc provision).

Some countries, such as PNG are also able to obtain revenue from extractive industries, which can take many forms, ranging from conventional corporate and employee taxes, through to a range of resource rents for the State and sub-national other stakeholders. This revenue needs to reflect the nature of the resource (largely owned by the State) being extracted on a once off basis,(ie being progressively exhausted) and its capacity to contribute to the State for the provision of the above infrastructure and services.

Generally resource taxes and rents should be substantially used, especially in times of higher revenue flows, (as with Aid funding), particularly as an investment for the longer term development of a more diversified and sustainable economy, rather than drawn down to expand budget consumption or to plug an immediate budget gap, and potentially disrupting the economy in the process (ie contributing to the so-called resource curse and Dutch Disease). Hence the concept also of the Sovereign Wealth Fund, recently introduced into legislation, for investment and stabilisation. But it's but not yet operational, as the time to have applied it was before and during the period of high commodity prices (ideally back in about 2006/7), ahead, like now. Admittedly the concept of revenue stabilisation isn't new to PNG, but past experience was poor, having prematurely drawn down the former MRSF before the time when it was really needed, but PNG also applied various export taxes in agriculture on a moving scale (as with log export taxes, and the ag stabilisation funds) which rose when prices were higher and fell or were discontinued when prices were low.

PNG has a mishmash of taxes and tax rates inherited over time from successive Budgets, sector reviews and adhoc efforts to stimulate sectors, subsectors, industries or even individual companies. There have been efforts to review the wider tax system periodically, as in 2000, and again in 2014/15,aimed at better tailoring the overall tax regime, specific taxes and tax rates, as well as the administration, to better meet the development needs and priorities of the country; it also aims to ensure the taxes and tax rates are reasonably competitive with prevailing international fiscal conditions affecting industries in other countries, which are also seeking to attract or retain investors and capital.

Taxes should not be used to perform multiple tasks, although excise and certain taxes, such as carbon tax and recent food & drink taxes in various countries, are widely used to influence social behaviour, health and environmental objectives. Experience in PNG and around the world has generally found, however, that tax incentives are a poor instrument to encourage specific behaviour, like investment in a particular activity, while causing a substantial loss of revenue and distorting markets. Generally, specific targeted subsidies are a more transparent and effective tool to encourage investment, for example in research and innovation, establishing agricultural nurseries or availability of seedlings, freight subsidies to help ship or fly rural produce out of remote areas and make it worth producers' while, and or building and home ownership; these are more effective, than using taxes and adhoc tax incentives and loopholes, and imposing an undue additional burden on already stretched tax authorities.

There are general principles of taxation, which enable it to be effective in performing its functions. Those functions are primarily to collect revenue for the State to deliver public goods, as efficiently as possible, without being unduly punitive on income earning households or businesses or undermining their capacity to utilise their money as they please, including for investment purposes. Most societies do seek to use tax mechanisms, together with social protection mechanisms, also to provide some redistribution of income within society, including to safeguard the welfare of the socially and economically disadvantaged, not only to keep them out of dire poverty, but also to enable them to reach their personal and economic potential and contribute productively to the overall economy; ...when trying to diversify an economy and put it on a more sustainable path of development, the most valuable resource is human capital and tax measures and private and public investment in that resource is critical; but again the question arises, who can deliver the intended outcome most effectively? The State, the household or business, or what combination?...and that depends on many factors, including the level of governance and public accountability of the State institutions.

So, as well as collecting tax efficiently, for the State to provide required services, it must also be fair, and not punitive on businesses and households, and preventing them from investing or reinvesting and perhaps stimulating the economy or delivering services more effectively than the State.

The mechanisms for tax collection must also be simple, practical and affordable, both to enable more revenue to be collected than the cost of its collection, but also so that it doesn't scare off households but especially small to medium enterprises from lodging returns, and moving from the informal to the formal economy. In common with fairness, this is critical to ensure that there's a level playing field for business, with many unregulated enterprises currently competing in the same product range with only a few that follow the rules, pay group tax, GST and at least minimum wages. Of course this gives them an unfair advantage and causes major loss of revenue to the State; more so if the legitimate business is ultimately squeezed out of business by its financially unburdened competitors.

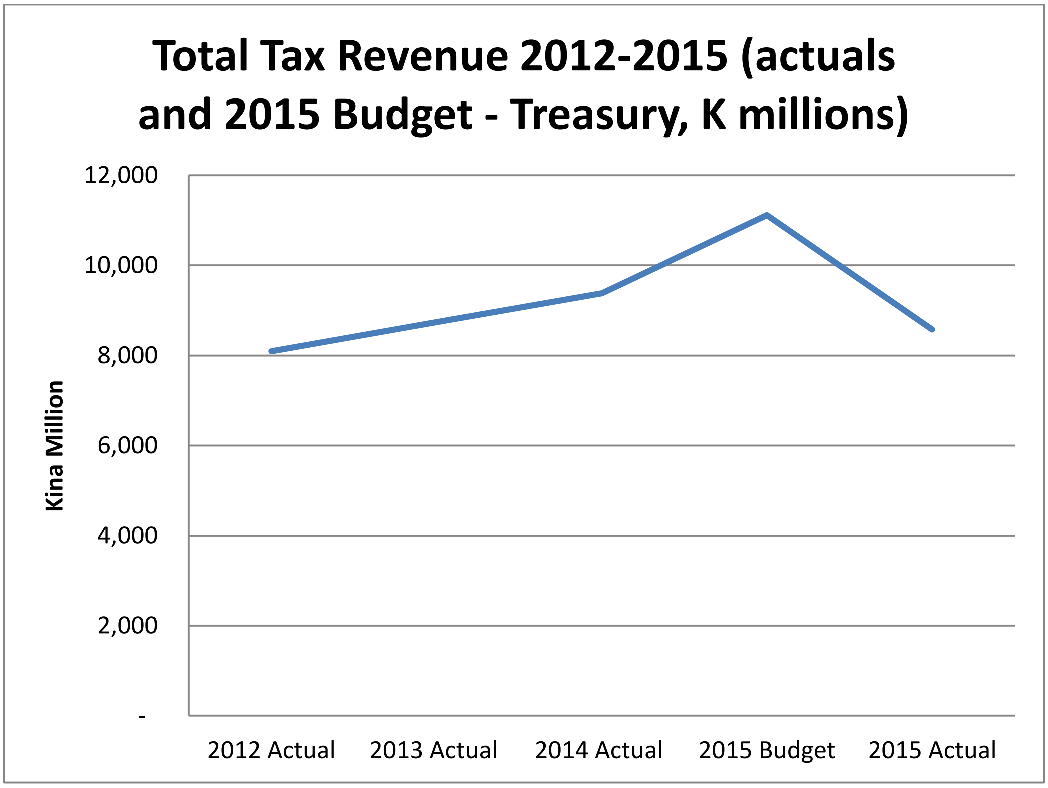
So this links with the further requirement of good taxation, namely trust that it will be honestly and evenly collected, but also that the State will honour its side of the bargain, and deliver the public goods for which taxes are collected, and provide the law and order, infrastructure and utilities required for business to thrive or survive. With respect to transparent revenue collection there's a clear preference, at least by honest businesses, for simple but automated processes, as with ASYCUDA in Customs, but also with resource permits and licensing, which provide the least opportunities for individual discretion of officials and fraud.

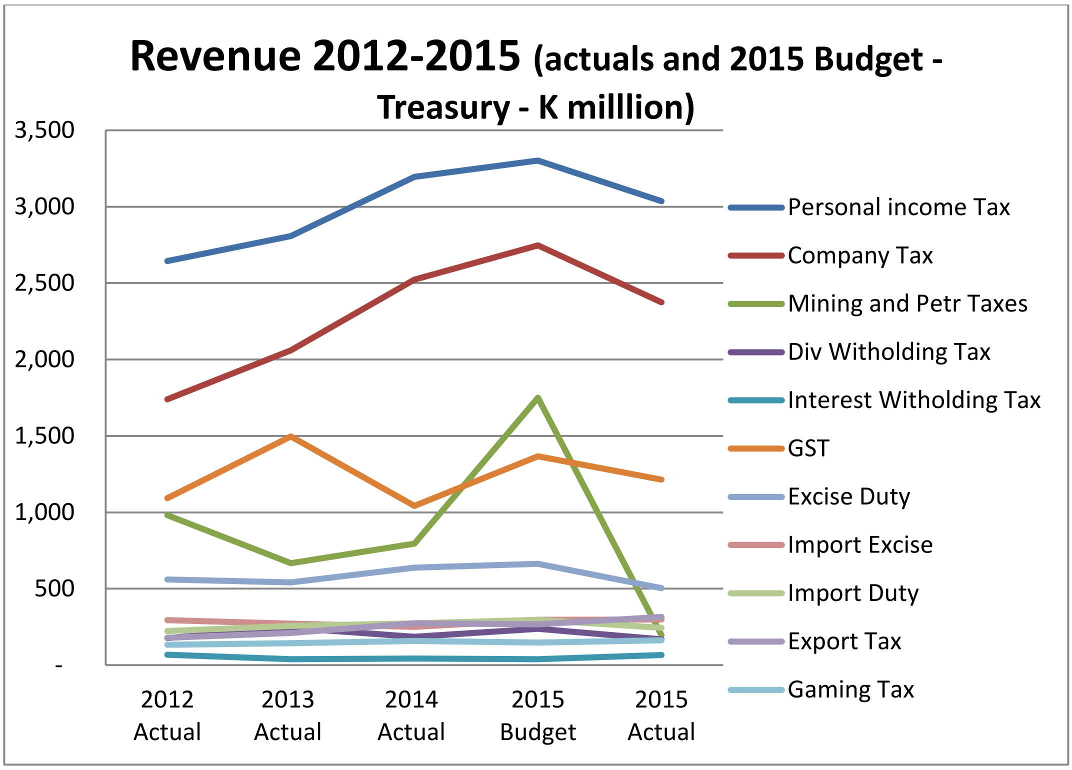
So, the nature of the PNG taxation environment is of a wide and complex of taxes, and other revenue mechanisms, levies, royalties, licensing etc, managed by a wide range of authorities, some going to Consolidated revenue and redistributed through the Budget process, but many going direct to other public authorities, or even through SOEs which operate in various forms partially separately from Government and even managing their own pseudo-public expenditure.

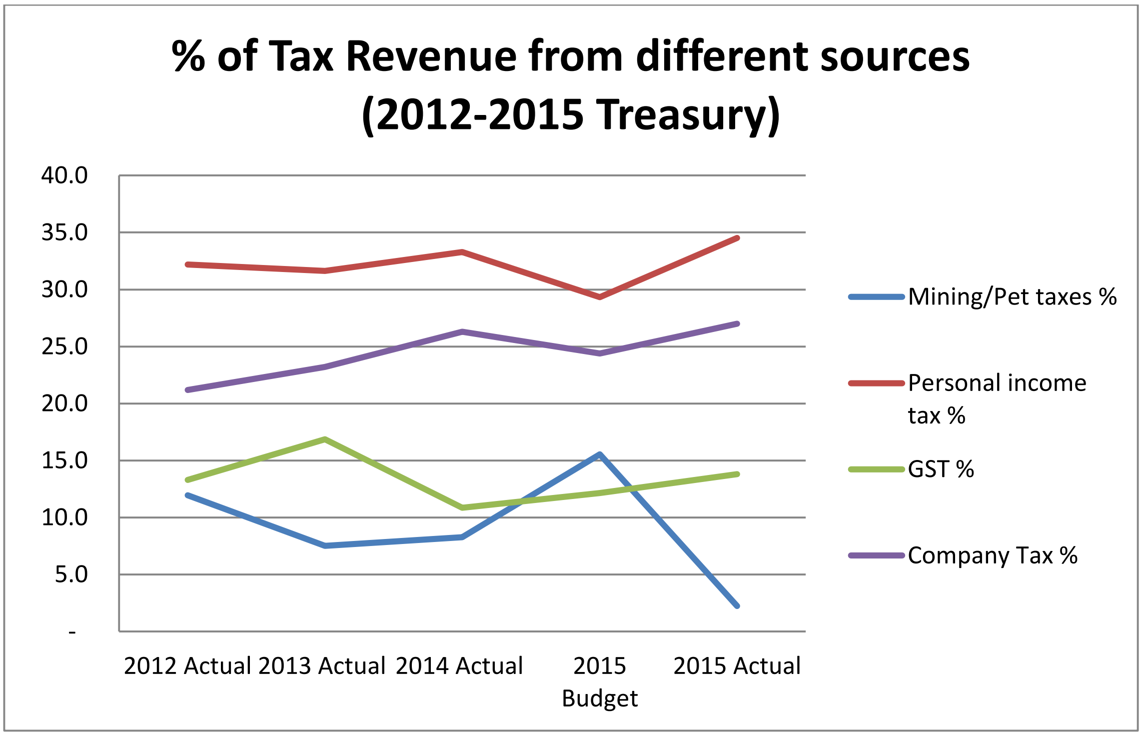
The revenue is narrowly collected from a small tax base of a relatively few companies, including resource companies, a very small portion of the workforce, and even a small portion of the formal sector workforce, as most earnings are low and living costs high, and GST.

The revenue from the extractive industries is surprisingly low and very volatile. Although mining overtook agriculture as the main export earner for PNG in 1984, and mining and petroleum, even before the onset of gas in 2014, provided some 80% of export earnings, and a good slice of recent GDP growth in some years, it only provided around 7.5% of government revenue and 7% of employment.

If you view these 3 graphs you'll see how substantially government tax revenue has fluctuated from 2012 to 2015, especially in 2014 and 2015, and particularly with mining and petroleum/gas revenue, where you'll also see the highly over-optimistic revenue forecasts for the sector in 2015, and in fact in 2014 also. In 2015 mining and oil/gas tax revenue was forecast at K1.75 billion, from different sources including LNG, but only actually achieved about a tenth of that at K195 million. (This also highlights the need for much more transparent budget preparation and review processes; for example, even in Nigeria they have open consultations with outside sector specialists in determining price forecast for the budget, rather than just preparing the figures quietly behind closed doors, as here) There were also, incidentally shortfalls in forecast revenue from mineral dividends in 2015, and a large gap in the Budget from the perhaps naive assumption of major income from landowners acquiring their stake in LNG.







Unfortunately there tends to be an assumption in PNG, especially amongst leaders, that high GDP growth rates, as in 1993 with Kutubu oil's commencement, and in 2014/15 with LNG, that this somehow translates into almost instant revenue, which they're eager to spend, often not too prudently, when there is invariably an extended lag, and in recent decades more so. I say imprudently, as although some level of

Budget deficit to provide fiscal stimulus can be sustained during downturns, it was unwise to do it also during the years of high commodity prices and it needs to be fiscally sustainable, with expenditure on priorities, such as maintaining core infrastructure, rather than costly new projects; yet I understand that only 1/5 of the amount required for maintaining the country's main highways is actually being received, as opposed to budgeted, for example, which invariably results in a deterioration of the capital asset base and much higher future costs.

With the succession of rather adhoc tax amendments, as with reducing the export tax rates on logs in the mid-2000s, and the 2003 adjustment to mining investment conditions, to attract more exploration and development, and more so with arrangements with specific mines, notably Ramu Nickel, but also PNGLNG, they've all tended to forfeit revenue to the State and notably deferred the early receipt of revenue. The rather extraordinary Ramu-Nickel deal, for example, apart from its questionable social, environmental, employment and distributional aspects, allowed the company several years of tax free production, even before the 10 year tax holiday commenced; leaving the company, nickel price regardless, not paying company tax, or effectively much else before 2025.

The need for greater transparency in the preparation and subsequent accessibility to resource contracts has been highlighted in the recent preparation of the first EITI report, along with much improved administration and reporting of revenue flows by the wide range of authorities from Petroleum and Energy, to MRDC, to the SOEs, as well as IRC/Customs/MRA etc and some of the less cooperative companies. This might require legislative amendments to authorise greater tax data sharing, as well as over at least aspects of contracts and contracting and over beneficial ownership.

As highlighted by the recent Tax review, the current arrangement of relatively low company tax and royalty rates, particularly in more recent projects, should be superseded with more standardised tax conditions, but including much less emphasis on buying and having to pay for equity upfront (often using debt), and diverting funding from other government functions or even investment diversification. The review recommends alterative mechanisms of resource rent, which take advantage of the State's ownership of the resource, reduce risk, enable earlier revenue flows, but avoiding undermining reasonable, as opposed to some exclusive, investment conditions for resource investors.

The review also recommends reinstating and extending some higher rates of Additional Profits Tax, as existed hitherto, before being whittled down, to ensure the State gains a greater share during the good times; not very popular with the resource companies, as highlighted in recent years in Australia, but can bring PNG into better international alignment... the major disincentives to resource companies in PNG are not the tax rate, in any case, they relate to various other factors, not least the State's capacity to perform its own administrative responsibilities with respect to projects, which sometimes push up costs and uncertainty for the companies.

This shift from equity to focusing on fiscal measures with resource projects is a direction many analysts have preferred over the years, as being less risky, less problematic with borrowing and revenue going through often less accountable quasi revenue streams, managed by SOEs, as well as undermining the State's relatively impartial role required as the regulator, once it becomes an equity holder, even sole owner as with OTML and latterly Tolokuma. Taking costly revenue in shortlived and experimental ventures such as Solwara 1 seems completely outside the responsible purview of the State, for example.

In the household area, the objective needs to broaden the tax base, and thereby also encourage citizens to hold their government more accountable, as clearly its funders, but also lightening the tax burden on lower formal sector income earners. The Tax review has proposed shifting the lowest tax threshold from K10-15,000. And reducing the tax rate from 30-20% in the lowest bracket, up to K33,000, and reducing the number of bands for income and company tax, as well as reduced reduced corporate tax rates to 25% over time.

To make up the shortfall from the reduced lower personal tax brackets, the tax review proposed, what has been topical around the region, namely raising the GST from 10-15%, and the introduction of Capital Gains Tax (except on customary land and personal homes). Capital Gains Tax is unpopular amongst wealthier members of the community, but frankly is a pretty universally applied tax worldwide, is largely progressive, and only allows the State a share of a gain received.

Of course raising GST would add complexity to transactions, and GST can be deemed a regressive tax, as it tends to fall disproportionately on lower income earners, unless on starts making it more complex and undermine the basic simplicity of the system, as in Europe, where a wide range of foods and more essential items are exempted or put on lower GST rates. It's certainly true that many households in the informal economy earn more than lower income earners in the formal sector, however, higher GST rates affects the even lower income earners, already below the lowest income tax bracket, as well as lower income earners, barely in the cash economy in rural areas.

With the reduced income and expenditure on infrastructure, health and education, households have reverted to provided school support again. Not calling it project support, which is currently forbidden, but calling it by another name, This commitment, in cash or kind, is a form of taxation and contribution to the State, but more directly to their own children's education, which people are generally prepared to make. It may not be entirely equitable, but if it can entail in-kind services it does reach out to communities and at the same time encourage investment by households in economic activities, notably agricultural cash crops.

The government is giving great emphasis on developing SMEs, and the latest policy, rather unrealistically perhaps calls for PNG-owned SME numbers to rise from some

50-500,000, a tenfold increase. Last year's CPA conference here, I recall, provided lively ideas for accountants assisting SMEs to develop, whilst recognising that it is a challenge for anyone making a business develop and sustaining it beyond the first 1 or 2 years.

Apart from concerns, that I and others have expressed over the very restricted reserved list, included in that SME policy, which I suggest would severely undermine needed existing as well as prospective FDI, and economic diversification and services, even if the policy was just on paper and not applied, the tax review and CIMC forums over the years, have emphasised the need for simplified and low tax arrangements for entry SMEs, stepping out of informality into the formal sector.

This seems critical, or there'll be seen to be few advantages, but just extra cost and effort to leaving informality. However, as well as designing and applying simple and streamlined tax arrangements, it does depend also upon many associated actions and benefits, from trust and provision to reliable public goods, especially more reliable rural transport access, to improved financial and business literacy training, to improved access to credit and other financial services, really only available now in the main urban centres, even with the rollout of improved mobile telephony.

Improved and more consistent revenue collection also very much depends upon that investment and support for the revenue agencies, IRTC, Customs and others and where possible streamlining their services, within and between agencies, including the capacity to reach out more effectively to the provincial centres and substantial untaxed unregulated businesses, which are increasingly rolling out around the country, including using official or unofficial tax free ports, such as Basamuk and logging ponds to import produce duty free. As we know well in PNG, tax and other laws are one thing, but their application quite another.