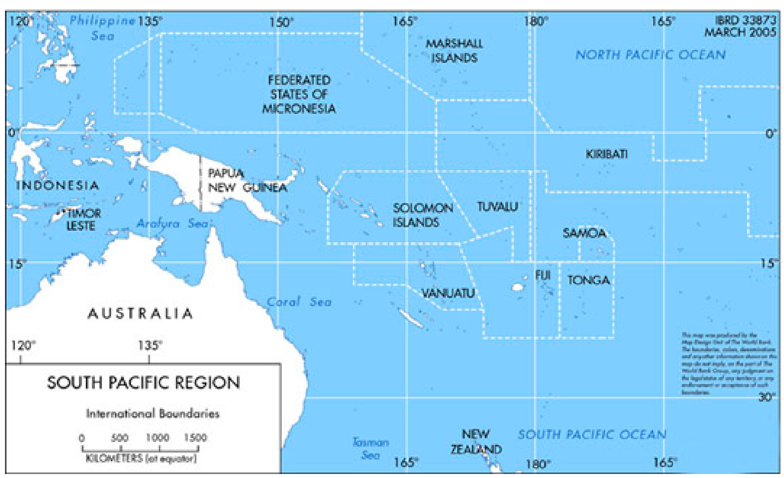
PFTAC Regional Papers

PFTAC

Improving Revenue Collection and Capacity in Forum Island Countries



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This paper was prepared by Margaret Cotton, Matt Davies, Jonathan Dunn and Carson McNeill. The views expressed are those of the authors and do not necessarily represent those of the IMF or IMF policy.

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For further comments and enquiries please contact:

Pacific Financial Technical Assistance Centre
GPO Box 14877
Suva
Fiji

Ph: +679 330 4866
Fax: +679 330 4045
Email: apdpftac1@imf.org

Website: www.pftac.org

EXECUTIVE SUMMARY

The global economic crisis highlighted the significant fiscal challenges that face Forum Island Countries (FICs) in the coming years. The crisis placed pressure on government budgets in most FICs. With fiscal deficits rising, effective revenue collection became increasingly important to moderate macroeconomic pressures and maintain crucial public expenditure programs.

Even with a global economic recovery, fiscal challenges are likely to intensify in FICS, particularly as they look to increase expenditure levels in areas key to growth and poverty reduction. This will have to be achieved in most countries at the same time as adjusting to one or more additional challenges which include: reducing trade tariffs in the context of trade liberalization, reducing high public debt, adjusting to declining overseas assistance and containing drawdowns from trust funds to sustainable levels.

Addressing the challenges will require reforms to both revenue and expenditure policy. Whether pressures come from decreasing revenue or through increased expenditure needs the objective remains the same. Countries need to be able to achieve and sustain an overall budget balance consistent with macroeconomic stability. Given the size of the pressures, responses are likely to have to come from both revenue raising and expenditure restraint. The balance between the two will depend on each country's political and economic circumstances. A broad, stable revenue base will moderate the impact of shocks and enable well-designed expenditure programs to be implemented.

Revenue reforms should create a system that is fair, transparent and easy to administer and consistent with the resource needs of the government. Taxation of domestic consumption and income generation should be the fundamental element of the revenue system, as it is sustainable and buoyant. Countries should aim to (a) levy taxes on the broadest possible base and minimize exemptions and relief to enable the lowest possible rates and (b) effectively administer taxes through adequate systems, processes and capabilities to achieve high levels of voluntary compliance and minimal opportunities for corruption.

Experience in the Pacific and elsewhere suggests a clear strategy. Consumption taxes, ideally through a VAT, supported by excise taxes, provide a broad, stable base for taxation. A VAT is a good fit with modernized corporate and personal income taxes which, when coupled with administration reforms, allows efficient and effective compliance and enforcement. This is essential in small economies where the resources available for administration are often highly constrained. Additional taxes, such as tourism taxes, if well designed can provide valuable additional revenue at relatively low cost. However, decisions to introduce small, sector specific taxes have to be carefully balanced against the pressures they add on the tax administration and the distortions they can create.

A VAT is the best method of taxing domestic consumption. Although VATs are conceptually complex, simple versions can be implemented successfully in even the smallest economies. Key characteristics for a VAT that is appropriate to small island economies with small revenue administrations are:

- one flat rate in a range of 10 – 15 percent;
- the turnover threshold requiring taxpayers to register should be set at a level to capture the largest 20 percent of taxpayers, who will often pay in excess of 90 percent of net revenues, and;
- exemptions and zero rating should be minimized to protect the revenue base, maintain neutrality, simplify administration and minimize potential for avoidance.

Implementing a VAT requires sustained political and institutional commitment. It is generally most successful when implemented as part of a broader economic reform package. Taxpayer consultation and education are vital for success as is prompt and reliable payment of tax refunds which is critical for the credibility of the VAT.

Excise taxes can be a useful supplement and are a major potential source of revenue for FICs. Both excise rates and the extent of excise taxes applied are relatively low in the Pacific. Extending their reach could be a useful method of replacing lost trade taxes. Excises should, however, be used judiciously; there should be a sound economic or social policy reason for applying an excise over and above a consumption tax.

Income tax has the potential to become a more effective revenue earner for FICs. Income taxes will continue to play an important role in revenue collection in FICs but need to be harmonized with the introduction of a VAT. They should be levied on net profit and not gross revenue to ensure efficiency and fairness. Progressive rates of income tax should be rationalized and simplified and in some cases reduced to take into account the burden of VAT on consumers.

Increased revenue should come from improvements in base, tax design and compliance. Income tax rates across the Pacific are likely to continue their gentle downward trajectory as FICs look to promote private sector growth and investment. Reversing the erosion of the income tax base from tax holidays, exemptions and concessions is therefore required to yield additional revenue while reducing distortions and inequities. This can be achieved while maintaining some incentives by shifting to investment allowance schemes that would apply to all new investors and to allow tax holidays and current exemptions to expire. Coordination of investment incentive schemes and of tax rates across the Pacific island countries could help ensure that FICs do not undermine each other's growth and revenue prospects through tax competition.

Natural resources can provide a valuable addition to domestic taxation. For those FICs with large fishing grounds, efforts should be made to negotiate collective agreements with fishing nations to ensure that fishing is a sustainable activity and to provide greater income to the resource-owning FICs. Other FICs, in particular Papua New Guinea and perhaps Palau, have significant mineral resources that are being developed. Taxation of these mineral resources will support the revenue base. At the same time, these countries should strengthen or establish stabilization funds to ensure that these revenues—which will be volatile—are managed effectively and that income flowing from mineral resources is integrated in a transparent and well-managed way with the budget.

Parallel strengthening of the revenue administration is vital for successful policy reform. Given the resource constraints faced by FIC administrations, voluntary compliance is the key to success as it yields higher collections for each dollar spent on administration. Assistance to taxpayers promotes compliance through education and support and is absolutely vital for a move to self assessment. Enforcement is still required though and resources should be focused on areas where the largest rewards (in terms of tax payment) are available. This means concentrating on the highest risk and largest taxpayers. Organizing the revenue administration by function or type of taxpayer rather than by tax type also helps achieve higher levels of voluntary compliance.

Designing and implementing major revenue reforms is a difficult political and technical process and takes a long time. Most countries underestimate the planning, resources and time required to implement major revenue reforms. Major revenue reforms have generally, but not always, been slowly implemented in FICs.

FICs should start considering possible revenue reforms soon, even if the need for adjustment is some time in the future. Early consideration of revenue reforms that could improve efficiency and effectiveness and provide a framework for coping with fiscal adjustment will be important to achieve success. Providing time and space for effective political and community consideration of the most appropriate tax system will increase the chance of success when decisions are finally taken. Reform timescales need to take into account the capacity of the revenue administration. The experience of FICs indicates that at least 36 months are needed for major changes in the law to become operational under the tax regime. Widespread consultation and taxpayer education are needed for implementation and sustained technical assistance through the reform period increases the chances of success.

I. Fiscal Adjustment in FICs

A. Sources of Pressure

The fiscal structure of FICs is characterized by relatively high revenue-to-GDP ratios, high—especially current—expenditure, and moderate budget deficits (including grants). FICs' tax performance as a share of GDP exceeds levels in low-income Asia and in some cases approaches OECD levels. High current expenditure has been driven primarily by large public wage bills and, in some FICs, by high interest payments on public debt and/or subsidies to public enterprises. FICs that rely heavily on foreign grant assistance typically have high levels of capital spending while other FICs do not. Deficits excluding grants for those FICs that rely heavily on grants and other grant aid are typically very high. For example, Palau's deficit excluding grants is around 23 percent of GDP, Kiribati's (a heavily aid dependent economy) deficit excluding external grants is around 70 percent of GDP and the Solomon Islands' deficit excluding grants is around 24 percent of GDP.

The global economic crisis placed pressure on fiscal positions in most FICs, highlighting shortcomings in revenue collection. Slowdowns in growth reduced tax revenues, particularly from trade as import volumes decreased and values declined in line with international commodity prices. Although these price decreases eased pressure on public expenditure, new pressures arose from the need to sustain growth and extend support to the most vulnerable sections of society. With fiscal deficits rising, effective revenue collection became increasingly important to moderate macroeconomic pressures and maintain crucial public expenditure programs.

The crisis also served to highlight the significant fiscal adjustment and reform challenges that face FICs in the coming years. The need for these adjustments and reforms arises from many sources, including trade liberalization and declining overseas assistance. The magnitude and nature of the required fiscal adjustment and reforms varies considerably across FICs, and Papua New Guinea faces the opposite challenge of how best to manage an expected sharp increase in earnings and revenue from mineral resources.

- **Trade liberalization is likely to decrease revenue from trade taxes in some countries**. There are a number of trade liberalization agreements currently in place or under negotiation, Appendix 1 summaries the key features of the main ones. All share a basic outcome—declining duties that, even in the event of increased trade flows, are likely to decrease the levels of revenue flowing from trade taxes. Box 1 summarises the potential magnitude of the various agreements on FICs' revenue bases.

Box 1: Potential Revenue Impacts of Trade Agreements

A number of studies have estimated the impact of trade agreements on FICs' revenue.* Although the estimates differ, due in part to methodological and data issues, their findings are broadly similar, with later studies reporting a lesser impact on revenues than the earlier studies. Error margins are relatively large, indicative of the difficulty of projecting trade patterns and questions over the accuracy of data available in these countries.

Soni, Harris and Zinner-Toa (2007), estimates are below, show that the impact on countries from all of the trade agreements varies considerably, with Vanuatu, Marshall Islands and Tonga most at risk and Fiji and the Solomon Islands less so. Tax revenue lost from PICTA will be smaller than from PACER, which is to be expected given that Australia and New Zealand are the main exporting nations to most FICs.

Table 1: Revenue Losses Associated with Regional Trade Agreements

Country	PICTA	EPA	PACER	MFN US 1/	Total (Error)
			(percent of total revenue)		
Cook Island	2	0	6	0	8 (3)
Fiji	0	0	3	0	3 (1)
Kiribati	4	0	15	0	19 (5)
Marshall Islands	0	0	5	20	25 (1)
FS Micronesia	0	0	1	6	8 (1)
Nauru	0	0	6	0	6 (1)
Niue	0	0	7	0	7 (2)
Palau	0	0	0	4	4 (1)
Samoa	1	0	12	3	16 (5)
Solomon Islands	1	0	4	0	6 (2)
Tonga	6	0	19	2	27 (10)
Tuvalu	8	0	5	0	14 (4)
Vanuatu	2	1	18	0	22 (3)

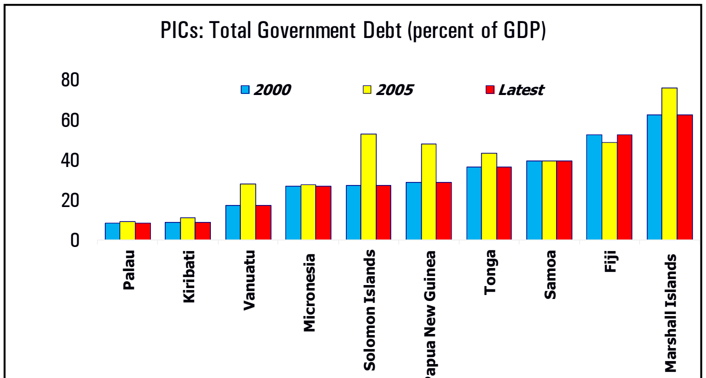
Source: Soni, Harries, and Zinner-Toa (2007).
1/ This relates to the agreement with the United States.

Estimates of tax revenue lost do not take into account increases in trade arising from the trade agreements which could create more revenue and help offset the reduction in the tariffs arising from the agreements. Similarly, they do not take into account impacts of revenue from changes in trading partners.

International experience suggests that the impact of trade liberalization on revenues is uncertain and differs across countries. In the early stages of trade liberalization increased trade flows are likely to increase trade revenues whereas in the later stages tariff reductions are more likely to be associated with revenue losses (IMF, 1999). Worldwide, trade liberalization has been associated with declines in levels of trade taxes over 1975-2000, particularly in low income countries, who managed to recover only around 30 percent of declines in trade revenues from other tax sources. Middle income countries also saw declines in tariff revenues but were able to recover them from other tax sources far more successfully (around 60 percent). (Baunsgaard and Keen, 2005).

* Scolley and Gilbert (1998), Filner and Lawson (1999). Institute for International Trade and Pacific Trade Consult (2007); Soni, Harris and Zinner-Toa (2007)

- **High public debt poses a fiscal risk in a number of countries.** High debt service costs constrain productive expenditure and increase fiscal risk by exposing the budget to interest and exchange rate movements. The nature of the risk differs by the composition of debt (domestic or external, level of concessionality) which varies widely in the Pacific.[1] High debt constrained the ability of some countries (Fiji, Tonga, and the Marshall Islands) to implement measures to support domestic demand during the recent global economic crisis. High debt levels will also limit these countries' ability to improve social safety nets and invest in much needed infrastructure. Reducing debt levels requires reducing deficits or running budget surpluses to reduce levels to sustainable levels. For instance, recent IMF recommendations for the fiscal balances required to normalize debt levels have been primary surpluses rising from 1½ to 3 percent of GDP in Fiji over the next 5 years and a move in Tonga to a primary surplus of 1 percent of GDP from the current primary deficit of 2½ percent of GDP.



Source: IMF, APDLISC database.
Note: The latest data is 2009, except for Samoa and Marshall Islands (2008).

- **Declining external assistance may also place pressure on the resource envelope in a number of countries.** This is likely to be most marked in the three northern Pacific countries—the Federated States of Micronesia (FSM), the Republic of the Marshall Islands (RMI), and Palau—which have relied heavily on COMPACT grants provided by the United States since gaining their independence between 1986 and 1994. To put their reliance on US grants in perspective, FSM, RMI and Palau received US grants for their budgets of 38 percent of GDP, 45 percent of GDP and 21 percent of GDP, respectively, in 2008. These grant figures correspond to overall fiscal deficits, excluding these grants, of 42 percent of GDP, 45 percent of GDP and 23 percent of GDP, respectively. These deficit figures adjusted for grants are a stark reminder of the extent of fiscal adjustment required by these countries as the COMPACT grants are phased out in 2023/2024. Other countries in the Pacific may also face similar pressures, although to a much less extreme extent, as extraordinary aid levels normalize (Solomon Islands with

[1] Fiji, which has the highest public debt in the region, has low external debt (15% of GDP) and high domestic debt (37% of GDP). Tonga, in contrast, has external debt exceeding 30% of GDP and very little domestic debt. Samoa's external public debt is rising sharply due to external financing for reconstruction after the 2009 tsunami, but is expected to be contained to sustainable levels in view of good debt management practices and concessional borrowing.

RAMSI and Kiribati are good examples) or countries graduate from concessional sources of finance (Samoa). Increased levels of budget support may help offset these declines or increase fiscal space in other FICs.

- **Trust funds ease immediate pressures in a number of countries, but drawdowns may have to be reduced to ensure the funds are sustained.** There have been a number of trust funds established in the Pacific (Appendix 2). Their mixed history emphasizes the need to withdraw funds at a prudent pace to ensure they can continue to finance budgets for future generations. In the Northern Pacific, although trust fund balances stood between 50 and 67 percent of GDP in 2008, current fiscal deficits including draw downs of 2-4 percent will need to be transformed into surpluses in order to be in a sustainable fiscal position when COMPACT grants expire.[2] A similar adjustment will be required in Kiribati, controlling deficits to around 7 percent of GDP compared to 15 percent of GDP during 2004-2008.

- **There are urgent needs to increase expenditure in areas key to growth and poverty reduction.** In particular**,** investment in health, education and infrastructure and developing stronger social safety nets. There are also likely to be significant expenditure needs to counter the challenges posed by climate change.

II. POSSIBLE RESPONSES

Adjustment will have to come from both the revenue and expenditure side. Whether pressures come from decreasing revenue or through increased expenditure needs the objective remains the same. Countries need to be able to achieve and sustain an overall budget balance—revenue plus grants less expenditure—consistent with macroeconomic stability. Given the size of the pressures outlined above, responses are likely to have to come from both revenue raising and expenditure restraint. The balance between the two will depend on each country's political and economic circumstances.

Expenditure policies need to focus on reducing low-priority expenditures to preserve fiscal space for investment and poverty-reducing expenditure. Public expenditure in many FICs is dominated by current spending; weak public expenditure management and accountability mechanisms; and large public enterprise sectors that drain fiscal resources and displace opportunities for private sector development and job creation. Addressing all of these can contribute to minimizing the need to increase revenues to reorient expenditure to high priority expenditure areas. The reorientation of expenditure,

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[2] Assuming strong revenue reform efforts, existing grant commitments over the next decade, and a rate of return of about 6 percent on its trust fund assets, the Marshall Islands will have to move to sustained fiscal surpluses of 5 percent of GDP by 2014 to ensure it is in a sustainable fiscal position in 2024. This compares to a balanced budget at present. The analogous figures for Micronesia under similar assumptions are sustained fiscal surpluses of 3.75 percent of GDP from 2011-2023 compared to a deficit of 2.8 percent of GDP at present. Similarly, Palau will need to run fiscal surpluses of 1.5 percent of GDP per year until 2020, in contrast to its present deficit of 2.5 percent of GDP.

complemented by measures to foster private business, could help lead to larger private contributions to GDP and stronger revenue bases in FIC economies.

- Expenditure on civil service wages and salaries in many FICs is high relative to GDP and as a share of total expenditure when compared to other countries. Average civil service wages in FICs are also high relative to GDP per capita compared to other countries. While relatively large civil services are a legacy of the lack of private employment opportunities in most FICs, efforts should be made to determine the right size and composition of the civil service in these countries. This is particularly important since government spending on health, education and infrastructure is constrained by large wage bills.

- This could be complemented by reducing financial support and subsidies to public enterprises as those enterprises are reformed to become more efficient and cover their own costs. For example the fiscal space occupied by public enterprises has been around 4-5 percent of GDP in Kiribati and the Marshall Islands in recent years. In other countries indirect subsidies provided through government guarantees on public enterprise borrowing threaten to become actual liabilities that will worsen the fiscal position and crowd out important development and poverty-reducing expenditures.

- Improved public financial management practices, as described in the regional PFM roadmap also being considered by the 2010 FEMM, will help FICs move toward fiscal consolidation. In particular, Medium Term Fiscal Frameworks (MTFS) will help guide overall fiscal adjustment. Better budget processes are also needed to prevent the adoption of unrealistic budgets that generate cash shortages during the fiscal year. These efforts should be complemented by reforms that ensure improved cash management, accounting and audit functions, and help achieve the best use of available resources.

On the revenue side, adjustment can be achieved through the mix of taxes collected, tax rates, base broadening, and administration reforms to improve the efficiency of tax collection. The remainder of this paper reviews the advantages and disadvantages of the options available to FICs, building on lessons learned from the countries that have already begun to make adjustments. Tax revenue from exploitation of natural resources, such as fisheries and mineral resources can also provide valuable support to domestic taxation but requires separate policy frameworks and, in the case of minerals, careful consideration of ensuring flows to the budget are well-managed, transparent and consistent with sustainable fiscal policy.

III. OPTIONS FOR REVENUE POLICY REFORM

Revenue reforms should create a system that is fair, transparent and easy to administer and consistent with the resource needs of the government (Box 2). Countries should aim to (a) levy taxes on the broadest possible base, minimizing exemptions and relief to enable the lowest possible rates and (b) effectively administer taxes through adequate systems, processes and capabilities to achieve high levels of voluntary compliance.

Revenue policy and administration in the Pacific has to take account of the particular characteristics of small open economies. Small markets and relatively open economies mean that the revenue base is narrow and focused on imported goods, often financed through remittances. Vulnerability to shocks, both natural and economic, can lead to volatility in tax revenues. This translates to a complicated operational reality for tax administrations as they have small numbers of staff with limited technical capacity and can often be affected by political pressure (Kidd 2010).

Experience in the Pacific and elsewhere suggests a clear strategy for revenue reform. Broad-based consumption taxes and well-enforced income taxes, with moderate rates and few exemptions, can provide a stable base for revenue and can assist in offsetting declines in trade taxes. Improved administration and enforcement of the taxes is usually also necessary. In contrast to the record in low income countries (Box 1), some countries in the Pacific have had considerable success with this strategy (Box 3). This section of the paper reviews the policy options available to countries in the major tax areas, outlines where they are most applicable, and identifies the lessons learned from FIC countries who have already attempted reforms in these areas, drawing mainly on the findings of IMF and PFTAC technical assistance in the region.[3] It takes particular account of the FICs' institutional capacity to manage change, especially the strength of the revenue administrations and the need to tailor advice based on international best practice to the challenges faced by the very small open economies of the Pacific.

A. Trade Taxes

Revenues from trade taxes will continue to decline for international and domestic policy reasons. Trade taxes tend to reduce the overall welfare of the population—by increasing the cost of consumption and discouraging efficiency of production. As a result tariff rates are likely to decline, particularly as economic policy arguments are buttressed by international trade agreements. Although this is likely to increase the volume of imports as trade becomes easier, overall revenues are expected to decline as the reductions in tariff rates outweigh the impact from increased trading volumes.

Trade taxes will nevertheless remain an important element in FICs' revenue toolkit. Almost all countries retain some trade taxes for a number of reasons: to preserve revenue for government service delivery; to provide limited preference to domestic producers and to influence consumption patterns. International experience suggests there are a number of key principles for setting trade taxes.

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[3] In addition to many country-specific PFTAC reports, key references include a 2008 IMF regional mission (Fiji, Tonga, Samoa, Kiribati and Solomon Islands) that drew lessons on regional tax policy and administration performance (IMF 2008).

Box 2. Tax Policy Reform Principles

Efficiency/Neutrality. Taxes should be raised, as much as possible, in a non-distorting fashion, leaving economic choices the same as they would have been without taxes.

Simplicity and transparency. Simple taxes are good taxes. A tax with simple rules, few and low rates, minimal exemptions, as well as a clear, wide and measurable base provides more revenue and less opportunity for evasion..

Equity. In general, individuals with similar incomes should pay similar taxes (horizontal equity) and individuals with higher income should pay more taxes (vertical equity).

High revenue generating capacity. The tax system should be able to supply the government with the resources it needs to meet its spending obligations on a sustainable basis. The tax system should rely on a number of taxes to lower the risk of wide annual fluctuations in overall tax revenue.

Harmonization/ Coordination with other systems. Tax harmonization and coordination with economic partners or geographical neighbors will help prevent opportunities for various forms of tax avoidance and/ or evasion, and avoid incentives for tax competition that could lead to revenue loss.

Greater reliance on domestic taxes. Less reliance on distortionary trade taxes and greater reliance on domestic taxes such as VAT and excises which tax all goods and services irrespective of their origins, helps countries to obtain the benefits of free trade, as well as to prepare for WTO entry.

Feasibility. The design of taxes should be aligned with the capacity of tax administration to actually implement and collect tax revenue.

Integration. All main taxes should be consistent, in terms of thresholds, rates and registration in order to ensure fair treatment of all taxpayers, and minimize administrative costs

Source: IMF (2010)

- **There should be very few exceptions or other concessions,** such as those related to specific uses of a type of import. These are difficult to enforce, introduce unwelcome discretion to the system and undermine the revenue base.

- **Imports should be valued on a c.i.f**. **(cargo, insurance and freight) basis** which is the internationally recognized and higher basis of valuation when calculating taxes on imports (trade taxes, excise taxes and the VAT). To the extent possible, taxes should be based on actual value rather than reference values (this is required for WTO members).

Tariff structures in FICs are moving in the right direction but concessions remain widespread. Most FIC's use the ad valorem basis and have between 3 to 6 trade bands within their tariff structure. The c.i.f. basis of valuation is the preferred method of valuation with the exception of some smaller countries like Nauru and Kiribati who continue to apply the free-on-board (f.o.b.) basis. Exemptions and concessions remain, however, prevalent across the region, undermining revenue collection and complicating administration. Some countries also retain complex tariff structures. For example, Kiribati has tariffs ranging from zero to 80 percent with no trade bands. Several different tariff rates can apply to the same goods and there are a large number of exemptions that render complexity for customs and importers.

FIC revenue administrations could improve collections by more effectively managing compliance risks to tax and customs revenues. The effective identification and targeting of risk is at the core of improving revenue administration. Globally, the traditional across the board check of all transactions and documentation filed by importers is gradually being replaced by self assessment with compliance activities focused on high risk areas. This is described in more detail in section IV.

B. Taxation of Domestic Consumption

Taxation of domestic consumption of goods and services, normally through a VAT, is the cornerstone of a modern tax system. It is also the best method of replacing revenues lost from trade taxation**.** In the small, import dependent FICs it to a significant extent simply replaces tariff revenues by taxing the same goods in a different way, while reducing economic distortions (Box 4). However, as VATs/sales taxes tend to be single-rate the incidence on particular goods may not be the same as under a tariff regime, even if the overall tax burden remains identical.

Why a VAT?

There are many advantages to using a VAT as the basis for taxation of domestic consumption of goods and services[4]:

- **A VAT set at a single rate with a broad base can raise revenue without distorting consumption or production decisions.** A well-functioning VAT has very little effect on the tax paid by producers. This is important if the country does not wish to discourage exports as the VAT is excluded from the cost of the exported goods and services, unlike tariffs (in the absence of a drawback mechanism) and sales taxes.

- **The VAT protects revenue by being imposed at all stages of production.** This means that under a VAT the government collects revenue even if some firms in the chain evade the tax, including those in the informal economy.

- **The crediting mechanism under a VAT prevents cascading.** Cascading occurs where tax is charged at intermediate stages of production as well as on the final sale meaning tax is charged on tax already charged in the earlier supplies. The final price is inflated and the burden is borne by businesses.

- **The VAT is better suited to the taxation of services,** which account for an increasingly important share of GDP and employment and hence the tax base.

[4] See for instance Ebrill, Keen, Bodin and Summers, The Modern VAT (IMF, 2001) for a detailed analysis.

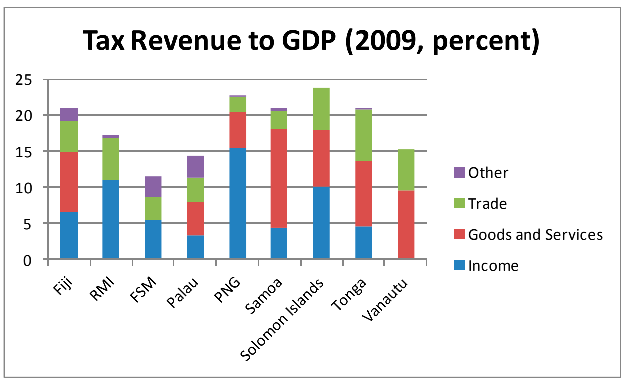
Box 3: FIC Revenue Systems

Most FICs have a combination of import, income and consumption taxes. In many countries, these taxes are supplemented by excises, resource taxes and non-tax revenue. Revenue from these other sources is generally small. . In some countries, the taxes are relatively unsophisticated and distortionary—for instance gross revenue taxes instead of profit taxes in a number of Northern Pacific countries and simple sales taxes instead of VATs.

PIC Tax Systems (2010)

	Income Tax			Indirect Tax		Imports
	Business	Personal	Gross Revenue	Sales Tax/ Goods Tax	Value Added Tax	Import tariffs
Cook Islands	✓	✓			✓	
Fiji	✓	✓			✓	✓
FSM		✓	✓	✓		✓
Kiribati	✓	✓				✓
Nauru						✓
Niue	✓	✓			✓	
Palau		✓	✓	✓		✓
Papua New Guinea	✓	✓			✓	✓
RMI		✓	✓	✓		✓
Samoa	✓	✓			✓	✓
Solomon Islands	✓	✓		✓		✓
Tonga	✓	✓			✓	✓
Tokelau	-	-		-	-	-
Tuvalu	✓	✓			✓	✓
Vanuatu					✓	✓

Trade taxes are contributing less to revenues than previously with domestic consumption taxes becoming the most important source of revenue. The shift towards domestic goods and services taxation in the Pacific and elsewhere reflects the fact that many FICs have begun the transition from a reliance on trade-based taxes through the introduction of domestic consumption taxes. (This outcome is consistent with trade tax revenue as a percentage of GDP declining in 80 percent of low – middle income countries during 1980 – 2000)



FIC revenue systems are, however, characterized by gaps in coverage and widespread exemptions. A common theme across many FICs is the granting of tax holidays and concessions relating to the income tax, particularly for businesses. This has undermined the tax base in many FICs and will complicate fiscal adjustment efforts. For instance, in the Solomon Islands, it has been estimated that the revenue cost of customs and income tax exemptions, most of which are discretionary, could be more than the collected revenue in the past. Excise taxes are considered to be underutilized in most FICs, both in terms of the use of excise taxes and the rates applied.

- **The VAT can be levied at the border using similar mechanisms for the collection of tariffs.** This is particularly important for small island countries where most of their taxes are usually collected at the border. Therefore, the convenience of border collection is maintained and the transition to the VAT on imports should be straightforward.

Box 4: Characteristics of a VAT

A Value Added Tax taxes the final consumption of goods and services. Although the physical payment of the tax is by the production or retail sector, conceptually it is a tax levied on the consumer.

- VAT is collected, generally at a uniform rate, on all transactions whether intermediate (where goods or services are sold to a company for processing) or final (the sale to the consumer).

- The tax paid by the producer on their inputs is refunded, explicitly in the case of exporters and implicitly (by being credited against output tax due) for those producing for local consumption. The tax is ultimately paid by the final consumer, not by producers.

- VAT is generally levied only on companies large enough to fulfill the documentation requirements.

- Suppliers or producers below the VAT registration threshold are exempted—they do not charge tax on their outputs and cannot claim refunds on VAT paid on their inputs. Tax is therefore collected from these businesses as if they are the final consumer.

- Zero rating is used for exports and a small number of staple goods. Producers of zero rated goods are reimbursed the VAT paid on their inputs so that the consumer pays no tax. Exports are zero rated (as there is no domestic consumption) as are a limited amount of staple goods consumed by the poorest sections of society.

- **The VAT is fully WTO-consistent**, including the payment of refunds to exporters (provided such refunds do not exceed the VAT actually paid). Refunds are recognized as simply a way of implementing a tax on domestic consumption, and the VAT treats domestic products and imports identically.

There are, however, a number of perceived drawbacks. While these are relevant, they generally do not present a strong argument for rejecting a VAT.

- **A VAT does not allow revenue to be captured from the informal sector**. A tariff can be hard to avoid, even for the informal sector. It has therefore been argued that the switch from tariffs to VATs reduces the tax that can be collected from this sector—except to the extent that they need to purchase taxed inputs from enterprises operating in the official economy. However, as informal enterprises in FICs are still quite dependent on imports and would pay VAT on their imports, the impact on collections will be moderated.

- **The VAT is regressive**. Consumption taxes, whether VAT or not, do tend to be more regressive than a progressive income tax. This has, however, to be balanced with their less distortionary effect on economic activity and their ease of collection—in contrast to income taxes. VATs can form part of a progressive tax system when used in concert with income and other taxes.

- **A VAT is too complex for less developed administrations and business sectors.** The relatively heavy documentation needs for VAT, its more complex conceptual basis and the burdens it places on revenue administrations (who have to not just collect but also refund payments to taxpayers) have led some to suggest that a VAT is inappropriate for less developed economies, particularly in small islands. Some of the perceptions of the VAT being a complex tax are based on experiences in developed countries, where most businesses are included in the regime and the VAT is often designed to deal with sophisticated transactions. It is true that if a VAT system in a developed country was taken and simply imposed in a small island country it will likely be unnecessarily complex. However, simpler VATs remain a valid option even for small, underdeveloped economies. The two smallest countries in the world have successfully implemented VAT. Niue has 15 registrants and there is no non-compliance with on-time filing and paying obligations

Simpler taxes have been proposed as an alternative for small island economies. The alternative most often proposed is a sales tax, either only at the border or on domestic transactions as well as imports.[5] The rationale for this is based on administrative simplicity—removing the need for refunds and tax credits, potentially omitting the more complex service sector and reducing the number of taxpayers to deal with by omitting wholesalers and intermediate producers. While these are valid concerns in small-island economies, particularly with regard to limited administration capacity, many can be addressed through a well designed VAT (see below). In cases where a VAT would strain the administration capacity or business will not cope with its introduction, a single stage sales tax could apply in the immediate term while capability is established for the later introduction of a VAT. If this approach is taken key priorities should be to broaden the base of taxation as far as possible and to choose a rate appropriate to the revenue needs of the government.

In most circumstances, though, a VAT remains the preferable tax. Sales taxes at the border are, in effect, tariffs and may not meet trade agreement obligations. They also can cause damaging cascading and make exports less competitive. A simple VAT scaled to the demands of small-island administrations can keep taxpayers to an appropriate number, increase efficiency, and improve documentation—with benefits for income tax collections and corporate governance.

International experience points to a number of important characteristics of a successful VAT for small island economies. To assist administration and efficiency of collection it is recommended:

- to have one flat rate of VAT in a range of 10 – 15 percent;

[5] For instance, the Marshall Islands has recently indicated that it intends to adopt a modified sales tax instead of a VAT approach.

- that for optimal effectiveness the turnover threshold requiring taxpayers to register should be set at a level to capture the largest 20 percent of taxpayers, who will often pay in excess of 90 percent of net revenues,[6] and;

- that exemptions and zero rating be minimized to protect the revenue base and maintain neutrality. Zero-rating, which allows firms to reclaim the tax paid on inputs, should be used for exports and high priority distributional/social policy aims. Exemption is more commonly used in difficult to collect areas. Unlike zero rating it does not result in a full loss of tax revenue as tax is still collected on the sale of intermediate goods—exempted sectors cannot claim a refund on this tax paid.

Experience with VATs in the Pacific.[7]

Eight FICs have a VAT in place with three being implemented in the last 5 years. The most recent countries to implement a VAT are Tonga in 2005 and Niue and Tuvalu in 2009. Experience in the Pacific is consistent with international experience that VATs are viable taxes even in small island economies. In the Caribbean 12 of the 21 countries have a VAT, of which 8 have been implemented since 2006. In all of those countries the VAT is regarded as the cornerstone of policy and administrative revenue reform. A further three Caribbean countries are considering implementing a VAT. In the Pacific, where a VAT has been in place for a number of years, the tax has proved to be successful in protecting, or even improving, overall revenue positions as trade tax collection has fallen. VAT productivity ratios for FICs are consistent with ratios exhibited by other small island economies.[8]

A number of other FICs are contemplating introducing a VAT. Detailed plans for a VAT have been drawn up in FSM and RMI and are under consideration at the political level. Discussions are at a preliminary stage in Kiribati. None have yet taken a firm decision to proceed due in part to a reluctance partly stemming from the perceived regressivity and complexity of the VAT.

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[6] This would also need to be balanced with the revenue administration's ability to manage that number of taxpayers.

[7] This section draws primarily on a review of 5 PIC countries' tax policy undertaken by IMF HQ and PFTAC (IMF, 2008). It is supplemented by subsequent PFTAC work in RMI, Niue and Tuvalu .

[8] The higher rates in small island economies could be due to the fact that much of the tax is collected on imports which are relatively easier to collect, but it may also be due to less than full refunds or underestimation of GDP.

International Comparison of VAT Revenue Productivity

Country	Standard rate (in percent)	Revenue productivity - with respect to GDP	Applicable Year
Fiji	12.5	0.69	2006
Samoa	15	0.83	2006
Tonga	15	0.75	2006
Selected other small island economies			
Barbados	15	0.68	2004
Cyprus	15	0.65	2005
Iceland	24.5	0.48	2005
Malta	18	0.41	2004
Dominica	15	0.68	2006
Selected other countries			
New Zealand	12.5	0.72	2005
France	19.6	0.39	2005
Ireland	21	0.35	2004
United Kingdom	17.5	0.62	2005

Source: IMF statistics and staff estimates. International Bureau of Fiscal Documentation; Corporate Taxes 2004-2005, Worldwide Summaries (PricewaterhouseCoopers).

FICs with a VAT are satisfied with overall performance (Box 5). The VAT generally is the main arm of revenue and is seen as a critical element in dealing with the challenges of trade liberalization. In removing impediments to exports it has been a central part of pro-growth economic policies. There are acknowledged problems in implementation, reflecting both the VAT's complexity and the political economy of tax reform. However, concerns about regressivity and complexity are not widespread. Countries tended to use the personal income tax to address equity by revising the threshold and rates to offset any potential negative impact of a VAT being implemented.

Implementation Lessons

Political commitment is critical for successful implementation. The VAT is often misunderstood and so is an unpopular tax. It therefore requires significant political leadership during implementation to avoid it being watered down with concessions, which would complicate the tax and greatly reduce its revenue potential. Political stability is also important as is a credible commitment to good governance; taxpayers are unlikely to participate in a reform of taxes levied by a government they do not trust.

A VAT is best introduced as part of a broader economic reform. This provides a sound context for the reform and seems to make the reform more palatable to taxpayers. This is especially the case if it is seen as part of wider fiscal reform, which not only introduces a new tax, but also includes, for example, the repeal or reduction in tariff rates or other taxes. In Tonga and Samoa, introduction or reform of the VAT was part of a broader package of reforms, including tariff reductions and income tax reform.

Box 5: Country experiences with VAT in the Pacific
Advantages

VATs have assisted FICs to make their tax systems more effective and efficient. In addition to providing fiscal space for reducing tariffs the VAT allowed the removal of nuisance taxes which are usually distortionary and cumbersome to administer. For example, in Tonga, a number of taxes were repealed, including the 20 percent ports and services tax which was, in effect, a tariff and regarded as anti-business.

The VAT has often led to higher levels of voluntary compliance. The introduction of the VAT has had a positive effect on overall tax compliance, not just with the VAT. Businesses that were outside the tax net prior to the introduction of the VAT joined the formal sector mainly to access credits for business inputs. This helps income tax enforcement but can place pressure on tax administrations. For example, in Tonga there are now over 500 registered VAT taxpayers compared to the original expectation that there would be around 260 registrants. In contrast, in Tuvalu compliance has been much lower than expected.

The VAT has proved to be a catalyst for revenue administration reforms. This is usually the outcome when the revenue authority is faced with the need to modernize in order to deal with the new tax. In Tonga, for example, since the introduction of the VAT there has been a noticeable improvement in business management practices and financial information systems, improved technology, as well as greater overall awareness of the impact of taxation on businesses.

Disadvantages

Tax planning in the corporate sector appears to be increasing. In Samoa and Fiji, where the VAT has been in place for some time, the authorities noted that tax planning with the VAT has become more sophisticated and poses a threat to tax revenue.

Swift processing of refunds has proved to be challenging in some countries. The efficient payment of VAT refunds is critical to the success of VAT. Issues have arisen in some FICs, particularly in Fiji and in the early stages of implementation in Tonga, where fraudulent behavior by a small number of taxpayers to obtain illicit refunds has delayed issuing legitimate refunds to compliant taxpayers The other issue arises when refunds are delayed by Governments as a cash management tool by resource strapped governments. Dialogue with the private sector and effective management can assist to counter this problem as proved to be successful in Tonga.

There has been pressure to expand concessions, exemptions, holidays and zero-rating which erode the tax base. This pressure can be difficult for governments to resist, especially in times of political instability. This tendency for" exemption creep" is not confined to the VAT, but pressure has tended to increase as the tax has become bedded in. As an example, Fiji has reported a doubling of the value of concessions (as a proportion of its revenue collection) in recent years.

Some businesses have found the transition to VAT difficult. Business practices such as keeping adequate documentation of transactions are not necessarily widely present in Pacific Island economies and can complicate the introduction of a VAT. Administrative processes need to accommodate this—for example, Tonga changed the filing time to 28 days (from 15) to provide businesses enough time to properly lodge their returns.

Keep it simple. The VAT seems to work best in small island countries if it has few exemptions, few zero-rated goods and services, and a single rate. In fact, the authorities in Tonga suggested that they would not have been able to introduce the VAT in any other way due to concerns over taxpayer misunderstanding or fraud, and the limited capacity of taxpayers and the revenue authorities to administer a complex VAT. Adopting a sophisticated VAT design from a developed country is not usually appropriate due to its likely complexity. However, there are opportunities to apply scaled down simplified versions of practices and procedures used in developed countries, including technology and law interpretation.

Set a high threshold for registration and keep it updated. Setting the VAT threshold at a level that limits registered taxpayers to a number commensurate with the capacity of the revenue authorities is critical for success. It allows the tax administration to focus on the largest taxpayers, which maximizes revenue and efficiency while minimizing the burden on small businesses. A threshold set too low or not reviewed over time can cause problems for the VAT's administration. For example, Fiji has recently increased its VAT registration threshold, and in Samoa the number of taxpayers is over 3,000 so that they have recently increased their threshold and are considering increasing it even further to limit the number of VAT taxpayers.

Consultation and education is crucial. Taxpayer consultation and education has been important to help taxpayers understand and be prepared and able to comply with the VAT. For example, in Tonga a revenue information office was established at the start of the reform process, which the authorities consider was critical to the successful introduction of the VAT.

Revenue administration reform needs to keep pace with policy reform. Tax reform often provides an opportunity to rebuild the capacity of the revenue authorities. The Pacific Island experience has been that the success of reform is dependent on increasing the resources of the revenue authority as well as re-skilling of staff (see section IV). Introducing a VAT in a dysfunctional revenue authority is likely to be unsuccessful. While this may deter some countries from major tax reform, it is possible for this capacity building to occur in parallel with the preparations for the reform. Sustained technical assistance, including through experienced resident advisors, can assist implementation greatly.

Ensuring the refund mechanism is prompt and reliable is crucial for the credibility of VAT reform. Refunds to eligible taxpayers are an integral part of VAT and are vital for its success. If taxpayers are not able to receive refunds they are entitled to it can cause significant cash flow difficulties for taxpayers, undermine the credibility of the reform and ultimately lead to reduced compliance.

C. Excise Taxes

Excise taxes can be a valuable revenue source and also assist countries to address social and environmental objectives. Excise taxes are applied on domestically produced and imported "excisable" goods such as alcoholic beverages, tobacco, petroleum products, and passenger motor vehicles. They generally are used to discourage consumption of goods with public costs, such as pollution or health impacts, while also yielding revenue to support government expenditure. They can be imposed as specific taxes (for instance a dollar for each liter of whiskey) or, like a sales tax, as a proportion of the sales value. An additional advantage of excises is that they provide more flexibility to policy makers for adjusting tax burdens in a targeted way in response to economic conditions. For instance, in the recent fuel and food price crisis a number of countries adjusted excises on fuel to moderate the price increase to consumers. In the absence of excises, such measures would have to be applied through changes in flat rate VAT or sales taxes, which should generally remain more stable.

Excise taxes are a good tool for increasing revenue performance in FICs as they are generally under-utilised in the region. The 2008 IMF review found that of the five countries surveyed, Kiribati and Tonga did not have excises in place, and Fiji and Solomon Islands had excises equating on average to 1.6 percent of GDP and 1.1 percent of GDP, respectively. On the other hand Samoa collected an average of 6.3 percent of GDP from excises. In 2008 Tonga passed legislation to impose a comprehensive excise tax regime to include excises taxes on: beverages and liquor; tobacco products; minerals and petroleum products; and vehicles.

In countries where excises do not exist they could replace some tariffs without discriminating against importers. Excises will be particularly useful in countries where the bulk of revenues currently come from high duties on excisable goods (for instance, petroleum) and in which a low tariff regime combined with a flat-rate sales tax may not compensate for revenues. For instance in Kiribati, where imports of normally excisable products accounts for the bulk of tariff revenues, much of the losses in revenues resulting from trade liberalization could be recouped by converting the existing tariff rates into identical excise rates, applicable to both imported and domestically-manufactured goods. The fact that none of these goods is currently manufactured in Kiribati is irrelevant.

In countries where excises exist there may be scope for widening the range of goods and increasing rates. Revenues can be increased by increasing excise rates and the number of goods to which the excise tax applies. Excises should generally be applied on an equal basis to imports and domestic production to minimize economic distortions. In countries such as Fiji and Tonga, where excises already exist, but are relatively low, the tax rates can be raised on imported and domestically-manufactured products alike. By contrast, in the Solomon Islands, where excises are levied only on domestically manufactured and tobacco products, the excise rates on these products are currently well below the trade tax rates levied on imports of such products.

Excises should, however, be used judiciously. There should be a sound economic or social policy reason for applying an excise over and above sales taxes. Careful assessment of the impact on consumers and producers is also needed. In the Pacific, which is very remote and has to import excisable goods such as petroleum, an excise can be a tax on remoteness and may impede economic growth.

D. Tourism Taxes

Tourism taxes are used to supplement revenues in a number of FICs. Tourism taxes provide flexibility to target taxes at users of valuable commodities that need protecting, are politically attractive as they shift the tax burden to non-voting foreigners and, to the extent that demand is inelastic, have little impact on tourist numbers. Tourism taxes are generally implemented as departure fees, excise-type taxes or sales taxes (hotel room tax, hotel turnover tax).[9] Excise-type tourism taxes occur where an 'access fee' is charged for visits to sites of historic or environmental uniqueness (e.g. Palau's rock island levy). The fee is levied to exploit the uniqueness of the site and to offset the external effects (damage) associated with tourist visits. Tourism related sales taxes are generally imposed on top of standard consumption taxes.

Care needs to be taken in adding tourism, or other specific taxes, into the policy framework. As with other minor taxes, tourism taxes complicate administration and compliance and often offer little revenue, relatively speaking, in return. For example, in Vanuatu and Fiji specific tourism taxes contribute only around 1-2 percent of total tax revenue, whereas in Palau it is more significant at around 10 percent. Adding such taxes into the policy framework requires administrative policies and procedures to be developed for each tax, staff and taxpayers must be trained in the specifics of each tax and verification and enforcement activity needs to be targeted across a greater range of risks. For small tax administrations typical of Pacific countries these are unnecessary compliance costs which require their scarce resources to be spread ever more thinly. They should instead focus on collecting highest net revenue over time and improving compliance across the taxpaying population.

When taxes are included in policy frameworks they should be designed to minimize burdens on tax administrations. Departure taxes, which are sometimes collected by airlines on behalf of the government, are a good example of a relatively low-cost revenue raising initiative that targets the whole sector. If fees are set too high, however, they can discourage tourist arrivals and airlines may refuse to collect them. Additional taxes on tourist-related sales, such as the turnover tax adopted in Fiji, are useful for targeting larger VAT-registered operations. Administrative costs can be contained since use can be made of information from existing VAT collection machinery. However, these taxes do still require taxpayers to file separate returns and the administration to undertake separate compliance activities and so are far from costless.

E. Income Taxes

Income taxes are a central part of most FICs' revenue systems. Most countries tax income through a mix of corporate and personal income tax, with some countries relying on a simpler gross revenue tax to proxy income. Only Vanuatu and Nauru do not currently have some form of income taxation. In many countries, including all those in the 2008 IMF survey, income tax was the largest proportion of taxation for some time, but in some countries where VAT has been introduced (Fiji, Tonga, Samoa) the VAT has become the largest revenue source.

Income tax rates have generally been decreasing. Corporate tax rates in the Pacific range between 25 and 35 percent, with many countries having a slightly higher rate for

[9] Departure taxes often apply to both tourists and locals but some countries charge different rates of departure tax depending on nationality.

non-resident companies. Rates have declined recently in a number of countries (Fiji, Tonga, Samoa) to promote investment. Tax competition between countries does not, however, seem to be prevalent in the Pacific at present. Personal rates have also been decreasing as countries simplify the progressive scale and increase the tax free threshold, particularly where VATs have been introduced. This approach is seen as assisting to offset the regressiveness of the VAT and was in preference to reducing the VAT rate.

VAT implementation appears to have strengthened income tax collections despite rate decreases. For those countries in the IMF survey with a VAT, income tax as a percentage of GDP remained broadly static even as income tax rates fell but increased steadily in the two countries without the VAT. This outcome has most likely arisen from improved compliance triggered in part by VAT strategies (see section IV).

However, concessions and exemptions undermine income tax collection in FICs. Concessions are also given for the other mainstream taxes (i.e., tariffs and VAT). The rationale is usually to attract domestic and foreign investments and boost economic growth in specific sectors, such as tourism and agriculture, and exports. FIC governments also provide concessions to attract donations to support cultural, sporting events and facilities by granting deductions of up to 200 percent. Unfortunately, few countries publicly report on the nature, value and recipient of the concessions granted; and little attempt is made to quantify the economic or social value arising from the concessions given.

Income tax has the potential to become a more effective revenue earner for FICs. Income taxes do have problems, particularly if rates are set high enough so that they become an effective constraint to growth and investment. However, they remain an important source of revenue and can be used to balance the regressivity of taxes on consumption. Income taxes continue to play an important role in revenue collection but need to be harmonised with the introduction of a VAT. Progressive rates of income tax should be rationalized and simplified and in some cases reduced to take into account the burden of VAT on consumers.

Increased revenue should come from improvements in base, tax design and compliance. Tax rates across the Pacific are likely to continue their gentle downward trajectory as FICs look to promote private sector growth and investment. The three areas that will improve the revenue from income taxes are (a) broadening the income tax base by eliminating unnecessary discretion (b) reducing the level of non compliance, and (c) institutional strengthening programs for the revenue authorities supported by simplified policy and modernized legislation.

Reversing the erosion of the income tax base from exemptions and concessions will yield additional revenue in most FICs while reducing distortions and inequities. Concessions have many problems—most significantly whether they actually generate significant economic or social value. Concessions also complicate governance, with approval often being discretionary and open to political abuse and favouritism. Streamlining and rationalizing them is an obvious opportunity to improve revenues and assist in trade facilitation in FICs. Although it is politically and administratively complex, it is possible. The first stage should be to account for all existing concessions and improve the transparency and accountability of the approval process. For instance, in the Solomon Islands a formal approval process for concessions is now required which includes a gazetting of the names and amount of the concessions given. The tax base could then be broadened while maintaining some incentives by shifting to investment allowance schemes that would apply to all new investors and to allow tax holidays to expire for existing firms and to remove current exemptions. Coordination of investment incentive schemes and of tax rates across the Pacific island countries would also ensure that FICs do not undermine each other's growth and revenue prospects through tax competition.

Income tax reforms work best when implemented as part of a broader package. Countries with an income tax and VAT consider that those taxes, together with business licensing, help to minimize non compliance and to reduce administrative overheads**.** Areas of particular importance include anti avoidance provisions; apportionments and the treatment of risk expenditures such as overseas travel and entertainment; collection and analyses of taxpayer data; use of common technologies; and multi revenue assistance and enforcement programs. An example is the common practice of those entities having met the VAT threshold being defined as large taxpayers, a group for which some of the countries are developing specific risk response strategies (see below).

F. Natural Resource Taxation

Some FICs have natural resources that can serve to support the revenue base. Utilization of these resources is normally entirely for export and, given the small private sectors in FICS, almost always undertaken by foreign companies. The mainstream income tax regime is not normally appropriate for natural resource sectors for a number of reasons: these natural resources are either totally (minerals) or partially (fish and forestry) non-renewable assets of the whole country; significant economic rents (profits over and above an investor's required return for investment) can be generated from the utilization; and extraction can have significant impacts on the public through environmental and other impacts.

Fisheries are an important resource for many FICs; revenue could be increased through improved licensing agreements. The bulk of the revenue available to FICs comes from offshore operations not subject to domestic taxation. Revenue is currently mostly derived from licensing agreements that allow fishing nations to catch defined levels of fish within FICs' fishing grounds. The aim for FICs with large fishing grounds should be to negotiate, and enforce, collective agreements with fishing nations to ensure that fishing is sustainable and provides greater income to the resource-owning FICs. Enforcement of these licenses will, however, continue to be difficult for FICs, given their resources and the size of the fishing grounds, One effort already underway to improve conditions is the Parties to the Nauru Agreement (PNA) effort to limit fishing (through stricter control over licensing) and strengthen conservation and management of tuna.[10]

Other FICs have mineral and petroleum resources that can significantly add to the revenue base for a finite period. Given that these resources are non-renewable assets of the nation, governments need to ensure the country receives a fair return from the extraction of the assets and that the proceeds are managed to ensure gains for current and future generations.

Revenue policies need to be generous enough to attract investment while also providing adequate return to the country. Extraction is a risky venture—up-front investment is high, payback periods are long and prices are highly volatile. The fiscal regime chosen for taxing mineral extraction will depend, in part on how much of this risk FICs wish to take on. If an investor is expected to take on more risk they will expect a lower overall tax burden. Governments effectively face a trade off between stability and size of revenue. Given FICs, on the whole, have limited access to capital markets, have relatively weak fiscal positions and are reliant on a few projects, it is likely that stability would be favored in the Pacific.

Fiscal regimes for resource taxation target a number of principles and therefore tend to be comprised of more than one revenue generating mechanism. Revenue regimes aim to be neutral (not distort investment or production decisions); to be progressive enough to capture economic rents; to provide stable revenue to government; to be administratively simple; and to promote international competitiveness. No one tax or non-tax mechanism is likely to meet all of these aims, thus fiscal regimes tend to be made up of a mixture of taxes, royalties and profit sharing. Box 6 provides details.

Prudent management of resource revenues is critical for macroeconomic stability and sustained poverty reduction. Countries with resource revenue should strengthen or establish stabilization funds to ensure that these revenues—which will be volatile—are managed effectively through time and that income flowing from mineral resources is integrated in a transparent and well-managed way with the budget.

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[10] The PNA countries are the Federated States of Micronesia, Kiribati, Marshall Islands, Nauru, Palau, Papua New Guinea, Solomon Islands and Tuvalu.

Box 6: Advantages and Disadvantages of Fiscal Instruments for Mining and Petroleum Sectors

Royalty: A fixed fee per unit produced or a percentage of production or gross revenue. Royalties provide a minimum payment for resources used, produce stable and early revenue, and are relatively easy to administer. However, beyond modest levels they can distort investment and production decisions because they are insensitive to costs. They are regressive.

Income based taxes Corporate income taxes are less distortionary since they are based on revenue less cost. Foreign investors appreciate the fact that they give rise to foreign tax credits. However, they are relatively more complex to administer. Revenue is also delayed: by how much depends on capital depreciation allowances, which are often made generous to attract investment (i.e., provide faster payback).

Rent based taxes. Pure rent-based taxes are neutral since payment is only required after the investor has earned its required rate of return. However, in practice rent is approximated. Those based on a measure of achieved return are most effective but are also the most difficult to administer. The balance of risks is skewed towards the government.

State equity. Enables the government to share in the upside and is often viewed to increase the sense of national involvement. However, "paid" equity requires the government to contribute to initial capital outlays, and often gives rise to conflicts of interest arising from the government's role as regulator.

Export duties. Not very common. Export duties are relatively easy to administer but they distort the decision of whether to sell extracted resources domestically or abroad and are insensitive to costs.

Import duties. Provides revenue even before royalties due to the import needs during project development. To mitigate the negative impact on investors, full or partial exemptions are often provided.

Other. Other instruments include: signature and production bonuses; land rental payments; withholding taxes on interest, dividends, and services; and value added tax, if applicable.

Source: Goldsworthy and Zakharova (2010)

IV. Improving Revenue Administration

Policy reforms can only be successful if the revenue administration can implement them efficiently and effectively. FICs' revenue administrations, which are often highly constrained in terms of human, technical and financial resources, need adequate systems, processes and capabilities to achieve increasing levels of compliance. This requires a clear and understandable policy, a sound legislative framework, corporate commitment to an institutional strengthening program, and significant attention to building appropriate systems and processes. Box 6 sets out the generic principles of effective tax administration. However, these have to be adapted to the resource-constrained contexts of the small economies of the Pacific Islands.

Given the resource constraints faced by FIC administrations, voluntary compliance is the key to success. Voluntary taxpayer compliance means taxpayers meet their tax requirements without enforcement. Increasing voluntary compliance essentially yields higher collections for each dollar spent on administration. It is maximized by self assessment, where taxpayers assess their own liability as opposed to submitting information to the revenue administration who analyze and assess each taxpayer's liability.

Voluntary compliance requires assistance and enforcement. Assistance promotes compliance through education and support and is absolutely vital for a move to self assessment. Enforcement is making people comply who choose not to comply and can include investigative and legal processes.

Enforcement resources need to be focused on the largest rewards. In all tax administrations, and particularly small administrations, enforcement resources are best used where the largest available revenues are. Large taxpayers and high wealth individuals tend to comprise about 20 percent of taxpayers but generally contribute in excess of 90 percent of total tax revenues. Enforcement resources should therefore be focused on these groups and on those taxpayers within it least likely to comply. PFTAC has produced two handbooks to assist countries manage compliance risk. The key elements are summarized in Appendix 3.[11]

Organizing the revenue administration by function and taxpayer type rather than by tax type helps achieve higher levels of voluntary compliance. Higher levels of voluntary compliance achieve greater revenues at a lower administrative cost. A functional organization makes it is easier to identify and manage risks and share information since a single function (e.g. audit) cuts across taxpayers and all types of taxes (organization by size of taxpayer or taxpayer industry can provide similar benefits). The common core functions of a revenue administration are:

- Taxpayer and importer registration (registration)
- Assessment and payment of revenues (processing)
- Taxpayer and importer services (assistance)
- Collection of outstanding returns and payments (collections)
- Audits and investigations (audit)
- Taxpayer objections and appeals (objections and appeals)
- Policy development (policy)

[11] Cotton(2008a) and (2008b).

Box 6. Principles of Effective Tax Administration

A proper legal framework for tax administration that provides an appropriate balance between the rights of taxpayers and the powers of the tax agency.

Efficient organizational and staffing arrangements, featuring strong headquarters; function-based organizational design; minimal management layers and appropriate spans of control; streamlined field operations; and organizational alignment to key taxpayer segments (e.g., a large taxpayer office); and sufficient numbers of staff assigned to each level of the organization and each function.

A system of self-assessment directed at creating an environment of taxpayer voluntary compliance (thereby minimizing intrusion of revenue officials in the affairs of voluntary taxpayers, while concentrating enforcement efforts on those representing a higher risk).

Streamlined collection systems and procedures aimed at securing timely revenues without imposing undue compliance costs and inconvenience on the business sector.

Service oriented approaches whereby the tax administration operates as a trusted advisor and educator, ensuring that taxpayers have the information and support they need to meet their obligations voluntarily.

Risk-based audit and other verification programs aimed at detecting taxpayers who present the greatest risks to the tax system, supported by effective dispute resolution.

Extensive use of IT to gather and process taxpayer information, undertake selective checking based on risk analysis, automatically exchange information between government agencies, and provide timely information to support management decision making and tax policy formulation.

Modern human resource management practices that provide incentives for high performance and non-corrupt behavior among tax officers as well as develop staff skills and professionalism.

Effective models for ongoing institutional change, including enhancing strategic planning capabilities, building coalitions with external stakeholders, and developing an internal culture that is receptive to change.

An environment of integrity and good governance with transparency of taxpayer rights and required staff conduct, with mechanisms to assure integrity of systems, procedures, and staff practices, and to regularly inform the public of organizational goals, plans, efforts, and outcomes.

Source: IMF (2010)

Supporting roles provide the capability for the revenue administration to operate and are critical to its performance and effectiveness. Key supporting roles include:

- **Information Technology:** IT solutions effectively process large amounts of data for the systems and processes of each core function.
- **Staff capabilities** (human resources): The maintenance and building of a diverse range of human skills and knowledge necessary to operate the revenue systems.
- **Communications:** Effective communications to stakeholders and the broader community encourage community confidence in the tax office.
- **Internal Audit:** Protects the integrity of the organization.

- **Reporting:** Revenue Administrations need to be accountable through having measures and reporting mechanisms in place for Government to ensure that revenue administration resources are used effectively and non compliance is being effectively managed.

There is scope for enhanced regional cooperation to improve revenue administration. Areas of particular impact are information technology and a regional communication tool, and identification of regional subject matter expertise, regional training programs, tax information exchange agreements. Regional co-operation may be appropriate in developing a common approach to deal with tax planning and with transfer pricing. This reflects in part the greater sophistication of the corporate sector and the increasing presence of trans-national transactions and in part the increased opportunities for tax planning and transfer pricing that more sophisticated taxes provide.

V. ACHIEVING CHANGE - REVENUE REFORMS AND THEIR IMPLEMENTATION

Designing and implementing major revenue reforms is a difficult political and technical process and takes a long time. Most countries underestimate the planning, resources and time required to implement major revenue reforms. Cotton (2008) reviewed the effectiveness of revenue technical assistance given to FICs and concluded that the greater the size of change recommended to a country the less likely that change will be implemented.[12] This finding has particular relevance when explaining why major revenue reforms are generally slow to be implemented in FICs. For example, in 2003 – 2004 PFTAC gave Niue and Tuvalu technical assistance to reform their revenue collection systems which included implementing a VAT. Both countries implemented a VAT in 2009.

FICs should start considering possible revenue reforms soon, even if the need for adjustment is some time in the future. Early consideration of revenue reforms that could improve efficiency and effectiveness and provide a framework for coping with fiscal adjustment will be important to achieve success. Providing time and space for effective political and community consideration of the most appropriate tax system will increase the chance of success when decisions are finally taken.

Reform timescales need to take into account the capacity of the revenue administration. Shorter implementation periods require more intensive activity and a greater concentration of resources at any particular time and can be difficult for small administrations to cope with. A longer period of implementation requires fewer resources at any one time and less intensive day-to-day activity and may therefore reduce the risk of failure or time slippage beyond the initial planned reform period. The

[12] Cotton (2008c.)

experience of FICs indicates that at least 36 months are needed for changes in the law to become operational under the tax regime.

Once reforms have been decided a project management approach maximizes the chances of success. Such approaches have been taken in FSM, RMI and Fiji and often incorporate a steering committee and project team. Depending on what degree of change is involved, a reform programme can be built around five integrated activities that, for a larger reform programme, may take up to three or more years to implement (Appendix 4).

Sustained technical assistance is needed for success. To undertake the major changes entailed in revenue reforms requires a structured approach supported by technical assistance. A high level a reform program will entail: developing high-level and detailed project plans; developing policy; drafting legislation; developing new capabilities; developing new processes and systems within the revenue administration; educating taxpayers and importers on their new compliance responsibilities and the process changes; and allowing taxpayers time to change their internal procedures. The type of specialist technical assistance needed to deliver a program such as this would include: project management; revenue policy analysis; revenue forecasting; legislative drafting; IT system development and support; and training. Also, at the time of implementation, it is advisable to have in place a long-term resident advisor.

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Appendix 1: Main International trade agreements involving FICs

South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA)

Concluded in 1981, this trade and economic cooperation agreement accorded PICs non-reciprocal preferential treatment for goods exported to Australia and New Zealand. One of its main objectives was to achieve progressively duty-free and unrestricted access to Australian and New Zealand markets for a wide range of PICs' products, subject to rules of origin. These rules required the last process of manufacture to be carried out in the country claiming the preference, and for products to have at least 50 percent local content in that country.[13] Australia or New Zealand may vary or suspend preferential access under special safeguard provisions, and actions against dumped or subsidized exports are handled according to each country's national legislation. However, the margin of preference accorded to PIC exporters has been eroded as a result of recent tariff reductions in Australia and New Zealand. Consequently, the importance of SPARTECA to PIC exporters has declined and will continue to do so.

Pacific Island Countries Trade Agreement (PICTA)

The PICTA, which was signed in August 2001 and became effective on 14 April 2003, is a free trade agreement among fourteen Pacific island countries. Of these, 12 are signatories to PICTA and seven have announced readiness to trade. The agreement is currently confined to trade in goods between butservices areunder negotiation and a comprehensive PICTA is likely in future years. One of the main provisions of the agreement (Article 7) pertaining to tariffs involves the reduction in tariffs to zero by "developing PICs" (including Fiji and Tonga) no later than 2010 and by the "small island states" and "least developed countries" two years later (Appendix II). Rules of origin are based on a 40 percent value-added criterion. However, Article 14 allows for continued tariff protection of "developing industries" (or infant industries) for a period of 10 years, or 15 years in the case of "small island states" or "least developed countries".

Pacific Agreement on Closer Economic Relations (PACER)

Also signed in 2001, the PACER is an economic cooperation agreement that, unlike the PICTA, includes Australia and New Zealand, the sources of a large share of the PICs' imports and thus their tax revenues. While not a free trade agreement, its key objectives are trade liberalization and trade facilitation. Under the PACER, negotiation of a regional trade agreement (RTA) between the PICs on the one hand and Australia and New Zealand on the other are to commence eight years after the PICTA enters into force, unless triggered by the provisions of Article 6. According to the latter, negotiations with Australia and New Zealand could start earlier in the event of any PIC commencing or

[13] Also counted as local content are inputs from any or all PICs, as well as from Australia and New Zealand (up to 25 percent of the required 50 percent minimum). In July 1994, New Zealand reduced the local-content requirement to 45 percent for garments imported from Fiji, while Australia agreed to include more marketing and packaging elements in the calculation of local content for these produVATs.

concluding formal negotiations of a free trade agreement with another developed country. The purpose of negotiations with Australia and New Zealand would be to extend such preferential treatment to them. Consequently, the PACER is a defensive agreement aimed at protecting the interests of Australia and New Zealand in PIC markets.

Economic Partnership Agreements (EPA)

The EPA negotiations seek to circumvent the problems of compliance with WTO agreements by establishing an RTA between the EU on the one hand and the African, Caribbean and Pacific countries on the other. The key feature of the EPA is the move from non-reciprocal to reciprocal preferences to ensure that the agreement covers "substantially all trade" in accordance with Article XXIV of the GATT. It is envisaged that the exports of African, Caribbean and Pacific countries will continue to be subject to reduced tariffs in the EU market, while duty-free access to African, Caribbean and Pacific countries' markets would be phased in during an agreed transition period. Only Fiji and Papua New Guinea among PICs have signed interim agreements with the EU .

Other agreements

There are other regional and bilateral trade agreements among PICs, including the Melanesian Spearhead Group (which encompasses Fiji, Papua New Guinea, Solomon Islands and Vanuatu), for example, but these have had a negligible impact on trade among those countries, so that their impact on tariff revenues has been small.

Appendix 2: Trust Funds in FICs[14]

Five FICs have established trust funds to equalize revenue, smooth expenditure through time or meet other fiscal objectives such as debt reduction. These countries are Kiribati, Nauru, Papua New Guinea, Tonga, and Tuvalu. Experience with these funds has differed dramatically, both across these countries and through time.

Management of Kiribati's Revenue Equalization Reserve Fund (RERF; established in 1956) was prudent through 2000 but the fund has come under pressure since then. Starting in 2001, budget expenditure began to grow faster than revenue and draw downs from the RERF rose from 13 ½ percent of GDP in 2001 to 24 ½ percent of GDP by 2004, despite near record levels of revenues. In subsequent years, continued large draw downs and negative average rates of return led the real per capita value of the fund to decline from A$7,250 in 2000 to under A$4,200 by 2008 (measured in 1996 dollars). If past trends persist, the RERF will be depleted around 2030. Stabilizing the RERF will require reducing fiscal deficits to 6 – 7 percent of GDP from deficits in excess of 15 percent of GDP on average during 2004-2008.

The Nauru Phosphate Royalties Trust was established in 1968 using dividends and taxes generated by phosphate mining. Despite declining revenues from phosphate in the 1980s as demand for phosphate waned, the NPRT balance rose to A$1.5 billion in 1990 (for a population estimated at 11,000). These assets were, however, depleted rapidly in subsequent years due to poor fiscal and trust fund management. The NPRT's assets were essentially exhausted by 2004 and at that time Nauru became heavily dependent on donor support—provided through the Pacific Regional Assistance to Nauru (PRAN) mechanism—because of the country's dire fiscal position. Poor NPRT management, including through the pledging of much of the NPRT's assets, has left Nauru with public debt estimated at 20 times current GDP.

Papua New Guinea established off-budget trust funds in which to accumulate windfall gains from mineral resources during the commodity price boom of 2005-08. These trust funds were initially designated to pay down debt, and to finance development needs through additional, one-off, public investments that were to be limited to no more than 4 percent of GDP in any given year. In 2009, however, controls over trust fund spending were relaxed and spending from these funds increased sharply, helping shift the fiscal position from a surplus of 2 ½ percent of GDP in 2008 to a deficit of almost 8 percent of GDP in 2009. Papua New Guinea faces the challenge of integrating expected further large windfall gains from energy resources into its overall macroeconomic policy framework.

Tonga established a trust fund in 1988 to provide for national emergencies and occasional special projects. This fund was based on revenue from the sale of special

[14] Based on ADB (2005), IMF (2006) and IMF staff reports.

person passports. By 1991, the fund had accumulated A$30 million in assets. In the late 1990s the management of the fund was handed to a single investment advisor. Subsequent investments went sour and the fund lost almost all of its value of A$26 million in 2001/02, equivalent to approximately 20 percent of GDP.

Tuvalu established the Tuvalu Trust Fund (TTF) in 1987 and capitalized it using its own funds and donations that year and in later years from Australia, Japan, the Republic of Korea, New Zealand and the United Kingdom. The goal of the TTF is to provide Tuvalu with additional resources for recurrent expenditures. Disbursements are made from the TTF to an intermediary buffer account (funded also from other sources, such as internet domain earnings) that is used to finance recurrent and capital spending in the budget. The value of the TTF increased from its original A$27 million in 1987 to just under A$107 million in 2007 (approximately 4 times GDP). The TTF is considered to be the most successful public fund in the Pacific and is managed by a board and advisory committee that are both staffed by Tuvaluan and international advisors. Over its life, the TTF has made annual average contributions to the budget equivalent to 21 percent of government recurrent expenditure.

Appendix 3: Managing Compliance Risk

Risks to compliance vary considerably by: taxpayer type (individual, company, partnership or trust); industry; and the size of the taxpayer's enterprise or business undertaking. The approach to managing compliance risk is usually a circular process made up of a number of steps.

Step one: Identify the risks to compliance

- Sort taxpayers into recognizable groups e.g. industry type, location, size, ethnicity
- Identify the risks presented by taxpayers in each of those groups using information obtained from a variety of sources including intelligence gathering, audit activity, general community knowledge .
- Use available intelligence. At this stage it is common for revenue administrations to realise how little information they have on taxpayers but this step provides an opportunity to think about other sources of taxpayer information (third party information)– eg, transport office records, land office records, utility company records

Step two: Prioritize those risks

- Identify the impact (revenue loss, reputational risk, public interest, administration effort) and likelihood of the risk occurring (compliance history, incentive)
- An example of a risk with high revenue impact and high likelihood might be the tourism industry where many goods and services are sourced and paid for offshore and records may not be in the FICs first language or in English.
- An example of a risk with low revenue impact but high likelihood is new small businesses – small businesses have a a high risk of failure leaving taxes unpaid and hard to recover. Given the importance and extent of small business in most economies this particular risk may be identified and prioritized

Step three: Put in place interventions to manage the prioritized risks

- The aim is to change the taxpayer's behaviour to voluntarily comply – not to penalize in itself but to improve future compliance behavior.
- Interventions are targeted at the risk and are usually chosen because they will be most likely to improve compliance behavior. For example; enforcement activity is expensive and time consuming so is best directed at taxpayers who have deliberately chosen not to comply with their obligations. Education and assistance can reach higher numbers of taxpayers and is usually less expensive making it most effective for taxpayers who want to comply and need help to 'get it right'. Policy change is best directed at risks where the legislative intent is unclear and causing uncertainty for taxpayers and the tax administration. .
- Using the new small business example in step 2, revenue administrations often deliver compulsory ongoing advisory services for all new small businesses of up to a year as a means of ensuring payment of taxes and the survival of the business.

- The industry risk presented in step 2 might require a combination of interventions, including audit for high end non-compliers, assistance for some and legislation reform to require all records to be kept in the 1st language or English.

Step four: Measure and report on the success (or otherwise) of the interventions

- Using objective measures for each intervention helps inform future risk management and enhances accountability of the revenue administration to Government and the wider community

Appendix 4: Developing a Reform Program

Implementation of the recommended tax reforms requires effective planning and management requiring considerable resources and clear accountabilities and is best organized around five high level programs:

1. **Planning, management and governance program.** Through a steering committee and project team this program will be accountable for the governance and the day to day management for implementing the overall tax reforms. This program includes: developing the terms of reference and implementation plan; obtaining, and effective use of, the necessary resources; and monitoring and reporting on progress of the reforms to Government.

2. **Law, policy and estimates program.** This program will manage the finalizing of tax policy, revenue estimates and the drafting and the passing of the new law through the legislative process.

3. **Revenue administration change program.** Through the course of the implementation, this program will carry out four simultaneous roles: (a) maintain ongoing revenue collections; (b) design new processes and structures, installation of IT systems, change management of staff, develop new staff capabilities; (c) support awareness and education activities to prepare and educate the private sector and the broader community to enable them to comply with the new taxes; and (d) support the implementation of the taxpayer registration process, including the VAT registration.

4. **Business and Community program.** This program will engage with the public sector, private sector, community interest groups and the community at large to raise the awareness and understanding of the tax reforms. Targeted education programs will follow for those taxpayers required to comply with the new taxes.

5. **Registration program.** This program will require all taxpayer entities, including VAT registrants, to register and be recorded on a registration database.

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