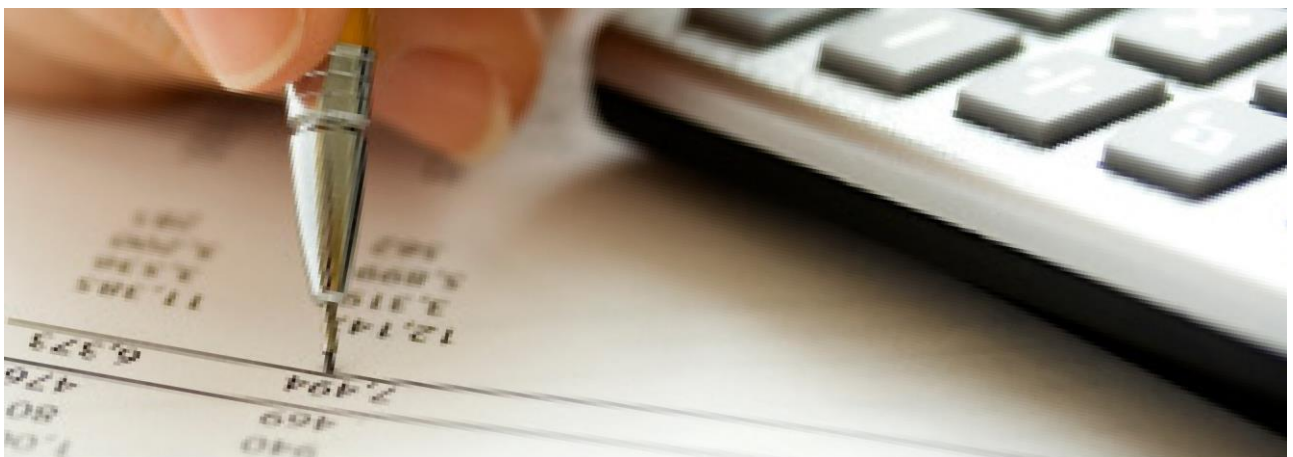

Report prepared for the Ministry of Foreign Affairs and Trade

Evaluation of taxation reform in the Pacific

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31 March 2014



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Glossary

CEO	Chief Executive Officer
CT	Consumption Tax
DAC	Development Assistance Committee of the OECD
DFAT	Australian Department of Foreign Affairs and Trade
FSM	Federated States of Micronesia
GDP	Gross Domestic Product
GST	Goods and Services Tax
IDG	Ministry of Foreign Affairs and Trade's International Development Group
IMF	International Monetary Fund
IT	Income tax
MFAT	Ministry of Foreign Affairs and Trade
OECD	Organisation for Economic Cooperation and Development
PACTAM	Pacific Technical Assistance Mechanism
PAYE	Pay As You Earn
PEFA	Public Expenditure and Financial Accountability
PFTAC	Pacific Financial and Technical Assistance Centre
PICs	Pacific Island Countries
PITAA	Pacific Island Tax Administrators Association
PNG	Papua New Guinea
RA-FIT	Revenue Administration Fiscal Information Tool, a Tax Administration Performance Measurement tool administered by the IMF
RAMSI	Regional Assistance Mission to Solomon Islands
RMI	Republic of Marshall Islands
RMS	Revenue Management System
TA	Technical Advisor or Technical Assistance
VAT	Value Added Tax

Executive summary

Purpose and scope of evaluation

The New Zealand Ministry of Foreign Affairs and Trade (MFAT) commissioned us to evaluate the efforts of donors to assist reform of government taxation collection in the Pacific over the period 2002 to 2012. The purpose of the evaluation is to seek insights into the process of reform to inform improvements to how donors support the design and delivery of tax reform programmes in the Pacific. We did not evaluate what would be the best form of taxation to meet the revenue raising, fairness, economic efficiency and other objectives of host countries.

In summary form, the main themes of this evaluation are as follows:

- Findings - donor support for tax reform has followed good processes in terms of dialogue and has produced improved tax systems in the Pacific. However, numerous weaknesses in terms of sustainability are evident.
- Conclusions - Pacific tax systems are fragile with a focus on changing rules and administration infrastructure rather than behaviour. This fragility is partly attributable to a donor focus on episodic rather than systematic tax reform.
- Lessons - donor support would be strengthened by moving to a more systematic engagement and dialogue with host countries focusing on incremental strategic improvements to the whole tax system involving overall behavioural change rather than changes to rules and systems.
- Implications – donors should consider whether to move to a more systematic support for Pacific tax systems.

Sixteen countries were within the scope of this evaluation.¹ These countries share the common feature of being members of the Pacific Financial Technical Assistance Centre (PFTAC) and most of them have attempted some form of improvement to their tax policies or administration since the early 2000s.

Tax reform is systematic and complex

A good and well-functioning tax system is critical to all countries. It provides the means by which governments can fund the services expected of it and, in the case of less developed countries, achieve greater self-sufficiency by way of lower reliance on overseas provided budgetary support. Equally importantly, the tax system is critical for sound state-building – establishing a functioning relationship between governments and tax paying citizens. Important as it is, tax reform is nevertheless extremely difficult to bring into effect. A good tax system is difficult to implement and sustain because taxation is inherently intrusive

¹ Cook Islands, Fiji, Kiribati, Federated States of Micronesia, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tokelau, Tonga, Tuvalu, Vanuatu.

affecting all aspects of a society and its economy. It impacts on income and wealth distribution and inter-reacts with all aspects of the economy. The tax system must of necessity, therefore, reflect the complexity of that intrusive inter-reaction and must change with changes in the country within which it operates. In addition, especially given the necessary focus on administering taxation systems through voluntary compliance, the tax system operates by altering modes of individual behaviour. It is not therefore just a set of legislated rules.

Given this context, tax reform should, as emphasised repeatedly by the 2011 Mirrlees Report on the UK tax system, focus on the tax system as a whole.² That review concluded with respect to the UK:

“To improve things, we need to see the system as a whole, we need to design the system with a clear understanding of the population and the economy on which it operates, and we need to apply economic insights and evidence to the design. We also need a much more informed public debate and a much better set of political processes than the ones we currently have.”³

While written in the context of tax reform in the sophisticated economy of the UK, these comments have general application to tax reform everywhere. To create sustainable taxation reform it is therefore necessary to manage the tax system as a whole. To quote again from the Mirrlees Review, when considering tax reform:

“there is a need to think about the tax system as just that – a system. The way that different taxes fit together matters, as does being clear about the role of each tax in the system.”⁴

Approach and method

We define reform success as taxation reform that brings about sustainable improvements in institutional capacity and in tax policies and administration, consistent with international good practice. The premise underlying this evaluation is that successful taxation reform is a matter of successful process and not just achieving technical results such as specified legislative changes.

As a process, successful taxation reform interventions might entail a sustained interchange of ideas, perspectives and analysis between donor-funded agents and their counterparts in the host country. The term “policy dialogue” is commonly applied to government to government processes in the source literature but the principles and indicators of good process apply equally to engagement between donors and host country agents. The literature suggests that a ‘policy dialogue’ approach is more likely to provide a systematic approach to taxation reform that builds-up the political, administrative and private sector infrastructure in a coherent and sustainable way.

² Tax by Design – The Mirrlees Review, Oxford University Press, 2011

³ Ibid, page 20.

⁴ Ibid, page 45.

This premise was articulated in the central evaluation question: “has donor funded intervention provided for effective policy dialogue at each stage of reform and what were the sustained consequences for the objectives of reform.”

Drawing from the literature on taxation reform and on policy dialogue, we anticipated that the indicators of procedural success would be:

- there is clarity as to objectives of reform
- informed and reasonable expectations as to what can be achieved
- shared and credible evidence base
- taxation advice is consistent with good tax design principles and accounts for local conditions and context
- donor and host country negotiate reform programme on relatively equal terms and maintain formal and informal dialogue.

The evaluation also looked at a range of intermediate and longer-term outcomes from taxation reform as a means of inferring lessons about the process to support taxation reform.

The research for this evaluation involved desk-based review of Programme documentation provided by PFTAC, MFAT and the Australian Department of Foreign Affairs and Trade (DFAT),⁵ including previous evaluations, literature, collection and analysis of data (both desk-based and in-country), and semi-structured interviews.

We conducted four in-depth case studies in Kiribati, Samoa, Solomon Islands and Tonga. These case studies were chosen as providing a variety of taxation reform experiences and geographic distribution. The case studies supplemented more general desktop research and interviews to generate the core research findings. The case studies were built on a combination of data generated from literature, targeted structured interviews carried out in each country and primary quantitative data. In total, we interviewed 49 people, mostly in Fiji, Kiribati, New Zealand, Samoa, Solomon Islands, and Tonga.

In addition, we presented a preliminary view of our evaluation to the Pacific Island Tax Administrators Association (PITAA) Heads Meeting held in Honiara 10th to 12th September 2013. This is the annual meeting of Tax Commissioners from throughout the Pacific and provided an opportunity to test our insights with those who have direct experience in implementing taxation reforms.

⁵ This department incorporates the Australian Government activities formerly known as the Australian Government Overseas Aid Program (AusAid).

Findings

Significant achievements from donor support

Over the period covered by this study considerable donor resources have been allocated to taxation reform. Between 2002 – 2012⁶ donors invested an estimated NZ\$55 million on tax reform projects in the Pacific.

This expenditure has produced some significant achievements. Across the region tax administration capacity has improved as demonstrated by the PFTAC baseline reviews. Where tax policy reform has been initiated, the reform has generally followed the guidance provided by PFTAC in terms of the “standard package”. The ‘package’ comprises five aspects:

- introduction of a broad-based, low rate income tax, with few exemptions and discretions
- introduction of a broad-based value-added tax with few exemptions and discretions
- a reduction in reliance on trade tariffs and sales taxes
- introduction of comprehensive revenue administration legislation establishing and standardizing the rights and obligations of the revenue administration office, taxpayers, importers, and exporters.
- development of systems and processes for tax administration that make proper and efficient use of withholding and third-party information and encourage maximum voluntary compliance with the tax regime.

Based on the extensive literature on taxation reform we accepted, for the purpose of this evaluation, that the “standard package” promoted by PFTAC will produce a tax system that is in line with international good practice and that will raise revenue relatively fairly and efficiently. Depending on the circumstances of individual countries, there may be alternative reform packages that arguably could produce better outcomes, but reaching any such view was beyond the scope of our evaluation.

In our core case studies, Samoa and Tonga have implemented tax reforms along the lines of the standard package together with administration capacity building. Solomon Islands has had limited tax policy reform but has undertaken extensive administrative capacity building. Kiribati’s recent reforms are generally consistent with the ‘package’.

Donor support has led to broad reform and convergence in the features of Pacific country tax systems. The picture that emerges from reform efforts in the Pacific is that they have yielded significant formal changes in tax regimes, but more modest changes in tax practices. This picture is consistent with outcomes of taxation reforms in other developing countries.

⁶ The years are defined with a 30 June year end.

Successful reforms have depended on effective policy dialogue at every stage of reform

Consistent with theory, this evaluation has found that reforms that can be considered to have been successful in the Pacific have featured effective policy dialogue, at each stage of reform. Successful reforms have been more likely to have exhibited a more ‘systematic’ approach than others, in which the political, administrative and private sector infrastructure in a country are built-up side by side. The case studies have thrown up patterns of strengths and weakness in the process of reform. A desktop review of the reform experiences of the other Pacific countries within the scope of this study and interviews with advisers who have worked across a number of countries suggest that these patterns are not unique to our case study countries.

On the positive side, there is clear evidence that host countries and donors are increasingly making a strategic commitment to long-term tax reform as a process. Long-term advisors are now present in Samoa, Nauru, Kiribati, FSM, RMI, Tuvalu, Timor Leste, Solomon Islands, PNG and Vanuatu. This contrasts to earlier in the decade, when reforms to policy and administration were commonly staffed by intermittent technical advisors (TAs). Similarly, funding commitments for reform programmes are lengthening in duration. The need for building core relationships by developing a dialogue across and between sectors in the host country also seems to be widely recognized although the extent to which this is put into practice seems more mixed.

Many paths to successful reform

There also seems to be a general recognition that taxation is a complex area affecting most aspects of society in the host country. Considerable flexibility has been shown by host countries and donors in their approach to taxation reform and to overcoming reform obstacles. Tonga advanced its tax reform using a top-down approach driven by the Minister whereas Samoa adopted a more bottom-up approach; both countries have achieved a widely recognized degree of success in terms of reform outcomes. PFTAC has taken the lead in assisting countries with diagnostic surveys and the agenda setting stage and, together with individual donors and Pacific Technical Assistance Mission (PACTAM), assists in making a diverse range of technical skills available in most countries.

The location-specific nature of taxation reform also seems to have been taken into account. We found no evidence that donors have imposed a pre-determined reform agenda on reluctant Ministers of host countries. Taxation reform, when it has been initiated, has been the result of a commitment by the host country. In the case of Tonga, the reform programme seems to have been initiated at the instigation of the host country Ministers contrary to the precautionary advice from PFTAC that administrative capacity may be lacking. In Samoa, the more recent administrative reforms of the revenue ministry are a central component of the public sector management reforms being undertaken in that country, and follow from significant structural change to the tax system a decade or so earlier. In Kiribati, policy reform remained off the agenda until it was adopted politically. In Solomon Islands significant policy reform has not been undertaken because, it seems, of perceived political constraints which may indeed be the right approach.

We accept that taxation reform may have been undertaken partly at least in response to external pressures, such as the need to meet WTO requirements for a reduction in import

tariffs and to move toward a more sustainable fiscal position. But the general picture that emerges from our review is that the taxation reform process in the Pacific has been owned by the host country, not imposed upon it.

Little evidence of long-term, systematic engagement from donors

Donors have not imposed pre-determined reforms on Pacific Island countries, and out of necessity they have provided ongoing funding for the programmes initiated. However, there is little evidence that donors have entered into a strategic engagement with host countries as to how to manage the long, complex, location-specific journey involved with successful and sustainable taxation reform. The current transition of support for the Solomon Islands Inland Revenue Department from a component of the Regional Assistance Mission to Solomon Islands (RAMSI), to a bi-lateral arrangement with New Zealand provides immediacy to this strategic consideration of managing long, complex, reforms.

It may be that donors have to date seen the management of the long, complex, journey of tax reform as a task for PFTAC. PFTAC has certainly established itself as a centre of regional technical expertise, and is valued by Pacific countries for being flexible and responsive. A series of evaluations have concluded that PFTAC has delivered high quality, effective and efficient services. However, PFTAC is not resourced or skilled to manage all aspects of taxation reform across all countries in the region. PFTAC's core competency is at the policy agenda setting stage and in assisting with technical aspects of the implementation stage of reform.

Mixed results when viewed against the DAC criteria

When viewed against the Organisation for Economic Cooperation and Development (OECD) Development Assistance Committee (DAC) criteria for evaluating development assistance the results of the reforms are mixed:

- When viewed as an aggregate of discrete projects, then donor support has achieved worthwhile outcomes in terms of impact and effectiveness.
- The reforms have mostly been relevant, in that the reforms have been consistent with orthodox or best practice, the need for reform was clear and recognised by the host country.
- When assessed against the objectives for the interventions, the programme documentation and interviews support a conclusion that the programmes are, typically, carried out efficiently.
- However, we found that the reforms and administrative improvements are fragile, and may not be sustainable into the future.

Conclusion - reform achievements are fragile

The above factors seem to explain to a considerable degree the success that taxation reform has had in the Pacific region over the period covered by this report. The limitations to that success are mainly its apparent fragility; that is, whether the reforms and administrative improvements put in place over the past few years have sufficient depth to be sustainable

into the future. A critical aspect of sustainability is establishing the environment in which incremental improvements in tax policy and administration become business as usual.

The sustainability of the reforms is at least questionable. While the experience of taxation reform in the Pacific overall is positive, substantial deficiencies remain in many Pacific countries in terms of:

- realization of revenue potential
- sustained improvement in the administrative capacity
- tax paying culture and understanding of the tax system in civil society.

To a considerable extent, the fragility of the reforms is a product of the severe capacity limitations in the region. A range of factors contribute to these deficiencies including:

- a legacy of inefficient tax systems
- weak capacity for tax compliance
- inconsistent patterns of business taxation
- limited local expertise to respond to changes in the tax environment (such as growth in extractive industries).

However, the perceived fragility of the reforms also seems to be partly caused by the reform processes adopted. In particular, donors seem overly to focus on episodic reforms – discreet projects whether they are policy changes (such as introducing VAT) or administrative capacity building. Obviously tax reform involves a number of discreet reform projects but they need to fit together to bring about ongoing change to the tax system as a whole. In focusing on episodic reforms donors seem to be under-estimating the commitment required for the implementation stages of reform and the ongoing nature of capacity building. Donors have supported reform programmes through the provision of technical assistance, training, equipment or infrastructure support during the initial stages of reform programmes but in some cases may be withdrawing capacity support before changes have fully embedded. There is also a risk in failing to appreciate that institutional development must be ongoing.

Lessons

We provide comment on more specific lessons below. These more specific lessons would remain useful if donors decide that their priorities do not justify the commitment required to adopt a more systematic tax reform focus. However, the lessons are also indicative of what is required in adopting a more systematic reform focus.

Lesson – taxation reform requires long-term commitment

Too-short timeframes for tax reforms, particularly those that involve deep organisational, institutional, or behavioural changes, can have adverse effects. To use the words of one commentator, holding unrealistic timeframes for reforms is a ‘deadly sin’.

The long-term commitment required for successful taxation reform makes it desirable for donors to commit to long-term funding of reform programmes. Short-term funded activities that are not fully integrated into a longer-term reform programme are unlikely to produce positive outcomes. The funding of recent administrative reforms in Samoa provide

one example of successful longer-term coordination. Donor countries, and the Samoan Government, established a fund for public sector management reform, and the revenue agency made its business case for funding a defined reform programme. There were several positive incentives from this approach, including:

- the reforms proposed by the revenue agency to be assessed against other priorities for public management reform
- once the reform programme was approved, the revenue managers had strong incentives to find the least cost mix of local and (more expensive) international resources to deliver the reforms
- as the revenue agency held the budget for reform, the reform programme avoided being stalled because donors (or their consultants) differed on the best path forward – although far from systemic, most reform programmes we reviewed revealed an example of where an aspect of reform stalled or was delayed because a disagreement between donors held up funding or support for some aspect of the reform.

Taxation reform has common features and regional networking is important

Benefits of co-ordination by donors on their approach to tax reform in specific host countries go beyond funding. Sustainable taxation reform requires ongoing administrative capacity to implement reforms and to promote supporting policy changes as required. Donors should support administrative capacity building on an ongoing basis.

Although taxation reform is location specific, there are a number of common features to tax policy across the region. Networking across the region provides one mechanism to at least manage the capacity building constraints faced by all Pacific Island countries. PFTAC provides one forum for such networking especially in terms of assistance on administrative capacity building, agenda setting and identifying options for technical assistance with implementation. The PITAA also provides opportunities for exchanges between administrations. These should be supported as providing valuable additional capacity for countries in the region. We note that no representatives of either the Australian or New Zealand tax authorities attended recent PITAA meetings.

Although the Australian and New Zealand tax administrations are much larger and more sophisticated than those found in the Pacific Island countries, it is easy to overlook the similarity of issues faced in basic tax administration such as dealing with the underground economy. The Australian and New Zealand tax administrations are a potential source of technical skills in high demand in the Pacific. These technical skills are being utilized where networks are well-established as is the case, for example, with Samoa and Solomon Islands revenue agencies and the New Zealand IRD.

With the exception of the support by the New Zealand IRD for the Solomon Island IRD - which is the subject of an agreement between MFAT and the New Zealand IRD - the arrangements tend to be ad hoc and dependent on particular personnel. Tonga, for example, seems to struggle to obtain any significant level of support similar to that provided to Samoa. Useful consideration could be given to establishing a more structured approach to administrative assistance for income tax administration along similar lines to that already operating with respect to customs authorities. A more structured approach would also ensure that the ultimately limited resources of the New Zealand and Australian tax

authorities are utilised in accord with the development priorities of the New Zealand and Australian governments.

Donors can inadvertently undermine reform efforts

Greater visibility of the efforts to reform taxation systems as part of the programme for economic development in the Pacific may help efforts to ensure different aid projects are mutually re-enforcing. Given the complex environment in which tax reform operates, donors can easily undermine reforms by themselves requiring tax exemptions or concessions for aid projects. Any requirement for tax concessions by donors should be handled carefully in line with United Nations guidelines and be subject to a dialogue with the host country so that clear rules and rationales for them are set out.

Integrity of overall tax system is critical to sustainability

The ongoing sustainability of taxation reform is dependent on maintaining the integrity of the overall tax system. For example, the growth or even the continuation of a significant underground economy evading taxes will undermine the integrity of the overall system and with it the most well-designed reform programme. A programme that successfully raises revenue in the short-term, by increasing the burden of poorly designed taxes on parties trying to comply with the tax laws while other sectors escape attention, may be self-defeating and reduce voluntary compliance in the medium-term. Donor support for audit activity and the basics of tax administration are essential to the long-term success of taxation reform.

Managing dialogue between parties is a task in itself

Given that taxation reform affects many different aspects of a host country society the dialogue involved in the reform process involves many players and is complex. One aspect of this is managing the dialogue between the host country and donors. This dialogue needs to be managed with specific skills relevant to that task as it involves navigating the political web of both donor and recipient governments (and the politics of delivery and recipient institutions). Donors should consider the need to assist host countries with support in this area; if this assistance it is to be effective, it may involve funding advisers to represent the interests of the host country and those interests may not always align with those of the donor countries and hence require clear briefs for the advisers.

There is a weakness in dialogue at policy setting stage

It is apparent from this study of the experience of the Pacific Island countries that there is a gap or relative weakness of policy dialogue at the policy setting stage, in which advisors, host country officials, host country politicians and civil society set the framework for the reform based on a realistic and achievable view of the administrative and political constraints. These weaknesses tend to be more prevalent in reforms that flow from an administrative, rather than political, agenda. A strong Minister with a reform agenda will tend to seek out the skills he or she needs to progress the reforms at a policy or political level, at the risk of stepping ahead of administrative capability of the revenue agencies to implement. An administratively capable revenue agency, however, may not necessarily have the experience or skills to assist their Minister identify realistic and achievable reform pathways and may be reluctant to seek support in this area as it may intrude on their relationship with their Minister.

Taxation is about political trade-offs and political constraints to reform need to be recognized. This may mean that substantial policy reform may not be possible in a specific country for periods of time. The focus should then be on administrative capacity building which should produce benefits in its own right and provide better foundations for reform when the political constraints ease. However, even in the presence of severe political constraints it will often be possible to advance policy reforms of a technical or remedial nature that can provide substantial benefits to the tax administration and the overall integrity of the tax system. Donors should consider supporting such programmes even though they may be seen as outside the ambit of tax reform as normally understood (that is discreet tax-specific projects associated with episodic tax reform). The skill base required for advancing such reforms are a mix of technical tax knowledge and experience in dealing with the political interface that host countries will not easily be able to access without donor support.

The evaluation has raised questions about whether legislators and senior public officials really understand the tax policies being promoted and the implications for tax reforms for their constituents. Donors who are considering providing finance for reform projects should consider whether the reform project plan provides sufficient support for advice and communication with political decision-makers. This includes user-friendly communication about the role and function of tax, the impacts of the proposed policy changes, the reasons for reform and so on.

Engagement with civil society matters

Differences in the level of engagement with civil society can have impacts on the sustainability of the reforms. Recent reform efforts have recognized that civil society actors – specifically tax agents, accountants and business associations - are likely to be crucial intermediaries in fostering political support for reform. Countries that have successfully targeted communication with the ‘demand side’ are showing better results in terms of registration and compliance. Donors who are considering supporting reform programmes should therefore consider whether there is room to include technical assistance for building tax capacity/knowledge in the business communities, especially for small and medium sized enterprises. Some support by some donors is provided, for example, for business organisations or community groups to undertake research and engage in policy discussions. But this support appears ad hoc and outside the primary reform programmes.

Reform does not always follow a linear path

Given the technical complexity of taxation and its complex inter-reaction with the host country environment, donors should not expect the reform process to be a linear one or to follow some text book ideal. Donors should be flexible and supportive to differing approaches to taxation reform.

Tax reform requires diverse skills

The complexity of taxation reform means that it requires a diverse range of skills through its various stages. These will range from tax policy skills, to tax administration skills, to IT skills to communication skills and so forth. No one person is likely to possess the range of skills required for any broad tax reform programme. Instead it is likely that tax reform will require a team of people with a diverse skill base. A key skill may be in identifying the expertise needed as the reform progresses and having a sufficient involvement in the networks of

potential advisers to contract individuals to fill specific gaps and build capacity as determined by the host revenue agency as it proceeds with its reform; the Samoan revenue agency has used this approach to build and supplement its internal capacity.

Be realistic about capacity

Taxation reform should be developed in light of the location specific capacity of the host country. A key feature of the Pacific region is significant limitation in the area of technical tax administration capacity. Any measures that can relieve those constraints will assist the reform programme. In that regard, donors should be cautious about supporting capacity building in areas requiring high levels of technical expertise such as transfer pricing.

Given that any tax reform programme needs to be tuned to the host country environment, donors should be careful about not advancing their own reform agendas as a condition for support except in the most justified objectives such as reducing the level of corruption.

Tax reform success cannot be measured by just revenue

Donors should be cautious about setting objectives for tax reform that are too short-term or too narrow. A common example is a short-term revenue raising target. This will often be inappropriate:

- Taxation reform should be focused on raising revenue in a fair and efficient way which will often be contrary to a short-term revenue raising objective.
- A revenue-raising target can be inconsistent with other potential projects that have a higher priority in terms of the overall reform programme (such as reducing compliance costs).

While revenue-raising is clearly a central objective of any tax system and the immediate concerns of host countries and donors to improve revenue raising capacity is understandable, short-term targets for the tax administration should be set in terms of their consistency with the longer-term reform programme.

Implications for donors

This evaluation has found that tax reform is a long journey that requires a sustained dialogue between different donors, host country politicians, host country officials, technical advisors and civil society. The reform journey is complex, may have no clear pathway, and is multi-faceted. Reform is also highly location specific; it is subject to local political and administrative constraints. As the UK Mirrlees Review noted, taxation is a complex system the reform of which should involve moulding an entire system not just changing aspects of it.

We have concluded that although donor support for tax reform projects seems to have followed good international practice, and although much has been achieved, it does not seem that the reforms and administrative improvements put in place over the past few years have sufficient depth to be sustainable into the future. A critical aspect of sustainability is establishing the environment in which incremental improvements in tax policy and administration become business as usual.

We have considered how the nature of donor funding may be impeding the establishment of a sustainable well-functioning tax system. Our conclusion is that donors have tended to support discreet taxation reform projects. We label this episodic support. Examples have been: the move from tariffs to VAT, the move to a self-assessment system for income tax, and the introduction of a computerisation to administration.

However, as the UK Mirrlees Review has stressed, the tax system should be viewed and reformed as a whole system. This requires a more systematic support by donors to taxation reform to establish the environment required for sustainable reform.

Figure 1 Systematic versus episodic taxation reform

Systematic tax reforms ...	Episodic tax reforms ...
... consider the tax system as a whole, considering the role that each tax plays in how they fit together. A reform programme for the entire tax system is developed in the dialogue between donor and host country.	... are viewed as a series of discreet projects, and discreet projects feature in the dialogue between donor and host country.
... involve building up the political, administrative and private sector structures and behaviours that make a tax system work.	... focus separately on tax rules, political, administrative and private sector infrastructure.
... tend to require longer term, more strategic commitments from donors and sustained dialogue between donor and host country.	... tend to require shorter-term project-based funding, with short term dialogue focused on funded projects.

We outline in the report, and summarise below, what this systematic approach is likely to entail for donors in the Pacific and how it differs from the current episodic approach.

The implication of this evaluation for donors is a choice between three broad options for future donor support of taxation reform:

- Given the mixed results from past donor support, move the focus of donor assistance to other priorities.
- Continue with the current episodic support for taxation reform with some improvements resulting from the lessons drawn in this evaluation.
- Consider moving to a more systematic approach to support for taxation reform.

The challenges to implementing systematic taxation reform are not to be under-estimated. The Mirrlees Report was highly critical of the UK in this regard. For Pacific economies that face significant economic and social obstacles and a less sophisticated public administration infrastructure than the UK, the impediments are large. Donors may therefore decide that

attempting to move to a systematic approach to taxation reform assistance, given the resource and time commitment that would involve, cannot be justified given other aid priorities.

However, if donors decide that the resource implications of a move to more systematic approaches are not justified, the limitations of episodic taxation reform assistance should then be recognised. Episodic reform can be expected to continue to produce worthwhile improvements in Pacific tax systems, as it has done, but with the associated fragility.

A more systematic approach by donors would require:

- A long-term commitment to working with host countries, ideally co-ordinating efforts with other donors, to develop a strategy of building the tax system of host countries as a whole.
- Donors would need to engage directly with host countries and support this with ongoing engagement and monitoring of the success in building up systematic tax infrastructure. To engage in this dialogue effectively over a long-term reform programme, donors will need access to experienced advisers who can assist them understand the realistic and achievable reform options within the inevitable administrative and political constraints of the host countries.
- Senior advisers within donor countries revenue agencies may have the necessary skills and experience to assist in identifying the realistic and achievable reform options, as do a small pool of international advisers. These individuals are unlikely to be available for technical assistance work for any extended period of time. Some consideration by donors will be needed in terms of how they build a network of relationships which assist them to engage effectively in the ongoing dialogue between the donor and the host country.
- Greater focus on providing assistance in the areas of the political/administrative interface and in building up the capacity of civil society given the importance of the private sector in making any tax system work.
- There needs to be a true and ongoing dialogue between the donor and the host country. This dialogue requires the donor, in its partnership with the host country, to appreciate that tax reform is not only about the provision of core technical taxation skills. To be effective, the donor must also understand the complexities of the host country environment so as to identify and engage in a dialogue over where there may be gaps in capacity, the nature of the obstacles being encountered, and the opportunities to build a constituency for improvements to the tax system.

1. Introduction

1.1 Purpose of this evaluation

The Ministry of Foreign Affairs and Trade (MFAT) asked us to evaluate the efforts by donors to assist reform of taxation systems in the Pacific over the period 2002 to 2012. During this period, most Pacific countries have made changes to their policy and administrative settings, and by and large these reforms have been supported by donors directly or indirectly. The purpose of the evaluation is to seek insights into the process of reform to inform improvements to how donors support the design and delivery of tax reform programmes in the Pacific.

This evaluation does not consider what would be the best form of taxation to meet the revenue raising, fairness, economic efficiency and other objectives of Pacific countries.

Our evaluation seeks generalised lessons on experiences that abstract from the specific circumstances to broader situations; these lessons might highlight strengths or weaknesses in preparation, design, and implementation that affect performance, outcome, and impact.⁷

MFAT identified, in its terms of reference for this study, that little analytical work has been undertaken examining the lessons from efforts to reform government revenue collection and there is little information to draw on from experiences in the Pacific.⁸ Research conducted to prepare this paper and the companion topography report has found that there is a body of existing evaluation and research material, but it mostly relates to countries in which large scale projects have been conducted with discrete objectives or focuses on short-term outcomes. No evaluations look at the reform programmes across the Pacific as a whole or reflect at a high level on the process of reform and how this is supported by donors. This evaluation seeks to fill this gap.

1.2 Taxation reform important for development objectives

A growing number of international aid agencies recognise that taxation is an important mainstream priority for development assistance.⁹ There are two primary reasons for this increase in interest in taxation reform.

⁷ The DAC Principles for the Evaluation of Development Assistance, OECD (1991), Glossary of Terms Used in Evaluation, in 'Methods and Procedures in Aid Evaluation', OECD (1986), and the Glossary of Evaluation and Results Based Management (RBM) Terms, OECD (2000). Available from www.oecd.org

⁸ 'Terms of Reference for the Evaluation of Tax Revenue Reform in Pacific', New Zealand Ministry of Foreign Affairs & Trade, Aid Programme, pages 1 – 2.

⁹ See for example, International Tax Compact, *Mapping Survey: Taxation and Development*, and Michiels, G and V Thuronyi, *Overview of Cooperation on Capacity Building in Taxation*, preliminary draft, Center for Taxation and Public Governance and IMF, 14 September 2010.

The first reason reflects a groundswell of interest in mobilising domestic resources as a foundation for sustainably funding essential public services, especially in the wake of the global financial crisis.¹⁰ Pacific economies have fortunately suffered less directly than many countries from the global financial crises, because their economies are generally closely tied to Australia and New Zealand. The Asian Development Bank (ADB) reports that many Pacific governments exceeded their revenue targets in 2011 and had tax collections that were higher than in 2010.¹¹

While the trends reported by the ADB are comparatively positive, many Pacific countries have substantial structural deficits that are a challenge to address. PFTAC reports that deficits excluding grants, for countries that rely heavily on grants and other grant aid, are typically very high. In 2010, for example, PFTAC reported that Palau's deficit excluding grants was around 23 per cent of GDP, Kiribati's (a heavily aid dependent economy) deficit excluding external grants was around 70 per cent of GDP, and Solomon Islands' deficit excluding grants was around 24 per cent of GDP.¹²

Achieving longer-term fiscal self-sufficiency remains a challenge in most Pacific countries given their limited resources. Many countries need substantial additional revenue to finance poverty-reduction, as well as pressing needs for infrastructure and adaptation to climate change. Most countries will need to achieve these increases in revenue at the same time as adjusting to other challenges which include: reducing trade tariffs in the context of trade liberalization, reducing high public debt, adjusting to declining overseas assistance and containing draw-downs from trust funds to sustainable levels.

The second reason for increased interest in taxation reform reflects increasing recognition that the development of an effective, efficient, equitable tax system is a central pillar of state building and governance;¹³ taxation and state-building are increasingly seen as linked.¹⁴ Taxation literature strongly supports the idea that a substantial governance 'dividend' can be gained from mobilising domestic financial resources through the tax system.¹⁵ If tax reform is undertaken in a way that promotes greater responsiveness and accountability, alongside improvements in the state's institutional capacity, then tax reform can become a catalyst for broader improvements in government performance.

¹⁰ OECD, *Tax and Development: Aid Modalities for Strengthening Tax Systems*, 2013, p 20.

¹¹ Fiscal Discipline Can Help the Pacific Navigate Global Financial Instability, Asian Development Bank, 14 December 2011.

¹² Improving Revenue Collection and Capacity in Forum Island countries, Pacific Financial Technical Assistance Centre, September 2010

¹³ OECD, *op cit*, p 20.

¹⁴ State building can be broadly defined as 'increasing the capacity of governments to interact constructively with societal interests, to obtain support and resources from those interests, and to pursue consistent lines of action', see Moore, M, 'Between coercion and contract: competing narratives on taxation and governance', in D. Brutigam, O. Fjeldstad, and M. Moore (eds), *Taxation and State-building in Developing Countries: Capacity and Consent*, Cambridge University Press 2008, pp 34-61..

¹⁵ See Moore, *ibid*, and Prichard, W, *Taxation, Responsiveness and Accountability in Sub-Saharan Africa*, PhD dissertation, Institute of Development Studies, University of Sussex.

Seen in this light, taxation is not just an administrative task for governments and citizens. It is also about politics and power, and the way that authority is exercised in a country through its formal and informal institutions.

1.3 Scope of this evaluation

Sixteen countries are within the scope of this evaluation.¹⁶ These countries share the common feature of being members of PFTAC and most of them have attempted some form of improvement to their taxation policies or administration since the early 2000s.

The differences between the countries within the scope of this evaluation are immense. Within this group of countries, there are over one thousand languages,¹⁷ and the region is as culturally diverse as anywhere on earth. Geographically, the countries range from a small island state supporting around 1,500 people, to sovereign states formed from nearly 1,000 islands and home to around 500,000 people, to a rugged land mass with over 7 million people. Politically, the countries range from communities sharing reasonably similar cultural identities within the country boundaries, to countries with populations with very different cultural affiliations and little shared history.

The evaluation delves deeper into the experiences of Kiribati, Samoa, Solomon Islands, and Tonga as case studies. These countries give a good geographic variation, variation in reform approach, and variation in terms of stage of reform achieved. The experiences of these countries have been used to highlight experiences or lessons that we understand to be common across the many Pacific Island countries that have attempted reform.

While the majority of the data comes from Solomon Islands, Tonga, Samoa and Kiribati we have in our research found useful information in the reform experiences of other Pacific countries. In particular, the Cook Islands, Republic of Marshall Islands (RMI), Federated States of Micronesia (FSM), Papua New Guinea (PNG) and Tuvalu each offer recent experiences of reform which have offered lessons of use for this evaluation.

1.4 System wide evaluation of lessons

This evaluation focuses on reforms that have been supported in some way with donor funds because the objective is to seek lessons that may ultimately inform improvements to how donors support the design and delivery of taxation reform. The evaluation is system-wide rather than programme-based. Our brief is to consider the entire combination of reforms during the period of interest, rather than assess the specific performance of any particular activity or agency. The objective of the study is to report lessons, or to form generalisations based on the evaluation research that highlight strengths or weaknesses in how donors have supported taxation reform efforts.

¹⁶ The 16 countries considered in this evaluation are members of PFTAC; Cook Islands, Fiji, Kiribati, Federated States of Micronesia, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tokelau, Tonga, Tuvalu, Vanuatu.

¹⁷ Documenting Endangered Languages of the Pacific, University of Sydney, http://sydney.edu.au/arts/research_projects/delp/index.php

The evaluation question underpinning our research was

“Has donor funded intervention provided for effective policy dialogue at each stage of reform and what were the sustained consequences for the objectives of the reform?”

1.5 Structure of this report

The remaining sections of this report are structured as follows:

- Section 2 outlines the evaluation approach and the methodology followed.
- Section 3 reviews taxation reform in the Pacific over the period 2002 to 2012.
- Section 4 reviews the role played by donors in this process of reform.
- Section 5 provides a summary of the outcome indicators and comparative data and statistics.
- Section 6 sets out the lessons from efforts by donors to assist reform of taxation systems in the Pacific over the past 10 years.
- Section 7 summarises the evaluation and considers the implications for donors with respect to ongoing support for tax reform in the Pacific.

1.6 Companion papers

This evaluation report is accompanied by three other papers:

- **A synthesis report:** This document summarises the lessons learned into a short paper.
- **The Evaluation Plan:** This document describes the project scope and our approach to the evaluation.
- **The Topography:** This document sets the scene for the evaluation and summarises the taxation revenue reform undertaken in the Pacific in the past ten years, the objectives of that reform, and who has undertaken, funded and been a party to this work.

This evaluation report includes summary information from the Evaluation Plan and Topography reports.

2. Evaluation approach and method

2.1 Understanding successful taxation reform

2.1.1 A good taxation system

A good tax system reflects a combination of good tax policy and good tax administration. Failings in either administration or policy will render a system vulnerable. In the following table we list, for illustrative purposes, some high level attributes which are typically found in descriptions of a good taxation system.

Table 1 Some attributes of a good tax system

Good tax policy	Good tax administration
Is seen as fair	Has efficient and effective processes for: <ul style="list-style-type: none"> • Registration • Processing • IT systems • Auditing • Collection
Is efficient – low economic costs	
Is simple – low compliance and administrative costs	
Is coherent – different parts fit	Allows for fair and equitable dispute resolution
Is acceptable - has community and political support	Has a focus on voluntary compliance

Taxation reform would bring about sustainable improvements in institutional capacity and in tax policies and administration, consistent with international good practice. The taxation literature highlights how difficult and delicate it can be to achieve a suitable and coherent set of tax policies and effective administration and that there is always more to do – a taxation system must constantly adapt and update to reflect changes in economic activity, taxpayer practices, and society values. A well-functioning taxation system is always being upgraded, and hence taxation reform might be said to be successful if it establishes a regime where incremental improvements in policy and administration become business as usual.

2.1.2 Objectives for particular reform programmes

At a particular point in time, changes to the taxation policy or administration may be pursued with one or more objectives in mind, including:

- **Increased revenue to fund government expenditure programmes** – a one percent gain in revenue over the 16 countries considered in this study would amount to about \$65 million per annum.¹⁸
- **Increased economic efficiency** - taxation is the single biggest intervention into the market economy and a poorly designed or administered taxation system may distort investment and production decisions and impede economic growth and be costly to administer and comply with.
- **Equity and public acceptance** – a tax system may be viewed as unfair or changes might contribute to the government's redistribution objectives or enhance public acceptance of the tax system; poverty reduction may be a key objective for some Pacific Island countries.
- **Fostering state building** – taxation may promote state building by providing a focal point for bargaining between the state and its citizens and through developing quality institutions for tax collection.
- **Meeting international commitments** – taxation reform may be required by external parties, for example reducing tariffs as condition of entry to trade agreements, conforming to reform 'models' as a condition of aid assistance, and participating in international agreements with regard to tax havens.

Each of these objectives could give rise to different measures of 'success' for a specific programme or activity, and the outcome of any particular programme would not be easy to interpret without an understanding of the objectives for that programme. For example, a programme aimed at improving economic efficiency or complying with international requirements might not raise additional revenue or may lean against the government's redistribution objectives. Value added taxes, for instance, have often been introduced with compensating assistance via the income tax and social welfare systems.¹⁹

The outcome measures for specific programmes or activities therefore should be viewed in the light of the objectives set for that particular programme or activity. Importantly, the outcomes must also be considered in terms of their consistency with the longer-term reform strategy as shorter-term objectives (especially revenue raising) may conflict with the longer term strategy for a good tax system.

Taxation reform necessarily involves political trade-offs and is not just a technocratic process. Taxation is a critical link between the citizen and the state and involves fundamental issues about the distribution of income and wealth in a society. An inevitable consequence is that tax reform is and should be subject to political and social trade-offs. Ultimately, successful reform would be viewed generally by participants (taxpayers, tax

¹⁸ Authors estimates from data presented in companion topography study: the 16 countries considered in this evaluation are members of PFTAC; [Cook Islands](#), [Fiji](#), [Kiribati](#), [Federated States of Micronesia](#), [Marshall Islands](#), [Nauru](#), [Niue](#), [Palau](#), [Papua New Guinea](#), [Samoa](#), [Solomon Islands](#), [Timor-Leste](#), [Tokelau](#), [Tonga](#), [Tuvalu](#), [Vanuatu](#).

¹⁹ New Zealand's own experience in introducing GST is cited in the literature as an illustration of a 'successful' reform. However, if the reform package were rated only on whether it was initially revenue positive, it would have scored poorly as it was achieved with substantial compensating welfare assistance and reductions in income tax rates. Ian Dickson, David White, *Tax Design Insights from the New Zealand Goods & Services Tax (GST) Model*, Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington.

administrators, and political representatives) as achieving results and having those results sustained over a long period. This means any assessment of interventions by donors to support taxation reform must consider both process and results. A reform programme that is technically sound but universally opposed by taxpayers is as unlikely to be sustained as a programme that may have broad support but is technically unworkable.

2.2 Conceptual approach

2.2.1 Three strands of literature

To develop an approach to this evaluation that would consider both process and results we reviewed, and drew conceptual foundations, from three bodies of literature and experience:

- *The literature and analysis of taxation policy design and administration:* This literature provides powerful guiding principles, or broad commonalities, for tax design and advice which should generally apply in the Pacific as elsewhere.²⁰ There also exists a reasonably extensive literature on how to apply these principles and how to administer tax systems within the context of developing economies.²¹
- *The literature and experience in studying the conditions for successful reform of taxation systems.* This literature identifies the conditions which should be assessed in diagnostic surveys to understand the environment within which taxation reform is to proceed.²²
- *The emerging literature and experience on policy dialogue in international development work.* This literature considers the elements of good processes for sustained interchange of ideas, perspectives and analysis between donor funded agents and their counterparts in the host country, through the relationship forming, agenda setting, policy options, and policy implementation aspects of reform.^{23, 24}

Drawing together the strands of these bodies of literature, suggests interventions by donors in taxation reform is more likely to be successful if the following factors can be achieved:

- The donor and the host country have reasonably clarity as to the objectives for the taxation reforms.

²⁰ See for example the principles set out in Michael Keen, *Taxation and Development – Again*, IMF Working Paper, WP/12/220.

²¹ See for example *Revenue Mobilization in Developing Countries*, Prepared by the Fiscal Affairs Department, International Monetary Fund, March 8, 2011.

²² See for example, OECD, *Tax and Development: Aid Modalities for Strengthening Tax Systems*, 2013 and IMF, *Tax Policy and Administration*, Topical Trust Fund, Draft Program Document, April 2010.

²³ McCullough, A. et. al. (2011). Review of Literature and International Practice in Policy Dialogue. Canberra, The Office of Development Effectiveness. Available at: http://www.ode.usaid.gov.au/current_work/documents/review-policy-dialogue.pdf

²⁴ The term “policy dialogue” is commonly applied to government to government processes in the source literature but the principles and indicators of good process apply equally to engagement between donors and host country agents.

- Expectations as to what can be achieved are reasonable in terms of social and political capacity and consistent with the level of tax administration development and result from a diagnostic survey of the conditions for successful taxation reform.
- The donor and the host country counterparts have a shared and credible evidence base on which to base their analysis and policy design (including a clear understanding of the social context and the implications of various options for different stakeholders and sectors).
- The fora in which dialogue takes place are neutral and provide space for formal and informal, technical and political engagement.
- The donor and the host country counterparts engage in negotiating the reform programme and the assistance provided with comparable negotiating capital – values are balanced and the parties engage on relatively equal terms and with shared information and analysis.

Taxation policy advice is consistent with established principles for good tax design and accounts for the context within which the reforms are to be implemented. Successful taxation reform interventions would incorporate targeted work streams in each of three stages: agenda setting, policy options, and implementation:²⁵

- The agenda setting stage focuses on forging an agreement on what issues require attention and outlining what broad changes are desirable.
- During the policy options stage, the donor agency and its host country counterparts explore existing and prospective policy options and decide which of these is feasible and appropriate, on the basis of evidence, in terms of the cultural context and realities of the political economy, and in terms of the resources available (including the revenue administration's capacity to implement any desired reform programme).
- During the implementation phase, dialogue focuses on facilitating and tracking progress on institutional and regulatory changes supporting taxation reform. Success should be assessed in terms of the outcomes or objectives of taxation reform.

The literature suggests that a fourth dimension - forming and maintaining relationships - is central to each of these stages of policy dialogue.²⁶ Trust and legitimacy built during the first stages of reform are likely to be critical when entering the implementation phase with its concomitant challenges and required dialogue.

We note that the literature we reviewed at the outset of this evaluation did not focus on the need for donors to engage in a systematic and strategic dialogue with host countries but this has been the major finding of this evaluation.

²⁶ McCullough, A. et. al. (2011). Review of Literature and International Practice in Policy Dialogue. Canberra, The Office of Development Effectiveness. Available at: http://www.ode.usaid.gov.au/current_work/documents/review-policy-dialogue.pdf

2.2.2 Outcome indicators

Intermediate outcome indicators

Reflecting this evaluation's interest in both process and outcomes, we sought evidence that the factors outlined above were leading to improvements over the medium term (3 – 5 years) in:

- Tax policies, consistent with international good practice, standards and codes, taking into account regional/national circumstances.
- Tax administration consistent with international good practice, standards and codes, taking into account regional/national circumstances.
- Skills and institutional capacity in the diagnosis, prioritization and implementation of appropriate policies and administration.

Longer term outcome indicators

The evaluation also sought evidence that the improvements in policies, administration and institutional capacity are leading to ongoing improvements in:

- state building and/or public financial management
- revenue adequacy
- the efficiency of the tax system
- the public acceptability (a proxy for equity) of the tax system
- the cohesion of the tax system
- meeting international commitments.

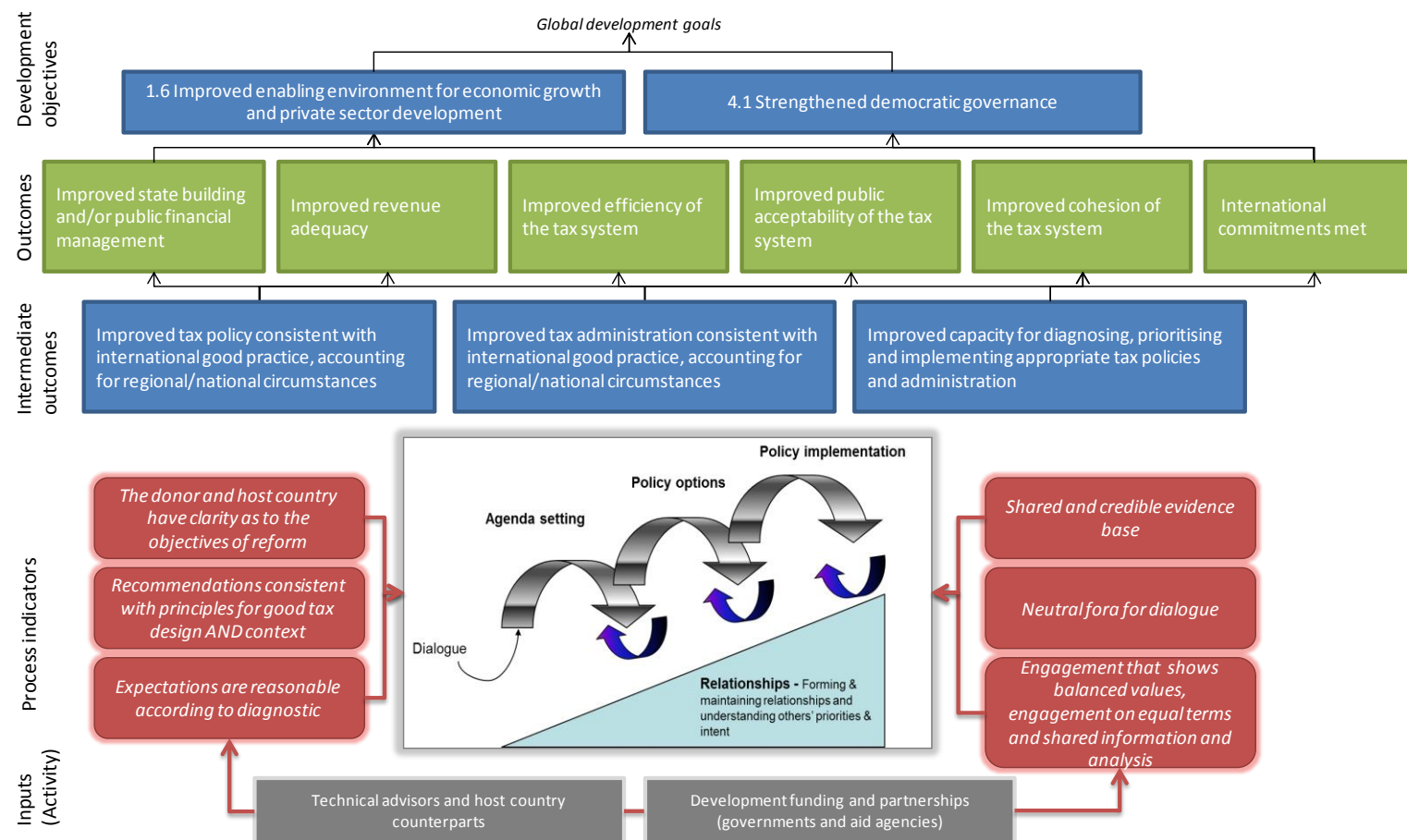
Taxation reform could be considered a success where the incremental improvements in these outcomes are viewed generally by participants (taxpayers, tax administrators, and political representatives) as achieving a satisfactory mix of results and those results are sustained.

2.2.3 Results diagram

In summary, our review of the existing literature suggested that the objectives of tax reform are likely to be advanced when improvements in tax policies, tax administration, and the skills and institutional capacity of the host country can be achieved. A programme for taxation reform is more likely to achieve these outcomes when there is clarity as to the objectives of the reform, informed and reasonable expectations as to what can be achieved, a shared and credible evidence base, taxation advice is consistent with good tax design and accounts for local conditions and context, and the donor and host country negotiate the reform programme on relatively equal terms and maintain continuing formal and informal dialogue.

This results framework is shown in diagrammatic form in figure 1 below.

Figure 2 Results diagram: Achieving outcomes in taxation reform using policy dialogue



2.3 Method

The research for this evaluation involved desk-based review of Programme documentation provided by PFTAC, MFAT and DFAT (including previous evaluations) and of literature, collection and analysis of data (both desk-based and in-country), and semi-structured interviews.

We conducted four in-depth case studies in Kiribati, Samoa, Solomon Islands and Tonga. These case studies were chosen as providing a variety of taxation reform experiences and geographic distribution. The case studies supplemented more general desktop research and interviews to generate the core research findings. The case studies were built on a combination of data generated from literature, targeted structured interviews carried out in each country and primary quantitative data.

In total, we interviewed 49 people, primarily in Solomon Islands, Kiribati, Samoa, Tonga, Fiji and New Zealand. We spoke to people from a range of organisations including:

- Pacific Island Country (PIC) government staff
- current and former Ministers of Finance and/or Revenue from PICs
- current and former technical advisors and tax specialists
- Chambers of Commerce and tax advisors in PICs
- Pacific Technical Advisory Centre (PFTAC) current and former staff
- New Zealand Aid Programme staff, New Zealand Posts and High Commission staff
- Australian Department of Foreign Affairs and Trade staff, Australian Posts and High Commission staff.

The interviews were conducted using an interview template that was structured around the research question themes, and comprised open-ended questions to prompt interviewees. Where possible and appropriate, we provided background material to interviewees in advance, which explained the evaluation framework and theory of change. The interview template and evaluation framework served as a general guide, with discussion being semi-structured and focussing on topics of relevance to each respondent's role and background knowledge. Notes from the interviews remain confidential to the evaluation team, and comments recorded in the report are not been attributed to individuals.

To analyse the interviews we synthesised responses into a template structured around the research questions. Findings from the interviews were grouped thematically, with the number of responses attributed to each view/statement. We then used the relative number of responses to weight the overall body of opinion and inform our own views.

The themes discussed in this paper were tested with a Steering Group comprised of staff from the New Zealand Ministry of Foreign Affairs and the Pacific Technical Advisory Centre. The themes were also presented by Robin Oliver at the Pacific Islands Tax Administrators' Association (PITAA) conference in Honiara in October 2013. The delegates included several Commissioners, senior officials and advisors from throughout the Pacific region.

2.4 Challenges and limitations

Limited scope for ‘before and after’ comparisons

Evaluations of this nature inevitably involve comparing observed outcomes with assumptions about what the outcomes would have been had the policy or program been implemented differently. There is limited or no scope for ‘with and without’ or ‘before and after’ comparisons. Instead, this evaluation assesses the current state and as best as possible draws a picture of the prior state (i.e. what was happening in the country at the beginning of the 2000s) and draws inferences as to what might have occurred under different reform processes.

We caution that linkages between process and impacts are neither mechanistic nor one-to-one, and findings of poor or sub-standard processes do not automatically sustain an inference that outcomes have been sub-standard or deficient. Nor does it automatically follow from observed sub-standard outcomes that the process of implementation has been unsatisfactory.

Data limitations for quantitative data

This evaluation includes a selection of quantitative data to illustrate two layers of information. The first layer presents information that illustrates the achievement of revenue outcomes across the Pacific Island countries as a whole. The second presents more detailed information specific to our four case study countries: Kiribati, Samoa, Solomon Islands, and Tonga.

We encountered significant difficulties with both data availability and data quality. There is a lack of consistency between sources. For example, tax revenue numbers in the ADB online statistical database and country-specific PFTAC reports do not line up, and country-specific reporting (e.g., PFTAC reports) do not always line up with answers provided in other country-specific sources (e.g., the RA-FIT questionnaire). At times the inconsistency between reported sources of macroeconomic data (namely ADB, WorldBank, PFTAC reports, RA-FIT) was sufficiently pronounced as to make the data unreliable.²⁷

Further difficulties arose because for some countries data is reported on a calendar year basis whilst other countries report on a financial year basis, and some countries report different data sets over different time periods. These data quality issues have made it difficult to build a comprehensive picture of the trends in tax revenue over time. We present the most comparable and credible set of data available.

For the case study information, we have used data provided by the revenue agency in-country, or reported in PFTAC reports as much as feasible. For total tax revenue, population and GDP data we used data from ADB’s online statistical database, as this was

²⁷ For example, various sources reported the population of the Cook Islands for 2011 at 20,600, 25,600 and 14,974, which made computation of taxation per capita figures problematic. Respectively, these figures are taken from ADB “Key indicators for Asia and the Pacific 2013”; ADB “Key indicators for Asia and the Pacific 2012”; and the Cook Islands Census 2011 resident population. The figure adopted, 25,600 is from the ADB online statistical database. This is the figure in the 2012 indicator report.

the best way to ensure consistency across and within country data. One trade-off of this is comparability: the ADB data has apparently undergone cleaning or reformatting, and as a consequence it is likely that what is reported in this evaluation will have differences to what is shown in other publically available sources.

Data availability issues meant that some indicators were not able to be assessed. Of note, the intended use of C-efficiency (a ratio of revenue to the product of the standard rate and consumption) for value added taxes to measure the broadness of a country's tax base was not possible due to data not being available at a sufficient level of quality. Instead, alternative metrics (namely, the number of registered tax payers and the extent to which a single tax type made a significant contribution to tax revenue) were used.

There was also a general paucity of data when it came to examining the contribution of each tax type to total tax revenue. It was not possible to gain a complete set of annual observations for any of the case study countries.

3. Overview of taxation reform in the Pacific

3.1 Donor support for taxation reform in the Pacific

MFAT and other donors have provided considerable support for taxation reform in the Pacific.²⁸ The information we have on the amounts spent is incomplete, but represents the best dataset available. We estimate that about NZ \$55 million was spent on taxation reform programmes in the Pacific over the period 2002 – 2012 by New Zealand, Australia and other donors in that period.²⁹

Donor funding for taxation reform is summarised in Table 2 below and further information is provided in Appendix 1.

Table 2 Donor financial support for taxation reform in the Pacific

	Total estimated spend by donors (\$ Million NZD)(1 July 2002 – 30 June 2012)
PFTAC – Tax policy and administration	\$8.1
Solomon Islands	\$7.2
Samoa	\$18.8
Tonga	\$3.7
Kiribati	\$1.3
Other countries	\$15.9
TOTAL ESTIMATED	\$55.0

²⁸ This support has included donors jointly funding the International Monetary Fund-led Pacific Financial Technical Assistance Centre (PFTAC) and donor-led initiatives to reform tax administration notably by DFAT. Support has also been provided by the Australia and New Zealand revenue agencies, the Asian Development Bank, the World Customs Organisation and the Oceania Customs Organisation, and the Pacific Islands Forum secretariat.

²⁹ Year ending 30 June.

While material in absolute terms, the amounts are small relative to the total aid budgets, for example the New Zealand Aid budget for 2012 was NZ\$562 million and the Australia Aid budget for the same year was AUD\$4.8 billion. The comparatively small amount spent on taxation reform suggests that donors have attached a relatively low priority to taxation reform relative to other aid objectives.

Funding from the New Zealand Aid Programme has tended to be applied to PFTAC (a total \$1.6 million in 2002 – 2012 is attributable to tax reform outputs) and has included an estimated \$12.8 million for reform projects. Funding has also been applied directly to reform efforts in Samoa and Solomon Islands and smaller contributions to projects in the Cook Islands, Kiribati, Niue and Tonga.

The New Zealand Inland Revenue Department (IRD) has assisted directly with Pacific reforms. Its assistance typically consisted of providing expertise, through secondments of expert staff. Over the last 10 years, NZIRD has provided assistance of this type to Niue, Samoa, Solomon Islands, and Tonga.

3.2 The role of PFTAC

PFTAC has been the main vehicle used to channel donor support for taxation reform. It has also been used as the predominant source of reform-related technical advice in the Pacific. Technical advisors to support reform projects have also been recruited through the Pacific Technical Assistance Mechanism (PACTAM) or have been sourced from Australia and New Zealand revenue agencies (IRD and ATO), the Asian Development Bank, the World Customs Organisation and the Oceania Customs Organisation, and the Pacific Islands Forum secretariat.

PFTAC has played a key role in the agenda setting stage by providing frameworks for both tax policy reform (“the standard package”) and administrative modernisation. Its experience across the Pacific means that it has been able to provide that advice in a manner that is cognisant of the specific issues facing Pacific countries. PFTAC has also been valuable in identifying sources of technical assistance and in monitoring progress in tax reform across the Pacific. Its role, however, is not to assist with dialogue management especially at the political interface.

PFTAC tend to provide complementary technical assistance, that is, to supplement assistance being provided using other means (this is not a stated policy, but is apparent from looking at the trends). For example, in the last few years in the Cook Islands, Nauru, Niue, Samoa and Solomon Islands where other advisors have been present, PFTAC technical advisors have been less utilised.

Non-local tax advisors work in almost every country in the Pacific.³⁰ We do not have data on how many advisors are working on reform-related projects (as opposed to capacity-

³⁰ In its FY2012 annual report, PFTAC notes that it has had either a resident advisor or short-term missions in association with tax policy and administration in all of the Pacific Island countries in the preceding year except Vanuatu and PNG (in which there are advisors present as a result of other programmes).

filling). The following text box expands on the role of PFTAC in supporting taxation reforms in the Pacific.

The role of PFTAC in tax reform

Over the period 2002 – 2012, donors invested approximately NZD \$8.1 million in PFTAC's Revenue Administration activities (between \$0.8 – 1.2 million per annum). This investment accounted for around 15 per cent of the total spend on tax reform and around a fifth of PFTAC's annual budget.

PFTAC is one of eight Regional Technical Assistance centres established by the IMF with the purpose of providing technical assistance (TA) and training in areas vital to macroeconomic management. Revenue policy and administration is one of five main bodies of work. The other four areas of focus are public financial management, economic statistics, financial sector supervision and macroeconomic management.

All technical assistance is integrated into the IMF's operations, and coordinated with other regional technical assistance centres. All TA is backstopped by IMF headquarters. The aim of this is to ensure quality and consistency of policy advice.

In the area of revenue policy and administration, PFTAC's activities are guided by its previous analysis of regional priorities and lessons learned and by benchmarking national tax administrations against the requirements of a model tax office developed through the regional tax administrators association (PITAA).

PFTAC's operations are made possible by financial contributions from:

- Asian Development Bank, DFAT, European Union-Pacific Islands Forum
- Secretariat, Korea, and New Zealand Aid Programme who finance the technical assistance activities of the center.
- The Government of Fiji, which finances PFTAC's office facilities;
- The IMF, who provides the centre coordinator, office staff and oversight and management.

PFTAC also works closely with a number of other development partners who do not contribute to the center including the World Bank, the Secretariat of the Pacific Community, and the University of the South Pacific.

PFTAC is considered to be the regional centre of technical expertise on tax reform. To give an idea about the volume of PFTAC's work, in the first six years of our focus period (2002 – 2007, inclusive) PFTAC gave a total of 1432 recommendations on taxation policy or administration, relating to 13 countries (Cotton, 2008), the majority of which revenue departments felt were substantial recommendations to them.

3.3 Brief overview of reforms

To provide context for our discussion of the outcomes of taxation reforms supported by donors, the paragraphs below summarise the reforms undertaken in the Pacific over the period 2002 – 2012.

3.3.1 Domestic taxes sought in response to pressure to reduce customs and tariffs

The sustained trend in tax reform in the Pacific over the past ten years has been the tax mix switch from import tariffs/duties through the introduction of goods and services tax (GST) or value added tax (VAT). The switch away from trade taxes to VAT mirrors a trend in developing countries worldwide.

In the period from 2002 until 2012, Tonga, Niue and Tuvalu joined Papua New Guinea, Fiji, Vanuatu, Samoa and the Cook Islands in implementing a GST or VAT. Plans for the introduction of a VAT are still working their way through the political system within the Federated States of Micronesia and the Marshall Islands. In addition, a VAT has been introduced in legislation in Kiribati and will be implemented in 2014. Timor-Leste imposes a sales tax on imported goods and on some designated services.

These reforms appear to have largely come about as a result of pressure, due to trade liberalisation, to move away from a trade tax system to a more domestic tax oriented system. In the case of Fiji, Papua New Guinea (PNG) and Solomon Islands, trade reform was a condition of membership of the World Trade Organisation (WTO), and trade reform would have been high on the agenda for observer nations (Tonga, Samoa and Vanuatu). In the Pacific, tariff reduction was driven by two agreements: PICTA, a free trade agreement,³¹ and PACER, an economic cooperation agreement. The key component elements in achieving this trade integration are trade liberalization and trade facilitation.

Text box 1: The rationale behind the introduction of VAT throughout the Pacific

There has been a particularly strong push for PICs to implement VAT as a way to counter-act the revenue impact of countries phasing out import tariffs and duties. This ‘push’ started in the early 2000s, and was a clear feature of communications from the IMF and by extension, PFTAC at the time. The potential to use VAT to increase revenue from its base was not the principal driving force behind the changes. Several arguments were given in favour of VAT:

- The principal argument for introducing VAT seems to have been that the introduction of a VAT provides a major opportunity to develop new tax administration systems and procedures that were felt to be needed in the Pacific countries. VAT was thought to act as a catalyst for change: first, within the tax collection agencies (spearheading the use of

³¹ PICTA came into force in April 2003. It covers trade in goods between members (services are not included), and says (paraphrased) that “no exports from member countries will be subject to any form of trade barrier when imported into other member countries”. It aimed to reduce tariffs to zero for all FICs by 2012 and “negative list” protection tariffs reduced to zero by 2016.

IT, modernizing the organisational structure, requiring registration of taxpayers and developing audit methods); and second, among taxpayers (developing a culture of record-keeping, establishing self-assessment and raising the level of voluntary compliance).

- VAT had been implemented at that time by five PICs (PNG, Fiji, Samoa, Vanuatu and the Cook Islands had adopted a single-rate VAT) and had become a major source of revenue there.
- International experience from the (then) 120 countries in which VAT had been adopted suggested that most countries had implemented it successfully (the experience is inevitably mixed) and that VAT played a central role in generating tax revenue (in the 120 countries that had implemented a VAT by 2001, it formed an average of 27% of total tax revenue or of 5% of GDP (Ebrill et al, 2001).
- Small island countries were thought to achieve good results from VAT in terms of revenue and administration, due to the relative importance of international trade to their economies. The presence of trade enables small island countries to collect VAT on imports and their geographical remoteness insulates the tax base, to some degree, from smuggling. The border is a convenient place to begin the withholding mechanism, and securing VAT collection on imports was considered a crucial part of ensuring effective collection of the tax throughout the chain of production and securing the success of the VAT overall.

3.3.2 Tax policy reform follows a standard package

The policy advice at the time followed a ‘standard package’ of reforms. The ‘package’ is a five-pronged approach for improving fiscal sustainability and operational efficiency and effectiveness:

- introduction of a broad-based, low rate income tax, with few exemptions and discretions
- introduction of a broad-based value-added tax with few exemptions and discretions
- reduction in reliance on trade tariffs and sales taxes
- introduction of comprehensive revenue administration legislation establishing and standardizing the rights and obligations of the revenue administration office, taxpayers, importers, and exporters
- development of systems and processes for tax administration that make proper and efficient use of withholding and third-party information and encourage maximum voluntary compliance with the tax regime.

Improvements in tax administration and compliance are seen as integral to achieving reform. In particular, there has been a focus on moves to modernise revenue IT systems; moves towards risk-based compliance strategies; increased emphasis on large tax payers (but a shift away from large taxpayer ‘units’); introduction of self-assessment capability; and allowing for cash-based assessment. This administrative strengthening has been accompanied by capacity building for the tax authority.

This ‘standard package’ was widely recognised as being consistent with orthodox or ‘best principles’ tax policy at the beginning of the evaluation period, and still is. For example, the Mirrlees review (United Kingdom) and the Henry review (Australia) and the report of the Tax Working Group in New Zealand each appear to rely on the underlying economic principle that raising revenue from taxes should be broadly based and avoid as much as possible distorting individuals’ choices. A primary goal was to minimise adverse effects on the allocation of resources. These reviews also stressed coherence, sustainability and intuitive sensibility. In each case, recommendations were made to concentrate (or continue to concentrate) efforts to raise revenue on four tax bases: personal income, business income, private consumption, and economic rents from natural resources and land. Other taxes were tolerated, provided they were precisely targeted towards correcting market failures (smoking, for example). In each case, tax simplification (such as reducing the number of income tax brackets and simplification of deductions and offsets) was seen as a goal.

Text box 2: The objectives behind the ‘standard package’

Taxation and government charges provide governments with the means to provide goods and services and to redistribute income and wealth. However, most taxes distort production and/or consumption decisions, causing inefficiencies in the allocation of resources, thereby imposing costs in excess of the revenue raised. The excess burden of taxation, also known as the distortionary cost or deadweight loss of taxation, is the economic loss that society suffers as the result of a tax, over and above the revenue it collects. In the case of a tax on a good, consumers will buy less of the good because of the higher price and producers will receive less on the sale of the good and hence reduce supply of the good. The excess burden of taxation represents the lost value to consumers and producers due to the reduction in the sales of the good or service, but not captured by government revenue.

Taxes and charges affect the distribution of income and wealth in various ways. Taxes may be used to redistribute income and wealth in accordance with the value judgements of government. The impacts of taxes have prompted economists and social philosophers to consider principles or criteria for design and assessment of taxation systems. Since Adam Smith (1776) proposed the “maxims of taxation”, economic and political analysts have further developed and refined these canons to provide a core set of principles of taxation that have become widely accepted by economic and political analysts and governments:

- Efficiency and growth: Taxes should be efficient and minimise impediments to economic growth.
- Equity and fairness: The tax system should be fair. This involves both horizontal equity (fair treatment of those in similar circumstances) and vertical equity (fair treatment of those with differing abilities to pay tax).
- Revenue integrity: The tax system should minimise opportunities for tax avoidance and arbitrage and provide a sustainable revenue base for the Government.
- Fiscal adequacy: The Government should raise sufficient revenue to meet its requirements.
- Compliance and administration costs: These should be kept to a minimum.
- Coherence: Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole.

3.3.3 Broadening the tax base and lowering rates

Several of the Pacific countries have adopted the ‘package’ advice to broaden the base and lower the rates of income tax. The objective of the reductions is consistently to either facilitate more investment or simplify the regime. In the period 2002-2012 many of the countries lowered personal income taxes through increases in the tax free threshold and reductions in marginal tax rates. Similarly, corporate tax rates for both domestic and non-resident companies have been reduced in the Polynesian countries (Samoa, Cook Islands, Tonga), Fiji and Timor Leste. In 2007 Samoa reduced its corporate tax rate from 29% to 27%. In 2008 Tonga introduced a corporate tax rate of 25% for both domestic and foreign companies, replacing differential rates for foreign companies of 37-40% and domestic companies of 15-30%. In 2012 Fiji cut the corporate tax rate from 28% to 20%. In 2008 Timor-Leste reduced the corporate income tax rate from 30% to 10%.

Admittedly, the base for levying income taxes is small. In a region where a significant proportion of the population is engaged in informal enterprises, subsistence agriculture and/or unemployed there is not a lot of corporate and personal income on which to levy taxes.

3.3.4 Many countries looking to mining and resource taxes

Over the past decade several Pacific countries have put in place regimes for mining and resource extraction, largely in anticipation of such activities. In 2003 only Papua New Guinea and Fiji,³² with established mining industries, had regimes in place to specifically tax mining. Since then, Palau has implemented a petroleum tax, Nauru is considering changes to capture the extraction phases for phosphates, and the Cook Islands is currently in process of implementing an underwater mineral resources tax legislative regime, on advice from PFTAC. Samoa and Tonga are in the process of preparing for resource exploration and extraction.

3.3.5 Improvements to tax administration sought

Improvements in tax administration and compliance have been sought in most of the Pacific countries over the past decade. In particular, there has been a focus on:

- moves to modernise revenue IT systems across the region
- moves towards risk-based compliance strategies
- increased emphasis on large tax payers (but a shift away from large taxpayer ‘units’)
- introduction of self-assessment capability
- capacity building for tax authority.

Modern tax systems place considerable requirements on the private sector in terms of registering for tax, filing returns and self-assessing. Tax design therefore has to take into

³² In the case of Fiji, there are concessions given to the mine owner under a tax agreement that has been in force since 1983 (the Vatukoula agreement) which has the effect that the large scale mining enterprise run in Fiji by Emperor Gold Mines is considered by many to be essentially tax free.

account the capacity of the private sector to undertake these tasks. A government could not, for example, expect the subsistence agriculture sector (significant in most countries in the region) to comply with what may be regarded in more developed economies as basic tax compliance tasks. In general, private sector capacity constraints have been taken into account in the tax reforms implemented by, for example, relatively high registration thresholds for GST (or its equivalent) so that only a relatively small proportion of businesses face the compliance requirements. In addition, some countries (such as Tonga) are moving towards presumptive taxes where micro-enterprises pay lump sum taxes or taxes based on turnover.

3.3.6 Meeting international standards on tax transparency

In 2000, in the course of the OECD's project on Harmful Tax Practices, six Pacific Island jurisdictions (the Cook Islands, the Marshall Islands, Nauru, Niue, Samoa and Vanuatu) were listed by the OECD as tax havens. In 2001, the Harmful Tax Practices initiative began to focus on transparency and exchange of information. In 2003, New Zealand and Australia entered into a partnering arrangement for negotiating tax information exchange agreements (TIEAs). As part of that arrangement it was agreed that, within the Pacific, New Zealand would take the lead in engaging with the Cook Islands, Niue and Samoa, and Australia would take the lead in respect of the Marshall Islands, Nauru and Vanuatu. A key focus was on ensuring that the Pacific jurisdictions signed up to TIEAs. There was a strong desire to assist the Pacific jurisdictions to meet their international obligations on transparency and exchange of information, and one of the ways to do this was to assist them in developing a TIEA network.³³

3.3.7 Overview table

Table 3 briefly summarises the status of the taxation systems in the Pacific countries then (2002) and now (2012).

³³ New Zealand was the first country to conclude TIEAs with the Cook Islands (in 2009), Samoa (in 2010), and Niue (last year). New Zealand also concluded TIEAs with the Marshall Islands and Vanuatu (both in 2010). With the Cook Islands, the Marshall Islands and Samoa, New Zealand also concluded Supplementary Agreements that included a limited number of DTA-style Articles (in respect of Government Service, Pensions and Students) and which established a mutual agreement procedure in respect of transfer pricing adjustments. Some of these negotiations were conducted through correspondence, but (in addition to the goodwill visits referred to above) visits to conduct face-to-face negotiations were required to the Marshall Islands (in 2008) and Samoa (in 2009). New Zealand is currently engaged in discussions with Samoa on a DTA.

Table 3 Taxation in Pacific countries, then and now

Then (2002)	Now (2012)
<ul style="list-style-type: none"> • The Pacific Island Countries Trade Agreement (PICTA) agreement recently ratified and in force. The agreement aims to foster and strengthen trade in the Pacific region through the removal of tariff and non-tariff barriers to trade. Agreeing to remove or reduce tariffs meant that other sources of government revenue would need to be found. • The OECD had recently identified seven Pacific Island countries as meeting the technical criteria for being tax havens: the Cook Islands, Marshall Islands, Nauru, Niue, Samoa, Tonga and Vanuatu. • The IMF and the newly established regional agency (PFTAC) were actively promoting a modernisation agenda consistent with the ‘package’ outlined above. • Papua New Guinea (PNG), Fiji, Samoa, Vanuatu and Cook Islands had already implemented a VAT with a single rate in the 1990s. By 2003 most other PICs (namely Kiribati, Tonga, Tuvalu, the Federates States of Micronesia (FSM), the Republic of Marshall Islands (RMI) and Niue) had requested additional information on the functioning of the VAT system. • Tax administration in all countries was recognised as poor and needing reform to meet the challenges ahead. By 2002 some countries had adopted a threshold to limit the net to a number of taxpayers compatible with their administrative capacity, but most had not. Only a handful of tax administrations had automated systems, including the Cook Islands, Samoa and Vanuatu which implemented RMS in the late 1990s. Source: www.pftac.org 	<ul style="list-style-type: none"> • In Polynesia, major policy reforms have been undertaken in all the countries except Tokelau and the Cook Islands (which had most of its substantive policy settings in place and focused largely on policy ‘tweaks’ and improving its tax administration). Tuvalu has simplified its Income tax regime, reduced import duties and improved its administration. Tonga has introduced the Consumption Tax (VAT) and overhauled its income tax regime. Substantial administrative improvements have been made. Like Tonga, Niue has introduced a Consumption Tax (VAT) and made changes to its income tax arrangements. Samoa (which already had a VAT in 2002) has undertaken substantial improvements to its administrative settings. The focus in Polynesia now is on improving administration. • The Melanesian countries have, in general, sought less policy reform than the other countries. Fiji, Vanuatu and PNG already had VAT in place in 2002 so the focus in these countries was on improving administrative capacity where feasible. The Solomon Islands has targeted administrative reform. Fiji is considered to be a regional leader and has focused on modernising income tax legislation, and has done preparation for the implementation of PAYE as a final tax. PNG has reactivated its Additional Profits Tax for designated gas projects, has reduced its border taxes and has had support to improve its administration operations. • Micronesia has shown mixed progress: while policy proposals have been accepted in principle it has been difficult to achieve substantive reforms in practice. Kiribati has very recently passed legislation allowing for a VAT and reduction of trade taxes. It has implemented a PAYE final regime for personal income tax and is currently pursuing a modernisation agenda. Palau has not yet implemented policy reforms but has instead focused on improving and modernising tax administration. Nauru has focused on revenue collection and establishing a revenue office. The Marshall Islands is in the process of implementing tax reform through by replacing the gross revenue tax and import duties with a net income tax and a consumption tax or value added tax. Thresholds for income tax have been change. No real reforms have been made in FSM yet, despite a reform agenda being in place for a long time. There have been administrative changes of a relatively minor nature, however.

4. Reform process

4.1 Theory of change

Our review of the literature prior to this evaluation suggested sustained improvements in tax policy, tax administration and institutional capacity was more likely if:

- there is clarity as to objectives of reform
- informed and reasonable expectations as to what can be achieved
- shared and credible evidence base
- taxation advice is consistent with good tax design principles and accounts for local conditions and context
- donor and host country negotiate reform programme on relatively equal terms and maintain formal and informal dialogue.

In our interviews and review of programme documentation, we considered whether donor support for taxation reform in the Pacific over the past decade was generally undertaken in a manner largely consistent with this guidance from the literature. Our findings are summarised below.

4.2 Donors have invested in projects with clear objectives

We found that there were clear objectives for the reform programmes in the case studies. Evidence for this finding include:

- The programme documents we reviewed consistently stated the objectives of the programme or activity donors would fund and support.
- Interviews identified no systematic concerns about the absence of clear objectives.
- Generally speaking, we found outputs produced at the agenda setting stage of reform that set objectives (like diagnostic or strategy reports) to be clear, well thought-through and accepted by the host country.
- The diagnostic assessment in all cases we saw drove the design of the intervention.

Having clarity of objectives is likely to be particularly important where the orthodox, or textbook, approach to taxation reform is not being followed. The orthodox, textbook, approach to taxation reform is to build up the capacity of the tax administration so that it can manage the implementation of reforms and then gain community buy-in for the need for reform. Once administration capacity has been developed, the next step is to gain agreement as to the broad parameters of the required reform, followed by consultation and agreement on specific reform options. Only then, with all the foundations laid would the reform programme commence. This is indeed an ideal process but in practice the ordering varies and flexibility needs to be shown by all parties involved in reforms.

Tonga is an example of a country that did not seem to follow this textbook process but still managed to implement a reform programme with relative success, and part of this success was due to having a clear picture of what it was they wanted to achieve. Interviewees were all clear that the reform process was “driven by the then Minister of Finance” in 1999-2002. Indeed the advice from PFTAC in 2002 was that Tonga’s administrative capacity was insufficient to introduce a VAT tax reform. The Minister was nevertheless determined to proceed contrary to that advice.

The catalyst for reform was a combination of a requirement to reduce fiscal reliance on tariffs in order to meet WTO requirements and a strained fiscal position under the existing tax system (which had many exemptions). However, it was clear that the direction of reform was determined by the Minister. Administrative staff commented that they “knew what they had to do” rather than convey any sense that they led the process. The private sector similarly, “followed the government lead”. The result was a reform process with clear and unambiguous objectives that were driven through. The weakness, still apparent, seems to be a lack of full buy-in as to what has been achieved both in the public and private sectors. Reform was achieved, but at the cost of some fragility in the sustainability of reforms. That is evidenced by frequent comments to the effect that exemptions are being gradually re-introduced.

Samoa by contrast has in the past few years followed a more textbook line in terms of reform process. Its current reform programme is placing more emphasis on community buy in and education, and as a consequence the results seem less fragile. Earlier legislative reforms (in the 1990s) appear not to have been supported by comprehensive reforms to change behaviour by tax payers and administrators and hence did not achieve its potential, though the structural changes (introduction of a VAT and lower trade and income taxes) have endured.

4.3 Donors generally have realistic expectations

We found mixed evidence about whether expectations about the particular challenges that may face the reform as a result of the country context were informed and reasonable, and mixed evidence about whether expectations about the time required for reform were reasonable:

- The programme documents we reviewed showed that donors viewed the programme or activity as being part of a reform strategy involving diagnostic work, planning management and governance, legal drafting, administrative strengthening work and business outreach.
- Interviews identified no systematic concerns about the absence of clear objectives.
- We saw evidence in Kiribati that host countries and donors may have an expectation that a person with tax technical skills in any area will be able to provide a broad range of assistance; interviews with tax advisers working in the Pacific suggest that the Kiribati experience is not unique and that under-resourced tax ministries (and donors) expect advisers to assist across a broad range of issues which in a larger organization would be undertaken by specialists.

- While the time scales involved seem generally acknowledged, most people we interviewed commented that the time required for implementation had typically been under-estimated. In all the case studies in which a tax reform programme has been implemented, that programme has lasted more than five years. In Tonga, for example the main reform period covered 1999 to 2007. A former tax advisor from Tonga noted that “it took nine months just to understand the environment”, and went on to note that “I don’t think donors understand how much is required for implementation and how important it is.”
- The time it takes for the idea of reform to seed and for a constituency to form in support of reform may also have been underestimated by those preparing diagnostic advice. It is clear that in some countries, reform can take a long time to get started. In Kiribati, detailed modernisation advice was provided to the government of Kiribati in 2003, and again in 2009 and 2010, but large-scale reform did not start in earnest till 2012. As further examples, PFTAC gave Niue and Tuvalu technical assistance in 2003-2004 to reform their revenue collection systems which included implementing a VAT; both countries implemented a VAT in 2009. In Samoa an Institutional & Situation Analysis was undertaken in 2007, but the first phase of this work did not commence until 2010 and some recommendations (e.g., small business taxation) remain under review.
- In some cases it was clear that the expectations in relation to the time required for reform were reasonable, but that did not flow through to the time allowed by host countries and donors in practice. Kiribati provides, in its recent introduction of VAT, an example of a reform programme in which policy setting and implementation tasks were conflated into a very short time period. While the policy agenda was clear and for the most part agreed for a number of years, the large majority of the reform activities were conducted “at the last minute” in response to a desire to have the policy reforms introduced before the end of the President of Kiribati’s third and final term. This rush occurred despite the agenda setting documents recognising that tax reform was a process that would take a long time, and would require long-term commitment, and illustrates that practical reform programme must adapt to circumstances.

4.4 Donors have invested in projects which were evidence-based

We found that the evidence base for reform projects was well-resourced at the agenda setting stage, but in many cases too little emphasis was placed on the skills and resources necessary for developing policy materials at the policy options stage:

- Diagnostic reports were typically prepared by donors or their agents prior to commencing taxation reforms; these reports were shared with the host country.
- Addressing social and equity concerns about taxation are central to achieving a tax system that is acceptable to the public. We have found that donors have not supported the interface with Ministers in assessing the social and equity trade-offs of reform options which is where these cross cutting issues are largely determined. Donors have not typically supported assessments of the social context and likely effects (positive and negative) on different stakeholders and social groups. Hence, there is no data available to this evaluation as to what outcomes donors expected in relation to these cross

cutting issues and whether those outcomes were assisted by the form of support provided by donors.

- It was particularly noticeable that few technical advisors had prior experience of dealing with Ministers and the political interface. Multi-tasking may be an inevitable requirement of the Pacific environment but lack of political inter-face skills (most importantly at the policy options stage) cannot be compensated for. The skills include knowing the political trade-offs of concern to Ministers (such as who are the winners and losers from reform and how can losers be accommodated to achieve a constituency for the reform while retaining the reform objectives). Tonga managed this issue by bringing in a person with the requisite skills on a short-term basis. It was clear that this was a key part of the success of these reforms especially given that they were driven by the Minister. Obviously, given the political nature of the tasks and the short-term nature of any such involvement importing such skills will cause some host country tensions and this needs to be carefully managed. Nevertheless, the experience has been that tax reform is highly politically charged. Political interface skills, as with all skills, are in short supply within the Pacific countries, and small countries need this skill base to successfully implement significant tax reforms as much as do larger countries such as New Zealand.
- Finally it is noted that working with Ministers to establish what is politically and practically achievable within current environment is not an area that PFTAC is resourced to cover. PFTAC focuses on the agenda setting stage and technical implementation of tax reform. It does not possess political interface skills and is in any case a long-term advisor whereas political interface skills are generally required on a shorter term basis at the policy options phase. As one person who has experience with PFTAC noted: “This sort of tax policy work isn’t something that PFTAC Suva is resourced to do. . . We do as much as we can, like broad strategies”.

4.5 Reform advice consistent with best practice

There is of course debate among experts as to what is the best form of taxation, and we identified occasional instances where reforms were delayed because of differences of view between advisers funded by different donors. However, we found no systemic concern about advice being inconsistent with established principles for good tax design and administration. Taxation reform in the Pacific has been heavily influenced by a set of policies that have been actively promoted by the IMF and regional agency PFTAC since the early 2000s (discussed in chapter 3). The high degree of influence of the IMF and PFTAC in setting the reform agenda is apparent in all aspects of the reform documentation and was a recurrent theme in interviews with those involved in reforms.

PFTAC has established itself as a centre of regional technical expertise, and is valued by Pacific countries for being flexible and responsive.

4.6 Reform packages agreed with host countries rather than imposed

We found no evidence that donors have imposed a pre-determined reform agenda on reluctant Ministers of host countries. Taxation reform, when it has been initiated, has been the result of a commitment by the host country. In Tonga, for example, numerous commentators spoke of how the Minister of Finance at the time reform was initiated “drove the reforms” contrary to the precautionary advice from PFTAC that administrative capacity may be lacking.

In Samoa, the more recent administrative reforms of the revenue ministry are a central component of the public sector management reforms being undertaken in that country, and follow from significant structural change to the tax system a decade or so earlier. The current reforms draw from an Institutional & Situation Analysis funded by DFAT, but the detailed design proposed by the study was not approved as a package by the Government of Samoa.

In Kiribati, policy reform remained off the agenda until recently when domestic political support for them emerged. In Solomon Islands significant policy reform has not been undertaken because, it seems, of perceived political constraints; reform has focused on improving administration.

We accept that taxation reform may have been undertaken partly at least in response to external pressures, such as the need to meet WTO requirements for a reduction in import tariffs and to move toward a more sustainable fiscal position. But the general picture that emerges from our review is that the taxation reform process in the Pacific has been owned by the host country, not imposed upon it.

However, there are cases where it is evident that donors have pressured host countries to give priority to reforms that suit the agenda of the donor country even though there are clearly higher priority issues in terms for reform of the wider tax system. Most often this is to focus on initiatives seen as more closely aligned to the “standard reform package” rather than the basics of tax administration. Understandably improved revenue raising always seems to obtain a high focus for donors. Again this can be to the detriment of wider reform goals. For example, in Solomon Islands there is a reluctance to change its mix of ad hoc domestic withholding taxes and this seems to some extent at least to be driven by the realisation that any reform in this area would be likely to reduce not increase revenue collection.

Dialogue appears to have been actively managed in the case studies, and it appears the majority of Pacific reform programmes have recognised that communicating the reform to a wide group of participants is an integral part of the reform process. For example, the reforms in Tonga included widespread consultation and communication with the community about the changes. In the most recent reforms (i.e., the 2012 reforms to introduce presumptive tax and extractive/natural resource tax) staff from the Ministry of Revenue and Customs largely led the consultation effort, with support from technical advisors. Similarly, reform programmes for Kiribati and Samoa provided for widespread communications activities.

Yet, there seems to have been more focus on communication between those leading the reform programme and the business community than with the host country politicians, who ultimately champion and ‘sell’ the reform. One former tax advisor noted “The politicians weren't aware of what was in the legislation, despite the consultation!” Another noted, “At the political level it seems that they did not really understand the details of what was implemented. They did not realise that a capital gains tax was in the legislation they enacted.”

4.7 Reform relationships have generally been successful

A common feature of successful reform programmes has been a central group of key advisors, political influencers and administrators present throughout the process. PFTAC is a common feature in these relationships. The continuity of core relationships ensures, for example, that the objective set at the agenda setting stage and the trade-offs negotiated at the policy options stage are carried through to the implementation stage. "If you lose consistency in the core team it's hard to keep the reform on track. Consistency is so important" – former tax advisor, Tonga.

A frequent comment from interviewees was the limited value of “fly in fly out” technical advice. Such short-term assistance generally had difficulty understanding the complexity of the reform process and the location specific nature of that reform. For example short-term assistance in providing IT advice to the revenue authority of Solomon Islands resulted in the building of an IT system that did not meet local circumstances and was not used.

On the other hand, where specific skills are sought for a discreet aspect of a longer term reform strategy this can be provided on a short-term basis. An example was Tonga which was received short-term assistance on issues relating to the political interface when it began its reform programme. This inevitably results in some tensions with those who are involved in the process on a longer term basis and donors should realize the need to manage this. In Samoa, the Ministry of Revenue arranged and integrated a succession of advisers to build knowledge within its management team under an agenda determined by the Ministry's management team.

Overall, however, in the Pacific there has been a clear move to longer term relationships that are able to build up the commitment and understanding necessary to sustain a reform project over a lengthy period of time. It was evident from, especially in the cases of Samoa and Tonga, that this could be achieved with advisors who came in on a short-term basis but did so a number of times over a number of years. This enabled building up of understanding and trust between the advisors and the host country officials.

4.7.1 External relationships with the business community formed but not always maintained

The importance to the success of reform of key influencers in the private sector is apparent in all case studies undertaken. In all cases there were key private sector influencers who were enthused about the need for taxation reform and motivated by public interest concerns. The level of dialogue with such groups, however, varied and their importance tended not to be recognised in diagnostic assessments prior to the reform. There is some, seemingly ad hoc,

support outside of the main programmes. For example, the Chamber of Commerce in Samoa is being supported in a study on the application of VAT to farming for the purposes of WTO compliance, and support is provided to the Chamber of Commerce in Solomon Islands which is being used to assist a survey of members on related issues.

Key private sector people easily lost motivation as a result of frustration with lack of change in areas that, while technical and maybe of lesser significance in terms of economic policy, cause ongoing difficulties with operating within the tax system on a day-to-day basis. The importance of dialogue with and support from such key influencers, and their role in making the tax system work in practice, means that their practical concerns should be given considerable priority in a wider reform process.

Modern tax systems place considerable requirements on the private sector in terms of registering for tax, filing returns and self-assessing. Tax design therefore has to take into account the capacity of the private sector to undertake these tasks. A government could not, for example, expect the subsistence agriculture sector (significant in most countries in the region) to comply with what may be regarded in more developed economies as basic tax compliance tasks.

A practical constraint faced by external advisers in consulting beyond the Ministry and a few individuals in the private sector is that many of the Pacific communities have a strong oral tradition and consultation involves meeting and discussion rather than an invitation to make a submission as may be undertaken in a policy development process in New Zealand or Australia. In general, however, private sector capacity constraints have been taken into account in the taxation reform advice supported by donors. Samoa and Tonga, for example, have relatively high thresholds for registration under their equivalents of VAT so that most small businesses do not have to register nor meet output tax requirements. In addition, some countries (such as Tonga) are moving towards presumptive taxes where micro-enterprises pay lump sum taxes or taxes based on turnover.

4.8 Reform packages reflect an episodic rather than systematic approach from donors

The reforms supported by donors can be categorised as episodic rather than systematic, though some of the programmes are reasonably lengthy and continue over many years – New Zealand, for instance, has supported reform of Solomon Islands IRD for the past 10 years. While there is some recognition in the programme documents of tax reform requiring a systematic approach, donor focus has primarily taken an episodic rather than systematic approach.

Donors have tended to fund and support discreet projects rather than engaging with host countries in implementing a strategy to, over time, construct a well-functioning sustainable tax system. In general, donor support has been by way of funding on or both of the following:

- policy packages consistent with the “standard package” – for example, introducing VAT to compensate for the reduction or removal of tariffs

- support for administrative capacity building.

Often the two are combined (the introduction of VAT has often been seen as requiring administrative capacity building) as has been the case with Samoa and Tonga. Solomon Islands is an example of the funding of administrative capacity building in isolation of major structural policy changes.

While the host country reform programme in some cases has been ongoing for a number of years, and while the host country may have a strategic overall reform programme (as seems to have been the case with Samoa and Tonga), the donor focus seems to have been on funding and engagement on specific projects making up a longer term strategy. As a result, donor support for reform appears not to have directly supported efforts to improve the efficiency and cohesion of the overall tax system, beyond promoting the ‘standard package’ (which is intended to be coherent). Issues that are viewed by donors as being of a technical nature are thus not part of the donor/host country dialogue even though they are likely to be critical to the overall efficiency and coherence of the tax system and thus the overall reform strategy.

A well-functioning tax system is critical to all countries. However it is extremely difficult to bring into effect. A good tax system is difficult to implement and sustain because taxation is inherently intrusive, affecting all aspects of a society and its economy. It impacts on income and wealth distribution and inter-reacts with all aspects of the economy. It must of necessity, therefore, reflect the complexity of that intrusive inter-reaction and must change with changes in the country in which it operates. In addition, especially given the necessary focus on administering taxation systems through voluntary compliance, the tax system operates by altering modes of individual behaviour. It is not therefore just a set of legislated rules.

Given this context, tax reform should, as emphasised repeatedly by the 2011 Mirrlees Report on the UK tax system, focus on the tax system as a whole.³⁴ That review concluded with respect to the UK: “To improve things, we need to see the system as a whole, we need to design the system with a clear understanding of the population and the economy on which it operates, and we need to apply economic insights and evidence to the design. We also need a much more informed public debate and a much better set of political processes than the ones we currently have.”³⁵ While written in the context of tax reform in the sophisticated economy of the UK, these comments have general application to tax reform everywhere.

To create sustainable taxation reform it is therefore necessary to manage the tax system as a whole. To quote again from the Mirrlees Review, when considering tax reform “there is a need to think about the tax system as just that – a system. The way that different taxes fit together matters, as does being clear about the role of each tax in the system.”³⁶ This requires a systematic approach to taxation reform that in turn involves building up the political, administrative and private sector infrastructure that makes a tax system work and

³⁴ Tax by Design – The Mirrlees Review, Oxford University Press, 2011

³⁵ Ibid, page 20.

³⁶ Ibid, page 45.

sustainable over time changing in a coherent way to meet the changing demands of the society within which it operates.

This systematic approach to taxation reform contrasts with an episodic approach where tax reform is viewed as discreet projects such as introducing a VAT to replace tariffs or up skilling the tax administration by investing in IT systems. The need to view sustainable tax reform as requiring a systematic approach is not entirely lacking in the Pacific. In some countries, for example Samoa (in its current reform programme), the host country demonstrates a clear attempt to systematically reform all aspects of its overall tax system over time. However, in our view the donor focus has been on an episodic approach. Donors have tended to fund and support discreet projects rather than engaging with host countries in implementing a strategy to, over time, construct a well-functioning sustainable tax system.

4.9 Conclusions

Donor support for taxation reform in the Pacific over the past decade appears to have been undertaken in a manner largely consistent with the guidance from the literature, at least in the agenda setting stage of reforms. That is, as broad generalisations:

- there is generally clarity as to objectives of reform
- diagnostic assessments are undertaken to inform expectations as to what can be achieved and establish a shared evidence base
- taxation advice is consistent with good tax design principles and accounts for local conditions and context
- donor and host country negotiate reform programmes in a manner which results in the host country owning the reform activities.

While there is some recognition in the programme documents of tax reform requiring a systematic approach, donor focus has primarily taken an episodic rather than systematic approach. Donors have tended to fund and support discreet projects rather than engaging with host countries in implementing a strategy to, over time, construct a well-functioning sustainable tax system.

5. Reform outcomes

5.1 Reforms target specific objectives

In this chapter we summarise our findings on whether donor support has helped achieve worthwhile improvements in the targeted elements of the tax systems of Pacific countries.³⁷ The elements, described more fully in the evaluation approach and method chapter (chapter 2), include:

- Intermediate outcomes
 - improved tax policy
 - improved tax administration
 - improved capacity for future reforms
- Longer-term outcomes
 - increased revenue to fund government expenditure programmes
 - increased economic efficiency
 - equity and public acceptance
 - fostering state building
 - meeting international commitments

Importantly, the outcomes must also be considered in terms of their consistency with the longer-term reform strategy as shorter term objectives (especially revenue raising) may conflict with the longer term strategy for a good tax system.

This chapter provides information on the contribution of the reform to these outcomes. As the outcomes are interconnected, we address them together. As well as making observations about the outcomes stated above, we have looked at whether support for discrete projects has helped move the taxation systems in host countries toward a well-functioning sustainable tax system. For example, this includes evidence that disproportionate effort was not directed at only one part of the system to a cost of others. For example, improved administration of a highly distortionary tax might not be an improvement to the tax system considered as a whole. Possible indicators of a systematic improvement in tax systems might include a combination of improvements in all of the elements described above.

³⁷ The material presented below presents summary and indicative data of reform outcomes. The accompanying Topography paper provides a more detailed summary of tax policy and administrative changes made in each country in the period 2002 – 2012.

5.2 Substantial improvements in tax policy for some PICs, but little change for others

Tax policy has converged across Pacific countries since 2002 and that convergence has been toward policies consistent with international best practice. Chapter 3 of this evaluation summarises the standout features of reforms over the past decade. Briefly, many Pacific countries now have a VAT or are the process of introducing it, there has been a trend away from import tariffs/duties as a form of revenue, and this has been accompanied by greater trade liberalisation. There has also been a trend towards lower personal income tax through increases in the tax free threshold and reductions in marginal tax rates along with reductions in corporate tax rates.

These changes represent improvements to the policy settings in the Pacific, which previously featured taxation policies commonly recognised as being inefficient (that is, the tax regimes distorted investment and economic activity, were overly-complex, or lowered rates of compliance, etc.).

Poor practices remain in several countries because reforms have not been implemented despite the seemingly consistent ‘package’ of reforms promoted by PFTAC and other advisers, and the apparent acceptance by host countries of the need for reform. For this reason there is still a large degree of policy diversity across the region. However, it is possible to make some broad observations by grouping the countries geographically.

Generally speaking, the American-influenced Micronesian countries (the RMI, the FSM, and Palau) continue to have rudimentary tax systems using a mix of gross revenue tax and presumptive tax in place of business income tax, and are heavily reliant on import duties and payroll taxes. There have been improvements in the legislative framework in RMI and Palau, but compared to other Pacific countries the degree of change has not been substantial.

The more Anglo-Australian influenced Micronesian countries (Kiribati and Nauru) are also heavily reliant on payroll taxes and trade tariffs, although Kiribati does have a simple business income tax and has now introduced a VAT into legislation. Changes in Kiribati and Nauru have been made recently (post 2012), which means our data/ranking may not adequately reflect the present day.

Conversely, the Anglo-New Zealand influenced Polynesian countries (the Cook Islands, Niue, Samoa, Tokelau, Tonga, and Tuvalu) have more comprehensive tax systems comprising business income taxes, VAT, and payroll tax in their policy frameworks: they are increasingly less reliant on trade tariffs. The degree of policy change in Tonga has been pronounced in the period 2002 – 2012, less so for the other countries. (The recent Samoan reforms have mainly been administrative, with substantive policy changes implemented in the 1990s).

The Melanesian countries are, perhaps, the most diverse in terms of their revenue policy settings and their experience of policy reform. The Fiji Islands and Papua New Guinea now have comprehensive policy frameworks and each has established its revenue agency as an independent authority. Solomon Islands has a plethora of goods and sales taxes and a rudimentary income tax, while Vanuatu, operating an offshore investment centre, largely relies on VAT and trade taxes.

5.3 Policy improvements have been supplemented with administrative strengthening

For the most part, the changes in policy described above have been supplemented by administrative strengthening. We did not find evidence that countries seeking reform were seeking policy change without corresponding administrative strengthening, although the degree of administrative improvement sustainably achieved varies between countries.

As noted in chapter 3, a common theme throughout the Pacific is that instead of the textbook approach of building administrative capacity and then introducing VAT or its equivalent there has it seems been a deliberate decision to use such reforms as a catalyst to bring about administrative modernisation and reform.

This has been generally successful (and may indeed be the main justification for tax reform involving a VAT-type tax). The comment has been made in a number of countries that the administrative transition to VAT type taxes has been easier than changing the administration of income tax along modernised lines. Again advancing reform prior to building administrative capacity has a cost (evident in across country complaints from the private sector about the slowness of processing GST refunds) but the cost does seem worth the benefits in terms of tax administration modernisation.

Administrative reforms driven by a strong local management team have made good progress in a number of client facing areas. For instance, in Samoa, considerable effort has been made to ensure clients arriving at the offices are greeted in a professional manner in a tidy, efficient, front office and the agency is developing and reporting on client focused metrics.

5.4 Generally good results in terms of the policies and systems put in place

To compare the progress of reforms across the region, and to indicate the degree of system-wide change that was achieved in each country, we have compiled a table which uses at its foundation the 'Baseline Assessment Framework' produced by PFTAC in 2011. The Baseline Assessment Framework assessed each Pacific tax system against nine core components of a model tax office: legislation framework, administrative framework, governance and accountabilities, corporate strategies, core processes, support processes, operating model, automation and Human Resources. Each of the nine core components was assessed using a series of simple questions, the responses to which were used to build a picture of the tax systems across the region. The baseline assessment provided a ranking of each country stood against a baseline (above baseline, on baseline, below baseline). The baseline was designed with the Pacific Islands in mind.³⁸

³⁸ Whilst the framework was designed with Pacific Island tax administrations specifically in mind it also took into account a number of other internationally recognized reference points: IMF Topical Trust Fund "Tax Policy and Administration" program document 2010; the European Commission Fiscal Blueprints "A path

The baseline assessment takes into account nine components, described below:

- **Legislation Framework:** A comprehensive domestic tax base with modern (simple and clear) legislation, low tax rates and few exemptions or discretions.
- **Administration Framework:** A comprehensive framework that allows for the effective and efficient operation of the tax administration and which provides for the rights of taxpayers and the powers of the authority, uses a system of self-assessment and provides a range of offences and penalties for non-compliance.
- **Governance and Accountabilities:** An environment of integrity that includes transparency of taxpayer rights and required staff conduct; with mechanisms to assure integrity of systems, procedures, and staff practices; with regular public reporting of organizational goals; plans, efforts; and outcomes based on agreed performance outcomes.
- **Corporate Strategies:** A comprehensive strategy set including business plans, compliance improvement, HR and IT strategies that provide for ongoing development and performance improvement across the operations of the tax administration.
- **Core Processes:** The streamlined operation of all core processes aimed at timely collection of revenue due, effective verification of liabilities based on revenue risks and resolution of disputes supported by a wide range of public education channels to enable taxpayers to voluntarily comply with their tax obligations.
- **Support Processes:** A wide range of support processes aimed at enabling the efficient and effective operation of the core processes of the tax administration.
- **Operating Model:** The operating model aligns organizational activities with taxpayer needs and the revenue risks presented by taxpayer segments, balanced against the size of the organization.
- **Automation:** Automation underpins all core processes, e-initiatives are utilized, and timely accurate reporting is available.
- **Human Resources:** Human resource management provides for optimum staffing levels, timely and efficient recruitment, incentives for high performance and non-corrupt behaviour among tax officers and development of the skills and professionalism needed to meet the demands of continuous improvements in the tax administration.

As part of this evaluation, we have taken the Baseline Assessment that was performed in 2010 and published in 2011, and updated it to June 2012. We have also made a judgement about what the change has been since June 2002: substantial, minor or minimal. Unfortunately, no such ranking of tax administrations existed in 2002 (or indeed, prior to 2011) so no direct comparison to earlier periods can be made. The results of this assessment are included in Figure 3 overleaf. The diagram shows, by country, the ranking against the baseline (green = above baseline; orange = on baseline; red = below baseline) and the direction of change.

to a robust, modern and efficient tax administration” 2007; the Report of the Tax and Customs Indicators produced by the Inter-American Centre of Tax Administrations 2002; and the World Bank Public Expenditure Financial Accountability Performance Measurement Framework 2005.

The diagram shows that 9 of the 16 countries in scope (Cook Islands, Fiji, Niue, PNG, Tonga, Tuvalu, Samoa, Vanuatu, and Solomon Islands) have made significant improvements to their administrative and corporate settings in the research period (2002 – 2012). A further three (Kiribati, Nauru and Palau) have made significant improvement in late 2012 and 2013. Of the remaining countries, only Tokelau has made little change at all. Samoa, Solomon Islands and Tonga all have functioning tax administrations with the basic requirements of such an administration in place. In almost all the countries there is still a lot to be done to improve the administrative settings. All except Tonga and PNG remain 'Below Baseline' on the majority of their rankings.

Figure 3: Assessment of core components of a model tax office and degree of improvement between 2002 – 2012

Country	Legislative framework	Administrative framework	Governance & accountabilities	Corporate strategies	Core processes	Support processes	Operating model	Automation	HR
Cook Islands	▲	▲▲	▲	▲	▲▲	▲	▲	◆	◆
Fiji	▲	▲▲	▲	▲	▲▲	▲	▲	▲	▲
Kiribati*	▲	▲	◆	▲	◆	◆	▲	◆	◆
Nauru*	◆	▲	◆	◆	◆	◆	◆	◆	◆
Niue	▲▲	▲▲	◆	▲	▲▲	▲	▲	◆	◆
Palau*	◆	◆	◆	▲	◆	?	▲	◆	◆
PNG	◆	▲	▲	▲▲	▲	▲	▲	▲	▲▲
RMI	▲▲	▲	◆	▲	◆	?	▲	◆	◆
FSM	◆	▲	◆	▲	◆	?	◆	▲	◆
Samoa*	▲	▲	▲	▲	▲▲	▲	▲	◆	◆
Solomon Islands	▲	◆	◆	▲▲	▲	▲	▲	◆	◆
Timor Leste	▲	◆	◆	◆	◆	◆	◆	◆	◆
Tonga	▲▲	▲▲	▲▲	▲▲	▲▲	▲	▲▲	▲	◆
Tokelau	◆	◆	◆	◆	◆	◆	◆	◆	◆
Tuvalu*	▲▲	▲▲	◆	▲	◆	?	◆	◆	◆
Vanuatu	◆	◆	▲	▲▲	▲	▲	▲	▲	◆

* There were substantial changes made in the tax systems in these countries post June 2012, which are not captured in ranking

KEY

▲▲	Above baseline, substantial improvement since 2002	▲▲	On baseline, substantial improvement since 2002	▲▲	Below baseline, substantial improvement since 2002
▲	Above baseline, some improvement since 2002	▲	On baseline, some improvement since 2002	▲	Below baseline, some improvement since 2002
◆	Above baseline, minimal sustained improvement since 2002	◆	On baseline, minimal sustained improvement since 2002	◆	Below baseline, minimal sustained improvement since 2002

5.5 Mixed revenue results, so far

Most Pacific countries have improved their revenue collection capability, some substantially so, in the period. We would expect that the revenue impacts of these changes would take some time to embed, so short term revenue results for countries who implemented changes in the latter half of the decade are of limited value. The revenue picture we paint is also compromised by the lack of availability of consistent and reliable data.³⁹

We cannot determinatively say whether reform has led to improvements in revenue overall. This is for a number of reasons. First, in many countries (like Kiribati, Nauru, Palau, Tuvalu and Samoa) significant reform work happened beyond our 2011 datapoint. Revenue results in those countries may be starting to emerge now, as occurred with Samoa in 2012. Secondly, in many countries (such as Nauru, Niue, Tokelau and Kiribati) data showing revenue outcomes was very poor. Lastly, we have not attempted to paint a picture of the counterfactual – that is, what might have happened if reform was not attempted.

The data we do have generally shows a mixed story:⁴⁰ We analysed tax revenue, GDP and tax revenue per capita data to see if the ten countries that had made significant changes to their tax regimes⁴¹ had experienced different results from the remaining six countries in the study. We found that:

- Tax revenue collection across the entire region was at least US\$3.96 billion dollars more in nominal terms in 2011 than it was in 2002.
- Tax revenue as a percentage of GDP (when defined as much as practicable in the country's own currency⁴²) increased between 2002 and 2011 in seven of the 16 countries (FS Micronesia, Fiji, Palau, PNG, Samoa, Solomon Islands and Vanuatu). These countries had high nominal revenue growth relative to other Pacific countries. There is a great degree of variation in the growth in tax revenue per capita, and the results show no consistent improvement for countries that have achieved substantial reform versus those that have not. Four of the seven who had increases in this metric were countries in which reforms had been significant (Fiji, Samoa, Papua New Guinea and Solomon Islands), but three were not (FS Micronesia, Palau and Vanuatu). For the countries in

³⁹ Readers are reminded about the data limitations that apply to these results, which are outlined in section [X] of the report. The revenue conclusions are based on known data only. Significant data gaps exist for Nauru, Palau, and Timor Leste. A further caution is that care must be taken with the interpretation of results in currencies other than the country's own. We have found that results reported in \$US currency (for reasons of comparability) vary greatly from results reported in the currency adopted by the country. Where possible, we have used the currency adopted by the country as the basis for our calculations.

⁴⁰ Section 2 of this report offers a note of caution about focussing too heavily on revenue as the metric of reform success. For example, reform aimed at improving economic efficiency or complying with international requirements might not raise additional revenue or may lean against the government's redistribution objectives. We therefore remind readers to exercise caution when interpreting these results without considering the reform objectives as a whole.

⁴¹ For our purposes, 'significant reform' was defined in terms of outcome achieved: having at least one component with a ▲▲ ranking in the table. This is Cook Islands, Fiji, Niue, PNG, Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu. Countries who are deemed not to have achieved 'significant reform' during the period were FS Micronesia, Kiribati, Nauru, Palau, Timor Leste, Tokelau.

⁴² Ibid, n 39.

which increases were not evident but which had undergone significant reform, we either have too little data to determine the change (Niue) or reforms were still occurring (Tuvalu, Marshall Islands) or this result was not indicative of a more positive general trend (Tonga⁴³).

- Countries that had not achieved substantial reform during the 2002-2011 period showed mixed results in terms of tax revenue as a percentage of GDP, and suffered from a paucity of suitable data (indicating that better data sets on tax could be a by-product of reform programmes). FS Micronesia experienced improving tax revenue as a percentage of GDP (from 10.9 to 12.0 percent), whereas Kiribati's percentage fell from 20.3 percent to 16.9 percent.
- Most countries have tax revenue as a percentage of GDP in the range of 15 to 25 per cent, with the Solomon Islands a high outlier at 36 per cent (this has since dropped to 30.1 percent in 2013 calendar year).
- While most countries improved tax revenue per capita in nominal terms, the increase only kept pace with or outstripped GDP growth in six out of 16 countries (when both metrics are defined in the country's own currency) (these are FS Micronesia, Fiji, Palau, Papua New Guinea, Samoa and Solomon Islands).
- While there have been improvements revenue adequacy, there still remain substantial gaps in most Pacific nations between government expenditure and tax take. For example, out of our four case study countries, only Solomon Islands and Samoa were taking revenues within the range of 90% - 110% of government expenditure in 2011. Kiribati was only taking 34% of its government's expenditure in tax revenue, and Tonga 76%.

⁴³ The Tongan decline appears to have been a 'blip' with more recent reports indicating a return to a ratio of around 20 percent of GDP in 2012/13.

Figure 4 Nominal tax revenue was at least US\$3.96 billion more in 2002 than 2011

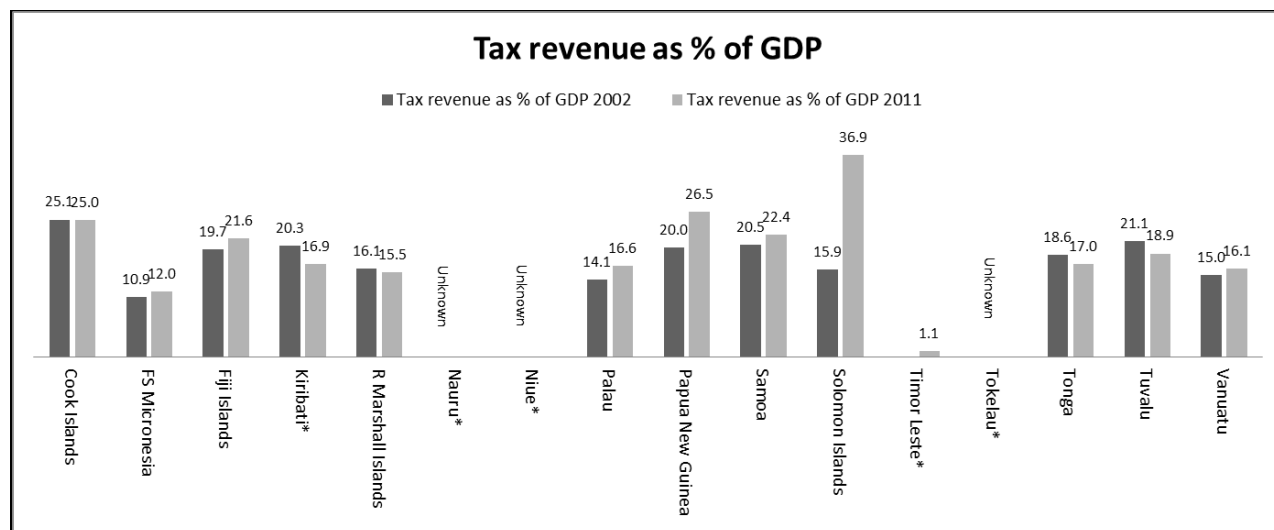
	Tax Revenue 2002 (\$US)	Tax Revenue 2011 (\$US)	Increase (\$US)	% increase (2002 - 2011)
Cook Islands	\$ 28,877,858	\$ 70,132,726	\$ 41,254,868	143%
FS Micronesia	\$ 26,300,000	\$ 37,200,000	\$ 10,900,000	41%
Fiji Islands	\$ 378,752,998	\$ 872,077,496	\$ 493,324,499	130%
Kiribati*	\$ 15,648,474	\$ 36,411,879	\$ 20,763,405	133%
R Marshall Islands	\$ 20,100,000	\$ 25,978,650	\$ 5,878,650	29%
Nauru*	\$ -	\$ -	unknown	
Niue*	\$ 3,200,000	\$ 4,950,000	\$ 1,750,000	55%
Palau	\$ 23,900,000	\$ 35,400,000	\$ 11,500,000	48%
Papua New Guinea	\$ 608,628,660	\$ 3,488,123,497	\$ 2,879,494,838	473%
Samoa	\$ 55,079,891	\$ 188,513,035	\$ 133,433,143	242%
Solomon Islands	\$ 34,627,418	\$ 265,171,174	\$ 230,543,756	737%
Timor Leste*	\$ -	\$ 64,900,000	unknown	
Tokelau*	\$ -	\$ -	unknown	
Tonga	\$ 34,635,815	\$ 76,618,049	\$ 41,982,234	121%
Tuvalu	\$ 3,398,952	\$ 8,852,821	\$ 5,453,869	160%
Vanuatu	\$ 42,144,768	\$ 131,771,754	\$ 89,626,986	213%
Estimated increase**				
Total (\$US)	\$ 1,275,294,833	\$ 5,306,101,081	\$ 3,965,906,248	
* Substantial data issues				
** Sum of all known increases				

Source: Sapere Research Group using data from Asia Development Bank, *2013 ADB Pacific report* and Asia Development Bank, *Online Statistical Database*

Figure 5 % Seven of the 16 countries grew tax revenue more than they grew GDP

Country	GDP (local currency)			Total tax revenue (local currency)		
	2002	2011	Change	2002	2011	Change
Cook Islands (NZ\$)	240,429,302	366,655,643	53%	59,334,000	84,674,000	43%
Federated States of Micronesia (US\$)	241,738,180	310,300,000	28%	26,300,000	37,200,000	41%
Fiji Islands (Fiji\$)	4,029,800,000	6,730,800,000	67%	789,700,000	1,543,500,000	95%
Kiribati (AU\$)	132,884,836	167,951,706	26%	27,780,000	33,933,000	22%
Marshall Islands (US\$)	124,698,071	170,747,697	37%	20,100,000	25,978,650	29%
Nauru						
Niue (NZ\$)	16,245,000	28,283,921	74%	6,574,892	5,976,330	-9%
Palau (US\$)	168,926,000	212,903,000	26%	23,900,000	35,400,000	48%
Papua New Guinea (Kina)	11,871,800,000	30,618,400,000	158%	2,370,000,000	7,904,200,000	234%
Samoa (Tala)	891,300,000	1,547,400,000	74%	182,700,000	361,600,000	98%
Solomon Islands (SI\$)	1,527,600,000	5,527,800,000	262%	243,500,000	2,038,000,000	737%
Timor Leste (US\$)	468,200,000	5,797,500,000	1138%	-	64,900,000	
Tokelau						
Tonga (TOP)	398,330,233	775,047,951	95%	73,982,100	131,986,300	78%
Tuvalu (AU\$)	28,574,289	38,112,000	33%	6,034,000	7,203,000	19%
Vanuatu (Vatu)	36,554,000,000	70,349,000,000	92%	5,671,000,000	11,563,000,000	104%

Figure 6 Most countries have tax revenue as a percentage of GDP in the range of 15 to 25 per cent, and some countries have poor data sets



Source: Sapere Research Group using data from Asia Development Bank, *2013 ADB Pacific report* and Asia Development Bank, *Online Statistical Database*

Figure 7 While most countries improved tax revenue per capita in nominal terms, the increase only kept pace with or outstripped GDP growth in six out of 16 countries

	Tax Revenue per capita 2002 (local currency)	Tax Revenue per capita 2011 (local currency)	% increase in Tax Revenue per capita (2002 - GDP growth 2011)	% increase in Tax Revenue per capita (2002 -2011)
Cook Islands	NZ\$ 3,225	NZ\$ 4,110	27%	53%
FS Micronesia	US\$ 248	US\$ 354	45%	28%
Fiji Islands	FJ\$ 975	FJ\$ 1,807	85%	67%
Kiribati	AU\$ 318	AU\$ 322	1%	26%
R Marshall Islands	US\$ 403	US\$ 472	17%	37%
Nauru				0%
Niue	NZ\$ 3678	NZ\$ 4093	11%	74%
Palau	US\$ 1,232	US\$ 2,282	85%	26%
Papua New Guinea	PGK 439	PGK 1129	157%	158%
Samoa	WST 1,031	WST 1,925	87%	74%
Solomon Islands	SB\$ 555	SB\$ 3,774	580%	262%
Timor Leste		US\$ 59		1138%
Tokelau				
Tonga	TOP 741	TOP 1,281	73%	95%
Tuvalu	AU\$ 631	AU\$643	2%	33%
Vanuatu	VUV 28,046	VUV 45,921	64%	92%

Source: Sapere Research Group using data from Asia Development Bank, *2013 ADB Pacific report* and Asia Development Bank, *Online Statistical Database*

5.6 Reasonably efficient and coherent systems have been achieved

The mixed reform outcomes in terms of additional revenue and self-sufficiency arising from Pacific tax reform should not be over-emphasised. The main objectives of reform (as indeed was the case in New Zealand in the late 1980s) was to move the tax base on to one that was more efficient. This meant introducing VAT to replace tariffs and reducing income tax rates with a broader income tax base. The broad international consensus is that this should produce a more efficient and coherent tax system although measures to demonstrate that are hard to identify.

On the whole, the picture painted is that taxation systems in the Pacific are more coherent and efficient than they were at the start of the decade, particularly in countries that have received donor-funded support. There are limits on the degree of efficiency and coherence achieved, however. Below we summarise some of the challenges that persist in the Pacific countries.

5.6.1 Issues with technical aspects of taxation law remain

Issues with the technical aspects of taxation law remain in the case study countries, which might potentially undermine the reform process and its implementation. For example, in Tonga there remained technical issues relating to the law and system for tax payments and the application of penalties for failing to pay tax on time. It should be noted that this is an area that most tax systems struggle to find a balance between the need to collect revenue on time and the need to provide reasonable treatment of those taxpayers who are trying to comply with tax requirements but, because of the inevitable complexity of tax laws, sometimes fail to do so.

In one case, in order to ensure timely payment of tax, penalties were imposed on late payments and any payments applied first to meeting that penalty. However, as the law is drafted it appears to mean that if an employer PAYE deduction is under-paid, future PAYE payments are deemed to be penalty payments, meaning that PAYE is then underpaid (with a consequent penalty) in the next period. This produces compounding penalties throughout the taxpayer's history post-the first under-payment. We were advised that such compounding penalties were normally waived on application to the tax administration. However, this approach required expensive legal tax advisory assistance for the taxpayer, is frustrating for tax advisors who are also key private sector influencers in the tax reform process, and has tied up key administrative staff who could more usefully be employed in leading and implementing the wider reforms.

Problems with payment and penalty rules seem to be the norm in most countries but receive little policy focus because they are not seen as major policy issues especially, one suspects, by donors. However, payment and penalty rules can alienate private sector support, create high compliance costs for business and tie up scarce administrative resources.

Another problem arising from faulty rules in these areas is that a priority of tax administrative reform is often to bring in modern IT systems. However, if the key payment and penalty rules produce incorrect outcomes better IT systems are likely to make the problem worse by automating the production of outcomes that no one wants to apply in practice.

Other problems with technical tax rules were also evident. In Solomon Islands, a common complaint of the private sector is a multitude of apparently inconsistent withholding taxes. Compliance with these rules is legally required, and larger enterprises attempt to do so, but we were informed that compliance by the general public was low. Such rules tend to tie up scarce administrative resources determining which withholding rate too apply and frustrates key influencers in the private sector.

5.6.2 Administrative capacity still weak

Administrative capacity limitations were also often cited, especially by the private sector, as undermining the sustainability of reforms put in place. For example, web-based lists of persons registered for GST that have not been updated for a year or more. Also in this regard were complaints about the inability to get decisions on difficult technical issues.

Key person risk was evident in all tax administrations. Senior administration officials were often candid that significant technical decision making was often dependent on 1 or 2 people in the administration. Reliance on these people is a risk but also hinders their development because important aspects of the administration could not operate without them. It was also generally noted that capacity issues were not limited to tax administration but common in the public sector with the result that high potential staff often moved to other departments.

The capacity issue in tax administrations seem in some cases to be exacerbated by the withdrawal of overseas technical staff who were engaged during the reform process and who have occupied key technical roles across the administration. With the reform process seen as having been “completed”, funding for these roles is being removed leaving capacity gaps in basic tax administration expertise that the host country administration seems challenged to fill. Often the advisers would have knowledge transfer as part of his or her terms of reference; however, the prevailing view was the need to get things done led to capacity development being displaced in many situations.

5.6.3 The underground economy persists

A common concern across countries, especially from a private sector viewpoint, is the prevalence of the underground economy with high levels of evasion seen in the small business sector. In Samoa, for example, on some estimates, the number of taxpayers who filed a 2011 income tax return may be less than 25 percent of those who appear to have an obligation to do so, and the number of tax payers who filed VAGST and PAYE returns appears to be less than 50 percent of those who had an obligation to do so. These problems are recognised by the Samoan Ministry of Revenue, which is rated by PFTAC as on the path to being a leader in tax administration in the Pacific, but are illustrative of the prevalence of the underground economy across the Pacific.

While we found no evidence that the underground economy is growing, or that it is a product of tax reforms; in most cases reforms have widened the tax base and put more emphasis on the ongoing presence of the underground economy. The private sector especially saw this as undermining the legitimacy of tax reforms. This emphasises the need to improve the basics of tax administration and not just focus on higher profile policy changes.

5.7 The improvements are fragile

We have found that the reforms and administrative improvements put in place over the past few years are fragile, and may not be sustainable into the future. There remains across the Pacific a legacy of inefficient tax systems, weak capacity for tax compliance, inconsistent patterns of business taxation, limited local expertise to respond to changes in the tax environment (such as growth in extractive industries), and limited engagement with the community to build constituencies for continuing taxation reform.

To a considerable extent this fragility of the taxation systems is a product of the severe capacity limitations in the region. However, our review of donor support for taxation reform in the Pacific during the period 2002 to 2012 concludes that donors have tended to fund and support discreet projects rather than engaging with host countries in implementing a strategy to, over time, construct a well-functioning sustainable tax system. This tendency to fund and support discreet projects seems to result outcomes that are fragile in terms of their sustainability.

5.7.1 More change to structures than behavioural change

Taxation reform is not just about changing legislation or implementing structural change in the administration. In a tax system based on voluntary compliance, legislation and administrative processes should be signals as to appropriate forms of behaviour. A tax system is a set of modes of behaviour (collecting tax in the appropriate way) and thus tax reform inevitably requires changes in prior modes of behaviour.

Bringing about and embedding behavioural change takes longer, is more complex and is more time-consuming than changing rules or changing administrative processes. The comparison can be made with organisational change. It is often noted that an organisation can most easily change its organisational chart or structure and its strategy but by themselves these are unlikely to bring about significant change in how the organisation actually functions. Fundamental organisational change requires change to the organisation's culture and values which is much more difficult to achieve. Similarly, changing a tax system often requires changes to the culture and values of participants in the system.

Changing these modes of behaviour takes time and ongoing effort. The private sector needs to be involved in the reform process. The case studies demonstrated considerable private sector enthusiasm for the reform process but this was clearly stronger in Samoa (where considerable effort has been made in recent reforms to engage with taxpayers) than in Tonga which was a more top-down Ministerial led reform process. It was also evident in all countries that the private sector's willingness to alter its behaviour in line with reform objectives could be set back if the basics of ongoing tax administration were seen as lacking (countering evasion, speedy refunds for VAT, or its equivalent, and timely resolution of technical issues).

Perhaps surprisingly, the greatest challenge to behavioural change has been within tax administrations. A good example of this has been the move to a self-assessment system in Tonga. It seems that the private sector adjusted to this change more readily than the tax office staff. As one commentator put it: "Revenue officials still do not understand the concept of self-assessment. They want to check and verify all returns before processing them." Self-assessment requires returns to be quickly processed then checked and audited in

accordance with a compliance strategy. However, the idea of processing returns that are not accurate seems to be contrary to ingrained beliefs and practices of tax office staff. The result is a back-log of unprocessed returns leading to out of date data and the inability to implement a modern compliance strategy.

Tax reform often requires significant changes in the work and behaviour of the staff of tax administrations and this can be especially difficult to bring about. In that regard moving to an entirely new tax system (VAT or its equivalent) seemed to be easier to achieve than changing the way an existing tax (income tax) is administered.

5.7.2 Still weak links between tax and government services

Anecdotal evidence from the case studies is that, with the exception of Samoa, the link between taxation and the provision of government services seems to continue to be weakly held by the general population. In most Pacific countries the popular view seems to remain that roads, schools, hospitals and other government services are provided by aid whereas tax funds an excessively expensive public service. This difference in outlook seems to be attributable to the more community focused tax reform programme in Samoa than elsewhere. Given that state building should be a prime objective of tax reform this suggests that there are good lessons to be learnt from the recent reforms in Samoa. This is not to say that its reform pathway should be applied in all cases, but even if reform is led from the political level, Samoa's experience suggests that whatever reform pathway is taken emphasis should be given to driving home the linkage between tax and government services. Such a linkage should not be assumed to be a natural result of tax reform.

5.7.3 Donor exemptions are not well-understood

Granting donor countries tax concessions as part of the reform to initiate and implement broad based taxes can be seen as inconsistent and undermine taxation reforms. A key aspect of the standard taxation reform package as found in the Pacific and promoted by PFTAC is a move to broad based income and VAT-type taxes with as few exemptions as possible.

Support for a broad base with few exemptions can conflict with the understandable desire of donors to have exemptions for the assistance that they provide. This may include income tax exemptions for technical advisors through to VAT exemptions for goods imported. The argument commonly advanced by donors internationally is that any tax imposed by the host country on assistance is in effect budgetary assistance beyond any agreed limits for such assistance. For example, the technical advisors normally will expect a post-tax income at a certain level and the donor will normally be required to meet any reduction in their income arising because of host country taxation to obtain the services of technical advisors.

Moreover, if the income of technical advisors remains taxable in the donor country, any tax imposed by the host country will be creditable against donor country tax thereby reducing donor tax and thus increasing its costs of providing assistance.

The temptation to offer such concessions is heightened in the Pacific by the general absence of double tax treaties that might otherwise deal with these issues, and the low general wages in Pacific countries with progressive income tax structures. This means that the average income tax rate faced by advisors can be much higher than would be the case in their home country. In countries where there is a strong presence of international advisers, such as the

Solomon Islands, private sector firms were conscious of the difference between the tax rules applying to them in bringing in international expertise and the tax rules applying to donor funded advisers in the government sector.

We are unable to state whether offering concessions has been a regular feature in the Pacific context. In general this issue appears to not be well-understood. Specifically, we did not see evidence that the United Nations guidance about donors granting tax concessions was being actively applied (however, this was not a primary focus for our research). The United Nations guidance is that the issue of concessions and tax treatment should be raised and agreed upon in the dialogue between the donor and the host country.⁴⁴ More detail on this issue is provided in Appendix 3.

5.8 Assessment against DAC criteria

This section summarises our findings against the Organisation for Economic Cooperation and Development's (OECD) Development Assistance Committee (DAC) criteria for evaluating development assistance.⁴⁵

5.8.1 Impact and effectiveness

When viewed as an aggregation of discrete projects, then donor support for taxation reform has achieved worthwhile outcomes. For a total donor contribution of about NZ\$55 million over the period, the following results have been achieved:

- Tax revenue collection in the region has increased, by at least US\$3.6 billion dollars in nominal terms in the period 2002 – 2011, but we cannot determinatively say whether reform has led to improvements in real revenue. While substantial gaps remain in most Pacific nations between government expenditure and tax take, the gaps have narrowed.
- There has been convergence in the features of Pacific country tax systems. The convergence has been towards what is accepted as best practice tax policy and administrative settings and will assist with regional trade and regional cooperation (less reliance on trade taxes).
- Significant improvements in tax administration have been made in 9 of the 16 countries within the scope of the evaluation (Cook Islands, Fiji, Niue, PNG, Tonga, Tuvalu, Samoa, Vanuatu, and Solomon Islands) during the research period (2002 – 2012). A further three (Kiribati, Nauru and Palau) have made significant improvement throughout 2012 and 2013. Of the remaining countries, only Tokelau has made little change at all.
- With the widespread reduction in trade taxes across the region, the obligations that arise with membership and/or accession of the WTO and the Pacific Island Countries Trade Agreement (PICTA) agreement are well on their way to being met. This is a work in

⁴⁴ UN Committee of Experts on International Cooperation in Tax Matters. *Tax treatment of donor-financed projects*. Second session. Geneva, 30 October-3 November 2006.

⁴⁵ OECD Development Co-operation Directorate *Criteria for evaluating development assistance*. <http://www.oecd.org/dac>

progress and the removal of tariff and non-tariff barriers to trade will continue throughout the present decade.

Successful outcomes in terms of the objectives being sought tended to be associated with significant donor long-term funding for taxation capacity building and reform, rather than reliance on one-off funding or funding subject to an annual cycle. Long-term funding has provided the host country with the confidence to make the commitment required (in terms of political capital and administrative resources) to set out objectives, determine policy options and then plan through to implementation. Tonga, for example, initiated its reform programme with a commitment by the ADB for 5 to 6 years of funding allowing Tonga to commit at the outset to a long-term reform programme. Samoa received funding for a medium-term administration reform.

The experience with one-off or short-term donor assistance has often produced poor if any successful outcome. In Solomon Islands, for example, a one-off project to upgrade the IT system of the tax administration produced an IT product that was not used. That was because host country staff were not properly trained in the new product and the new product used tax data that the administration knew was poor or inaccurate. There was no point in having poor or inaccurate data better processed. Samoa had a similar experience in relation to a donor funded study on a proposed IT project and large taxpayer unit. These proposals were initiated through one-off projects but not implemented once reviewed in the context of a staged, medium-term programme which saw the upgrade of an existing IT system at considerably less cost.

While some countries have had positive experiences with short-term (under 3 week) technical assistance for specifically defined contributions to a wider reform project, the general preference was for assistance of a longer-term nature (2-3 years) where the advisor has a commitment to the long-term nature of the reform process and was able to better integrate with the host country culture and institutions. There are specialist advisors in the Pacific who, although they are only able to visit a country on a 2-3 week basis, they do so regularly and over many years and thus gain institutional knowledge of the whole reform programme.

Short-term engagements have worked well where the skill need was identified, contracted, and managed by the host revenue agency as a component of its capacity building programme, for example as has occurred in Samoa.

5.8.2 Sustainability

To create sustainable taxation reform it is necessary to manage the tax system as a whole. Managing the tax system as a whole requires a systemic approach to taxation reform that in turn involves building up the political, administrative and private sector infrastructure that makes a tax system work and sustainable over time by changing in a coherent way to meet the changing demands of the society within which it operates.

We have found that the reforms and administrative improvements put in place over the past few years are fragile, and may not be sustainable into the future. To a considerable extent the fragility of the reforms is a product of the severe capacity limitations in the region. However, it also seems to be partially a product of the reform processes adopted which is episodic in nature. There is little evidence that donors have entered into a strategic

engagement with host countries as to how to manage the long, complex, location-specific journey involved with successful and sustainable taxation reform.

5.8.3 Relevance

We have found that the reforms pursued by donors have incorporated an approach that is widely recognised as being consistent with orthodox or best principles tax policy. In each instance, the need for reform was clear, and there was recognition from the host country of the need for a programme of reform.

However, there are many examples of one-off discrete projects which proved a poor fit for the host country given its circumstances at the time the project was delivered. These examples included IT systems that host country staff were not properly trained to operate or used tax data that the administration knew was poor or inaccurate, large tax payer centres which the host country could not staff as a separate unit, and tax administration acts which could not progress because of political constraints. These examples tended to be less in longer-term programmes, in part because outputs from the programme could be adjusted as circumstances changed.

5.8.4 Efficiency

An assessment of the efficiency of an intervention generally requires comparing alternative approaches to achieving the same outputs, to see whether the most efficient process has been adopted. A quantitative efficiency evaluation is better suited to programme-level evaluation than a strategic assessment of this nature seeking general lessons for how donors support reform programmes.

If donor interventions are assessed against the objectives for those interventions (typically discreet projects), then the programme documentation and interviews support a conclusion that the programmes are, typically, carried out efficiently. For example, a series of evaluations have concluded that PFTAC, the predominant source of technical advice to Pacific countries, has delivered high quality, effective and efficient services. We also met and interviewed many talented and dedicated individuals who were working on fee scales significantly less than they would likely command from corporate clients given the specialised nature of tax advice.

If assessed against an objective of creating sustainable taxation reform in which it is necessary to manage the tax system as a whole, the efficiency of episodic reform is less clear as many of discrete achievements remain fragile.

6. Lessons

6.1 Reform is a long journey

Expect to commit to a long-term strategy

Taxation reform is a long journey, measured in increments of at least 5 years for many discrete projects; if a commitment is made to implementing systematic taxation reform donors would be embarking on a programme that would be measured in decades.

To achieve serious tax reform objectives donors need to commit to a long-term strategy, which in turn raises questions about funding priorities; how commitments can be made within the donor's own budget cycle; and how tax reform is weighed against competing demands for donor support.

Long-term strategies will likely encompass all stages of reform

The long-term nature of the reform process, the need for ongoing (including remedial measures) to buttress initial reform efforts and the importance of good basic tax administration capacity to support the legitimacy of the reforms (as well as to achieve the objective of those reforms) means that donors need to be conscious that taxation reforms are only sustainable if there is ongoing support for capacity in the tax policy agency and the tax administration. Consistent with the literature, successful taxation reform interventions incorporate work streams in each of three stages: agenda setting, policy options, and implementation.

Reform timescales need to account for capacity and resourcing

Unrealistic timeframes for tax reforms, particularly those that involve deep organisational, institutional, or behavioural changes, can have adverse effects. Consistent with the literature, impatience with institution building and co-ordination failure are among the “seven deadly sins” of foreign aid (Birdsall, 2010).⁴⁶ Institutional needs to disperse funds and achieve short term results often create what Birdsall calls “willful naiveté about the absorptive capacity of host country institutions”.

Shorter implementation periods require more intense 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.

⁴⁶ The other five “sins” according to Birdsall are failure to evaluate, failure to exit, mistaking participation for ownership, unreliable and stingy funding and underfunding global and regional public goods.

Tax reform requires behavioural change

The challenges faced in implementing change in practice rather than just in theory are often under-estimated. A tax system is more than a set of laws. It is also a set of modes of behaviour by those in the tax administration and by the public. The emphasis tax administrators rightly place on voluntary compliance is testament to that. It is universally recognised that it is beyond the capacity of any tax administration to rely on simple enforcement to collect tax.

No tax reform will take root unless it changes modes of behaviour and this is seldom achieved by simple legislative change. Efficient tax administration requires a high degree of voluntary compliance so that the limited administrative resources can focus on the most difficult areas and a small section of society that will inevitably be reluctant compliers. This means that well after the laws are put into effect sustained effort is required to bring about behavioural change. Often the hardest behavioural change to effect is that of the staff of the tax administration. In this regard donors should appreciate the importance of providing support to tax administrations for doing the basics right (registering, advising and auditing) on an ongoing basis. If the basics of tax administration are not continued to be carried out well, that will ultimately undermine the wider reform programme.

Don't underestimate the task of implementation

The implementation phase is usually the most critical, complex and time consuming phase of any tax reform programme. That is because it is at this stage that the practicality of the proposals developed over the prior two stages is tested. If there is inadequate agreement as to the issues requiring attention and the broad changes desired, or if there are deficiencies in the earlier assessment of the context and realities in which reform is to take place, then these will become apparent in this phase. This may require a re-assessment of key aspects of the reform programme and any problems with implementation can de-rail even the most well-considered tax reform agenda.

It is also at the implementation stage that the buy-in and commitment of different sectors in the host country (at the political, administrative and community levels) will be tested. The earlier stages can appear to be successfully implemented without host country buy-in and commitment but any lack thereof is likely to create severe problems in the implementation stage.

The implementation stage is multi-faceted. It includes building the necessary administrative capacity to implement reform and in addition it is likely that reform will require building up the capacity of the tax administration in terms of the basic requirements of: taxpayer registration, processing returns, IT systems, an auditing programme, collection of debts, dispute resolution mechanisms and a focus on voluntary compliance.

As well as building this administrative capacity, the implementation phase needs to build the community support for reform to make it politically sustainable and to provide a base for the voluntary compliance on which all modern tax administrations rely. The implementation phase also includes drafting and enacting the necessary legislation, putting in place an educational and training programme for those administering the law and the public and then administrative implementation.

Because implementation is multi-faceted, the implementation phase involves many participants and issues. The dialogue accompanying this reform phase needs to be

commensurately complex involving the various key participants from initiators, politicians, administrators to community leaders and the various issues.

Reform programme managers need to facilitate and track progress on institutional and regulatory changes supporting taxation reform. In doing so an appropriate balance needs to be maintained between retaining the necessary focus on the original reform objectives and accommodating lessons arising from the implementation phase and the associated dialogue over that phase. Modification of some of the choices made in the policy options phase should be seen as an expected outcome of the implementation phase (if not in fact a success of the dialogue undertaken during it) not as a failure to implement a pre-determined plan. On the other hand, if there is excess flexibility or an unwillingness to confront entrenched opposition, the original reform objectives are unlikely to be met.

Late-arising issues can derail the reform

Even when a reform programme has been implemented as developed in the agenda setting and policy options stages, implementation is likely (possibly almost inevitably) to highlight other problems with the tax system (both the policy and administrative infrastructure). Such problems may be either brought about by the reform (unanticipated reform outcomes) or they may be issues previously embedded in the tax system that become more evident or critical post-reform. For example, the reform may bring a greater number of persons into the tax system highlighting long-standing problems with the system for taxpayer registration, or the reform may bring a wider group of the community into the ambit of tax highlighting sectors of society that have a long-standing history of non-compliance.

If such arising issues are not dealt with in an ongoing manner, the tax reform programme is likely to be undermined even if it were initially successfully implemented. Taxation reform is therefore a never-ending process. Significant reforms are likely to be intermittent (while still taking five plus years to implement) but this is required to be supported by ongoing repairs and maintenance to the overall tax system including fine-tuning the actual reforms themselves.

Ongoing support to build capacity

Ongoing repairs and maintenance of the tax system is a particular challenge to Pacific countries which generally have relatively small tax administrations and significant capacity constraints. The complexity of taxation runs through both the policy development and the administrative implementation. In both areas there are limited economies of scale.

In any tax administration there are of necessity likely to be only a small percentage of staff who have the capacity and mandate to exercise complex and technical judgement calls such as how to deal with difficult issues regarding the interpretation of the law or whether to waive penalties or other obligations. Where, as is usually the case with Pacific countries, the tax administration staff numbers 100 or less, there are likely to be only a handful of such people in each agency. These are the same people who are generally required to advise on and lead any tax reform programme including consequential reforms and ongoing remedial measures. Even if a country is small (as is the case with the majority of Pacific countries) this does not limit the diversity of impacts of taxation and thus the range of skills required to reform the system.

Key person risk is a significant concern and a major risk to the long-term success of tax reform across the region. Countries in the region can and are meeting the challenge this

poses by internal capacity building and greater regional co-operation and dialogue (including using PFTAC), but ongoing support to meet capacity constraints seems an essential feature of any tax reform assistance.

A project management approach to maximise chances of success

A project management has been undertaken in FSM, RMI, Fiji and Samoa and incorporate a steering committee and a project team, with a project co-ordinator. Depending on what degree of change is involved, a reform programme can be built around several integrated activities that, for a larger reform programme, may take 5-10 years to implement.

The many facets of a reform programme

A typical reform might involve a number of programs, many occurring in parallel, each strand equally important

- 1. Diagnostic (typically in the agenda setting stage).** There is a need prior to embarking on any sort of tax reform to perform an assessment which evaluates the current context for the reform, including: support from political leadership, support of civil society, support from and coordination between international development partners, stability in the executive group of the tax agency, buy-in from the leadership group of the tax agency on the need for reform, the availability of technical assistance and/or experts, and the degree of clarity on reform objectives. This assessment should drive the design of the intervention including: identifying 'entry points' for intervention and mode of intervention, and determining what is realistically achievable. It should also enable the evaluator to reflect on the prospects for success for the intervention.
- 2. Planning, management and governance (typically in the policy options and implementation stages).** This program would be accountable for governance and the day to day management for implementing the overall revenue reforms, including for example: developing the terms of reference and implementation plan; obtaining resources and ensuring they're used effectively; and monitoring and reporting on progress of the reforms to the Government.
- 3. Law, policy and estimates (typically in the agenda setting and policy options stages).** This program would manage tasks like finalizing the administration and tax policy, preparing revenue estimates and drafting and passing legislation through the Parliament. It may also involve senior policy advisers who can work with Ministers to identify and support achievable changes within changing political constraints, prepare policy analyses and so on.
- 4. Revenue administration change (ideally present throughout all stages).** This program would have multiple roles, but could include: (a) maintaining ongoing revenue collections; (b) designing new processes and structures; (c) installing IT systems; (e) registering taxpayers and recording them on the database; (d) change management of staff; or (e) developing new staff capabilities.
- 5. Business and community outreach (ideally present throughout all stages).** This program would engage with the public sector, private sector, community interest groups and the community at large to raise the awareness and understanding of the revenue reforms.

Source: Sapere Research Group and International Monetary Fund, 2010, *Improving Revenue Collection and Capacity in Forum Island Countries*, PFTAC Regional Papers

6.2 Managing core relationships

Relationship should support host country not impose reform programme

Given the long-term commitment required for tax reform it is critical that the host country “owns” the reform programme and process. There will simply not be the necessary commitment if the reforms are externally imposed. As one long-time adviser noted: “the funding model on its own won’t make a difference if there is not domestic ownership of the change”. The location specific nature of taxation reform and the sensitive political trade-offs this involves should always be uppermost in the minds of donors.

The success of the Pacific it seems is that the reform programmes do seem to be domestically “owned”. They may have been introduced because of fiscal pressures and/or the need to reduce trade tariffs as a condition of WTO entry, but in all cases observed it was clear that where reforms had taken place they were considered to be reforms of the host country rather than reforms imposed upon them.

There are suggestions that in some cases donors may have used the imbalance of power they can have in the policy priority stage to advance key policy priorities of the donor by, for example, refusing to release funding for budget support unless a specific identified reform is progressed. While this may be done for the best of intentions, it is a blunt tool and effective only for clearly defined and uncontroversial (among donor supporters and technical advisers) reforms, such as closing the worst of explicit leakages from corruption. In other cases it can lead to the legitimate priorities of the host country being relegated even though the host country priorities better reflect the specific circumstances and constraints of the country.

Continuity is important

Forming and maintaining relationships is central to each of stages of policy dialogue – agenda setting, policy options, and implementation. Trust and legitimacy built during the first stages of reform are likely to be critical when entering the implementation phase with its concomitant challenges and required dialogue.

Successful reform programmes have benefited from the continuity of core relationships. The Pacific tax reform experience demonstrates that managing the complexity of the reform process requires a long-term commitment by key participants and the continuity of core relationships. Core relationships are important because taxation involves all aspects of society and requires a relatively large complex administrative infrastructure to operate.

Dialogue needs to be activity managed

In any reform there is a need to manage complex dialogue to clarify objectives and constraints and gain buy-in from all participants in the reform: donors, host country politicians, host country officials, technical advisors and civil society. This is needed to communicate the impacts of the reform and prepare people for change. Furthermore, such communication is essential for state building: higher quality communication gives visibility to tax and its role in society. Tax visibility can be addressed through public information, taxpayer education, and programmes to mobilise civil society and business groups around these issues.

Since taxation affects most aspects of a host country's society an effective dialogue across and between different participants in the reform process has been demonstrated to be critical to changing the modes of behaviour that tax reform requires. This dialogue should include a dialogue between the donors and the host country so that donors are, on an ongoing basis, aware of the challenges posed by and the issues arising from the tax reform process and how these change over time. Otherwise donors may look for the wrong skills or systems or may have an incomplete understanding of what is involved in reform.

The host country should also be made aware of donor expectations which may also alter as the reform process proceeds.

Donor co-ordination is key

If there are, as has often been the case, multiple donors, there should be a dialogue between donors to ensure that their expectations are consistent and that projects they are funding are consistent with the overall reform agenda. Managing such a dialogue is complex and requires skills unlikely to be readily available to the host country. Donors need to consider providing assistance in that regard as part of the overall aid programme.

A long-term strategy is likely to raise issues of co-ordination amongst donors for funding and technical support; who undertakes this role, how objectives are set and accountabilities determined. Projects in which a 'pot of money' facility have been established by donors, and where the project is responsible for contracting or purchasing the required inputs (including experts, systems) seem to have worked well.

Support from the private sector is important

Civil society, including tax practitioners, is important for identifying and supporting 'technical' changes to tax systems (within the political constraints) and may need to be supported as part of the reform process. The importance of dialogue with and support from such key influencers, and their role in making the tax system work in practice, means that their practical concerns should be given considerable priority in a wider reform process. Funding for public communications of the purposes and consequences of tax reform should be considered as part of any overall reform assistance. In addition, it may be justified for donors to assist professional and business groups in the host country (such as Chambers of Commerce). Such groups are important to the acceptance of the reform and its implementation in practice but are often under-developed in the region by comparison with say New Zealand.

6.3 Reform is complex, multi-faceted and doesn't follow a pre-determined path

Taxation reform reflects the complexity of the underlying subject matter. There are significant political and economic objectives to be identified, numerous sectors and interested participants, and difficult trade-offs in terms of income and wealth distribution to be managed all within the context of changes implemented by way of a set of complex legislation and administrative processes. Taxation reform is therefore very challenging for small Pacific economies already facing significant capacity constraints.

Programme of reform may not be linear

A lesson from the reforms in the Pacific is that a programme of taxation reform is not always linear, but reform plans and advice given to countries about reform often suggests that it is or should be. In reality, reform is often an iterative process in which agendas are revisited, policies are revised, and implementation monitored and adapted. Impasses at the policy implementation stage, may, for instance, require revisiting policies and legislation. Reform is rarely a sequential process, what happens next changes future possibilities, and feedback loops are inevitable and important.

Textbooks describe ideal reform processes of agenda setting, policy options, implementation, and review and improvements; real world reforms require a combination of policy and administrative reform but the ordering can vary and reform can still be successful. One cannot it seems say that any particular reform path is right or wrong – it depends upon the circumstances and opportunities to hand.

If Tonga had followed the advice to defer reform until administrative capacity had been appropriately built up, the political leadership to drive the reforms may not have been present by the time that happened. On the one hand, its reforms may have been more robust, but on the other hand they may not have happened at all. The decision to use the political leadership available to push reform “out of order” seems perfectly legitimate provided the host country and donors recognise the cost in terms of fragility of the end result and thus the need to provide buttressing support for the reforms once put in place.

A variety of skills are needed

The long-term nature of the taxation reform process, the variety of required stages in the process and need to integrate political policy and administrative reform means that different skills are required to be brought together reflecting the different challenges.

The agenda setting stage requires skills and experience in tax reform strategizing, evaluating the local context, providing a diagnostic analysis of that context and engaging in a dialogue with key political decision makers as to their objectives and expectations. PFTAC has played a key role in this area.

The policy options stage requires a variety of skills in terms of understanding local capacity to implement differing options. An important aspect of this stage is determining social and political trade-offs. Inevitably any taxation changes will involve some economic “winners and losers” in the shorter term. The sustainability of reform will be heavily dependent on managing a constructive dialogue with political decision-makers so that they understand and are comfortable with the likely outcomes.

The complexity of the tax reform process and the various differing stages involved means that a diverse skill base needs to be brought together for any assistance package. Support will be required for each stage of the ‘reform dialogue’ cycle (agenda setting, policy options and implementation) and the skills involved in each stage are different. Getting this right in the first two stages should form a foundation for the implementation stage when the dialogue involves multi parties and issues. Managing this well is likely to be a key to the success of any tax reform programme and is something donors should focus on as well as more obvious technical assistance.

Host countries may have an expectation that a person with tax technical skills in any area will be able to provide a broad range of assistance. In general such expectations are not well-founded although there have been examples of legislative drafters in particular who also seem to have provided good advice across a broad span of technical issues. No one individual is likely to hold all of the relevant skills:

- A policy expert residing in Australia or New Zealand may not have sufficient understanding of the context of the country or of developing economies more generally.
- Experts who can describe the broad strategy for developing economies may not have the ‘political economy’ skills to help Ministers identify feasible reform paths.
- Tax administrative experts may not have the tax policy skills to identify detailed technical changes that (within current policy constraints) can achieve significant gains for taxpayers and tax administration.
- Policy experts may not be skilled in implementing necessary reform to tax administrations (such as enforcement, IT and systems, registrations).

Shortages in portfolios of skills are a feature of the Pacific. In the cases of Tonga and Samoa it seems that the host countries were able to access a reasonable variety of technical skills with donor support. Particularly appreciated have been those showing commitment to the process over a number of years who have been able to bring different skill-sets to the process. Because of this continuous relationship, these advisers are able to add value on relatively short visits to address specific issues as part of a long-term strategy – this is qualitatively different than one-off missions from short-term experts.

On the other hand in Kiribati a person with IT skills was still expected by the host country to advise on all aspects of reform. That is not a reasonable expectation. A common theme was the isolation of technical advisors with valued specific skills but who are expected to provide advice outside their areas of experience. Consideration should be given to providing such people with greater support (through for example more networking opportunities) and providing a broader portfolio of skills under assistance programmes.

6.4 Skills in managing dialogue especially the political interface given less focus than warranted

In the reform programmes that have been adopted, understandably, the skills that have been most often identified and provided are those associated with the agenda setting stage (most often through PFTAC), general policy development skills and technical law drafting skills, tax administration and IT and systems skills. However, there seem to be some notable gaps in assistance packages to date, mainly in pathway management.

In particular there seem to be gaps in expertise needed to manage the pathway of reform (dialogue management) and senior policy advisers who can work with Ministers to identify and support achievable changes within changing political constraints (the political interface). These gaps become more critical the longer and the more complex the pathway.

In many cases those with taxation technical skills have by necessity been required to provide assistance in this area developing expertise in these areas as they go with little prior background or experience. PFTAC provides valuable assistance to Pacific countries considering tax reform but its strength appears to be in agenda setting and requirements of administration reform, not in pathway management.

While technical advisors may have done a commendable job in this respect the importance to the success of the reform programme of managing the dialogue properly suggest that greater focus should be placed on providing assistance from people with in-depth experience of operating at the level of Ministerial/advisor interface and experience in managing reform dialogue.

6.5 Tax reform is location specific and dependent on the local social, political and administrative context

Working through political obstacles is a core aspect of dialogue

Successful tax reforms are implemented in the specific context of the country in which it takes place. Good tax policy reform generally follows the standard package of introducing a mix of broad, low rate income tax and consumption tax buttressed by modernized tax administration as outlined in Chapter 3. However, successful reform also needs to accommodate the capacity constraints faced by the tax administration and the private sector, and the constraints imposed by the political system.

Taxation is a critical link between the citizen and the state and involves fundamental issues about the distribution of income and wealth in a society. An inevitable consequence is that tax design is and should be subject to political and social trade-offs. Working these through should be seen as part of a healthy tax reform process and not as an unnecessary obstacle.

This is a core aspect of the dialogue that needs to take place at the policy options stage of reform. This does, however, mean that the viability of tax reform is subject to political constraints. It is the variation in the constraints imposed by the varying capacities of differing tax administrations and the private sector in each country, and the varying political constraints, that makes tax reform so context specific, albeit within a general common framework of broad income and consumption tax bases. While countries in the region have many common features and thus similarity of constraints they still vary and these variances will impact on what is achievable in terms of successful tax reform.

Administrative capacity constraints are not as pressing as they used to be, but are still fragile without ongoing support

The constraint imposed by the level of development of the tax administration in each country is probably the easiest constraint to relax. Across the region, over the past twenty years, considerable progress has been made in modernizing and up-skilling tax administrations. In many cases, such as Samoa and Tonga, this has been part of wider tax reform. Indeed a common theme in the region has been the use made of the introduction of GST (or its equivalent) as a catalyst for administration reform. This has in many instances

been deliberately, and to the large part successfully, used to engineer change in tax administrations.

While administrative capacity constraints can be relaxed in the manner outlined above, they clearly continue to exist. This is most evident in the most sophisticated areas of tax administration such as the auditing of Multi National Enterprises and in particular the application of transfer pricing rules and the possibility of entering into double tax agreements with other countries.

Many countries in the region are considering or trying to develop expertise in these areas. The ability to do this in some of the smaller jurisdictions in particular must be questionable as:

- the few administrative staff in these jurisdictions with high levels of expertise are needed to manage and leading existing reforms
- the ability to retain highly qualified staff in these areas is untested.

A more regional approach to these types of issues is being considered (through for example PITAA) drawing on the skills of the larger economies in the region (Papua New Guinea and Fiji). However, even then capacity levels are stretched and it is not evident that a strategic consideration of how this could be achieved within capacity limitations has taken place. Reforms in these areas may need more active support from Australia and New Zealand (or may need to be supplied on a project by project basis from the private sector) if they are to succeed.

Our conclusion is that administrative capacity constraints remain a significant constraint on reform moving beyond the basic requirements of income and consumption taxes.

Tax reforms can work, even in the presence of constraints

Political constraints on tax reform, where entrenched, seem to be the hardest to relax. Successful tax reform programmes, such those in Samoa and Tonga, benefitted from high level political support. Samoa and Tonga are also relatively homogenous societies. Where these conditions do not exist and there is no political support for tax reform, this can be an insuperable barrier to major policy changes. That seems to have been the case in Solomon Islands and, to a lesser extent and until recently, Kiribati. Given the sensitive trade-offs usually required in any significant tax reform programme, political constraints may preclude model type reforms.

It is evident, however, that political constraints do not preclude all taxation reform processes from being initiated. First, considerable progress can be made with increasing the capacity of the tax administration in isolation of a wider tax reform programme. That seems to have been the case with Solomon Islands for example. Solomon Islands have just introduced a new Customs Act that rewrites its Customs procedures and aligns them with upgraded IT systems; Solomon Islands have also reformed how exercise taxes are levied on alcohol. These reforms proceeded despite the severe political constraints in taxation reform in Solomon Islands. This demonstrates that a technical change can be implemented even within such significant political constraints.

Secondly, and equally importantly, technical changes to the tax system, which substantially improve outcomes for taxpayers or tax administration, is generally feasible even where severe political constraints exist that would preclude moves to adopt 'model reforms'. For example,

changes to the laws relating to tax payments and penalties can produce many benefits to the tax system and start building the foundations for wider reform when the political constraints are reduced. Better payment and penalty rules would in many observable instances reduce business compliance costs and risk as well as reduce private sector frustrations with the tax administration increasing the likelihood of private sector support for wider reform. Such changes are also likely to reduce the resource cost of the tax administration in dealing with rules that are in practice unworkable or difficult to work with.

These changes of technical rules do not require the difficult, complex, political trade-offs required under a wider reform programme and thus should be, and in some case have been shown to be, achievable even when political constraints have led to fundamental tax reform being rejected. Nevertheless, technical reforms along these lines require their own specific range of skills. It requires a detailed understanding of existing tax codes, how the tax system operates in practice, and an ongoing conversation with Ministers as to what can be achieved and with taxpayers as to what would be broadly supported. It is thus likely that a technical reform programme along these lines would require donor support.

Our observation is that donor support for this type of technical improvement to the tax system has not been forthcoming under the programmes we have considered, unless provided in the context of a more substantive reform programme. This may be because donors do not view technical taxation changes as leading to the development goals they seek to advance. However, that does not seem to give due weight to the economic and administrative benefits and longer term foundations for wider tax reform such a programme can deliver. It is thus similar to the need for tax administrations to continue get the basics of auditing and tax administration right to bed in and support wider more recognized taxation reforms.

Tax reform programmes require flexibility

Diagnostic assessment should drive intervention design, but shouldn't prevent reform from occurring. The diagnostic assessment may indicate that the administrative capacity is more limited than desirable to implement significant reform. However, if the political leadership to drive reform exists such opportunities (which may be time limited) should be exploited provided the administrative capacity limitations are acknowledged and the weaknesses in the reform programme this will inevitably give rise to are managed. The assessment may in this way determine the ordering of reform tasks.

Similarly, although standard reform maps would have administrative reform preceding policy reform, tax reform in the Pacific has demonstrated that policy reform along the lines of the introduction of a VAT (or its equivalent) can be used to overcome host country resistance to administrative modernization. This seems to be a feature of VAT-type reforms because such reform makes administrative modernization a necessity.

The complexity of the tax reform process means that there is a need for continuous re-evaluation during any programme of tax reform, and adaptation of the programme accordingly. Aspects of the reform may need to be modified in light of experience and unexpected obstacles are likely.

One consequence of this need for continuous reevaluation is that donor engagement in the reform process needs to be ongoing. There is a tendency for donors to engage at the initiation stage - when design objectives, funding and resourcing are considered - and to

engage periodically at review stages - when the focus is on whether the reform has achieved its initial objectives. However, given that the tax reform process requires flexibility, the reform process is likely to undergo constant adjustment.

Donors need to retain engagement throughout the process. Not doing so raises the danger that, for example, the reform is being undermined by public perceptions that the underground economy is not being addressed. Donors may then need to alter the nature of some of the assistance provided to ensure that such obstacles to reform are managed appropriately. As noted above, given the complexity of the reform process the tax treatment of assistance should be part of and agreed as part of the initiating dialogue between donors and the host country.

Donors should recognise the location specific environment in which reform is proposed

Administrative capacity can and has been successfully built before in tandem with or after a broad reform programme has been adopted. Private sector capacity can to some extent be accommodated by the actual policies put in place but generally also needs to be built up. This could usefully be given higher focus by donors.

The basics of good tax administration will ultimately determine the success of any tax reform programme. Donors should regard support for the ongoing basics of good tax administration and support for technical policy reform programme as integral aspects of sustainable more fundamental tax reform. That is especially the case where political constraints preclude a more fundamental reform programme.

6.6 The measures of reform success need to be broader than revenue

Because taxation impacts deeply in the economy of the host country, measures of reform success are likely to be complex and subtle.

The most obvious and easiest to measure objective of reform is improved revenue raising. It is understandable that donors are likely to place a heavy emphasis on revenue as a measure of reform success. Increased revenue improves the self-sufficiency of the host country and reduces pressure for budgetary support. If revenue raising is to be achieved through improved tax laws (base broadening and reduced exemptions) that is likely to be reasonable

However, good tax reform usually has broader objectives such as economic efficiency and/or improved equity or fairness. In addition revenue raising as an objective may, in some circumstances, be in direct conflict with wider reform objectives. For example, an over-focus on a revenue raising objective can lead to pressure being placed on the tax administration to enforce poor laws more rigorously. That is likely to be counter-productive to the long-term goal of reform which should be to replace poor laws not have them more rigorously enforced.

More generally, the measure of reform success should not be so much revenue raising but how that revenue is being raised. Reform objectives and measures of success should be broadly based. Donors should follow developments internationally in how measures of success can be broadly stated and should resist any temptation to pressure host countries to

give priority to projects that may be inconsistent with those objectives or that have a lower priority in terms of improving the overall tax system.

Value added taxes, for instance, have often been introduced with compensating assistance via the income tax and social welfare systems. New Zealand's own experience in introducing GST is cited in the literature as an illustration of a 'successful' reform.⁴⁷ However, if the reform package were rated only on whether it was initially revenue positive, it would have scored poorly as it was achieved with substantial compensating welfare assistance and reductions in income tax rates. The 'standard package' promoted by PFTAC does not address the 'negative income tax' (welfare packages) which have been an integral part of the reform packages in many countries. This is part of the political interface that we have highlighted elsewhere tends to be a gap in existing assistance provided.

In other words, donor supported programmes appear to need clearer and better measures of what success in tax reform looks like. It is appreciated that objective measures are hard to obtain but progress is being made in this area with, for example, the IMF RA-FIT benchmarks.

6.7 Regional networking is a valuable asset

Although we stress the context specific nature of taxation reform it still seems important to recognise that many tax issues are common across jurisdictions (including New Zealand and Australia), though they vary in scale and capacity of tax administration and taxpayers:

Relationships with New Zealand Inland Revenue Department and Customs are important for skills and knowledge transfer and support that these New Zealand agencies can offer. It is likely that networking with Australian and New Zealand revenue authorities will be necessary for Pacific countries to maintain in the future the successes achieved to date and build upon them. At present such networking outside the Customs area seems to be of an ad hoc nature and to vary greatly.

Support by the New Zealand IRD for a particular country seems to be highly dependent on relatively ad hoc networks. New Zealand IRD engagement with Solomon Islands and Samoa has been high. New Zealand seconded staff have led to networks within the IRD that both countries seem to be able to draw upon for ongoing support. In Tonga, by contrast, there was no engagement between the revenue agencies and the Tongan Commissioner did not know the New Zealand Commissioner even by name. Nevertheless, Tongan officials stressed the value they thought they would get from greater engagement. By contrast, Customs officials from New Zealand have standing funding arrangements with the New Zealand Aid Programme to support customs agencies in the Pacific as does IRD in relation to Solomon Islands.

Regional networking is an important mechanism by which tax administrations in the region are trying to manage their capacity limitation issues. PFTAC and PITAA play important roles in this regard and are worth supporting. Network relationships such as those fostered

⁴⁷ Ian Dickson, David White, *Tax Design Insights from the New Zealand Goods & Services Tax (GST) Model*, Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington.

by PITAA are important but underdeveloped and may be a focus for future strengthening. Neither New Zealand nor Australia has attended PITAA meetings for a few years.

The importance of networking in the region was also highlighted by some individual technical advisors who noted that from an administrative background in a revenue agency they often found themselves the sole source of taxation advice in a country without any support.

7. Summary and implications for donors

Our brief was to review the support provided for tax reforms over the period 2002 to 2012 and uncover lessons about the way that donor funded interventions are delivered in relation to taxation reform.

We have drawn a number of lessons on how donor supported projects could in our view be improved. More fundamentally, however, we have considered how the nature of donor funding may be impeding the establishment of a sustainable well-functioning tax system. The following paragraphs summarise our findings, and our views about the implications for these findings for donors.

7.1 Evaluation findings

Our evaluation of donor funded interventions in taxation reform in the Pacific over the ten years from 2002 to 2012 found that:

- There has been a significant investment by numerous donors to taxation reform. Between 2002 – 2012⁴⁸ donors invested an estimated NZ \$55 million on tax reform projects in the Pacific.
- PFTAC was a main vehicle for providing support to host countries and PFTAC is well-regarded by Pacific countries and has played a key role in agenda setting, the provision of technical support and administrative capacity building.
- With respect to the process adopted by donors, this has generally been in line with good international practice:
 - Donors have invested in projects with clear objectives, usually comprising the standard ‘package’ of a broad base VAT and income tax backed with modern administration.
 - Expectations as to outcomes have generally been realistic, although the timeframe for implementation has often been overly optimistic.
 - Projects have generally followed an appropriate, evidence-based diagnostic analysis of host country circumstances.
 - Critically, we found that projects were agreed and owned by the host country, following an appropriate dialogue rather than being imposed on them. This is demonstrated by the experiences of our four in-depth case studies:

In the case of Kiribati, reforms did not take root until recently when a political commitment for reform emerged.

⁴⁸ The years are defined with a 30 June year end.

In Samoa and Tonga, it is clear that the reforms were owned by the host governments and had political support.

In the case of Solomon Islands, policy reforms remain off the agenda because of lack of political support and reform has focused on administrative capacity building.

While donor support has contributed to evident improvements and broad convergence in tax systems, as demonstrated for example by the increased ratings in PFTAC baseline reviews of Pacific country tax systems, the outcomes nevertheless have been mixed:

- Structural changes to the tax system (both policy and administration) seem more evident than the more fundamental behavioural changes on which a well-functioning tax system relies.
- There are still weak links between taxation and overall state capacity building – the linkage between taxes and government services funding those remains weak.
- Revenue results have been mixed (although revenue increases are not necessarily the only or main reform objective).
- Most critically, we found that tax systems remain fragile. For example in Solomon Islands the senior tax administration positions remain dependent on seconded staff and in Tonga it was evident that key person risk could easily undermine the reforms implemented. In all countries, administrative challenges and the perceived presence of a large level of non-compliance is seen as inhibiting the development of the tax system.
- There remains across the Pacific a legacy of inefficient tax systems, weak capacity for tax compliance, inconsistent patterns of business taxation, limited local expertise to respond to changes in the tax environment (such as growth in extractive industries), and limited engagement with the community to build constituencies for continuing taxation reform.

This fragility, according to the theory of change posited in the evaluation plan, will result in:

- lowered realization of revenue potential; that is, there are weaknesses that compromise ongoing improvements in revenue adequacy
- little or no sustained improvement in the skills and institutional capacity in the diagnosis, prioritization and implementation of appropriate policies and administration
- persistent weaknesses in tax paying culture and understanding of the tax system in civil society; that is, there are weaknesses that compromise ongoing improvements in state building and public acceptability of the tax system).

The picture that emerges from reform efforts in the Pacific is that they have yielded significant formal changes in tax regimes, but more modest changes in tax practices. No country has achieved sustainable taxation reform. Donors are not focused on a systematic approach to taxation reform that involves building up the political, administrative and private sector infrastructure that makes a tax system work and adapt over time to meet the changing demands of the society within which it operates.

7.2 Answering the evaluation question

The central evaluation question was: “has donor funded intervention provided for effective dialogue at each stage of reform and what were the sustained consequences for the objectives of reform?” The hypothesis was that successful taxation reform is a matter of successful process and that a sustained interchange of ideas, perspectives and analysis between donor-funded agents and their counterparts in the host country would lead to good reform outcomes.

Our answer to the above central evaluation question is that in the Pacific donor support has provided for effective dialogue but of an episodic nature. We have concluded that although donor support for tax reform projects seems to have followed good international practice, and although much has been achieved, it does not seem that reforms and administrative improvements put in place over the past few years have sufficient depth to be sustainable into the future. A critical aspect of sustainability is establishing the environment in which incremental improvements in tax policy and administration become business as usual, and this has not been achieved.

We considered how the nature of donor funding may be impeding the establishment of a sustainable well-functioning tax system. Our conclusion is that donors have tended to support discreet taxation reform projects. We label this episodic support. Examples have been: the move from tariffs to VAT, the move to a self-assessment system for income tax, and the introduction of a computerisation to administration.

However, as the UK Mirrlees Review has stressed, the tax system should be viewed and reformed as a whole system. To produce sustainable consequences the dialogue, between donor countries and host countries, needs to be deeper and at a more systematic level. This requires a more systematic support by donors to taxation reform to establish the environment required for sustainable reform. We outline in the report, and summarise below, what this systematic approach is likely to entail and how it differs from the current episodic approach.

7.3 Options for future donor support of taxation reform

The implication of this evaluation for donors is a choice between three options for future donor support of taxation reform:

- Given the mixed results from past donor support, move the focus of donor assistance to other priorities.
- Continue with the current episodic support for taxation reform with some improvements resulting from the lessons drawn in this evaluation.
- Consider moving to a more systematic approach to support for taxation reform.

We comment on each of these options below.

Refocus assistance away from taxation reform

The mixed results from donor support over recent years does not, in our view, justify redirecting the focus of assistance in the Pacific away from taxation reform. The available indicators (in particular the PFTAC baseline reviews) show steady if uneven improvements in Pacific tax systems. The progress is fragile but still evident. Recent development theory has increased the importance given to investment in tax systems in the development process not only in terms of mobilising host country resources but in terms of state building.

Continue with episodic support for taxation reform

Continuing with the current episodic style of support can be expected to produce similar results as in the past. Incremental improvements can be expected over time (as is continuing to be the case in Samoa and Tonga), but major policy reform is likely to be in bursts and subject to the relaxation of political constraints (as in the case of Kiribati). In some cases the political constraints are such that there is a low prospect of major policy reform in the near term as in Solomon Islands. The issue across the Pacific would be one of investing to maintain the progress made to date with intermittent improvements as circumstances allow to tax systems that remain fragile.

Our evaluation has drawn a number of lessons that could improve the current episodic form of donor assistance. The main ones are:

- Recognise that taxation reform outcomes require sustained effort; donors should not under-estimate the timeframes and should commit to long-term projects.
- Ideally, the commitment to long-term projects should be a co-ordinated effort of multiple donors.
- Networking across jurisdictions helps relieve the capacity constraints. PFTAC and PITTA play critical roles in this regard in the Pacific and should continue to be supported. Networking between host country revenue authorities and the Australian and New Zealand tax agencies is currently ad hoc and there is considerable potential if this were increased and put on a more structured basis.
- Be cognisant that the tax systems of host countries can be impacted by non-tax interventions. Be cautious that these do not undermine the host country tax system.
- Consider supporting projects that buttress the tax system and relieve pressures on it such as audit activity to reduce evasion and technical policy changes that would relieve frustrations of the private sector and resource costs on tax administration (replacing inappropriate penalty rules was a common example).
- Be aware that short-term revenue raising objectives can be inappropriate if they come at the cost of undermining the tax system by increasing inefficiencies, high compliance costs or perceived unfairness.
- Consider the need for support in providing host countries with assistance in managing the dialogue between the host country and donors.
- Provide more support at the policy setting stage (the political/technical interface) where we identified a noticeable gap currently.
- Consider supporting civil society more (business and tax practitioners) who are key players in any tax system's operation.

- Be flexible in terms of reform pathways that are location specific and recognise the windows for taxation reform are often opportunistic.
- With respect to any reform project recognise that it will require a diverse range of skills. Donors should engage with the host country and identify the different skills required and work through how these will be provided.
- Recognising capacity limitations in the Pacific donors should be cautious about supporting projects requiring ongoing complex technical skills such as in the area of transfer pricing.

Move the focus to more systematic support for taxation reform

Underlying the above suggested improvements to donor support for taxation reform in the Pacific is the view that the tax system should be considered as a whole and taxation reform is about managing that system as a whole in a direction that raises revenue efficiently and fairly.

Tax reform is more about managing behaviours (voluntary compliance) than about legislating and administering a set of rules. Thus we emphasise:

- the long-term commitment required in taxation reform
- the importance of the political/administrative interface
- the importance of trans-jurisdictional networking
- the role of the private sector
- the danger to the integrity of the system of a large underground economy
- the need to change technical rules (such as inappropriate penalty rules) that create unnecessary private sector compliance costs and absorb scarce administrative resources.

Donor support for taxation reform has, understandably, been focused on specific reform projects with clear objectives negotiated through dialogue with host countries. While this seems in accordance with generally accepted views of good practice we observed that taxation reform in the Pacific remained fragile and has not established the environment in which incremental improvements in tax policy and administration become business as usual. The focus is on rule and administrative changes rather than bringing about behavioural change. A stark example of this is Kiribati. Kiribati is now implementing significant rule-change reform (the introduction of VAT) but in doing so relied on one technical advisor with an IT/tax administration background.

To bring about sustainable taxation reform in the Pacific more seems to be required. We see this as a move from the current episodic, project based, support to more systematic support for an overall strategy of managing taxation systems in host countries. A frequent response from interviewees in host countries was that ‘fly in, fly out’ technical advice (one off TA missions by short-term experts) was usually of limited value. A longer commitment to the reform process is required. A move to systematic support is a move further along the spectrum of long-term commitment and engagement by donors in the reform process.

It is beyond the scope of this evaluation to detail how a systematic approach would be implemented. However, it would involve donors entering into a long-term relationship and a continuous dialogue with host countries on incrementally improving the management of the host countries overall tax system. This would include all the suggested improvements to donor support noted above but considered in an ongoing manner and more structured way

in a system-wide sense. For example, we have suggested that donors be prepared to support programmes to reduce the underground economy and modify technical rules incompatible with appropriate behaviours. However, how are host countries to identify and convince donors that these are priority areas in the overall management of the host country's tax system?

The expertise in managing an overall tax system is scarce. Technical advisors to host countries tend to have expertise and experience in managing parts of the system and not the whole system. It is expertise in managing the whole system, most likely to be found at the senior levels of donor's revenue agencies, that could be provided to host countries through a more systematic and strategic partnership in ongoing taxation reform.

Clearly any move to a systematic approach to assistance in taxation reform would involve more resources than currently provided. Of necessity it would seem to require a substantial commitment from donor revenue agencies. We are not in a position to comment on where aid priorities should lie but simply note that without such a commitment it seems unlikely that the Pacific will establish an environment in which incremental improvements in tax policy and administration become business as usual.

We stress that in some countries a systematic approach to taxation reform seems to be being attempted. Samoa is an example. It is donors, rather than the country itself, that have a more limited engagement in the process. That is the case even where funding is on a long-term basis – the issue is ongoing partnership, engagement and dialogue on improving the management of the tax system.

Finally, we note that systematic taxation reform is not an easy task. The Mirrlees Review in the UK was critical of the UK's efforts in this regard and achieving such reform (and bringing about behavioural rather than simply rule changes this requires) in the Pacific will always be even more challenging than in the UK given its less developed infrastructure and greater capacity constraints.

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Appendix 1 Donor assistance for reform

Considerable donor support has been provided for tax reform in the Pacific over the period 2002 – 2012⁴⁹: we estimate that something in the vicinity of NZ \$55 million was spent on reform programmes in this time by New Zealand, Australia and other donors in that period.

Technical assistance for reform is provided by a range of agencies. Arguably, the most predominant source of technical advice on matters taxation is the Pacific Financial Technical Assistance Centre (PFTAC), but advisors have also come from Australia and New Zealand revenue agencies, the Asian Development Bank, the World Customs Organisation and the Oceania Customs Organisation, and the Pacific Islands Forum secretariat. Over the period 2002 – 2012, donors invested approximately NZD \$8.1 million on PFTAC's Revenue Administration activities (between \$0.8 – 1.2 million per annum). This investment accounted for around 15 percent of the total spend on tax reform.

PFTAC tend to provide complementary technical assistance, that is, to supplement assistance being provided using other means (this is not a stated policy, but is apparent from looking at the trends). For example, in the last few years in the Cook Islands, Nauru, Niue and Solomon Islands where other advisors have been present, PFTAC technical advisors have been less utilised.

The following table captures the main areas of reform work, according to whether it has been led by PFTAC or through some other programme.

	PFTAC technical assistance (2002 – 2012) - NZ\$8.1 million	Other donor support (2002 -2012) – Estimated at \$47 million)
Cook Islands	In 2012 and 2013 PFTAC took the lead in a comprehensive review of the Cook Islands tax system. It has also recently provided technical assistance to the authorities to develop a draft revenue policy framework for future sea-bed mining operations. It aims to help implement these recommendations in coming years.	<p>Support estimated at <\$1 million between 2002 - 2012</p> <p>Direct support for revenue administration is provided by the New Zealand government in the form of secondments from IRD to the Ministry of Finance and Economic Management and to the customs department. They are more 'in-line' roles that 'reform' roles. This is a longstanding arrangement.</p> <p>New Zealand Aid has provided top-up funding to support salaries in the Cook Islands Ministry of Finance and</p>

⁴⁹ Year ending 30 June.

	PFTAC technical assistance (2002 – 2012) - NZ\$8.1 million	Other donor support (2002 -2012) – Estimated at \$47 million)
		<p>Economic Management for a senior tax auditor and a financial secretary.</p> <p>NZIR's legal drafters provided assistance to the Cook Islands by drafting legislation for the Cook's to implement in support of the operation of their TIEAs.</p> <p>New Zealand IRD was asked by the Cook Islands to assist them with their Phase 1 Global Forum peer review (i.e. a review of the regulatory and legal framework for transparency and exchange of information for tax purposes). A staff member was allocated to lead the Cook Islands' response and prepare answers to the Global Forum phase 1 questionnaire. This work was conducted between October 2011 and March 2012, and necessitated two on-site visits to the Cook Islands in late 2011.</p>
Fiji Islands	<p>Fiji has been PFTAC's largest user of revenue TA in recent years. PFTAC has supported FIRCA in a comprehensive modernization process including the development of enhanced corporate planning, simplified income tax legislation and streamlined personal income taxation policies and procedures.</p>	<p>No evidence of bilateral support from Australia or New Zealand</p>
Kiribati	<p>In 2003 PFTAC recommended several reforms to the Kiribati tax system. These reforms included: a value-added tax (VAT); a presumptive tax; and a single ad valorem tax on imports from non Pacific countries; simplified personal income tax (PIT); single rate of corporate income tax (CIT).</p> <p>Kiribati continues to receive advisory support from PFTAC for the reforms. PFTAC's main focus will be</p>	<p>Support estimated at \$1.3 million between 2002 - 2012</p> <p>DFAT is currently funding and providing lead support to a project for a modernisation of the tax system in Kiribati. Specifically, DFAT funds a tax advisor (in place since May 2012), who has led the first stage of the reform programme including seeing legislation through parliament which introduces a VAT. DFAT have also funded installation of new tax software</p>

	PFTAC technical assistance (2002 – 2012) - NZ\$8.1 million	Other donor support (2002 -2012) – Estimated at \$47 million)
	<p>on improving domestic revenue collections, in particular through supporting the implementation of IT systems that will allow Kiribati's scarce administration resources to achieve better collection performance. This will include strategic guidance to the DFAT-supported resident advisor. Following this, PFTAC will provide support to enhancements of the policy framework, including possible implementation of a VAT which may include legislation drafting support.</p>	<p>(datatorque) and training/scoping missions for staff from the Kiribati Ministry of Finance in relation to the software.</p> <p>The New Zealand government has supported advice from New Zealand customs advisors.</p>
Nauru	<p>Nauru has been a relatively light user of PFTAC TA, mostly due to the DFAT resident advisor.</p> <p>PFTAC recently supported the authorities as they established a revenue office and policy framework. In 2012, PFTAC stated that it aimed to work closely with the DFAT financed revenue advisor to improve revenue policies and processes in 2012 and 2013, with a view to ultimately implement a basic consumption tax. PFTAC planned a policy mission in 2012 with follow up on corporate planning and processes in 2013 (PFTAC, 2012).</p>	<p>Support estimated at <\$0.5 million between 2002 - 2012</p> <p>DFAT has funded the in-line position of Deputy Secretary of Revenue, Dept of Finance since June 2011.</p> <p>In 2012/13 DFAT is funding a review of Nauru Customs regulatory framework and audit procedures. It is also funding a review of taxpayer/customer information management systems.</p>
Niue	<p>PFTAC provided policy advice cumulating in a number of reform recommendations in the period 1997 to 2003. The reform options were accepted in principle by the Government of Niue.</p> <p>Niue did not draw heavily on PFTAC assistance for the reforms in Niue that were implemented in 2009 because the majority of this work was performed with help from the New Zealand IRD under a cooperative partnership. PFTAC has</p>	<p>Support estimated at \$1.26. million between 2002 - 2012</p> <p>New Zealand IRD provided both policy and technical support to the Government of Niue throughout the reform programme that started in 2007. In 2008 and 2009, NZIRD seconded two officers to the Niue Tax Office to provide assistance on taxation reform (specifically, the National Consumption Tax) and to support capacity building. Specialist legal assistance was also provided.</p>

	PFTAC technical assistance (2002 – 2012) - NZ\$8.1 million	Other donor support (2002 -2012) – Estimated at \$47 million)
	recently become active again in Niue: providing advice on tax policy and administration following Niue's implementation of the NCT.	Niue also used assistance from New Zealand IRD with its Phase 1 Global Forum peer review.
Palau	While there has been a lot of TA support provided for Palau in recent years, the focus has not really been on taxation and taxation reform. There has been assistance provided for administrative improvements, and PFTAC intends to continue this stream of work (PFTAC, 2012). PFTAC states that its ultimate aim is to lay the foundation for a modernized tax policy and the introduction of VAT. Reform in Palau is recognised as overdue.	Neither DFAT nor New Zealand Aid have provided assistance.
Papua New Guinea	PFTAC TA in the revenue area has been limited to IT strategy development and development of enhanced Balance of Payments statistics.	<p>Papua New Guinea has had the largest expenditure on tax reform support. Support estimated at \$12 - \$15 million between 2002 and 2012. Australia has a long history of support for the IRC through government to government programs. There are strong institutional links between the IRC and the ATO and significant bilateral and regional cooperation. Since 2005, under the Enhanced Cooperation Program and its successor, the Strongim Gavman Program (SGP), Australia has supported a team of senior tax technical advisers, seconded from the ATO to work with the IRC.</p> <p>Other international partners providing support in the last eight years include the World Bank, US Treasury, IFC and the Australian economic programme.</p>
RMI	PFTAC Technical Assistance has supported the design of revenue policy and administration reforms, including the drafting of legislation that awaits approval. PFTAC aims to continue its TA input on revenue, in	<p>Support estimated at <\$0.5 million between 2002 – 2012</p> <p>DFAT placed a tax reform advisor in RMI in early 2012.</p>

	PFTAC technical assistance (2002 – 2012) - NZ\$8.1 million	Other donor support (2002 -2012) – Estimated at \$47 million)
	coordination with DFAT and ADB.	
FSM	<p>PFTAC Technical Assistance supported the design of revenue policy and administration reforms, including the drafting of legislation. However the reform programme largely stalled and still awaits approval. PFTAC aims to continue its TA input on revenue, in coordination with DFAT and ADB.</p>	<p>Support estimated at \$1.5 million between 2002 – 2012.</p> <p>DFAT has supported the tax reform agenda at national level through the provision of advisors since 2006.</p> <p>DFAT has funded two tax advisors since 2009, one working exclusively on tax policy (specifically, getting the legislation through each of the States) and the other on tax administration issues.</p>
Samoa	<p>Support from PFTAC has been provided in Samoa's modernization of its income tax legislation, which began in 2007.</p> <p>The Ministry of Revenue received an award from the IMF Pacific Financial Technical Assistance Centre for Achievements in Tax Administration in the Pacific in 2009.</p>	<p>Support estimated at \$18.8 million between 2002 – 2012.</p> <p>New Zealand IRD has provided a lot of technical assistance to Samoa over this period. They have seconded a total of 10 staff to Samoa in that time (not all of whom were involved in the ISP described below)</p> <p>Samoa's Ministry for Revenue began its Institutional Strengthening Programme (ISP) for Inland Revenue Services in October 2010, with a primary objective of strengthening the quality of tax administration and laying the foundations for a sustainable change in the way it administered the tax system. Some aims of the project included to strengthen Samoa's potential tax base through improved compliance, better client service, and consistent policy advise on the reform of Samoa's tax structure. Phase 1 was completed in December 2012, and phase 2 is currently in progress. The ISP was co-funded by New Zealand and Australia, with support from NZ IRD in the form of a secondment.</p> <p>NZIR assisted Samoa in recruiting a number of experts in various aspects of</p>

	PFTAC technical assistance (2002 – 2012) - NZ\$8.1 million	Other donor support (2002 -2012) – Estimated at \$47 million)
		tax administration, for secondment to Samoa. These secondments have been funded by Samoa, from its Public Sector Improvement Facility.
Solomon Islands	The Solomon Islands were one of the largest recipients of PFTAC technical assistance in the early part of the 2000s. There has been little need for PFTAC technical assistance in Solomon Islands since the start of the RAMSI programme.	<p>Support estimated at \$7 - 10 million between 2002 – 2012</p> <p>DFAT and New Zealand Aid funding for the Regional Assistance Mission to Solomon Islands (RAMSI) programme. RAMSI has funded long and short term advisors to the Inland Revenue Division since 2004. New Zealand Aid provided support for RAMSI from July 2009. Prior to the RAMSI programme there was New Zealand Aid funding for “Solomon Islands tax project”: RAMSI evolved from this project.</p> <p>There is also government to government arrangements between the IRD in NZ and in Solomon Islands for advice on tax legal issues.</p>
Timor Leste	Timor-Leste and PFTAC are still in the early stages of partnership. Timor-Leste became a member of PFTAC at the beginning of Phase IV (July 2011). PFTAC has provided small amounts of TA thus far, mainly in conjunction with IMF HQ missions on revenue administration and macroeconomic management of resource revenues	<p>Support unknown</p> <p>In 2008 a major tax overhaul was made in Timor Leste. On 25 June 2008, the Timor-Leste parliament passed the Taxes and Duties Act, which provides a single framework for the imposition of tax in Timor Leste. IMF and World Bank assistance in Timor-Leste in association with the Public Financial Management project.</p>
Tonga	<p>Tonga was the recipient of a large number of TA recommendations and missions in the period 2002 - 2007.</p> <p>More recently, the focus of PFTAC TA has been on areas other than tax. There have been TA missions to benchmark, and provide advice on, tax administration.</p>	<p>Support estimated at \$4 million between 2002 - 2012.</p> <p>Since 2005, the government of Australia has provided ongoing assistance to customs reform as well as the Ministry of Revenue. Australian support has included funding two tax advisors (at least one of whom is resident), funding the Head of Customs and funding for customs infrastructure (including x-ray</p>

	PFTAC technical assistance (2002 – 2012) - NZ\$8.1 million	Other donor support (2002 -2012) – Estimated at \$47 million)
		<p>technology, a customs boat for Vava'u and an automated processing / customs management system (CMS).</p> <p>NZAid funded a two-week secondment of a tax compliance expert to the Tongan Revenue Service in 2006. NZIRD helped with recruiting that expert.</p> <p>In 2012 PFTAC conducted a review of Tonga's tax system and further work (that DFAT would fund) is likely to flow from that.</p>
Tokelau	No relevant reforms in the period	No relevant reforms in the period
Tuvalu	<p>In mid-2009 a comprehensive set of tax reforms were introduced in Tuvalu. These reforms were designed by PFTAC.</p> <p>In 2013 and beyond, PFTAC will provide assistance to enable the administration to adopt risk management and compliance improvement strategies and to enhance corporate planning</p>	<p>Support estimated at <\$0.3 million between 2002 – 2012. DFAT funds a tax advisor (in place since mid 2012).</p> <p>Prior to the tax advisor being appointed there was an ADB funded project in Tuvalu to implement reforms recommended by PFTAC. The ADB project has now ended, and recent PFTAC TA has been focused on-the-job assistance in revenue administration.</p>
Vanuatu	<p>Vanuatu has been a relatively heavy user of PFTAC TA in the tax/revenue area, aimed at strengthening administrative systems, including through intensive on the job training. PFTAC TA has helped identify a programme of reforms, including implementing an income tax.</p> <p>A PFTAC TA was brought in under the Ministry of Finance and Economic Management to support increased revenue collection through greater compliance in VAT and customs collection.</p> <p>There are no current PFTAC missions or resident advisor in</p>	<p>Support estimated at <\$0.3 million between 2002 – 2012.</p> <p>The Governance for Growth (GfG) program funded by DFAT, which began in 2007, has provided support for improvements in revenue collection (alongside a PFTAC TA).</p>

	PFTAC technical assistance (2002 – 2012) - NZ\$8.1 million	Other donor support (2002 -2012) – Estimated at \$47 million)
	Vanuatu (but there is a GfG resident advisor).	

Source: Sapere Research Group using information provided by New Zealand Aid, DFAT, PFTAC and the New Zealand Inland Revenue Department and New Zealand Customs.

Appendix 2 Statistical overview of PICs

The table overleaf provides a snapshot overview of the economic statistics for the country sample in 2002 to 2011, including GDP, Population, Tax Revenue and two ratios: Tax per capita and Tax : GDP. These ratios can be used as possible indicators of the performance of a tax regime. It was possible to find the relevant data for the majority of countries, with the exception of Nauru, Niue, Palau, and Tokelau which have significant data gaps.

The table shows that tax revenue as a percentage of GDP is revealed to be relatively stable for the majority of the sample countries, suggesting that growth in GDP and tax revenue have broadly been in proportion. Most countries have tax revenue as a percentage of GDP in the range of 15 to 20 per cent, with Solomon Islands a high outlier at 36 per cent and Timor Leste a low outlier at just 1 per cent. Somewhat confusingly, tax revenue for Niue appears to be multiple times greater than GDP (this is partly because the tax revenue is predominantly income tax and customs duties and excises on imported goods, and the income tax is mostly generated from public service employees).

A small number of countries experienced declining tax revenue as a percentage of GDP (Tonga and Tuvalu). The Tongan decline appears to have been a 'blip' with more recent reports indicating a return to a ratio of around 20 percent of GDP in 2012/13.

The data also shows that there is a great degree of variation in the growth in tax revenue per capita. The growth can be categorised into one of three groups:

- low (<25% change in the time period): the Cook Islands, Kiribati, Marshall Islands and Tuvalu;
- medium (25-75% change): the Federated States of Micronesia, Tonga and Vanuatu; and
- high (>75%): Fiji, Papua New Guinea, Samoa, and Solomon Islands.

Table 4 Summary of economic statistics

The table below provides a snapshot overview of the economic statistics for the country sample in 2002 to 2011, including GDP, Population, Tax Revenue and two ratios: Tax per capita and Tax as a % of GDP. These ratios can be used as possible indicators of the state of a tax regime and how it has changed over time. It was possible to find the relevant data for the majority of countries, with the exception of Nauru, Niue and Tokelau which have significant data gaps.

Table 5 Summary of economic statistics

Country	GDP (current US\$)		Population		Total tax revenue (US\$)		Tax revenue per capita (US\$)		Tax revenue as % of GDP		Tax revenue as % of GDP	
	2002	2011	2002	2011	2002	2011	2002	2011	2002	2011	2002	2011
Cook Islands	117,016,941	303,688,969	18,400	20,600	28,877,858	70,132,726	1,569	3,405	24.7	23.1	24.7	23.1
Federated States of Micronesia	241,738,180	310,300,000	106,200	103,600	26,300,000	37,200,000	248	359	10.9	12.0	10.9	12.0
Fiji Islands	1,932,757,794	6,730,800,000	810,000	854,000	378,752,998	872,077,496	468	1,021	19.7	21.6	19.7	21.6
Kiribati	74,854,028	180,220,941	87,400	105,300	15,648,474	36,411,879	179	346	20.3	16.9	20.3	16.9
Marshall Islands	124,698,071	170,747,697	49,900	55,000	20,100,000	25,978,650	403	472	16.1	15.5	16.1	15.5
Nauru		90,029,076	10,100	9,900								
Niue	7,906,442	23,426,654	1,788	1,460	3,200,000	4,950,000	1,790	3,390	N/A	N/A	N/A	N/A
Palau	168,926,000	212,903,000	19,400	17,800	23,900,000	35,400,000	1,232	1,989	14.1	16.6	14.1	16.6
Papua New Guinea	3,048,741,654	13,511,900,064	5,400,000	7,000,000	608,628,660	3,488,123,497	113	498	20.0	26.5	20.0	26.5
Samoa	268,706,663	668,168,811	177,200	187,800	55,079,891	188,513,035	311	831	20.5	22.4	20.5	22.4
Solomon Islands	217,235,495	719,241,028	439,000	540,000	34,627,418	265,171,174	79	491	15.9	36.9	15.9	36.9
Timor Leste	468,200,000	5,797,500,000	886,000	1,092,000		64,900,000		72		1.1		1.1
Tokelau												
Tonga	186,484,191	449,915,346	99,900	103,000	34,635,815	76,618,049	347	744	18.6	17.0	18.6	17.0
Tuvalu	16,095,897	32,316,744	9,560	11,210	3,398,952	8,852,821	356	790	21.1	18.9	21.1	18.9
Vanuatu	271,655,766	801,696,022	202,200	251,800	42,144,768	131,771,754	208	523	15.0	16.1	15.0	16.1

Source: Sapere Research Group, using data from ADB Statistical Database System Online and ADB 2013 Pacific Report. Where possible, supplementary data was used from World Bank, World Development Indicators 2012, and IMF Aides Memoires

Limitations: Figures are reported in USD for comparability. Currency conversion can introduce errors and make data less reliable.

Appendix 3 A note on tax exemptions for donors

Summarised from UN Committee of Experts on International Cooperation in Tax Matters. *Tax treatment of donor-financed projects*. Second session. Geneva, 30 October-3 November 2006

Donors can undermine reform by supporting tax exemptions and breaks for taxpayers or for themselves. Tax exemptions, and especially tax holidays which are time-limited exemptions from the corporate income tax, are among the most damaging single bad tax practice. A high occurrence of tax exemptions reduces the tax base, creates room for bribery and corruption, and increases the appearances of loopholes for tax evasion. Often, exemptions are misguided: private investment is more likely to respond positively to more predictable, unambiguous tax policies and practices than to specific changes in tax regimes.

Projects involving development, humanitarian and other assistance provided by donors often enjoy tax exemptions. Often these exemptions are at the insistence of donors, due to an underlying presumption that such projects should be tax-exempt. Exemptions may apply to imports and procurement of goods and services, and may extend to both direct and indirect taxes (including customs duties). The means by which exemptions are provided for could include a variety of legal instruments and administrative practices: exemption might be granted by the general domestic tax rules, by general rules of double tax treaties, by specific exemptions in domestic law directed to international assistance, or by bilateral agreement. Possible transactions and taxes to which exemptions apply include non-residents importing goods either temporarily or permanently (possible exemption from customs duties, VAT and other indirect taxes) or non-residents coming to the country to provide services to be paid for using project funds and stays in the country for only a limited period of time (possible exemption from individual income tax and social contributions, perhaps under a general provision of domestic law, under treaty provisions or under a bilateral agreement).

Tax exemption imposes costs on tax administrations of recipient countries in keeping track of the various exemptions provided and administering them. This difficulty is amplified by the diversity of the practices and expectations of the multiple donors that recipient countries may need to deal with. The administrative burden and the risk of fraud can vary depending on the way that exemptions are structured. Not least, granting exemptions to any market participants always runs the risk of creating pressures for further exemptions, whether directly as a means of alleviating competitive distortions that the initial exemption created or indirectly by creating a precedent that others can call on.

Amongst the international aid community there is increased awareness of the difficulties created by exemption. Simultaneously, there has been an easing of some of the concerns that have traditionally made donors reluctant to pay tax on their support. For example, in the past donors may have had concerns about “unreasonable” taxation in recipient countries (high tax rates or tariffs, or double-taxation), or about how their contribution to the host country government coffers might be spent. Pacific countries, and developing countries worldwide, have made substantial progress in reducing rates of tax, removing trade taxes and improving the transparency in public expenditure. For these reasons, it is hard to find a convincing rationale for a donor who is simultaneously providing both targeted and general budgetary support to insist on tax exemptions.

Appendix 4 Case studies

Tonga case study

Background to the reform

Tonga has taken at least ten years to see its tax reforms through. It took initial steps to investigate a reform program in 1999 and worked with PFTAC to formulate a policy reform package. Tonga had a reform strategy in place by mid-2002. It implemented the Consumption Tax in 2005 and followed this with income tax modernisation in 2008 with a rationalization of exemptions and concessions. Customs tariffs were also reviewed and reduced in 2008 as part of the WTO accession and excises were increased.

Administrative strengthening at the Ministry of Revenue and Customs (MoRC) and its departmental predecessor (the Revenue Services Department at the Ministry of Finance) began in earnest in 2003 and was largely completed in 2012, when the last donor-funded technical advisor left. The administrative strengthening comprised structural changes, system and process changes and the adoption of modern risk assessment and self-assessment administration principles⁵⁰.

Reform was supported by resident technical assistance and over a number of years there was a combination of in-line advisory and reform advisory positions attached to both the Customs and Inland Revenue Divisions of MoRC. The long term advisory positions were recruited using the PACTAM mechanism and PFTAC provided short term technical assistance.

The Inland Revenue division of MoRC no longer has assistance from long term advisers, but the division is still pursuing further reform tasks. Most recently they have sought technical assistance in relation to four tax policy issues: natural resources taxation; small business taxation (presumptive tax); penalties; and carry forward losses. This is in response to the recommendations for tax policy and administration reforms made by a PFTAC mission on tax policy and administration in October 2011.

Modernisation was the driving objective

The driving objective behind the numerous changes made to the Tongan tax system was to modernise the systems for administering tax so that tax collection was more efficient and effective⁵¹. A 2002 diagnostic report prepared by PFTAC noted that modernisation of the

⁵⁰ Tonga: Modernisation Plan for Revenue Services Department: Christophe Grandcolas and Graham Daniel, June 2002; Tax Policy and Administration: Facing the Challenges of Trade Liberalization Peter Mullins, Michael Daly, Carson McNeill February/March 2008; Kingdom of Tonga Revenue Policy and Administration Review: Cotton, Jenkins, Mullins October 2011; Kingdom of Tonga Natural Resources Framework and Small Business Taxation: Mullins August 2012; Kingdom of Tonga Revenue Administration Update, Hayes June 2013.

⁵¹ There was very little dispute or divergence from this theme in interviews – every person interviewed as part of the case study research mentioned the need to modernise the tax system as a primary objective for the reforms.

tax and customs organization and procedures was considered as a priority task by the government of Tonga. Tax and customs reform was taking place in the context of government efforts to improve transparency and good governance in the fiscal area. Moreover, the implementation of the tax policy and tax and customs administrative reform package was considered as a core element of the ADB loan and technical assistance grant for the Economic and Public Sector Reform Program.

The inefficiency of the tax system had equity and social consequences that were becoming very apparent. For example, the tax structure at the beginning of the 2000s included a wide range of exemptions (for example, for those who held development licenses). This not only required a massive bureaucratic infrastructure to support the decisions about who did, and who did not, qualify for exemptions but also meant that some taxpayers who should have been paying tax were not. This clearly was not equitable for those who were paying tax, and in many cases those who were paying tax were paying too much.

Naturally, revenue also mattered

Sitting behind the modernisation aim was a recognition that if nothing was done to improve the system Tonga would find itself in a challenging revenue position. While the tax policy package was designed to be revenue neutral (i.e. reducing reliance on customs and duties levied at port, and replacing them with consumption tax), it was recognised that the new mix of taxes would provide the Tongan government with a better cushion or safety net.

Tonga's tax system was at the verge of collapse in 2002

A PFTAC diagnostic report noted numerous issues with tax administration in 2002:

- Frequent management vacancies and a lack of skill, resulting in a poor commitment of staff to revenue performance, uncertainty, disrupted administrative processes, reduced accountabilities and management controls leading to highly inefficient operations.
- A huge level and scope of exemptions, and as a result, a high probability of corrupt practices.
- Heavy reliance on trade taxes.
- No effective independent internal audit function.
- No system to identify the taxpayers, to follow up their obligations and to help crosschecking information between customs data and tax data.
- Absent or limited coordination between tax and customs to prevent or detect customs duty and tax evasion.
- No self-assessment system and no special organizational units and systems to monitor and control the largest taxpayers.
- No structured programs existed for in-depth audits or post-clearance reviews. Audit of enterprises' books and records were not being performed. No procedures or manuals existed on audit procedures.

“The inefficiency of the tax system was widely recognised, which made the reforms easier to sell politically and to the electorate.” Former Tongan Minister of Revenue

- Few staff in the Revenue Service possessed accounting qualifications.
- No valuation reference database for use in verifying values (during both clearance and post-clearance operations) was in use.
- A high degree of manual processing in which the method employed to register, assess, record collect, and enforce both lodgment and payment were done by hand in both tax and customs divisions. Everything was “paper based”. As a consequence there was much duplication of work, few controls and no statistics even though many cashbooks and logbooks were filed. There was a massive backlog of income tax work.
- No taxpayer identification numbers were assigned and no systems for identifying taxpayers existed.
- There was no management reporting system.
- There was no long term training plan but only various technical training courses provided for the most part by foreign technical experts.
- There was no program of public education and no publications existed except the law itself.

Based on this list of issues, if assessed against PFTAC’s Revenue Administration Baseline Assessment Tool, Tonga would have ranked as ‘Below Baseline’ on every metric.

Tonga’s policy settings are now reasonable but still require work to take them into the next decade

Tax policy settings have improved markedly since the start of the reform programme but there is still more to do. The Inland Revenue Division of MoRC has undergone significant change over the past decade and has adopted new ways of operating based on best practice established a decade ago. A 2011 PFTAC mission noted that tax policy settings in Tonga were reasonable and did not require significant change but there were several areas that could be reformed to simplify the tax system, make it fairer, and increase revenue collections⁵².

As the division matures, it is recognising that it needs to adapt to the practices of the coming decade. This shift will require a move from transaction-based thinking to a greater concentration on transformation, and the significantly different behaviour and leadership that that will demand. Recognising this challenge, the most significant recommendations made by the 2011 PFTAC mission related to exemptions, penalties and interest, the taxation of small businesses, natural resources and land rental. The mission also recommended a number of key strategic and operational tax

“Set against the guiding principles for tax policy, the policy settings in Tonga are reasonable, and do not require significant change, but compliance needs to be improved”

PFTAC (2011) report

⁵² International Monetary Fund, 2011, Kingdom of Tonga Revenue Policy and Administration Review, Margaret Cotton, Darryn Jenkins, Peter Mullins, October 2011

administration reforms to enhance revenue performance⁵³. A follow up visit was carried out in 2012.⁵⁴

Summary of the Tax Policy Settings in Tonga

Income Taxes

The personal income tax (PIT) has a progressive rate structure as follows: T\$0 to T\$7,400—exempt; T\$7,400 to T\$30,000—10 percent; T\$30,000 and above—20 percent.

The company income tax (CIT) rate is 25 percent (taxed on a worldwide basis). Tax losses can be carried forward indefinitely, except if there is substantial change in ownership. There are four depreciation categories with straight-line rates of 5, 12.5, 20 and 25 percent (diminishing value rates are 160 percent of the straight line rates).

Dividends paid to resident shareholders are exempt. Interest paid to residents is subject to a withholding tax of 10 percent, while rent is subject to withholding tax of 3 percent. Payments of dividends, interest and royalties to non-residents are subject to a 15 percent withholding tax.

There is a proposal to introduce a new taxing regime for small businesses (not companies) with an annual turnover of less than \$100,000. The regime introduces presumptive tax amounts for turnover less than \$50,000 and a 2% rate for turnover between \$50,000 - \$100,000. Small businesses will not need to file detailed tax returns. It is hoped that this will reduce the record keeping requirements for small businesses and reduce the administrative costs of the Ministry devoted to small businesses.

Consumption Tax

CT is imposed at a rate of 15 percent. The threshold for CT registration is annual turnover of T\$100,000.

The range of exempt and zero-rated supplies is small and consistent with international practice, with exemptions for financial services and donated goods, and zero-rating for exports.

Trade Taxes

Import duties are imposed on a range of goods with four rates: 3 (for capital goods), 10, 15 and 20 percent. Excises are imposed on alcohol, tobacco, fuel and motor vehicles.

Other taxes under consideration

Tonga is considering introducing a regime for taxing extraction of natural resources, the details of which are yet to be confirmed.

⁵³ Some of the tax policy recommendations of these reviews have since been implemented. These include: a more detailed review of the existing exemptions and concessions; and introduction of a tax expenditure statement in the budget. The authorities also established a committee to review the recommendations of the 2011 review, and there appears to be appreciation of the need for ongoing reviews of the policy programme – a Revenue Policy Committee consisting of the Chief Executives of Finance, Revenue and Labour.

⁵⁴ International Monetary Fund, 2012, Kingdom of Tonga Revenue Policy and Administration Review Follow-up Mission – Margaret Cotton February 2012

Tongan tax administration has now been substantially modernised

The Inland Revenue Division has undergone substantial administrative change. It is now part of a Ministry that is independent of the Ministry of Finance. Staff numbers have stabilised at around 41 people and basic functions, (registration, return and debt collection, and simple audit techniques) have been strengthened. The Division now has capacity to manage returns and money, the number of active taxpayers continues to grow, all taxpayers have Tax Identification Numbers (TINs), there is a dispute resolution process in place and there is a focus on voluntary compliance for larger taxpayers (i.e. on-time filing, on-time payment and accurate reporting).

There are some gaps, however. The focus on large business compliance appears to have come at the expense of taxpayer services aimed at educating taxpayers and improving compliance by small business⁵⁵. This is, perhaps, reflective of the limited resources available to the Inland Revenue Division.

Measured against other Pacific Islands, Tonga is considered to have been a reform success. Assessed against the PFTAC baseline assessment, Tonga has moved from 'below baseline' on every measure to 'above baseline' (the assessment notes limitations on Governance and Accountabilities, Automation and HR).

Some major issues remain

Tax exemptions continue to seriously erode the revenue base

Exemptions totaled T\$44.6 million for the period July 2009 to August 2011 (inclusive of exemptions granted under donor development projects).⁵⁶ This is as a result of the process for approving and monitoring exemptions lacking transparency and efficiency. This is an issue that has been identified by the Inland Revenue Division and a review is currently being undertaken.

The penalties regime is problematic

Further, the penalties regime continues to be a major impediment to effective administration and a source of frustration amongst the community. The current legal rules for penalties are not appropriate, and include a drafting error. The Inland Revenue Division acknowledges that the penalty regime is not appropriate and routinely remits a large portion of the penalty. However, the continued imposition of penalties distorts the outstanding tax debt and creates reverse work flows.

⁵⁵ Kingdom of Tonga Revenue Policy and Administration Review Follow-up Mission – Margaret Cotton February 2012

⁵⁶ Kingdom of Tonga Revenue Policy and Administration Review– Margaret Cotton, Darryn Jenkins, Peter Mullins, October 2011.

⁵⁷ While incentives may be justified to encourage the production or consumption of a good that provides a benefit that the market does not fully take into account (i.e., positive externalities), there are a number of problems with tax exemptions. First, tax exemptions create economic distortions, including the inefficient allocation of resources by encouraging investment away from the non-preferred (taxed) activity into the other preferred (exempt) activity. Second, exemptions complicate the tax system making it difficult for Inland Revenue and Customs to monitor. Third, exemptions open opportunities for abuse. Fourth, tax exemptions narrow the tax base and hence cost revenue, which usually means increased taxes for those not fortunate enough to be able to access the concessions. This makes the tax system less fair, especially for those taxpayers who do not receive the concession.

It has taken time for some ideas, like self-assessment, to embed

“Self-assessment is still not a ‘norm’. It is difficult to persuade processing staff not to do audit.” - Former revenue advisor

The income tax and CT legislation in Tonga bases the assessment of tax on the principle of self-assessment. Self-assessment is a core principal of modern tax administration and has been implemented by most countries because they recognise that the physical examination of every return rarely adds any value towards revenue collection. There is some frustration in the Tongan business community that tax officers are continuing to physically examine large numbers of income tax returns after inputting tax return data to RMS. In many cases, physical examination of returns, other than in the course of a tax audit or taxpayer profiling, creates reverse work flows and actually becomes counterproductive. The 2011 PFTAC review found that:

“improvements in effectiveness and efficiency can be made by embedding the principles of self-assessment into the modus operandi of [Inland Revenue Division]: reintroducing the taxpayer services function, increasing the analytical capability to identify and more effectively focus resources on risks, and building greater political and community awareness of the aim of [Inland Revenue Division] to collect —Revenue from the Community, For the Community”.

This quote recognizes that to be effective self-assessment requires the introduction of a dedicated taxpayer services function. Self-assessment requires an attitudinal change to recognise that not all cases can be actively managed and the onus is on taxpayers to accurately report and pay their obligations on a timely basis. The cultural change needed for the revenue administration is greater with self-assessment than with CT. This attitudinal change requires educating taxpayers, government officials, stakeholders and Inland Revenue staff on what self-assessment is: many still see a need to “approve” all returns including PAYE rather than process and selectively audit.

Mixed views about issues with processing refunds

The efficient payment of CT (VAT) refunds is critical to the success of this form of taxation. In the first few years after the CT was introduced there were significant problems with processing refunds under CT. This has now improved but there are mixed views as to whether it is still a problem. Our interviews with persons from the Tongan business sector noted that there had been issues with CT refunds, particularly in the earlier years of the tax, and suggested that these were as a result of inefficient processes within the Inland Revenue Division. A review in 2009 found that rather than this being a result of inefficient processes it was more likely that in the early days of the VAT, the division struggled with the concept of self-assessment, and coming to grips with approving refunds of those taxpayers who received regular refunds, which mostly related to those exporting and hence entitled to zero rating. It noted that a risk assessment process would be devised as part of the program for strengthening the Division and that the heat had gone out of this issue following dialogue with the private sector.

On the whole the reforms are fragile

Despite the vast improvements that have been made the Tongan tax system remains fragile. This fragility is largely due to only moderate improvement in the capacity for diagnosing, prioritising and implementing future improvements. This means that the future changes to tax policies and administration risk of undermining the successes of the previous reforms.

Confidence in capacity for future reform

Tonga is currently working on its next round of reforms which includes introducing a simplified regime for small taxpayers, incorporating a presumptive tax, a review of its penalties regimes and a natural resources tax. This has required coordination of a national work programme and analysis of all core business processes and work flows so that a clear roadmap for the reforms can be prepared. A 2012 review by PFTAC noted that the Inland Revenue Division advised that “they are able to undertake the planning and process reviews without further assistance” (although short-term assistance from PFTAC advisors was sought since that statement was made). One of our interviewees noted that “in a way the Technical Advisors were a crutch” and “it was time for us to rise to the challenge.” This indicates a certain degree of confidence within the Tongan authorities of their own capacity for future reform. This is a positive outcome.

Heavy dependence on a small, core group of staff

“I feel that I can’t leave to study or go on secondment – the place would fall apart!”

Despite this confidence, there are signs that the next round of reforms may have been harder to achieve without assistance than expected. Certainly, progress has been slower than expected. A key part of the problem is sustaining a workable level of administrative capacity. The Inland Revenue Division has 41 staff but there is a large degree of separation between the skills and attributes of those in leadership positions and those in in-line roles. This has led to heavy dependence on a very small number of people. Staff who show promise are routinely sought for jobs within other parts of the Tongan public service or leave for positions overseas. “Compared to Vanuatu, Tonga is hard”, one former advisor noted, “as soon as you train them they leave”. Many interviewees, including the Commissioner, believe that long term advisers are necessary to ensure that the new administrative policies are implemented effectively and will lead to sustainable revenue growth.

Despite a strong emphasis on taxpayer communication, gaps in taxpayer understanding remain

Reform communication was a deliberate component of the reform programme, for both the introduction of the CT and for subsequent changes to the Income Tax. Interviewees were aware of the education programmes held by the Independent Committee for Tax Reform (established in 2006 following the introduction of the CT) and were largely complimentary of about what the programmes achieved. They were also impressed with the widespread consultation (including the outer islands) that has occurred recently with the resource taxes and presumptive taxes.

“Consultation with business much improved in most recent reforms. With the CT there was education about tax but not consultation. This is changing now, our opinion is being sought.” – Member of the business community

However they felt the stop-start approach to consultation and communication could be significantly improved. One interviewee commented that Inland Revenue seemed to do a public session or one-on-one taxpayer education visit but did not follow this up with effective communications through its website or paper materials. Another noted that the website was consistently out-of-date. The strength of feeling behind this sentiment was expressed by a number of commentators who had drawn the conclusion that the Revenue Authority was being told to ‘do’ communication for reform programmes and that once it was ‘over’ they could go back to the more important audit compliance work.

There were also comments made that while it was positive that consultation and communication was being 'owned' by Tongans, sometimes it wasn't the right people delivering the message:

"In some cases the consultation wasn't done by officials from the Revenue Ministry itself (it was done by the Minister of Finance and his advisors instead). Sometimes they didn't know exactly the contents of the reform."

Despite Tonga's emphasis on communications programmes during the Tongan reforms, the evaluation team found that it was not clear that taxpayers understood all aspects of the reforms put in place. In one instance there was a major policy addition made to the legislation – a provision for capital gains to be comprehensively taxed - without it being signalled to the community at all. Another example is the tension between company tax rate 25% and PIT rate (0 up to \$7,400 then 10% and 20% with dividend exemption). This difference in rates creates an incentive to carry out business in non-corporate form. It is not clear that the implications of this are understood. One response has been a proposal to tax partnerships as companies so that the higher company rate applies to businesses in general. However, that would create a new boundary between partnerships (taxed as companies) and sole traders (taxed at the lower individual rate). A full understanding of the implications of the lower company tax rate (with dividend exemption) would seem to require a consideration of only applying the higher company tax rate to widely held companies that cannot in practice be operated by individuals. This is an example of quite complex problems arising from seemingly simple policy decision setting the company tax rate.

Another example of reforms not being widely understood is the recent experience with CT. There is increasing pressure for CT exemptions at border to help business (fisheries and capital goods). A legacy of replacing tariffs with CT since CT should not in theory tax business income so this is a strange way of providing industry support. In addition, the Inland Revenue Division is having ongoing issues with CT invoices and non-inclusion of TINs on invoices.

A 2012 review by PFTAC⁵⁸ recommended that communications strategy to engage government, staff and the community should be prepared. It also recommended that a taxpayer services function needs to be developed within Inland Revenue.

The Tongan reforms are generally positive in terms of revenue adequacy

In the early stages of the reforms, revenues rose faster than expected and the reforms were generally seen as positive measures

By 2007, international experts were regarding the outcomes achieved as generally successful, with compliance levels and revenue receipts meeting most expectations.⁵⁹ A 2008 review of the experience of VAT in the Pacific by the International Monetary Fund highlighted Tonga's Consumption Tax (CT) as a VAT success story, and noted that Tongan authorities

⁵⁸ Kingdom of Tonga Revenue Policy and Administration Review Follow-up Mission – Margaret Cotton February 2012

⁵⁹ Margaret Cotton, Consumption Tax Review, Report of PFTAC Mission to Tonga, June 2007

were “very satisfied with the VAT and see it as a critical element in dealing with the challenges of trade liberalization.”⁶⁰ This report mentioned that in the case of Tonga, VAT and its revenue benefits had provided fiscal space for reducing tariffs as well as removing a number of small nuisance taxes which were distortionary and cumbersome to administer. For example, on introduction of the VAT in Tonga, a number of taxes were repealed, including the ports and services tax which was essentially a 20 percent tariff and was extremely disliked by business.

There was a decline in revenue in the later stages of reform

There was a decline in revenue performance between 2009 and 2010, falling from 20.8 % of GDP in 2008 to 17.8% in 2010.⁶¹

⁶⁰ International Monetary Fund, Tax Policy And Administration: Facing The Challenges Of Trade Liberalization, Peter Mullins, Michael Daly, and Carson McNeill, May 2008

⁶¹ Sapere Research Group. The decline in revenues is true when measured using a number of different measures of the tax base including: GDP, the standard benchmark for revenue performance; GDP supplemented by remittances, which do not contribute to domestic production but do finance a significant amount of domestic consumption; and market GDP, to reflect the fact that the informal sector is not really part of the effective tax base (although it is part of the base for Customs tariffs, excises and CT collected at the border).

Figure 8 shows that Tonga's overall tax revenue performance peaked in 2007 and then experienced a decline both in nominal terms and as a proportion of GDP. The nominal declines were to a certain extent a result of the second phase of reforms where custom duties and income tax rates dropped and excises increased. However, interpretation of the causes of the declines is complicated by the fact that growth and imports also declined markedly at the same time, reducing the overall tax base.⁶²

Fortunately, this decline appears to have been arrested

Revenue had improved again in 2011 and 2012 and revenue collections are expected to exceed budget in 2013. According to PFTAC this growth will lift revenue collections to the region of 20% of GDP in 2013 financial year⁶³. Notwithstanding the most recent improvements, the revenue GDP share is low in comparison with other Pacific Island Countries (PIC) with similar tax regimes⁶⁴ and this may indicate cause for concern.

⁶² There are a number of reasons for the changing revenue performance since the tax reform commenced. For the corporate income tax the main reasons for the decline were the significant reduction in the tax rates, as well as the impact of the economic slowdown caused by the global economic crisis. The global economic crisis also had an impact on personal income tax collections. For consumption tax the decline in revenue collections may reflect factors including: (1) a substantial decline in consumption of items that have domestic value added (possibly due to lower remittances caused by the impact of the global economic crisis); (2) declines in the post-duty value of imported goods due to the reduction in trade taxes; (3) a possible decline in compliance; and (4) a decline in enforcement. The decline in trade taxes reflects an overall reduction in trade tax rates (despite increases in excises), together with revenue leakage due to exemptions and/or lack of compliance and enforcement.

⁶³ Kingdom of Tonga Revenue Administration Update, Draft Aide-Mémoire, John Hayes June 2013

⁶⁴ Solomon Island 30.1%; Fiji 27.5%; Cook Islands 25.1%; Papua New Guinea 24.6%; Samoa 21.6%

Figure 8 Indicators of revenue adequacy

Outcome 2- Ongoing improvements in revenue adequacy											
Indicator name	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Result 2012
Total tax revenue (US\$)	42,391,743	47,351,574	49,360,569	56,394,775	70,103,227	72,297,874	72,171,871	73,972,065	65,629,415	75,628,150	72,670,840
Total tax revenue as % of GDP	23.3%	22.8%	20.5%	21.3%	23.7%	24.0%	20.8%	23.2%	17.8%	17.4%	
Total tax revenue as % of government expenditure	89%	94%	90%	98%	79%	91%	82%	80%	61%	76%	69%

Source: ADB statistical database online, Query “Tonga Central Government Taxes 2002 – 2013 on 02/10/2013.

Other indicators of success are present

Progress on state building and public financial management

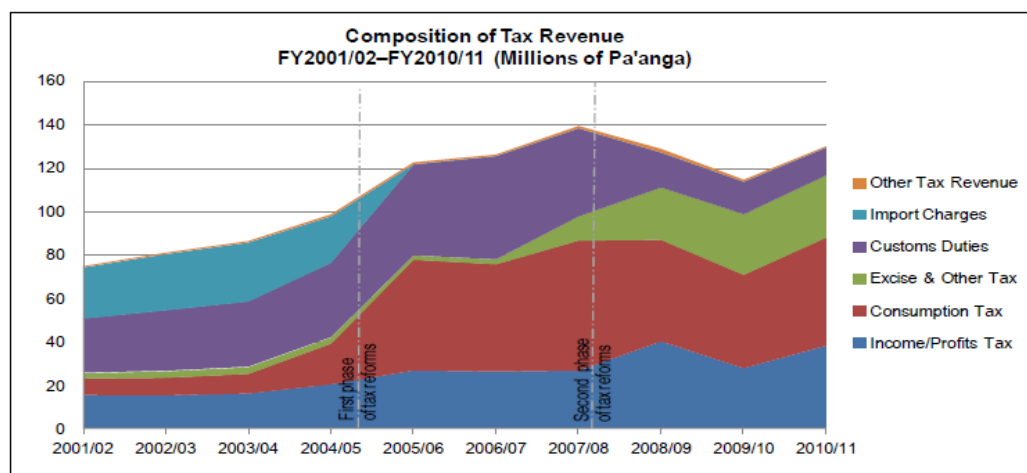
The Comprehensiveness and Transparency Indicators in the Tonga PEFA report for 2010 gave Tonga an A rating for ‘Transparency of taxpayer obligations and liabilities (PI13)’ and an A rating for ‘Effectiveness of measures for taxpayer registration and tax assessment (PI 14)’. It however ranked Tonga with a D+ for ‘effectiveness in collection of tax payments (PI 15)’, which mirrors the comments above that while tax administration has improved dramatically, substantial gaps remain.

“It was overall a very successful reform. When you look at the stats you can see a massive increase in the registration of tax payers, revenue and so on.” Former Technical Advisor

Efficiency has improved

As envisaged by the reforms, the composition of taxes has changed significantly, to what would be regarded internationally as a more efficient set. Customs duties and border charges were replaced with excise and consumption taxes, as planned. Income taxes increased as a share of total revenues, again as planned. Tonga’s tax system now has the bulk of the revenue made up from income tax and consumption tax instead of trade taxes. **Figure 9** below illustrates.

Figure 9 Composition of tax revenue - Tonga



Source: PFTAC aide memoire

The VAT has been widely embraced and accepted

The Tongan experience indicates that the introduction of the CT has had a positive effect on compliance, not just with the CT. 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. In Tonga this is one reason why the number of registered VAT taxpayers is almost double the number compared to the original expectation.⁶⁵ This also runs counter to the suggestions in some literature that a VAT could encourage businesses to move to the informal sector.

We did hear some lingering concerns about the unfairness arising from Inland Revenue not being seen to address CT evasion. This concern as expressed by interviewees is closely linked with their concern about Inland Revenue's 'excessive' focus on refund checks. Some interviewees made the statement "there are still people who should be registered but aren't". There is a widely held awareness that many taxpayers are not registered for CT who should be. The Inland Revenue is seen by some to not be addressing the question of evasion and some registered taxpayers have a perception that they are being 'picked on because they are easy targets'. Interviewees commented 'Inland Revenue knows about those who have registered and so focuses on us, and yet we are the people who are at least trying to do the right thing.' It needs to be recognized, however, that evasion jobs are notoriously difficult in any Revenue jurisdiction, and more so where staff are inexperienced in evasion investigation techniques.

The reformed tax system was not necessarily seen as an important element in creating a pro-growth economic environment – this was not a comment we heard at all in interviews.

The tax system is more cohesive, but there is still work to be done

As mentioned above, Tonga's tax system has vastly improved its cohesion. There are many possible indicators of improved cohesion. Relevant indicators for Tonga include:

The exemptions and ad-hoc discretions that were present in 2002 have been scaled right back, although some remain and pressure is increasing to add more.

The tax collection is now over a broader set of taxes. No single tax type has more than 50% of revenue (import charges and customs duties represented over 50% of revenue in 2002).

The tax collection also captures tax from a broader base of taxpayers. The number of active taxpayers has increased markedly since 2002, across all types of taxpayer: corporate, employees and self-employed. There were no electronic systems to identify taxpayers in 2002 so data from this time is poor. But in 2011 there were 736 corporate income taxpayers, 9818 salaried and self-employed income taxpayers (and 807 PAYE withholders) and around 500 registered entities for CT.

In 2002 the administration of income tax and sales tax was spread across four Divisions of the Revenue Services Department, and customs data was not integrated or cross-checked against tax data. This resulted in a lack of coordination at the operational level. Now

⁶⁵ It was expected that there would be around 260 registrants for VAT in Tonga; there are now more than 500.

taxpayer services are coordinated under one Division. Data integration between tax and customs data remains incomplete at the time of writing.

International obligations on the way to being met

The reform of customs duties in 2008, which was undertaken as part of Tonga's accession to the WTO, met the majority of Tonga's obligations on trade. The reduction in tariff rates is consistent with international trade liberalization and was necessary in preparation for a range of international trade agreements coming into effect.

In 2008, excises on fuel, alcohol, tobacco and vehicles were increased significantly. For example, beer was increased from T\$17 per litre of alcohol (lal) to T\$42 per lal and cigarettes from T\$150 to T\$200 per 1000 sticks. Further increases were made in 2011. While the 2008 increases applied to both imported and domestic goods, the 2011 increases applied only to imported goods, with a decrease in excise being provided for domestic goods. While this has no immediate impact as there is little, if any, domestic production of these goods, the change is not WTO compliant (as excises have to be imposed equally on domestic and imported goods) and could theoretically be objected to by other WTO members.

Tonga was identified as a tax haven in 2000 on OECD's list of tax havens.⁶⁶ It was removed from this list in 2001, but has not since become a member of the OECD global forum on Transparency and Exchange of Information for Tax Purposes.⁶⁷

While Tonga has signed and ratified PICTA, it has not announced that it is ready to trade under PICTA.

Summary of outcomes indicators

In summary, our findings with regards outcomes are:

- Tonga has achieved improvements in tax policy and improvements in administrative practice, consistent with international good practice and its successes are considerable given regional and national circumstances.
- Measured against other Pacific Islands, Tonga is considered to have been a reform success. Assessed against the PFTAC baseline assessment, Tonga has moved from 'below baseline' on every measure to 'above baseline' (the assessment notes limitations on Governance and Accountabilities, Automation and HR).
- Some gaps remain, and these gaps are reflective of the limited resources available to the Tongan Inland Revenue Division. On the positive side, the gaps that do exist have been identified by the Inland Revenue Division and confidence has been expressed that they can continue to resolve them either independently or with a small amount of support from advisors. This suggests that Tonga has made some improvement in the outcome category we have termed 'improved capacity for diagnosing, prioritizing and implementing appropriate tax policies and implementation.' Despite this confidence, we have found that the capacity improvements are unlikely to be sustainable. This is the key 'gap' in the Tongan reform story.

⁶⁶ OECD, 2000, Towards Global Tax Co-operation - Progress report in identifying and eliminating harmful tax practices, p. 17

⁶⁷ OECD Global Forum on Transparency and Exchange of Information for Tax Purposes - Member List

Reflections on the process of reform

A high degree of clarity as to the objective of the reform

Of each of our four case studies, Tonga stands out as having had a very high degree of clarity about the objectives of reform. All interviewees commented that the primary objective was modernisation. Many shared the view that the reform was designed to be revenue neutral (reducing reliance on port, customs and trade taxes) and that the CT was used as a catalyst for modernisation.

Recommendations were consistent with principles for good tax design and the Tongan context

The recommendations made in 2002 were completely consistent with best practice principles for the time: they reflected the ‘standard package’. An overwhelming majority of interviewees felt that the technical advice was very sound throughout.

There is also evidence that every effort was made to accommodate the Tongan context in the reform programmes put together, from the earliest reforms to the ones that are being introduced now.

The initial set of recommendations appears to have been the result of close consultation the Minister of Finance. This meant that ‘none of the recommendations came as a surprise’ to the Minister of Finance. The senior personnel in the newly-amalgamated Ministry of Revenue and Customs were new recruits, however, and were tasked with implementing the changes.

Tonga’s introduction of CT was, in contrast to most of the examples in our other case studies, a top-down policy reform process. In other words, it was driven at Ministerial level rather than from senior tax officials or by external, donor-funded advisors. One advantage of this approach was that things were driven to happen. One disadvantage of a top-down reform is limited buy-in from the tax administration. In the case of Tonga, senior officials in the tax administration felt that the changes were largely imposed and they ‘had to just get on with it’. Furthermore, the top down nature of the reform meant that changes were ‘pushed through’ despite concerns from advisors about Tonga’s readiness.⁶⁸

Top down reform can work, provided there is recognition of the need over time for broader engagement. This need seems to have been recognised in the case of Tonga, which invested heavily in education immediately after the reforms were

Tonga’s introduction
of CT was a top down
policy reform process

⁶⁸ There was a lot of work around at the time that suggested that a VAT had potential to be an excellent policy option for Tonga, including the relatively recent experience of New Zealand, Samoa and Fiji. However the advice from PFTAC in 2002 was that Tonga was not ready for such a change. Its advice recommended various pre-conditions for reform be met, which recognised that the success of the project to develop a new tax system for Tonga was very dependent on the ability of the revenue administration to improve its operations. PFTAC’s 2002 diagnostic report suggested that several key objectives that should be met before the tax policy reform started. These include the recruitment of a tax commissioner and deputy, elimination of backlog of income tax work, Taxpayer Identification Number (TIN) system established and TINs allocated, Large and Small Business Divisions be set up and staffed, procedures and penalty system in place, including penalty ruling, for self-assessment. The report also suggested that the new computer system be fully installed and tested.

introduced. This education programme went some of the way toward correcting the balance of engagement but it is possible that the damage had already been done: the lack of political dialogue and widespread public consultation about the proposed policies before they reached parliament was met with a low level of genuine understanding of the reforms. As a consequence, passing the CT through the political process proved challenging. Concessions were made to zero rate some inputs, as a result of political challenges to the tax. (Zero ratings for inputs are commonly recognised as undermining the integrity of a VAT, making it less broad-based and less efficient). The former Minister of Finance noted to us that in his view “this was an acceptable compromise.”

True consultation (in which the private sector and others were actively engaged in policy conversations *prior* to reforms being passed through into implementation), only happened in later rounds of reform. For example, for the 2007 reforms it was apparent that a high degree of effort made to engage at a political level at least. ‘Politicians really came on board. This was a result of a conscious effort to engage nobles, politicians (MPs) and large business. We weren't frightened to talk to Tongan MPs about the reforms’. The Inland Revenue division staff are now involved in public consultation over presumptive tax.

Expectations were reasonable and diagnostic material was produced

“The PFTAC assessment led to needs identification: this was a very important piece of advice and set out the guiding strategy”

It is clear that in the Tongan case, intervention from donors was what prompted reform and set the agenda. The customs administrative reform package was a core element of the ADB loan and technical assistance grant for the Economic and Public Sector Reform Program. And the PFTAC advice was instrumental in establishing the modernisation agenda. Their 2002 advice, which recommended introducing a broad-based consumption tax, a single duty rate, excises, and reducing or, at minimum, controlling and monitoring exemptions, was widely recognised as the document that guided the policy reform. Similarly PFTAC’s advice for Tonga’s administrative systems guided the administrative changes. This advice demonstrated a good understanding of what was required in Tonga and the time needed to implement reform.

The reform work was also carried out with a high degree of certainty, relative to our other case studies, about what resources were available for reform. Tonga began with 5-6 year ADB funding so could commit to long term reform. One interviewee commented “When we started the reform process there was certainty about what funding was there and what inputs would be available for the reform. This was a positive.”

Expectations were reasonable that the reform required not only policy changes, but also widespread administrative change. This is perhaps as a result of the advice from PFTAC, which emphasised this point.

Shared and credible evidence base

The Tongan experience shows a mixed view about whether evidence was shared. For the initial round of reforms there was detailed examination of policy options and implementation plans but these were not always shared with senior officials and people outside of the immediate reform team.

At the time it seems it was difficult to get Tongan civil society to engage about the changes: those in the reform team felt they gave it a good try. One official noted that “the public

were not interested until it affected them” and another noted that “Largely the response from the other parts of the Tongan bureaucracy and within the political sphere were apathetic”.

This apathetic response to efforts to engage could be partly due to a lower overall level of engagement between civil society and the state. In Tonga one interviewee noted that “most people have no understanding of link between taxes and services”. Furthermore, Tonga at the time was experiencing a high degree of political change so attention was distracted elsewhere.

Neutral fora for dialogue

“There was a true dialogue between players, but in the end it was our decision”

“We explored, discussed and reached consensus. There was a Revenue Policy Committee set up, which allowed for regular contact with reform team.”

Every person interviewed felt that dialogue was neutral, and that Tonga ‘owned the reforms’. Most commented that, with the later reforms in particular, there was plenty of opportunity to debate and disagree.

We heard that a key to Tonga’s success in maintaining this dialogue was continuity of key players – political, admin and technical advisors all working together with same objective and understandings.

Engagement that shows balanced values, engagement on equal terms and shared information and analysis

“Was overall a positive experience with good advisors and assistance and good dialogue.”

“We've gone through quite a few advisors but I've never felt that they didn't trust me or understand me. We've had a good relationship and I've looked forward to, and appreciated, the advice they've offered.”

“They [the technical advisors] were seen as helping hands.”

In the case of Tonga, it seems that a true partnership emerged between the donor funded agents and their host country counterparts.

Summary of process indicators

In summary, our findings with regards to the process indicators are:

- There was a high degree of clarity about reform objectives.
- There was sound technical advice, consistent with the local context, throughout.
- Expectations were reasonable and there is evidence of strong strategy and planning upfront.
- There was detailed examination of policy options and implementation plans but these not always shared with, or understood, by all parties.
- There was neutral fora for dialogue and a high degree of country ownership.
- Relationships were balanced and respectful.

Conclusion

In conclusion, donor funded intervention in Tongan tax reform has provided for effective policy dialogue at each stage of reform, but has provided for some areas more effectively than others. We found that the Tongan reforms satisfied all of the indicators of good process, in the context of a top down reform. We also found that the intermediate outcomes of improved tax policy and improved tax administration were achieved in Tonga. So the outcomes story was overall a very positive one.

The key ‘gap’ in the Tongan reform story is there are signs that the capacity improvements are not sustainable. Cracks are already beginning to appear. To some extent this fragility seems inevitable given the capacity constraints Tonga faces. However, what was always going to be a challenge seems to have been made more challenging by the relative absence of donor support for building up all aspects of the tax infrastructure outside of the specific reform projects. Donors have not shown a willingness to engage with Tonga on a long term systematic and strategic programme of capacity building. This is evidenced by the withdrawal of most technical assistance now that the headline reforms (the introduction of the Consumption Tax) supported by donors have been implemented. If any criticism could be made of the reform intervention, it would be that post-reform activities have not been provided for. That is, there seems to be limited focus on how to achieve incremental improvements. For example, while donor funded interventions have allowed for communications efforts during the reform period, it seems that post-reform the emphasis on communication has waned. Weaknesses like failing to keeping websites up to date were beginning to appear.

The sustained consequences for the objectives of the Tongan reform are mixed, therefore. A well-functioning taxation system is always being upgraded. So while Tonga’s reform programme has achieved many of the outcomes set for it, it does not appear to have established a regime where incremental improvements in policy and administration have become business as usual.

Lessons to be learned from Tonga

Reflecting on Tonga’s experience, several lessons can be learned.

- Tax reform is a mix of policy and administrative change processes. The orthodox approach is to focus first on administrative capacity but it is possible to use policy change as a catalyst for administrative reform provided it is understood that basic administrative infrastructure present and there is recognition of the need for administrative reform.
- Tonga was a top-down policy reform process, i.e. it was driven at Ministerial level. An advantage was that things were driven to happen. A disadvantage was limited buy-in from the administration, private sector and politicians outside the immediate circle of the reform team. As a result of this perhaps more compromises were made in passing the legislation. Tonga is now moving to a more inclusive process.
- Tax reform is a long-term process that is achieved over a number of years of sustained effort on policy and administrative front. The Tongan reforms took a full ten years: enquiries and research began in 1999, diagnostic materials were produced in 2002, substantial policy reforms commenced in 2004 (with substantial changes introduced in 2005 and 2007). The bulk of the implementation work didn’t draw to a close until late 2012.

- Tax reform and capacity building never stops. Even if a reform programme has been successful, and the reform process has been impeccable, it can all fall over if effort is not sustained to keep the policy and administrative settings current. For example, a member of the business community noted that the Inland Revenue has ITNs on website but as these are not updated they are no longer useful, making her job difficult. Another example is that staff still require support for auditing capacity building. Taxpayer auditing is one of the more difficult functions carried out by any tax administration and audit staff require specialized skills and training. A PFTAC 2013 review noted that “auditing techniques and methodology are continuously evolving and it is important that [Inland Revenue] continues to have strong support in this area for some time”.
- Tax reform requires a mix of skills but is substantially reliant on long- term technical advisors. Tonga used a combination of short term technical skills and long term advisors (for example PFTAC provided broad guidance, a private consultant was used to support the Minister on political issues, and donor-funded short term technical assistance was given on compliance and computerisation. There were also long term advisors who provided continuity for the reforms). Long term technical advisors have to have a commitment for the long haul: 2-3 years at least. The type of advisor is also critical – the best are those who work with officials, are quiet and listen to local views. They do not necessarily have to live in the country for the entire duration. In Tonga an example of a successful technical advisor was the legislative drafter, who went to Tonga for 2-3 weeks 4 or 5 times a year between 2000-08. His relationship with Tonga started by providing legislative drafting but ended up being the general trusted advisor to administration and Ministers. Every senior tax official we interviewed cited his contribution.
- Capacity building within the tax administration is important, but there are limits to capacity building potential. It is difficult to find and retain people who have the capacity to make technical decisions. The Inland Revenue division lost secondees support at the end of 2012 and feels vulnerable. A PFTAC report earlier this year noted that “It is clear that [Inland Revenue] cannot implement the [Taxpayer Services] and develop and implement an effective outreach program without long term TA”. There has been high staff turnover (15 of 41), and many have been lost to other Ministries. If the objective is giving priority to ongoing revenue capacity there will probably need to be ongoing support from IRD/ATO – a secondee for 2-3 year period, and the ability for Tonga Revenue to second staff to IRD for 3 months once every two years or so.
- Many of the issues that the Tongan Inland Revenue faces are similar to those faced by NZ IRD in the small business sector – for example, the cash economy. This suggests that there is potential for regional capacity building.

Kiribati case study

Background

Kiribati provides, in its recent introduction of VAT, an example of a reform programme in which policy setting and implementation tasks were conflated into a very short time period. While the policy agenda was clear and for the most part agreed for a number of years, the large majority of the reform activities were conducted “at the last minute” in response to a desire to have the policy reforms introduced before the end of the President of Kiribati’s third and final term.

Support for reform

Approximately NZ\$2.1 million of direct donor investment in tax reform projects has been spent in Kiribati since 2002. In addition, substantial support and advice has been provided by PFTAC, including numerous diagnostic visits and legislative drafting support in 2008.

The donor investment has funded a tax advisor (in place since May 2012) and has provided for the purchase of new tax software (datatorque RMS) and associated installation. There has also been funding from donors for administrative strengthening and computerisation between 2004 and 2007 and for advice on customs integration in 2013.

Reform was slow to get started

Reform recommendations existed for some time before reform activities began. A reform agenda document was prepared by PFTAC in 2003 in response to a request from the Kiribati government. The recommendations included:

- A consumption tax to replace the hotel tax and progressively replace import duties.
- A temporary single ad valorem Customs Duty (5%), on all goods imported from countries outside the regional trade agreement free trade areas based on CIF value.
- Excise duty on imports and local production of alcohol products, tobacco products, sugar products, petroleum products, motor vehicles.
- A simplified income tax rate.
- A final withholding at source (PAYE) on wages and salaries.
- A single rate business income tax restricted to companies.
- A presumptive taxation based on turnover for businesses.

In 2005 laws were drafted to introduce these changes into law. The law was eventually passed with some amendments to the original in 2009, after four years of relative inaction. A number of factors contributed to the delay including financial constraints and reluctance in some quarters to the introduction of VAT, which promoted waiting to see how other Pacific reform efforts panned out. In 2007 the Kiribati authorities had discussions with DFAT regarding technical assistance and support such as the purchase of IT systems. Nothing substantive appears to have resulted from those discussions but the reasons for this are unknown.

PAYE final reforms in 2009

Recognising that it was time to make some improvement to the tax system, in 2009 the Tax Division focussed on a project to implement PAYE final (this having been suggested in

diagnostic advice from PFTAC in 2003⁶⁹). The objective of this initial change was to free up tax administration capacity in Kiribati by making the tax assessment process for employees far simpler (by removing the need for most employees to file tax returns). At the same time, an increase to the personal income tax threshold to A\$4,000 was introduced. Kiribati received legislative drafting support from professor Lee Burns in support of this reform. The process of reform involved review of the legislation (the Income Tax (Amendment) Act 2008), constituting a steering committee, training staff, implementing a tool to provide ready calculation of PAYE taxes given the amount of chargeable income (Ready Reckoner) and conducting a public awareness/consultation programme.

By late 2009 the Government of Kiribati was pushing for further modernisation.⁷⁰ Responding to a request from the Secretary of Finance for technical assistance, a PFTAC revenue advisor undertook a mission in November, 2009. The mission purpose was to review and scope a revenue modernisation implementation plan. The resulting aide memoire noted that the Tax Division needed an overhaul: modernisation of current processes and realignment of the operating model, a reduction in the resources committed to manual processes and the development of compliance improvement strategies.

Still more delays

A broad reform programme and indicative costings were included in the November 2009 aide memoire. In it, the author requested financial support from the Government of Kiribati and/or donors to achieve the reform in practice. Specifically, it proposed a long term in-country tax advisor be engaged to oversee an automation and institutional strengthening project. The plan was based on the premise that the automation and modernisation of the operations of the Tax Division would pave the way for a longer term review of the wider fiscal policy framework needed to broaden the existing tax base and identify new sources of revenue. That is, it is clear that the agenda setting documents recognised that tax reform was a process that would take a long time, and would require long term commitment.

It took two years before the long term advisor position was advertised⁷¹ and 16 months before bilateral donors indicated they would be willing to provide donor finance to support the reform proposals. One factor in the delay was the lack of Commissioner throughout 2010 – the Tax Division was run by an Acting Commissioner during that time.

Preliminary scoping work regarding the appropriate technology and software to purchase was conducted during 2011.⁷² It was universally accepted that IT should support the activities of the tax office and will be used as a catalyst for further reforms.⁷³

⁶⁹ 2003. Christophe Grandcolas, *Kiribati: Modernization of the Tax System and its Administration*, PFTAC Aide Memoire, September 16, 2003.

⁷⁰ At the annual meeting of the IMF and World Bank held in Istanbul, October 2009 Kiribati indicated that the cabinet is ready to progress the modernisation programme.

⁷¹ Australia Volunteers International advertised for a Tax Advisor in December 2011.

⁷² As part of scoping, three officials from the Ministry of Finance went on a study tour to Tonga, Samoa and New Zealand. This tour was funded by DFAT.

⁷³ At the development partners meeting in May 2011 it was agreed between Government and donor partners that the two most urgent public finance priorities were strengthening accounting and revenue administration and that steps should immediately be taken to advance work in these areas. The Pacific Financial Technical Assistance Centre (PFTAC) was requested to take the lead in supporting revenue administration reform with

The original job description

An experienced, long term tax advisor finally arrived in Kiribati on a 24 Month contract in 2012. His role was to “provide advice and guidance to Government of Kiribati on the timely implementation and effective management of the new tax automation system through the Government of Kiribati Tax Improvement Program.”⁷⁴ The job description emphasised automation and administrative processes – but did make it clear that this was a first step in a large scale reform:

“The automation and modernisation of the operations of the Tax Division will pave the way for a longer term review of the wider fiscal policy framework needed to broaden the existing tax base and identify new sources of revenue.”⁷⁵

The planned, staged trajectory for the reforms changed rapidly when the President of Kiribati strongly expressed his desire to introduce a VAT prior to the end of his term in office. Behind this was the recognition that Kiribati was “in a revenue hole” as a result of trade reforms and urgent action was needed.⁷⁶

According to PFTAC, tax revenues as a share of GDP declined from 18.9 percent in 2008 to 16.9 percent in 2011. This indicated a worrying trend: that tax revenues were not keeping pace with economic trends. A recent report prepared by the World Bank and the Ministry of Finance and Economic Development (MFED) suggests the reasons for this decline were compliance problems, especially with customs duties, and policy changes, such as the increase in the PIT tax-free threshold to A\$4,000 in 2009.⁷⁷

The system was in desperate need of modernisation

The revenue performance was one indicator that the

The plan: start by automating the Tax Division with help from in-country technical assistance and then follow this up longer term by reviewing the policy and legislation framework.

The reality: Kiribati will be implementing the new RMS system at the same time as implementing the new policy framework, with an already capacity-constrained tax office.

the initial focus to be on improving information technology (IT). At that time bilateral donors indicated they would be available to provide financing to support the reform proposals developed by PFTAC. PFTAC prepared a follow-up IT implementation plan following a visit by PFTAC advisor Margaret Cotton on 4th – 10th August 2011.

⁷⁴ Australia Volunteers International, Tax Advisor job description, December 2011.

⁷⁵ Ibid, n74

⁷⁶ Kiribati is a Party to the Pacific Islands Countries Trade Agreement (PICTA) and is currently negotiating the Pacific Agreement on Closer Economic Relations (PACER Plus). The assumption in 2009 was that these two agreements would be ratified in 2011 and that tariff revenues were expected to reduce over time by an estimated 19 percent or AU\$10m -17m per annum.

⁷⁷ See Note 4: Revenue Performance, Kiribati: Public Expenditure Analysis, prepared by the World Bank and MFED, July 2012.

need for modernisation was indeed desperate. In 2010 Kiribati's tax system was recognised as 'under-baseline' on seven of the nine indicators⁷⁸ (with key deficiencies in all nine areas).⁷⁹ For example it joined the Federated States of Micronesia, the Republic of Marshall Islands, Palau, Solomon Islands and Vanuatu in being ranked 'below baseline' on its legislative framework. This indicated that Kiribati's legislation needed updating to make the country's tax base more comprehensive, and introduce broader based, lower rate taxes.

According to reform documentation from 2009 and 2011, a lack of automation was a persistent cause of administrative failure.⁸⁰ Despite the changes to introduce PAYE, the manual resources being applied to a backlog of wage and salary earners' returns were consuming a disproportionate amount of the tax office's time and non-compliance was a major issue.

The reform

With the arrival of the long term advisor things started to get moving. The Government of Kiribati decided to replace trade tariffs as the primary source of revenue in 2014 by introducing⁸¹:

- a consumption tax (VAT)
- excise tax on selected goods
- changes to corporate and personal tax.

In July 2013, the Government of Kiribati introduced legislation allowing for the VAT and for repeals to customs duties into law. The VAT is due to come into force on 1 April 2014. On 1 April 2014, all tariff rates on goods imported into Kiribati will be zero. The tariffs will be replaced by VAT and excise tax, and unless exempted, the new taxes will apply to both imports and domestic production.

At the time of writing the Tax Division, supported by the long term tax advisor, are preparing for implementation. The preparations include installation of an automated IT system (datatorque's RMS), staff training, a public communications programme and customs integration.

Summary of the Tax System in Kiribati prior to the 2013 legislative change

Income Taxes

The personal income tax (PIT) has a progressive rate structure as follows: A\$0 to A\$4,000—exempt; A\$4,001 to A\$15,000—20 percent; A\$15,001 to A\$30,000—25 percent; A\$30,001 and above—30 percent. Personal deductions are available for contributions to the Kiribati

⁷⁸ As a result of the 2009 changes to the legislation and PAYE it was able to rank itself on the baseline for operation and administrative framework.

⁷⁹ PFTAC Baseline Assessment Framework, 2011.

⁸⁰ The 2010 PEFA assessment also identified automation as a catalyst for reform of the tax office.

⁸¹ These changes were agreed following a PFTAC tax policy mission was undertaken in September 2012 to develop the details of a modernized tax policy framework. The advice provided a strategy to broaden the tax base and improve revenue performance in Kiribati, and in particular to provide advice on the design of a value added tax (VAT).

Provident Fund and for life insurance premiums.

The company income tax (CIT) also has a progressive rate structure for resident companies with three rates: A\$0 to A\$25,000—20 percent; A\$25,001 to A\$50,000—30 percent; A\$50,001 and above—35 percent (taxed on a worldwide basis). The CIT rate for non-resident companies is a flat 30 percent. Tax losses can be carried forward for three years. There are six depreciation categories with rates of 3 percent for storage tanks, 5 percent for industrial buildings, 10 percent for ships, 12.5 percent for furniture and fittings, 20 percent for motor vehicles, and 15 percent for any other article, machinery or plant. Higher rates apply in the first year if the asset is new (20 percent for ships, 25 percent for furniture and fittings, and other articles, plant and machinery). Depreciation is on a diminishing value basis except for buildings, ships and tanks, which are on a straight-line basis.

Dividends and interest paid to resident individuals are taxed at the PIT rates, although the first A\$250 of interest income earned is exempt. Dividends and interest to resident companies are taxable, although a 90 percent deduction is available for dividends paid between resident companies. Payments of dividends, interest and royalties to non-residents are subject to a 30 percent withholding tax. Kiribati has two double tax agreements (DTA) with Australia and an old agreement with the UK. Under the DTA with Australia the withholding rates are 20 percent for dividends, 10 percent for interest, and 15 percent for royalties. Kiribati intends to soon sign a DTA with Fiji.

Trade Taxes

Customs duties are imposed on a range of goods with rates ranging from zero to 80 percent with an average of around 15 to 20 percent. While most duties are on an ad valorem basis, there are also a few specific duties. There are a large number of exemptions and special conditions that render it complex for both customs and importers. There are no excise taxes however “excisable goods” have a higher rate of duty. Kiribati levies duties on an f.o.b. basis, which is 15-20 percent lower than the usual c.i.f. An additional import levy of \$30 per cubic meter is imposed on the volume of imports, and is used to subsidize the distribution of goods to outlying islands. Kiribati does not impose export taxes.

Hotel Tax

A 10 percent tax applies to the turnover of hotels.

Outcomes of the reform

Unfortunately, it is too early to tell what the outcomes of the VAT / tariffs reform will be (the VAT is due to come into force on 1 April 2014), so our comment on these reforms is by necessity limited to the process indicators. We can speculate that the delays in advancing reform may have contributed to a fall in tax revenue as a percentage of GDP to a low 16.9 percent in 2011. Nominal tax revenue per capita only increased by 5 percent over the period 2002 to 2011, low in contrast to countries that did actively pursue reforms in that period. Again, this is speculative and not a finding.

Certainly the legislation that was adopted by the Kiribati Parliament in July 2013 represents ‘improved tax policy’ on paper but our interviews conducted in the month before the legislation was adopted suggested that there was fear of the changes in political circles, very little discussion of evidence and ignorance about the impending change in the wider

community.⁸² As a consequence there were few people in the position to judge whether the policy changes would represent a true improvement for Kiribati or not. This is a significant finding: even if the world looks on the policy changes as improvements, this has little consequence if people in Kiribati do not have the information to judge success for themselves. One comment from an interviewee sums up the lack of sustained dialogue by admitting that the unique policy context for Kiribati was only taken into account at the last minute:

"We started with the standard model but fit it to conditions in Kiribati (exemptions for rice, flour, sugar) - although I have to say that these were last-minute additions to the law rather than something that was developed as policy from the start."

Early indications are that effort continues to be directed toward improving tax administration and capacity but we are unable to comment on the outcomes of those efforts this early.

The reform to introduce PAYE final in 2009 is showing mixed signs. The Commissioner of Tax noted:

"this reform [PAYE final] has been successful. We have noticed a positive impact on revenue. It is simpler for us because we don't have to process refunds."

But another party noted:

"the implementation [of the PAYE reforms] wasn't very effective, from what I can see, but they seem to have had some good results anyway. People are out of the income tax/refund system now and instead are paying tax through PAYE. It has freed up capacity."

All of the interviewees commented that most of the real change would happen when the RMS system arrived and automation happened.

The process of reform

A DIY reform

"We've done it on the hop really" – reform advisor

Looking back on the VAT reform, it is miraculous that those involved in the reform achieved what they did in the time they did. There was barely more than a year between when the decision was made by the Kiribati government to pursue the VAT reform and when the legislation was passed through Parliament.

As a consequence of this haste, the reform activities associated with the introduction of VAT in 2012 and 2013 lacked a 'project management' approach and essential tasks (such as ensuring that stakeholders were actively co-ordinated throughout). Reform activities have been largely driven by a single resident reform advisor, drawing in expert advisors where

⁸² There was no widespread consultation about VAT in 2013 at the request of the Secretary of Cabinet. Targeted consultation with Chamber of Commerce, tax agents, businesses and parliamentarians did occur, however. Wider communication about VAT is planned to occur in early 2014.

possible. There has been no dedicated project manager to coordinate reform activities and ensure “right thing, right place, right time”.

Having limited active co-ordination is not unusual for taxation reforms. Solomon Islands has similarly lacked coordination of its tax reform activities into a programme. But in contrast to the Samoan and Tongan reform efforts, which had established long-term, dedicated programme funding and had well-documented project plans prior to setting out on the path to reform, the Kiribati reforms are unquestionably ad-hoc.

Kiribati was a very DIY reform. There was no bucket of funding for reform activities in Kiribati (i.e. the funding was apportioned to agreed outputs by donors), or easy access to outside support (for example, from the ATO). The advisor was expected to ‘go it alone’. In contrast, the reform team in Samoa had access to funds and could access technical resources it wanted at any time from the NZIRD.

Kiribati was a DIY reform – there was no bucket of funding or ready access to help.

The reform advisor noted how grateful he was to have PFTAC skills available to him:

“I have been able to grab people and expertise at very short notice. We used two of the best experts in the world: Lee Burns and Peter Mullins. This is a benefit of PFTAC: quick response from experienced people.”

The expert advisors demonstrated remarkable flexibility, and it is a credit to their willingness to go beyond the normal level of commitment that critical reform inputs were delivered in time. A comment from the former commissioner was:

“[the drafting advisor] was always willing to respond to suggestions.”

The quote above relates to an example of the flexibility demonstrated by the reform team, as described earlier, are the last minute exemptions to VAT for rice and flour that were introduced to the legislation. These exemptions were made in response to concerns about equity for Kiribati citizens, many of whom rely on these staples for subsistence living. In an ideal world such changes would have been introduced in policy proposals early in the process and debated widely, but the reform team had to form a quick conclusion and work with what they had. The fact they were sufficiently flexible to include them is an indicator of their flexible attitude as well as the access to experienced advisors on short notice.

Like a DIY project, the inputs for reform were constrained

In contrast to the other case studies, Kiribati had very low levels of resourcing. Kiribati took \$2.1 million to get the legislation drafted and passed and to commission a new tax IT system. In contrast, the Samoan reforms by that stage had spent over three times as much on similar outputs, \$6.5 million. (Kiribati funded a new IT system, RMS, with that funding. In contrast, Tonga and Samoa applied funding to upgrades for existing systems).

Kiribati had low levels of resourcing - Samoa spent three times as much on similar outputs

As noted earlier Kiribati was largely run by a single long term tax advisor, who was also diverted on other outputs, plus short term a legislative drafter. In contrast, Samoa had a permanent advisor supported by 9 or 10 short term advisors. Tonga had a team of two semi-permanent advisors, plus a team of shorter term external advisors from New Zealand.

This comparatively low level of financial commitment probably arose as a consequence of the changed agenda part way through.

A common theme in interviews was the isolation of the technical advisor, who possessed valued specific skills but who was expected to provide advice outside his areas of experience. Multi-tasking may be an inevitable requirement of the Pacific environment but in the case of Kiribati, the reform process would have been more smooth if the technical advisor's skillset had been supplemented by a person with experience in managing the political inter-face. The skills involved include knowing the political trade-offs of concern to Ministers (such as who are the winners and losers from reform and how can losers be accommodated while retaining the reform objectives, organising and contracting appropriate policy material, and ensuring that the appropriate parties 'remain in the room' throughout the process).

"I feel very sorry for the AusAid advisor, only one person with a massive task"

The symptoms of the speed of the reform, the reduced emphasis on project planning and the lack of resourcing for someone experienced in the 'political' aspects of tax reform showed early on. One example is that the core personnel involved in the reform stopped meeting on a regular basis for some months immediately prior to the legislation being passed. Key people, including the Tax Commissioner, were 'not in the room' for critical discussions. Often, the technical advisor was left making important policy decisions that should have been the domain of senior officials and ministers. Another symptom is that even though analysis was prepared regarding the policy implications of certain decisions, it is not clear that it was widely read or debated by this core team. One party questioned whether some of the policy analysis material presented accurate or useful data, but there is little evidence that the material was sufficiently engaged with by others make it worthwhile having the analysis corrected or performed by someone else.

As evidence of a reform process under strain, interviewees noted the following:

"Trying to do too much at once"

"They are conflating support work with reform work"

"I think we should have put in place the RMS a long time ago."

"We've done the best we could in the context"

"They were advised that the reform plan was too compressed but they decided to go ahead anyway. We have been really running with our tails between our legs."

Implementation and system-wide change seems to be an after-thought

One result of the strained process is that very little planning had been done when we conducted our research to provide for the implementation stage, even though there was only a few months to go before payment VAT was to be introduced. The Tax Division had done some preliminary work (for example, they are expecting around 90 registrations for VAT and had begun recruiting for new staff to assist with VAT implementation) but overall there was a feeling that 'anything to do with implementation would have to wait till after the legislation

had passed.’ Somewhat worryingly, it was not clear that donors and the Kiribati government were forming a longer term plan beyond the term of the current advisor. There was no evidence that a 3- or 5- year plan had been put together to provide for implementation.

This is an indicator that donors may have been seeing reform as consisting of short, discrete projects (we call this “episodic” thinking, as opposed to “systematic”).

Good relationships were formed and sustained but process for sharing information was poor

“We know what our respective roles are. Relationship with [the resident advisor] is good. We share ideas.”

“Really I don't think anyone feels like there is a balance where everyone knows what everyone else is doing.”

Despite the short timeframe and constrained resourcing, responses from senior officials in Kiribati were very positive in particular about the role that the resident advisor and PFTAC had played. They felt that the engagement with advisors and PFTAC had shown balanced values, engagement on equal terms and had been done in neutral forums. Where information was available, it was shared and discussed with other parties within the Tax Division.

The Internal Revenue Board (a steering group for the reform) was created in an attempt to ensure that all relevant parties had the right information. It worked well at first and it successfully functioned as a place to raise issues twice weekly. Unfortunately the committee stopped functioning, and failed to function in the 6-9 months leading up to the introduction of the VAT legislation into parliament. This left the resident advisor on his own making decisions that affected multiple interests and having one-on-one conversations. During that time was very little shared dialogue between the various affected parties. It was not possible for each of the parties to understand others’ priorities and intent.

One example of the consequences of this weakness in process is the lack of clarity between Kiribati Customs Service (KCS) and the Tax Division about the responsibility for managing the aspects of the reform at customs end. It was never clear who would take the lead in resolving any issues (KCS, the Tax Division, donors, or technical advisors). The communication breakdown between the reform team and KCS was perhaps a consequence of the Technical Advisor’s brief, which expressly excluded Customs issues. Donor agreement to fund a Customs review was late in the piece, with reviewers only arriving on the ground in Kiribati three weeks prior to the legislation being passed.⁸³ This team noted that “there seemed to be a lack of recognition of the need to take into account that organisational change is required in the shift away from revenue collection to a greater emphasis on voluntary compliance and self-assessment by traders.” The authors commented that there was very little understanding that the reform would have wider impacts than ‘a

⁸³ The New Zealand advisors discussed the impact of the tax reform, providing advice on the new legislative framework and identifying issues. They provided KCS with assistance so that the tax reforms could be implemented as smoothly as possible, and provided examples of how to calculate the customs value using FOB. The advisors also provided advice on customs control and clearance procedures, Post Clearance Audit (PCA), the automated customs system being used (PC Trade), and the organisational structure of Customs.

new computer system'. The advisors advised against changing the IT systems employed by KCS, and instead suggested that the KCS focus on organisational change.

In contrast to the other case studies, Kiribati exhibited a low degree of clarity on objectives for reform

Kiribati showed a distinct lack of clarity about what the reform was about in comparison to other reform programmes. For example, there was never a project document, shared by all parties, that outlined the reasons and objectives behind the reform. Instead there was a collection of aides memoires and correspondence between the donors and officials. A possible consequence of this is that each interviewee gave different responses when asked about what the objective of the reform was – responses ranged from “Kiribati has to fill a finance hole” to “it’s about compliance with trade agreements”, to “the main objective is revenue”, “it’s not about revenue; its collection and compliance” to “its about efficiency and simplification”

One possible reason why there was little clarity about objectives is that key personnel had moved on. No-one from the agenda setting work in 2003 or from the first lot of PAYE reforms in 2009 was a core member of the reform team in 2012. There was no tax Commissioner for a whole year in 2010. The present Commissioner was recruited from Customs and at the time had little tax administration experience.

The political influencers had also moved on. The Minister in 2003 was very supportive of the reform programme and at that time the Minister and Ministry of Revenue worked very closely with PFTAC. There have been two Ministers since, each of whom “were aware of the changes but perhaps less driven to see them through” (in the words of one interviewee). One interviewee hinted that the Kiribati government “had no skin in the game” but this comment was not followed through.

In addition, there were changes in the donor team. The DFAT key contact went on maternity leave in 2012 just as the Tax Advisor had been recruited and set up. “AusAid disappeared off the face of the earth for a few months... It wasn’t clear what I was supposed to be doing.”

It will be important for Kiribati to continue core relationships from the earlier stages of reform over into the implementation phase.

“A big risk for reforms in the Pacific is the advisor leaving and then the revenue ministry taking short cuts in the implementation. That’s why permanent tax advisors are now scattered around the Pacific. You need to make sure that the things that are recommended actually get done.”

Summary of process indicators

In summary, our findings with regards to the process indicators are:

- Kiribati showed a distinct lack of clarity about the objectives of reform in comparison to other reform programmes.
- There was sound technical advice, consistent with the local context, in the agenda setting stage. Sound advice was sought and received in the policy options stages but this was ‘ad hoc’ and it is only due to the ability to grab expertise at very short notice (and the willingness of these experts to operate flexibly).
- There was good quality diagnostic work done prior to the reform.

- Expectations for the reform path from the host country Government were not reasonable. The reform team challenged the unreasonable boundaries provided to them but the boundaries did not change substantially.
- Expectations about project management and project inputs were not reasonable. The process lacked a detailed project plan and a 'project management' approach. Very little planning had been done regarding implementation.
- Implementation activities were not suitably provided for by donors. While there is evidence that advisors from PFTAC were communicating the reform as requiring long-term commitment, there is not evidence that this long-term commitment was agreed as part of funding arrangements with donors. Long term project plans did not seem to be in evidence (but noting that the information set is incomplete).
- There was not a shared evidence base. Policy material was gathered in haste and not shared widely. There were some concerns (we do not know how widely felt these concerns were) about the credibility of the policy material produced but there was limited debate to allow these concerns to be aired and addressed.
- Fora for dialogue was neutral when it happened but there was very limited shared dialogue between parties directly affected by the reforms. As a consequence we saw little understanding of priorities and intent between, for example, customs and tax divisions.
- There was insufficient time for widespread engagement and shared information and analysis.

Conclusion

While it is too early to form evidence-based conclusions about the consequences of the reform from the process followed in Kiribati it is possible to point to the weaknesses and strengths in policy dialogue. It is also possible to speculate on what the consequences of these strengths and weaknesses might be. The theory of change applied in this evaluation suggests that efforts to reform tax policy and administration sustainably are heavily dependent on effective policy dialogue, and upon policy dialogue being maintained at each stage of reform. This theory of change suggests that the shortfalls in the process of reform at the policy options stage will become apparent as weaknesses as implementation progresses.

The evaluation approach taken also suggests that in order to create sustainable taxation reform it is necessary to manage the tax system as a whole. This requires a systematic approach to taxation reform that in turn involves building-up the political, administrative and private sector infrastructure that makes a tax system work and sustainable over time changing in a coherent way to meet the changing demands of the society in which it operates. This systematic approach to taxation reform contrasts with an episodic approach where tax reform is viewed as discreet project such as introducing a VAT to replace tariffs or up skilling the tax administration by investing in IT systems.

While the need to view sustainable tax reform as requiring a systematic approach is not entirely lacking from the experience in Kiribati, in our view the donor focus has been on an episodic approach.

We speculate, based on our Theory of Change, that successful implementation of Kiribati's VAT is greatly at risk. This vulnerability is a consequence of the reform programme providing insufficiently for effective policy dialogue at the policy options stage of reform.

The long lead-in period before reform actively started has meant that there has been sustained emphasis on diagnosis and agenda setting. The rushed 'policy options' stage has meant that there are numerous parties who in an ideal world would have been planning and preparing for the change alongside the Tax Division. These parties will need to be rapidly brought up to speed and will have to race to prepare for the changes that affect them.

So, there is considerable work to be done in 2013 and 2014. It is not impossible but most people interviewed recognised that the Kiribati Tax Division's capacity will be stretched to achieve all of the component parts of the implementation (i.e. taxation systems, customs interface, taxpayer registration, communications programmes, etc). This is a weakness that exists as a result of unreasonable expectations that existed from the outset. While it is difficult to turn down an invitation to pursue reform donors should accept the role they play in setting and managing expectations.

Lessons

Reflecting on Kiribati's experience, these lessons can be learned:

- Despite the short timeframe and somewhat unrealistic expectations, the reform team performed well and operated in a highly responsive manner. Engagement with advisors and PFTAC has shown balanced values, engagement on equal terms and had been done in neutral forums.
- The complexity of taxation runs through both the policy development and the administrative implementation. In both areas there are limited economies of scale. Even if a country is small (such as Kiribati) this does not limit the diversity of impacts of taxation and thus the range of skills required. Kiribati's reform process would have gone more smoothly if the technical advisor's skillset had been supplemented by a person with experience in managing the political inter-face. The skills involved include knowing the political trade-offs of concern to Ministers (such as who are the winners and losers from reform and how can losers be accommodated while retaining the reform objectives, organising and contracting appropriate policy material, and ensuring that the appropriate parties 'remain in the room' throughout the process.
- There are substantial risks for the sustainability of a reform if the long tail of implementation is not planned for or funded, and where the consistency of core personnel is lost. Similarly, there are substantial risks for sustainability where reform projects are viewed as discrete, short term commitments rather than part of a systematic, long-term change.
- There could be limited understanding of the true nature of the impact of taxation reform on customs. This suggests that more could be done by donors to consider how they integrate support for customs reform and support for taxation reform.

Samoa case study

Background to the reform

During the 1990s, Samoa instituted major trade policy and tax reforms and was among the first Pacific Island countries to introduce a consumption tax. The 1994 Value Added Goods and Services Tax, known in Samoa as the VAGST, laid the foundation for significant reductions in tariff rates and reform of corporate and personal income tax rates.

In the late 1990s tariffs were reduced on most business inputs from 20–42 percent to 10 percent, and on most consumption goods from 50–60 percent to 10–20 percent. Tariff reforms have continued as part of WTO accession process.

The VAGST was increased to 12.5 percent in 2001, and to 15 percent in 2006. Personal income tax rates and corporate income tax rates were decreased at that time to offset the increase the VAGST, and exercise duties were increased.

Samoa signed a Tax Information Exchange Agreement (TIEA) with Australia in December 2009. The TIEA provides for exchange of information, on request, in both criminal and civil tax matters. Samoa has also signed an agreement with Australia that deals with the allocation of taxing rights and transfer pricing adjustments. Samoa is currently negotiating a double tax agreement with New Zealand.

In 2003, the Ministry for Revenue was established with the merger of Customs and Inland Revenue Departments. Following the merger, several donor supported reviews were undertaken, including:

- In 2006, PFTAC undertook a mission to design a large taxpayer unit, develop audit case selection processes and undertake staff training to better manage issues and risks imposed by large taxpayers.
- In 2007, DFAT supported a development of an Institutional Strengthening Project framework with an Institutional & Situation Analysis.⁸⁴
- In 2008, an IMF mission reviewed tax policy and administration in Samoa (and several other countries) in relation to the challenges associated with the impact of trade liberalization.⁸⁵
- Professor Lee Burns carried out a number of drafting missions to develop modernised tax legislation, reflected in new Income Tax Act 2012 and the Tax Administration Act 2012.⁸⁶

The Ministry embarked on an Institutional Strengthening Project (ISP) in October 2010. The primary objective of this project was to strengthen the quality of tax administration and lay the foundations for a sustainable change in the way the Ministry of Revenue administers the tax system. Aims of the project included strengthening Samoa's potential tax base

⁸⁴ DFAT Samoa Inland Revenue Department ISP: Institutional and Situation Analysis. Hayes 2007.

⁸⁵ IMF FAD Tax Policy and Administration: Facing the Challenges of Trade Liberalization May 2008.

⁸⁶ IMF, Samoa: Revenue Policy and Administration Review, Hayes, Motteram, 2013; and project team interviews with Professor Burns.

through improved compliance, better client service, and consistent policy advice on the reform of Samoa's tax structure.

Funding for the ISP was structured through a Public Sector Improvement Facility (PSIF) funded by Australia, New Zealand and the Government of Samoa. PSIF has received funding from 2008 to 2013. NZIR assisted Samoa in recruiting a number of experts in various aspects of tax administration, for secondment to Samoa. These secondments have been funded by the Ministry for Revenue through funding received for the ISP from the Public Sector Improvement Facility.⁸⁷ The Ministry for Revenue received an award at the 2011 PITAA annual meeting for its progress with its ISP.

In 2013, at the request of the Chief Executive Officer of the Ministry, PFACT provided an independent review of the existing legislative and administrative framework and whether those frameworks were appropriate for Samoa.

Samoa's tax system

Tax structure aligns with principles for tax design

The structure of Samoa's tax system implemented in the late 1990s aligns with the 'standard package' promoted by PFTAC, and uses conventional instruments to tax consumption, personal income, profits and imports. The Samoan tax system is summarized in the following text box.⁸⁸

Income Tax: Residents are taxed on world-wide income, with a credit for foreign taxes paid. Non-residents are taxed on Samoan sourced income.

Personal income tax rates for residents and non-residents are:

<i>Taxable Income Band (SAT)</i>	<i>Rate</i>
0 - 12,000	0%
12,001 - 15,000	10%
15,001 - 20,000	20%
20,001 - +	27%

Residents are subject to a final withholding tax on salary (at marginal rates). A withholding tax applies to bank interest (15 percent rate). Non-resident withholding taxes (15 percent rate) apply to interest, royalties, 'natural resource payments', management fees, fees for personal services, and insurance premiums (life premiums are taxed at a 7.5 percent rate).

Capital gains are taxed (at 27 percent), but the tax is limited to gains on assets held up to three years (that is, assets purchased with the intent of reselling for a profit).

⁸⁷ New Zealand IRD has provided a lot of technical assistance to Samoa over this period. They have seconded a total of 10 staff to Samoa in that time (not all of whom were involved in the ISP)

⁸⁸ This summary is taken from IMF, Samoa: Revenue Policy and Administration Review, Hayes, Motteram, 2013; and project team interviews with Professor Burns, page 4.

The capital gains tax rate is 27 percent, aligning with the highest personal income tax rate. An exemption for distributions from resident companies for resident and non-resident investors provides shareholder relief for corporate taxes. International shipping and aviation is taxed at 5 percent of receipts from outward freight and passenger transport, subject to exemptions.

Fringe benefits are taxable at the employee's marginal tax rates and there are comprehensive rules to support calculations. Tax losses can be carried forward indefinitely, except if there is a greater than 50 percent change in the underlying control of a company. Depreciation is based on international financial reporting standards. A simplified system of tax accounting is available for individual small traders.

Incentives and exemptions for income tax are wide ranging. For example there are exemptions from the sale of agriculture and (non-commercial) fishing products; tax holidays for up to 15 years for tourism and hotel investors, some international airline operations are untaxed; income of Ministers of Religion is exempt. Certain non-resident suppliers of services and employees can be exempted, subject to Ministerial approval. The offshore finance sector, including non-citizen employees, is quarantined from the local income tax regime.

VAGST: VAGST is imposed at a rate of 15 percent. The threshold for VAGST registration is annual turnover of SAT 78,000. The range of exempt and zero-rated supplies is small and generally consistent with international practice.

Trade Taxes: Imports are subject to: (a) import duty – majority of imports; (b) import excise (see below); (c) import VAGST – all goods and (d) Accident Compensation Levy – petroleum fuel only.

Excise: Excise is levied on domestic tobacco products, alcohol, soft drinks, passenger vehicles, kerosene and aviation gas. An equivalent excise applies to imported goods.

Administration: Penalty arrangements are consistent with international practice with an interest to compensate the government for the loss in the time value of money; penalty for failure to comply with obligations, and penalty for under-reporting.

When viewed against generally accepted principles for good tax design, the tax policy settings in Samoa are reasonable:

- Consumption and income taxes are applied across reasonably broad bases.
- Very low reliance on taxes on trade, consistent with WTO membership (taxes on trade comprise about 10% of total tax revenue, down from around 50% prior to the reforms in the 1990s).
- The personal income tax has a smooth transition from the tax-free amount to 10 percent, 20 percent, and 27 percent rates.
- Samoa's personal income tax system avoids the use of personal deductions, which tend to benefit high income earners (undermining the progressivity of personal income tax rates). The lack of personal deductions should also reduce compliance and administration costs because it reduces filing requirements and the need to document and verify deductible expenses.
- Samoa's highest person income tax rate of 27 percent is, after Tonga's (20 percent), the lowest in the region. Cook Islands and Fiji have similar maximum tax rates.

- The rate structure for personal income tax and company income tax rates are well aligned; the highest personal income tax rate is the same as the company tax rate.
- Interaction of the personal income tax and company income tax systems avoids potential double taxation of corporate income by exempting dividends paid by resident companies for resident and non-resident shareholders. Importantly, the company rate and the top personal rates of income tax are aligned so there is no tax advantage (as there is in Tonga) of operating a business as a company versus operating it as a sole trader.

Areas for policy improvement

While the tax regime is generally sound, there are areas for further policy development identified in IMF and PFTAC assessments, including:

- Exemptions from income tax are wide ranging, with over 30 income tax exemptions available, including industry development incentives or concessions such as tax holidays for tourism and hotels, interest on loans obtained for the benefit of Samoa, and primary production income, and possibly international aviation.
- Retirement savings are taxed differently depending upon whether the employer contribution is to the Samoa National Provident Fund (tax exempt) or private superannuation funds (taxed twice - on contribution and on distribution).
- While Samoa has a comprehensive capital gains system, gains are only taxed for assets held less than three years, on the assumption that these assets have been purchased for the purpose of re-sale.
- Samoa introduced thin capitalization rules, and other measures to deal with cross-board issues, in the Income Tax Act 2012. But regulations are required, and many countries have revised their thin capitalization ratios to reflect general changes in corporate gearing following the global financial crises.

Additional areas for further policy development are discussed in the IMF and PFTAC 'Revenue Policy and Administration Review' March 2013.⁸⁹

A recent review of the VAGST found that the legislation remains generally effective.⁹⁰ It also found that there are grounds for generally refreshing the text of the current VAGST legislation to conform to the more modern and user friendly drafting style found in other Samoan revenue statutes. The review suggested that the tax legislation could benefit from refreshing its structure and drafting style.

The same review found that further work needs to be done to better understand the small business sector in order to design a small business regime, and to consider the revenue impacts of such a tax regime and possible alternatives. The reviewer recognised that changes to small business taxation are likely to be contentious, and briefing government requires a good sense of likely impacts. Community consultation would be required to overcome data limitations in assessing likely impacts. PFTAC has recommended that Samoa seek technical

⁸⁹ Ibid.

⁹⁰ IMF, PFTAC, Samoa Small Business Taxation and VAGST Law, Motteram, 2013.

assistance to a develop a new natural resource tax in anticipation of any future development of deep sea mining and exploitation of subterranean water resources.⁹¹

All tax systems have a list of improvements and work that needs to be done to adapt and adjust the tax system for changes in the economy and society. The remarkable feature of policy development in Samoa is that this ongoing work on repairs and maintenance, which is an integral part of a good tax system, appears to have been largely unattended and unsupported for almost a decade following the major structural reforms of the 1990s.

Revenue performance

Table 1 shows that the pattern of tax revenue in Samoa in the last five years.

Table 6 Revenue performance 2009 – 2013 (SAT millions)⁹²

Table 1 : Revenue Performance 2009 – 2013					
	2009	2010	2011	2012	2013
<i>(SAT millions)</i>					
Taxes on Income	75.3	76.3	80.4	84.5	70.7
PAYE Tax	42.7	45	46.2	52.8	37.5
Company Tax	32.6	31.3	34.2	31.7	33.2
Taxes on Goods and Services	207.9	207.8	222.5	210.8	218.2
VAGST	124.2	116.9	123.5	121.6	159.1
Petroleum Levy	2.7	6.7	5.5	1.6	1.3
Import Excise	38.3	40.8	43.3	43.5	31.4
Domestic Excise	42.7	43.3	50.3	44.1	26.4
Taxes on Trade	36.6	35.8	38.1	35	35.3
Other Taxes	4.9	4.9	5	4.7	11
Total Tax Revenue	324.7	324.8	346	335	335.2
<i>(Percent of Total Tax Revenue)</i>					
Taxes on Income	23	23	23	25	21
Taxes on Goods and Services	64	64	64	63	65
Taxes on Trade	11	11	11	10	11
Other Taxes	2	2	1	1	3
Total Tax Revenue	100	100	100	100	100
<i>(Percent of GDP)</i>					
Taxes on Income	5	5	5	5	4
Taxes on Goods and Services	15	14	15	14	14
Taxes on Trade	3	2	3	2	2
Other Taxes	0	0	0	0	1
Total Tax Revenue	23	22	23	21	21
Nominal GDP (SAT millions)	1426	1452	1514	1559	1603

Source: Ministry of Finance, IMF

⁹¹ IMF, Samoa: Revenue Policy and Administration Review, *ibid*

⁹² Table reproduced from IMF, Samoa: Revenue Policy and Administration Review, *ibid*.

Some features of this revenue profile include:

- Total tax revenue has remained fairly static, both in absolute terms and as a percentage of GDP (2009 collections were affected by the tsunami and 2013 collected were impacted by cyclone Evan).
- Samoa's tax-to-GDP ratio is close to mid-range of small island states in the Pacific.
- Samoa relies significantly on exercise taxes – in recent years excise taxes have exceeded income tax collections.

Tax administration

Proposed institutional strengthening

In 2006, the Samoan Cabinet Development Committee approved an Institutional Strengthening Project to modernise the Inland Revenue Services (IRS) of the Ministry of Revenue. In 2007, DFAT provided funding for Institutional and Situation Analysis for the IRS and a detailed design study was undertaken in 2008. The analysis identified 10 key strategic areas of reform that were critical for improving tax administration in Samoa and noted that the recommended changes were a significant departure from the systems and processes then in use in the IRS.

The design study jointly undertaken by DFAT and the Government of Samoa confirmed the following problems:

- Insufficient revenue collection: a wide spread perception within the Government of Samoa that improved administration of IRS should make a significant contribution to total tax revenue through improved compliance and reduced arrears of taxes payable.
- Poor service to tax payers as 'clients': complaints concerning inefficiency, bias and lack of transparency in IRS systems and procedures.
- Poor or non-existent linkages between IRS tax administration and tax policy formulation, and between related administrative and/or data processing systems.

DFAT was interested in funding the Institutional Strengthening Project project. However, the Government of Samoa did not approve the design. Amongst other issues, the Government viewed the proposed IT design, at an expected cost of \$12 million, as too expensive for Samoa's needs and requiring too high a proportion of expenditure on overseas experts. The IMF financed technical support to prepare the required draft legislative amendments. Those amendments would have amended the Income Tax Act and Income Tax Administration Act to:

- introduce a presumptive tax for small business
- introduce self-assessment
- make changes to numerous administrative arrangements.

However, the proposed amendments had not been subject to consultation with the tax-paying community and no preparation had been done to modify systems and procedures to

implement the changes.⁹³ The Government determined that there would be a need to take the proposed changes to the legislation through consultations and prepare the IRS for the changes.

In October 2010 the Ministry for Revenue embarked on an Institutional Strengthening Project. This programme drew from the 2008 review, but reduced the scope of the project and structured the work into several phases. Phase one focused on five core components, shown in table 2.

Table 7 Institutional Strengthening Project Core Components

Component		
Component 1	Operating model	A strengthened policy, advising, legislative and institutional foundation
Component 2	Staff development	Improved motivation, ethical standards, gender awareness, knowledge skills and client service ethos amongst staff
Component 3	Business process improvement	Reform tax operations to ensure effective integrated outcomes which produces maximum revenue under the laws at an efficient cost to both IRS and taxpayers
Component 4	Investment in IT	Selective, effective, and cost efficient use of information and communications technology to improve staff productivity, service to taxpayers and sustainability of the ICT infrastructure
Component 5	Program management	Effective program management monitoring and reporting with skills transfer to the Ministry of Revenue

Source: IMF, Revenue Policy and Administration Review, March 2013

The Ministry also proceeded to modernised two core components of tax legislation, reflected in the new Income Tax Act 2012 and the Tax Administration Act 2012; these were advanced as ‘technical’ changes without material policy change. The technical advisor providing legislation drafting support was provided with Samoan legislative drafting conventions to

⁹³ Project Identification Brief for Stage 1 of Institutional Strengthening of the Ministry for Revenue under the PFM Reform Plan.

ensure the draft legislation fitted with the style and format for modern legislation in Samoa. The proposal to introduce a presumptive tax for small business, which had been included in the draft IMF advice, were deferred for further consideration after the phase one changes had been completed.

This phase one of the ISP was funded through the Public Sector Improvement Facility (PSIF). The PSIF was established in 2005, with the goal of improving the efficiency and effectiveness of the country's Public Service to support national development. A total of 35 projects were funded by the facility.⁹⁴ A total of SAT \$3.6 million was provided for the two year phase one programme for technical support and IT development, with the Ministry of Revenue contributing counterpart staff (that is, all of the deliverables for phase one, including the upgraded IT systems, would be delivered for about 1/3rd of the costs initial proposed for the IT upgrade alone).

A second phase of capacity building was planned to follow phase one. The Ministry proposed to undertake the reforms in stages so as to develop improved competence in basic systems before moving to higher level reforms.⁹⁵ With the end of the PSIF, funding for stage two and subsequent stages would need to be appropriated on an annual budget cycle. At the time of the study, the Ministry considered that the Government was likely to fund further development in 2014, given the success of phase one.

Ministry has led the institutional strengthening

An important attribute of the recent taxation reforms in Samoa, is that the institutional strengthening programme has been led by the Ministry of Revenue. A recent IMF / PFTAC mission reviewed the Ministry's performance and commented:⁹⁶

the mission commends the leadership shown by Chief Executive Officer (CEO), Deputy Chief Executive Officer (DCEO) and Project Manager in bringing about change and is of the view that the successes would have been far less, if not for the commitment to change that these officers have brought to the organisation. It is also apparent that IRS staff have embraced the new organizational values and the manner in which they conduct their business activities appears to be a reflection of their belief in the fundamental principles of taxpayer service and risk management. These organizational values were not apparent when the 2007 Situation Analysis was carried out.

The Ministry maintains a good relationship with PFTAC and draws on PFTAC for advice on tax policy matters, such as the recent reviews of VAGST and small business taxation.⁹⁷ The Ministry also seeks advice from PFTAC, and utilises PFTAC's networks, to gain access to experts for specific tasks, such as legislative drafting and IT strategy.

Phase one of the ISP has seen the Ministry develop and implement a comprehensive range of key strategies and policies that accord with international practices. These strategies and policies have been linked to a range of business activities, and new management reports

⁹⁴ End-of-Program Review of Samoa's Public Sector Improvement Facility (PSIF), April 2013, Shead.

⁹⁵ Project Identification Brief for Stage 1, op cit.

⁹⁶ IMF, Samoa: Revenue Policy and Administration Review, ibid, page 24.

⁹⁷ IMF, PFTAC, Samoa Small Business Taxation and VAGST Law, Motteram, 2013.

require monthly reporting against the key performance indicators for these activities. The strategies were developed with extensive staff consultation and, as a result, there is a strong sense of IRS ownership and engagement.

In developing the strategies and policies, the Ministry drew on the expertise provided by NZIRD, with about 12 short-term visits. NZIRD senior staff, who are specialists in their field, acted as short-term consultants working alongside the Ministry staff to assist them develop and implement the new strategies and policies. The costs of the NZIRD support were met by the Samoan Ministry of Finance out of its PSIF funding, and the Ministry identified the skills and expertise it needed to supplement its internal work programme.

The arrangements with the NZIRD appear to have developed out of the personal relationships between individuals (we understand that there is no formal agreement between MFAT and NZIRD to provide support for Samoa, as is the case with the Solomon Islands IRD).

Some of the changes achieved by the Ministry include:

- A detailed Corporate Plan drawing on recent developments in international tax administration, particularly in the area of relationship building with taxpayers to promote voluntary compliance and includes a customer charter and corporate values. The Ministry identifies its strategic direction for 2011 – 2016 in a document titled “Our Future”. Both the Corporate Plan and Our Future have strong customer service focus and set out a significant directional change from what was apparent in 2007.
- A Compliance Improvement Plan (2012 – 2014), identifying a compliance approach that is consistent with all developed tax administrations. It is based on promoting voluntary compliance and making it easier for taxpayers to comply through service help and education but also recognizes that there will be occasions when it is necessary to use the full range of enforcement activities to ensure that those who choose not to comply do meet their tax obligations. The Compliance Improvement Plan identifies the Ministry’s top priority compliance risks together with a schedule of agreed actions to mitigate the risks, activity completion dates and the persons who are accountable for activities. The Ministry has established a Compliance Advisory Committee (CAC), to provide governance over the multi-year improvement plan.
- A new Inland Revenue Service performance monitoring system, introduced as an aspect of strengthened Corporate Governance, during the ISP requires that activities and key performance indicators are monitored monthly in senior management team meetings.
- An Organizational Risk Management Framework for 2011 – 2013 using the key benchmark framework and methodology in Australian and New Zealand - AS NZ 4360 Risk Management Standard. This standard and methodology is utilized by many tax administrators including Australia and New Zealand and is recommended by Organisation for Economic Development (OECD).
- The Ministry has implemented a modern functional structure based around market segments; the three functional Divisions of IRS are Taxpayer Services, Audit and Investigations and Collections and Enforcement. The Ministry did not implement a separate Large Taxpayer Unit as recommended and designed by PFTAC (because this would have involved duplication of scarce resources), rather within each Division staff have responsibilities for either Large Enterprises (LE), Small/Medium Enterprises or

Specials (but are also available to respond to demands within other categories of tax payer).

- An upgraded Revenue Management System (RMS 7) was implemented in 2011. The Ministry was previously operating the 1997 version of the Revenue Management System (RMS) but the data had become corrupted to the point where the system was largely ineffective. The registration data base was never cleansed to remove taxpayers who no longer operated a business and significant keying errors and omissions had resulted in the manual accounting records being more accurate than the RMS record.
- The Ministry has made considerable efforts to improve voluntary compliance through public information seminars. In 2012/2013, about 1100 people attended Ministry seminars, which is impressive in the context of a taxpayer base that may be in the region of 2,500 to 3,000.

A recent review by PFTAC of the operational effectiveness of the Ministry concluded:⁹⁸

MfR has carried out a number of reforms during the ISP to improve its operational effectiveness. Taxpayer Services Division (TS) has introduced a stronger client focus with a range of proactive service initiatives. Collection and Enforcement Division (C&E) has been strengthened with new collection strategies, mapping of job processes and development of decision trees. New collection tools such as arrangement calculators have been developed together with new service initiatives have been implemented to make it easier to comply. In addition, the Audit and Investigation Division (A&I) processes have been strengthened. Specialist audit advice has been provided to assist in delivery of the CIP. Audit risk criteria have been developed and case selection is now entirely risk based. Specialist audit training has been delivered to increase staff competency.

The review concluded that the “IRS is now on the path to being a leader in tax administration in the Pacific but the mission notes that two years is a very short time in which to make sustainable institutional change.”

Some major issues remain

The Ministry recognizes that it is only part way through its reform programme. Some areas it seeks to improve in the next phases include:

- IRS has limited confidence in the accuracy of its data base and can only estimate the number of taxpayers who may have tax obligations.
- Following implementation of RMS 7, the Ministry has established a task force to cleanse taxpayer account and registration data, a process that is proving to be lengthy and time consuming.
- In the absence of reliable taxpayer registration data, IRS has not been able to accurately determine how many taxpayers are expected to file an annual income tax return and bi monthly VAGST return. On some estimates, the number of taxpayers who filed a 2011 income tax return may be less than 25 percent of those who appear to have an obligation to do so, and the number of tax payers who filed VAGST and PAYE returns appears to be less than 50 percent of those who had an obligation to do so.

⁹⁸ IMF, Samoa: Revenue Policy and Administration Review, *ibid*, page 30.

- Collection and enforcement remain work in progress – at the time of the evaluation, there was no evidence of any recent prosecution for debt or failure to file a return.
- It is also apparent from audit records that almost all audit cases identify instances of taxpayer, either because of carelessness or deliberate evasion. This is likely an indicator that the level of taxpayer compliance is still low and that more community work is necessary (rather than just good case selection).
- The introduction of the RMS 7, poor data, and lack of collection on debts, means the IRS has a significant problem with outstanding debt. The Tax Administration Act 2012 absolves debt applicable to tax years ending prior to 1 January 2006. After absolving this debt, the debt to tax revenue ratio will remain around 30 percent, which is high relative to developed taxation regimes (the ratio in Australia and New Zealand, for instance, is about 5 per cent to 8 per cent).
- The current legal rules for penalties are not appropriate, and include a drafting error. The Inland Revenue Division acknowledges that the penalty regime is not appropriate and routinely remits a large portion of the penalty. However, the continued imposition of penalties distorts the outstanding tax debt and creates reverse work flows.

The IMF/PFTAC review observed that notwithstanding the good work carried out by the Ministry, it is apparent that the task of changing community behaviour to one of being voluntarily compliant has not yet been completely successful. The reviewers also considered that the community perceives IRS as an organisation that does not strictly require all taxpayers to comply with their obligations, and that the penalties regime continues to be a major impediment to effective administration and a source of frustration amongst the community.

Summary of outcomes indicators

In summary, our findings with regards outcomes are:

- Samoa's tax structure generally accords with principles for good tax design. However, Samoa is only in the early stages of addressing a decade long back log of policy repairs and maintenance and modernizing its tax laws; it needs to address this back log while making progress on 'new' policy considerations around broadening the tax base by removing exemptions, considering the tax treatment of small business, international tax, and natural resources taxes; the Ministry of Revenue has yet to build in-house capability for diagnosing, prioritizing and implementing tax policy changes.
- Samoa has achieved substantial improvements administrative practice in recent years, consistent with international good practice and its successes are considerable. It is also apparent that IRS staff have embraced the new organizational values and the manner in which they conduct their business activities appears to be a reflection of their belief in the fundamental principles of taxpayer service and risk management.
- Samoa is increasingly been seen as an administrative reform success. Assessed against the PFTAC baseline assessment, Samoa has shown considerable improvement in the two years to 2012 and further successes were achieved in 2013.
- The task of changing community behaviour to one of being voluntarily compliant has not yet been completely successful, though considerable efforts are being made to consult and communicate with tax payers.

Reflections on the process of reform

In recent years, the Samoan Ministry of Revenue has embarked on a staged programme to systematically improve the administration of the Samoan tax system. Its approach involves progressively building up the administrative and private sector infrastructure that makes a tax system work and to develop the capability to adapt the system over time to meet the changing demands of the society within which it operates. The Ministry is only two to three years into this programme of reform and has achieved substantial progress, though two years is insufficient time to form definitive views about the sustainability of the reforms. However, the manner in which IRS staff have embraced the new organizational values and the way in which they conduct their business activities promises further ongoing improvements.

The approach adopted by Samoa could not yet be categorised as a systematic approach to taxation reform – policy developed is separated from tax administration and the Ministry of Revenue has not yet developed the capability to undertake a systematic approach with respect to technical/remedial tax measures as evident from its difficulties with penalties and debt.

Direct support by donors for taxation reform has to date been largely project; in the 1990s, donors supported legislative reform of the tax system (e.g., introducing VAGST and lowering income and trade taxes); in the mid 2007s donors supported the design of an institutional strengthening programme, and also supported the drafting of specific legislative reforms (these programmes were not adopted at the time by the Samoan government). PFTAC has continued to provide support in terms of meeting specific requests for policy advice and assistance.

The more systematic approach adopted by the Ministry of Revenue to administrative reform was made possible by monetary support from donors contributing to a Public Sector Improvement Facility, rather than by donors directly supporting taxation reform. Considerable assistance has been provided by the NZIRD, at the request and funding of the Samoan Ministry of Revenue. To the extent that the assistance provided by the NZIRD and PFTAC forms part of a systematic approach to reform, the agenda and design for that approach is being driven by the Ministry, not by donors.

When viewed on a project by project basis, the process adopted by donors has generally been in line with good international practice:

- Donors have invested in projects with clear objectives; the policy changes in the 1990s aligned with the standard ‘package’ of a broad base VAT and income tax with reduced trade taxes. The objectives for the Institutional Strengthening Project were clearly articulated and in accord with modern tax administration practice.
- Expectations as to outcomes have generally been realistic. There are examples of the Ministry reaching different conclusions in terms of implementation based on its assessment of the local context. An example is the Large Tax Payer Unit as recommended and designed by PFTAC, where the Ministry accepted the need to focus on large tax payers, but integrated this advice into staff responsibilities with each division rather than establish a separate unit because of limited staff resources.
- Projects have generally followed an appropriate, evidence-based diagnostic analysis of host country circumstances. There are examples of healthy disagreement on the outcomes of this diagnostic analysis. The Samoan government, for instance, did not

accept the DFAT study's recommendations on IT strategy, though it accepted the problems identified by the study and the need to implement a solution. External reviewers also face severe limitations in consulting beyond the Ministry and a few individuals in the private sector; Samoa has an oral traditional and consultation involves meeting and discussion rather than an invitation to make a submission as may be undertaken in a policy development process in New Zealand or Australia.

- Projects that proceeded were agreed and owned by Samoa, rather than being imposed on it.
- The Samoan Ministry of Revenue has established effective working relationships with PFTAC and the NZIRD, and is building relationships with other tax ministries in the Pacific, some of whom share the same IT platform.

Lessons to be learned from Samoa

Reflecting on Samoa's experience, several lessons can be learned.

- Successful tax reform requires both good tax policy and good administration. Tax reform is a mix of policy and administrative change processes. Achieving legislative change consistent with good tax design (as occurred in Samoa in the 1990s) is not sufficient to achieve a good tax system.
- Tax administrations undertaking reform are likely to need important support for the doing the basics right (registering, advising and auditing) on an ongoing basis. If the basics of tax administration are not carried out well, that will ultimately undermine the wider reform programme.
- There is no single path to taxation reform. Textbooks describe ideal reform processes of agenda setting, policy options, implementation, and review and improvements; real world reforms require a combination of policy and administrative reform but the ordering can vary and reform can still be successful. If policy changes precede administrative capability, as occurred in Samoa, the host country and donors should recognise the fragility of the end result and thus the need to provide buttressing support for the reforms once put in place and the need for further administrative change for policy reform to achieve its potential.
- A key challenge of taxation reform is to implement changes in practice and behaviour, and not just in legislative rules. No tax reform will take root unless it changes modes of behaviour and this is seldom achieved by simple legislative change. This means that well after the laws are put into effect (in the case of Samoa, a decade later) sustained effort is required to bring about behavioural change.
- Many tax issues are common across jurisdictions (including New Zealand and Australia), though they vary in scale and capacity of tax administration and taxpayers. These commonalities of good tax administration strategy and policies means the NZIRD advisers have played an important role in assisting with skills and knowledge transfer. The relationship between the NZIRD and the Samoan Ministry of Revenue and other networks are important sources of support for taxation reform in the Pacific.
- The commonality of many tax issues suggests that there is potential for regional capacity building; the Samoan Ministry is sharing its experiences with other revenue ministries, especially on IT strategy, but there is not yet a systematic approach to regional capacity building.

- Not all skills and experiences are readily transportable; systems or policy designs developed with larger economies (and hence organisations) in mind may not be suitable for local needs, as evident in the initial donor funded IT strategy and Large Tax Payer Unit designs not being adopted by the Samoan government.
- Attention to the technical aspects of the tax system, especially the laws and procedures relating to tax payments and penalties, reduce business compliance costs and risk as well as lower private sector frustrations with the tax administration increasing the likelihood of private sector support for wider reform. Such changes are also likely to reduce the resource cost of the tax administration in dealing with rules that are in practice unworkable or difficult to work with.
- Technical reforms and ongoing repairs and maintenance to the tax system require their own specific range of skills; it requires a detailed understanding of existing tax codes, and an ongoing conversation with Ministers as to what can be achieved and with taxpayers as to what would be broadly supported. It is thus likely that a technical reform programme along these lines would require donor support (but has not typically been supported in Samoa or elsewhere).
- In recent years, the Samoan Ministry of Revenue has embarked on a staged programme to systematically improve the Samoan tax system. Its approach involves progressively building up the administrative and private sector infrastructure that makes a tax system work and to develop the capability to adapt the system over time to meet the changing demands of the society within which it operates. This systematic approach adopted by the Ministry of Revenue was made possible by monetary support from donors contributing to a Public Sector Improvement Facility, rather than by donors directly supporting taxation reform. The approach by the Ministry contrasts to some extent with the more project based support previously provided by donors. It is not clear whether the staged, but sweeping, programme of reform could have proceeded without the surety of medium to long term funding provided by PSIF.
- PFTAC provides valuable assistance in tax reform in Samoa (as elsewhere in the Pacific). Its strength appears to be in agenda setting (including diagnostic assessments) and the requirements of administration reform. However, there seem to be some notable gaps in assistance packages previously provided to Samoa directly for taxation reform. These gaps were mainly in pathway management. Prior to the most recent reforms, there seemed to be gaps in expertise needed to manage the pathway of reform (dialogue management) and few senior policy advisers who can work with Ministers to identify and support achievable changes within changing political constraints (the political interface). These gaps become more critical the longer and the more complex the pathway. Hence, the Institutional Strengthening Project funded by DFAT in 2007 – 2008 identified many of the changes needed but not how to manage the process of reform.
- The Chief Executive and Deputy Chief Executive at the Ministry of Revenue have led the recent reforms and worked at ensuring commitment to change across the organisations and support for the changes externally. These officers were supported by a long term Project Manager who brought to the Samoan Ministry established networks within the NZIRD, and an ability to build relationships with PFTAC and other networks for expert advisers. These networks have provided the Ministry with the ability to identify senior staff within NZIRD, and other experts, who could provide expertise and experience in key areas, on short term contracts, to fill knowledge gaps in

the ongoing reform programme. It is not clear how this pathway management could have been achieved under project based donor support.

- Capacity building within the tax administration is important, but there are limits to capacity building potential. The reform programme in Samoa remains vulnerable to key person risk. Overcoming key person risk is likely to require a more systematic support by donors to taxation reform in order to establish and support the environment required for sustainable reform.

Solomon Islands case study

The country case studies are intended to highlight experiences or lessons that we understand to be common across the many Pacific countries that have attempted taxation reform. These experiences or lessons would help answer the central question of the evaluation: has donor funded intervention provided for effective policy dialogue at each stage of reform and what were the sustained consequences for the objectives of the reform?

The experience of Solomon Islands over the relevant period, 2002 to 2012, differs from the other three case studies in that tax reform has not been attempted in the Solomon Islands, if tax reform is interpreted to mean bringing about sustainable improvements in institutional capacity and in tax policies and administration, consistent with international good practice. Rather, the reforms in Solomon Islands had a more limited focus of stabilising Solomon Islands IRD (IRD) and increasing revenue (2003 to 2008) and “strengthen the core and build on the work done to date” (2009 to 2013). That is, the reforms in Solomon Islands have been comparatively narrowly focused on institution building and increasing revenue from existing policy settings. A number of the outcome indicators and other parameters used in the other three case studies have limited application in Solomon Islands; for instance the reforms were never intended to improve the economic efficiency of the tax system or improve the coherence of the tax system.

It should also be borne in mind that the starting point for Solomon Islands was behind that of most other Pacific countries in terms of taxation reform. Whereas, as examples, Samoa and Tonga had significant tax policy improvements to make and out-dated administrations that needed to be modernised, Solomon Islands had a tax administration that was not just out-dated but dysfunctional. Understandably, priority has always been given in Solomon Islands first to building the very basics of a functioning tax system, something other countries already had and could build upon. The success of donor funded initiatives in Solomon Islands should be measured against this lower initial benchmark.

Background to the reform

RAMSI, IRD, and New Zealand

The Regional Assistance Mission to Solomon Islands (RAMSI) is a partnership between the people and Government of Solomon Islands and fifteen countries of the Pacific. RAMSI arrived in Solomon Islands in July 2003 at the request of Solomon Islands Government.

RAMSI has provided assistance to the Solomon Islands Inland Revenue Division (IRD) since 2003 as part of its Financial Management Strengthening Program. This programme is aimed at strengthening the core functions of the Ministry of Finance and Treasury. In November 2005, the New Zealand Aid Programme complemented this support by providing New Zealand public servants - staff from the New Zealand Inland Revenue Department (NZIRD) – to fill the role of Deputy Commissioner in 2006 and 2007. From 2008, the position of Commissioner has been filled by an officer on secondment from NZIRD. NZIRD have also provided officers to fill other technical and advisory positions at the IRD, with the programme at the time of the evaluation providing for five secondees and two advisers.

The direct involvement of NZAID and NZIRD re-established a relationship which has seen New Zealand provide assistance to the Solomon Islands IRD on a regular basis throughout the 1980s and 1990s. The work and support offered by the then titled New Zealand Official

Aid Agency proved not to be sustained over time, as evident from the position of the IRD in 2003.

For the first period through to 2008, the New Zealand Aid Programme obtained approval for a maximum commitment of \$2.3 million. In October 2008, the New Zealand Aid Programme obtained approval for a commitment of \$13 million to fund a five year medium-term Programme of Assistance for the Solomon Islands IRD. In approving this commitment, the New Zealand Prime Minister, the Rt Hon Helen Clark (as acting Minister for Foreign Affairs) noted:⁹⁹

I've approved this, but really do need to know that the emphasis is on upskilling SI personnel, rather than maintaining dependence on foreign advisers.

In 2009, Ministerial approval was obtained to increase the commitment to \$13.5 million over 5 years to 2013.¹⁰⁰ The submission noted that:¹⁰¹

An improved taxation system is critical for the Solomon Islands economy. A transparent, efficient and business friendly tax regime is essential for private sector development. Stabilising and maximising revenue is essential for the Solomon Islands Government's ongoing fiscal viability.

And that:

The aim of the programme is to strengthen the core capability of the SI-IRD so that it is able to operate effectively to protect the revenue base and increase tax compliance.

Officials advised the Minister of Foreign Affairs that the funding was to be used primarily to cover costs for seven technical positions working in the areas of the executive (Tax Commissioner), compliance, audit, policy, accounts and human resources. Funding would also cover professional development for SI staff and IT/financial systems. Officials added that “over the five years, costs of staff and training will increasingly be met by SIG; and funding will reduce to reflect growing SIG capacity.”

The Memorandums of Understanding entered into between NZAID and DFAT and between NZAID and NZIRD describe the aims and objectives of the support from 2009 to 2013 in the following terms:

The Programme is designed as a follow through from the first RAMSI Programme of assistance, the overarching themes of which were to stabilise the organisation and to increase the revenue base. The overarching themes of this design for the next 3 – 5 years are to strengthen the core and to build on the work done to date. It is envisaged that further support over a longer term horizon will still be needed.

⁹⁹ Hand written annotation by the Prime Minister, to Approval for expanded support to Solomon Islands Inland Revenue Division, Ministry of Finance and Treasury, AID/SLB/GG/3, 3 October 2008.

¹⁰⁰ Continuation of support to the Solomon Island Inland Revenue Department, AID/SLB/GG/3, 31 March 2009.

¹⁰¹ Ibid, Key points.

The papers governing the programme do not give prominence to the role of the tax system in establishing a functioning relationship between governments and tax paying citizenry, or the importance of the tax system to economic activity or its impacts on income and wealth distribution, etc. The focus of the support is on strengthening the IRD as an organisation and on raising revenue.

IRD in 2003

Some understanding of the starting position for the reforms helps explain the focus on administrative changes in the Solomon Islands IRD. Design documents for the programme of assistance for the Solomon Islands IRD describe the situation in 2003. The following text box contains an edited (for length) summary of the description found in the design documents for the medium term programme of assistance for Solomon Islands IRD.¹⁰²

IRD 2003 – Independent review

The combination of the effects of the Tensions during 1999 to 2003, the related instability with Government and years of neglect meant that the tax system as a ‘system’ was under significant stress. Most processes were no longer functioning or not functioning properly, many others were out of date, unclear, incomplete or missing.

Many staff did not have the skills they needed to do their entire job, were inexperienced or for various reasons disengaged. Resourcing levels were too low and staff felt underpaid and lacking support. There was little investment in the up-skilling of managers, nor coaching or growing of leaders.

The Division had no strategic plan, nor was there a clearly established view of how the tax system fitted into the economic plans of Government, or should evolve over time. There was little or no reporting on Divisional performance, nor management information on which to plan or forecast.

IRD was inward looking, unresponsive, and not well regarded by the business community. Compliance levels were extremely low, practical support for the business community non-existent, and processes were designed around what was best for the Division, without any regard to the compliance cost or impacts on the public. There was no engagement on design, and proactive service did not feature in delivery, while reactive services were slow and disjointed. Audit activity was minimal.

There was no effective management of taxpayer accounts. There were no processes to ensure payments and assessments were posted to the ledger, no follow up on outstanding returns or on the non-payment of accounts. Ledger cards and taxpayer files frequently went missing resulting in taxes not being assessed or collected.

Refund issuing was poorly controlled. Duplicate refunds were common, the time taken to supply refunds was measured in years and the non-management of the annual refund appropriation meant the Division was unable to refund overpayments by business, leading to a culture of non-payment by businesses which preferred to wait until IRD demanded

¹⁰² Design of a medium term program of assistance for Solomon Islands Inland Revenue Division, Jane Wright, Consultant for DFAT and Michael Hewetson, Design Manager, NZ IRD (and former Acting Deputy Commission and Commission of IRD, Solomon Islands), January 2009.

payment than risk using the provision tax system and being unable to obtain a refund for overpayment.

As a senior advisor commented to us:

Returns, assessments, payments and debt were never reconciled. From a tax administrator's point of view, there was nothing to go on.

A lack of effective decision making processes and retention of discretion at senior levels and by successive Ministers without defined processes or transparency, created a culture where granting of concessions became 'endemic'. Tax holidays, MOU's and exemptions for goods tax, stamp duty and income tax were widespread. Relief from taxation was granted with little regard to the cost to the country that would arise from the revenue forgone. These processes continued through until early 2006.¹⁰³

The extent of the culture change that was required with the organisation is perhaps indicated by the disciplinary and code of conduct issues addressed in the period 2005 to 2008, the most significant of which included:¹⁰⁴

- The suspension of the former Commissioner who was charged with more than 80 counts of fraud involving improper granting of exemptions.
- Four staff suspended over a fire inside the IRD building which threatened to destroy the MOFT building.
- Four staff suspended in 2007 in relation to an incident which resulted in \$1.6 million of Government revenue paid into IRD disappearing, including over \$60,000 in cash.
- One former staff member who has been charged over the improper granting of exemptions.

In addition to poor processes and systems, the working conditions for staff were difficult. Review teams noted extremely hot offices due to broken air conditioners, broken toilets, lack of running water, broken office furniture and filing cabinets, crowded conditions, rat infestations, long electrical cords crossing areas where people worked, etc.¹⁰⁵

There are suggestions in the programme documents that some attempts to rectify the problems had had unintended consequences:¹⁰⁶

In addition to the effect of the tensions and instability within government, IRD has also been affected by a change to organisational structure imposed following a Pacific Financial Technical Assistance Centre (PFTAC) recommendation to make the IRD more customer – oriented. An unfortunate outcome of this well-intended proposal was a loss of confidence and great confusion in roles which diminished rather than enhanced internal capacity.

¹⁰³ Ibid, page 11.

¹⁰⁴ Ibid, pages 15 -16.

¹⁰⁵ Ibid, page 16.

¹⁰⁶ Solomon Islands Inland Revenue Division, Design of a medium term programme of assistance; Aide Memoir; Report on first trip to the Solomon Islands, June 2008.

Summary of achievements

All reviews of IRD made available to us, and our interviews with current and former IRD staff, all pointed to significant improvements in IRD as an organisation. NZIRD, in a report to their Minister in May 2012, summarised the achievements as follows:¹⁰⁷

- Significantly enhanced revenue collection, from \$365.5 million in 2005 (before New Zealand involvement) to \$1.337 billion collected in 2011, and a predicted collection of \$1.7 billion in 2012 (a fourfold increase)
- more involvement of local staff in providing tax policy advice
- demonstrated improvements in local staff managing aspects of the administration independently
- levels of compliance in all the tax types improved from the 30% estimated by PFTAC in 2008
- major successes in auditing, including the first conviction and imprisonment of a prominent businessman for tax evasion, and increases in the amount of tax assessed as a result of audit activity from \$11.2 million in 2006 to \$191 million in 2011.
- improved resources for technical decision-making, and
- a more strategic focus in leadership

One of the more significant achievements has been in instituting more transparency and control around the management of tax exemptions, resulting in an annual decline in the number and value of tax exemptions granted. The ad hoc granting of tax exemptions by Ministers (and it seems IRD staff) had bedevilled the tax system raising concerns about corruption and undermining the integrity and coherence of the overall tax system. As noted above, the fraudulent granting of such concessions resulted in the then Commissioner being charged with fraud. In this context it does not seem unreasonable that DFAT advocated the removal of all such exemptions. However, the ability to provide exemptions in this manner was embedded in the socio-political system.

Rather than attempting, probably unsuccessfully, to repeal the ability to grant exemptions, a more subtle approach was adopted over a number of years. First, the granting of exemptions was required to be made public along with the revenue loss involved. Then the granting of exemptions was moved to a formalised public service committee. From 2013, Ministers have retained the ability to recommend exemptions, but they must be approved by the public service committee which they cannot overrule but if there is a negative response they can refer the matter back to the committee. While the final stage of this reform process is new, we were informed that the number and value of tax exemptions has considerably reduced.

While this has not removed the exemption system (which would be the theoretical ideal), it has made it less capricious, more transparent and less open to fraud. It is an example of demonstrating flexibility in the reform process, taking into account the location specific circumstances but achieving the main policy objective – the enhanced integrity and

¹⁰⁷ New Zealand Government Programme of Assistance to Solomon Islands' Inland Revenue Division, 21 May 2012

coherence of the tax system and reducing the opportunities for fraud. It is nevertheless noted that the process took a number of years of consistent effort to put into place.

The improvements made by the IRD were recognised by IMF/PFTAC Award for Achievement in Tax Administration for 2011.

We were informed in interviews with senior staff at the IRD that there is widespread acknowledgement of the success of the support New Zealand has provided to Solomon Islands IRD. A success factor in Solomon Islands is that the reform programmes in terms of tax modernisation does seem to be domestically “owned” and supported by the host government. There seemed to be general support for the achievements to date and for the staffing of the IRD by expatriates. A senior adviser observed:

The SI Prime Minister singled out as exemplary, IRD’s capability development at the meeting between Cabinet Ministers and Officials from New Zealand and Solomon Islands.

The lack of structural policy reform does in fact reflect domestic ownership of the reform process since donors have on many occasions promoted such reforms but they have been rejected by Solomon Islands. However, it seems there have been occasions where donors have used the imbalance of power to advance key policy priorities of the donor by making the release of funding for budget support conditional on (amongst other things) progress with specially identified reform being progressed (in Solomon Islands, this occurred with the new rules for decisions on tax exemptions). While this may be done for the best of intentions, it is a blunt tool and effective only for clearly defined and uncontroversial (among donor supporters and technical advisers) reforms, such as closing the worst of explicit leakages from corruption. In other cases it can lead to the legitimate priorities of the host country being relegated even though the host country priorities better reflect the specific circumstances and constraints of the country.

The NZIRD reported to its Minister in 2012 that:¹⁰⁸

Strengthening Inland Revenue’s administration involved embedding processes and systems that were developed before 2009. These enabled Inland Revenue staff to manage the systems and processes independently, and to continue to improve revenue collections and reduce tax evasion. Most importantly, strengthening Inland Revenue’s administration involved developing leaders who create, share and lead a vision for Inland Revenue, and ensuring that staff see how what they do is aligned with that vision.

These comments were echoed in interviews with a NZIRD executive who had been involved in the support for the Solomon Islands IRD over much of the past decade. He commented, after a visit mid – 2012:

During my two days in the office I met with all five NZ Advisors as well as the IRD Deputy Commissioner and the three Assistant Commissioners. I observed a workforce which was more positive, confident and capable than when I left in early 2008. The professionalism of the staff was noticeably higher and I observed a significant lift in morale and examples of new capability and skill.

¹⁰⁸ New Zealand Government Programme of Assistance to Solomon Islands’ Inland Revenue Division, *ibid*

The NZIRD report emphasises that from 2008, the assistance programme has focused on leadership and management, to ensure changes will be sustainable over time with less reliance on advisor intervention. Officials advised the Minister that:

the assistance programme strengthened Inland Revenue's existing administration, and resisted large-scale legislative reforms that the administration and taxpayers would struggle to implement and maintain.

Other viewers, while recognising the institutional gains, have been more guarded in comments about capacity building. The SIG-RAMSI Financial and Economic Management Strengthening Program, March Quarter 2013 Monitoring and Evaluation Report, for instance comments in relation to capacity building:

Advisor support to date has focused more on the doing rather than capacity development.

While acknowledging that advisors are working with Assistant Deputy Commissioners to support them taking more ownership of the work, the review highlighted that:

The new Senior Investigator Adviser is currently working on old investigation cases. Therefore, the majority of his time is utilised on capacity substitution.

At the time of the review, the expectation was that another NZ IRD secondee would be appointed to the position of Commissioner of IRD when the current secondment finishes at the end of 2013. Several parties commented to us that they hoped the next Commissioner may be the last appointment from overseas, and that perhaps by 2016 Solomon Islands might appoint a local ahead of an expat Commissioner taking up the role in 2018.

Building capacity was made more difficult by a 'vacancy freeze' in place over the 12 to 15 months leading up to this evaluation, which resulted in 37% of roles in IRD being unfilled. At the time of the evaluation, the Solomon Islands Government had only very recently given the go-ahead for IRD to recruit to its full establishment of 116 staff.

Much still to be done

All reviews made available to us, and respondents we interviewed, were frank that much more needed to be done, even within the relatively narrow brief of the current engagement:

- Filing and payment compliance is still low. The underground economy remains large, and the non-registration of business is of concern. While Goods Tax revenue has largely increased in line with GDP growth, business tax collected has remained relatively static over the last 3 to 4 years, promoting concern that more needs to be done to address non-compliance, rather than 'managing' those already in the system better.
- The IRD has produced a compliance strategy which received a lot of publicity. Work has commenced or plans are underway to address a number of the tax risks set out in the strategy. This includes addressing the large tax debt book and outstanding tax returns, residential and commercial rentals and target taxi and coach operators which are all major initiatives this year. The Transport Management System which was scheduled to be rolled out late in 2013 would present an opportunity for IRD to improve the data integrity, as well as allowing it to better identify 'business taxpayers' who are outside the system.

- The IRD are working their way through a myriad of data integrity and accuracy issues arising from implementing their Revenue Management System. Part of addressing this is the review of debt cases, many of which stretch back to the early 2000's.
- Concern was expressed to us that revenue loss through the port remains a significant issue for Solomon Islands and without measures to improve the performance of Solomon Islands Customs, gains in IRD will be less effective and will inhibit the ability of Solomon Islands to initiate any future taxation reform.

Other Findings

No significant tax policy reform in the Solomon Islands

Solomon Islands stands out in the Pacific for having substantial donor provided technical assistance but little significant tax policy reform.¹⁰⁹ The tax policy and legislation remains much as it was in 2003. Indeed as one Solomon Islands practitioner put it to us:

There has been no significant change in tax legislation here for the thirty years I have been in practice.

This lack of policy change is not because of a lack of enthusiasm by donors who have most often advocated the PFTAC standard package of a broad-based GST, a more comprehensive income tax with lower rates. For instance, PFTAC in 2008 proposed a set of policy reforms to be implemented in three stages.¹¹⁰ The following table summarises progress against the policy reforms recommended by PFTAC:

Table 8 Progress against PFTAC 2008 proposed policy reforms

PFTAC proposal	Progress ¹¹¹
In the income year commencing January 2009	
Introduce a minimum threshold for business income tax	Not progressed
Apply minimum turnover tax to large companies making a small profit or a loss	Income Tax Act provides for tax at 5% up to minimum of \$20,000. Tax not applied to persons with low profits
Align the income tax rate for resident and non-resident companies	Not progressed

¹⁰⁹ Legislative reforms in the Marshall Island, the Federated States of Micronesia, and Palau have also been less significant than elsewhere in the Pacific.

¹¹⁰ PFTAX Mission to the Solomon Islands Ministry of Finance and Treasury, 25 February – 14 March 2008, Tax Reform Identification and Sequencing Plan, Cotton.

¹¹¹ Interviews with senior executives, IRD.

PFTAC proposal	Progress ¹¹¹
Review Personal Income Tax exemption threshold and rates	Threshold increased from 1 January 2012. No review of rates
Remove exemptions for taxpayers and non-residents benefiting from rate reductions (allow some grandfathering)	Not progressed
In the income year commencing January 2010	
Introduce a presumptive tax for small hard to tax businesses	Not progressed
Rewrite the Income Tax Act with associated changes including depreciation review, bad debts, high risk deductions, corporate profits, limitations on losses carried forward, trusts, partnerships, retirement income	Not progressed
Introduce Self-Assessment	Not progressed
Introduce a Revenue Administration Act, including filing, payments and debt management, penalties, objections and appeals, information exchange, secrecy	RAA drafted, but apparently little consultation. Not progressed
Second review of personal income tax rates	Not progressed
Review withholding tax rates & categories	Not progressed
Remove exemptions for presumptive taxpayers and non-residents benefiting from rate reductions (allow some grandfathering)	Not progressed
In the 2011 income year	
Introduce indirect tax changes (Goods or Sales Tax or VAT)	Not progressed
Introduce specialist regimes for taxing	IMF Mission prepared proposal. Policy

PFTAC proposal	Progress ¹¹¹
natural resources	agreed by Government mid-2011. Awaiting A- Chambers to endorse draft for approval of introduction of Bill
Non-cash benefits tax regime	Not progressed
Reduce remaining tax exemptions and holidays and replace with targeted allowances	Not progressed, but strengthened controls on exemptions legislated for December 2012 and operational from 1 August 2013

While donors have advocated the PFTAC standard package of reforms, there has been little domestic support for such a reform programme at the political or administrative level.

There seems to be a number of reasons for this.

The most often cited to us was capacity constraints. As one interviewee put it:

The Solomons had no infrastructure – administrative or private sector – to implement a VAT. You have to get a garage first.

The garage reference is to an old New Zealand television advertisement for garage doors that pointed out that it was necessary to get a garage before buying one of the doors.

The need for policy reform to have an adequate tax infrastructure is reasonable although it is noted that other Pacific countries have implemented reform, with reasonable success, in tandem with, or even before, strengthening the tax infrastructure. Tonga is an example. It should be accepted that the tax infrastructure challenges in Solomon Islands are higher than elsewhere, but there is no indication in Solomon Islands of a pathway from investment in the tax infrastructure to policy reform.

Another cited reason for lack of policy reform has been political constraints. Taxation reform always requires difficult and complex trade-offs over the sharing of the tax burden within society. Solomon Islands has a fractured political system making management of these trade-offs very difficult. As one interviewee put it:

It is difficult to get any legislation through. Everything requires the personal endorsement of the Prime Minister just to begin the process. The parliamentary process is very slow so that the politicians change and you have to start again.

Unlike Kiribati, Samoa or Tonga, there has been no political champion of tax policy reform. The window of political opportunity to advance tax reform has simply not been present.

This seems of itself to be a reasonable explanation for the lack of reform together with the significant infrastructural challenges. However, it seems that donors, far from assisting in opening the window of opportunity, have in fact inadvertently helped keep it shut.

First, with respect to taxation, the donor focus seems to have been on revenue-raising in an attempt to increase the Solomon Island's self-sufficiency and thus reduce reliance on budgetary support. As one interviewee put it:

RAMSI has always had a set idea. This is increasing revenue raising capacity. VAT was never a goer here because there was no ability to offset reduced post-tax income of the poor by reducing tax revenue. There is no clear tax strategy.

As another put it with respect to policy reform:

There is so much to do here. There are higher priorities than tax policy. The economists' focus is on raising the tax to GDP ratio.

Secondly, donors also seem not to have been consistent in their views of taxation reform nor fully cognisant of local circumstances. An example was provided to us of a donor advocating a land tax for Solomon Islands. A land tax can be very efficient in an economic sense in that once introduced it does not distort decisions. However, it achieves this by redistributing land property rights (the government takes effective fiscal ownership of a proportion of the land). In a country such as Solomon Islands, where land property rights are a highly sensitive political issue, this was never viable.

Significant political constraints and poor tax infrastructure combined with no apparent strategic focus by donors on the efficiency and equity merits of taxation reform seems to leave policy tax reform "off the agenda" in Solomon Islands. As one interviewee put it:

There is no comprehensive package meeting local circumstances that has been sustained over time. We just get advisors who come here for two weeks, recommend a VAT and go home.

One practitioner was of the view that:

New Zealanders are always coming here to impose their tax system on us. They do not stay long and we see them off. We desperately need someone here to drive policy change.

Tax rules that are difficult to work with remain unchanged

Template major tax reform thus is "off the agenda" in Solomon Islands. One can to a large extent attribute this to the difficult political situation. However, other more remedial and technical tax legislation reforms seem to be equally difficult to achieve.

There are a number of aspects of Solomon Islands tax laws that create administrative difficulties and frustrate the private sector.

As with other Pacific countries, the penalty and payment rules seem to produce somewhat ad hoc results that need to be fixed administratively. This ties up scarce administrative resources since key administrative personnel are required to exercise judgment to correct the results of faulty legislation. Such key staff could be better engaged in advancing modernisation of the tax system and building the capacity of local staff but are instead required to spend their energies "fixing things". Private sector support for reform is also alienated because they are never sure that the results of faulty legislation will in fact be fixed – it is discretionary.

The problems created by not being able to remedy known faults with technical aspects of the tax laws was well illustrated by Solomon Islands experience with a donor funded IT project to automate IRD data. We were informed that an IT system was provided by technical

advisors who flew in for a few weeks and presented an IT system. There was little training for local staff on how to operate the new system. Even if it could be made to work, the new IT system simply processed quickly data that the IRD knew was faulty (partly because of problems with the penalty rules). There was no point in having faulty data processed more efficiently. The IT system was switched off and never used.

Another example of faulty technical rules is the plethora of withholding taxes. The Solomon Islands' tax system seems to rely heavily on withholding taxes which can indeed, if well designed, ease tax administration. However, we found a range of such taxes and were informed that it was difficult to determine what rate should be applied. For example there is a significant difference between the rate applying to management advice (35%), contracting (7.5%) and professional services (20%). When you are a professional providing management advice on a contract, what rate should apply? Working this out again absorbs scarce key administrative resources and frustrates the private sector. In addition, the withholding taxes are attempted to be applied broadly, including, for example, residential rentals – an individual renting a dwelling should by law withhold part of the rent and remit it to IRD along with the appropriate tax filings. Commonly, the law is not enforced except with respect to the larger business sector which not surprisingly feels aggrieved that they are the only ones to whom the law is being applied.

We also gained the impression that there is a reluctance to review withholding taxes because any rational reform is likely to result in a reduction in some of the very high rates applied which is likely to have a revenue cost. It seemed to be felt that this would be contrary to the main objective of donors which is to increase revenue raising capacity rather than build a more coherent tax system that is more efficient with low compliance costs for business.

Overlaps between the application of sales tax (imposed at the retail level) and goods tax (imposed on imports) rules was also cited as a problem by the private sector. A recent issue for the private sector was the application of comprehensive taxation of “benefits” (houses, cars, schooling etc.) provided by large business to its expatriate management workforce. While in many countries the comprehensive taxation of this form of remuneration may be appropriate, it is more doubtful in the context of Solomon Islands where businesses at the moment have to import these skills so that the burden of taxation is probably borne mostly by the internationally competitive private sector.

In all our discussions with the private sector it was clear that these issues resulted in considerable frustration and alienation from the tax system. The IRD was aware of the issues but in general considered that their job was too administer the law and reform was the responsibility of other parts of the government such as the Economic Reform Unit. However, those parts of the government, substantially staffed by donor funded expatriates without a tax administration background did not demonstrate any evidence that these types of technical changes to the tax system was an area of priority or interest.

The result seems to be that Solomon Islands is caught between the inability to implement major template reforms but also no priority is given to remedial reforms. The default is doing nothing. In the end, critical tax administration resources that could be used to advance the modernisation programme and up-skill local staff are instead fully engaged in fixing problems arising from faulty legislation. IT systems cannot be made to operate effectively because this would result in more efficiently processing of faulty data. The private sector is frustrated and alienated from the reform process.

An example with the problem with trying to get remedial or technical reforms through the system has been a new Tax Administration Act. This has been work in progress since 2005. It was largely driven by outside advisors, had limited local consultation and received a low priority. It has yet to be implemented.

By contrast, Solomon Islands has implemented a comprehensive rewrite of its Customs Act. This rewrites Solomon Islands Customs procedures and aligns them with upgraded IT systems and the Solomon Islands have also reformed how exercise taxes are levied on alcohol. These reforms proceeded whereas similar necessary income tax remedial measures have not. The reason seems to be that the changes to the Customs Act was seen by donors and the Customs administration as an integral part of the modernisation of the Customs service. The rewrite of the Customs Act was part of a systematic overhaul of all aspects of the Customs Service beginning in 2008 with the automation of processes. Throughout it was supported by donors: ADB, Australian Customs and the Solomon Islands Economic Reform Unit. By contrast there has been no such priority has been given by donors or domestic officials and advisors or systematic approach adopted with respect to technical/remedial income tax measures.

Even if a high priority were to be given to technical/remedial income tax changes, it would seem that the existing assistance provided by donors does not include the skill sets needed to design and implement such a programme. The people needed for this are those who have or can quickly acquire a good grasp of Solomon Islands income tax legislation, and have the experience of working through solutions at the political and administrative interface, as well as having credibility with Solomon Islands private sector to bring them on board. Tax advisors present in Solomon Islands have little or no prior experience working at the Ministerial level or with implementing tax policy changes at the detailed level. As one IRD staff member put it:

What we need is people who know the situation here and who we can work closely with on details so that we can work some complex issues through and bring others on board.

A deficiency of skills at the level of political interface.

The inability to advance technical/remedial improvements to the tax system highlights the deficiency of skills apparent at the level of the political interface.

Although Solomon Islands has had considerable input from external advisors on taxation matters, the skill bases provided have been limited. The focus has been on technical skills: administration, IT, and economic. There has been a paucity of those with experience on pathway management and dealing with the political/technical interface. As one senior advisor noted:

From my experience in the Solomons, although numerous advisors were provided, few of those had ever had any prior experience with dealing with Ministers, with change management, or with implementing significant tax changes. All simply had a background in tax administration and they struggled in an environment where the tax administration lacked what would in most countries be considered the very basics.

The senior advisor noted that although PFTAC is good at agenda setting using its standard package and at providing the framework for administration modernisation:

It [PFTAC] is not there to provide long-term, in depth, on the ground involvement. If you are not in a position to adopt PFTACs standard policy and administrative package, PFTAC is of more limited use.

This, in our view, is to say that PFTAC is focused on a type of assistance, which it does well, but it does not easily meet the needs that are different from promoting its standard package of reforms.

The underground economy is a concern

As in other Pacific countries, the clear presence of a large underground economy not complying with tax rules was often cited by interviewees. The obvious existence of a large underground economy was always seen as undermining support for tax modernisation and reform by the private sector. These views are despite what should be acknowledged as obvious improvements made over recent years. Still, as one interviewee put it, from his point of view:

IRD spends all its resources on fixing problems with the legislation and on chasing compliant companies. The large non-compliant sector is seldom touched. It makes me wonder why my clients even try.

Weak links between tax and state

We found that the links between taxation and the provision of government services and thus state capacity building seemed weak. This was expressed in the view of one private sector interviewee as:

Here, tax just funds the public service. Aid pays for all the essentials such as roads, hospitals and schools. Hard to get people to comply with the tax rules when they see it going on public service salaries.

Private sector capable and keen to be involved with tax reform

We interviewed a number of people from the private sector. Our overall impression was that they were highly supportive of modernisation and reform of the tax system based on sound principles. They did not seem to be lobbying for client incentives or exemptions but instead supported sensible broadly based taxes with low rates and modern administration.

The Chamber of Commerce seemed to be the main collective group and it seemed to be following these principles. For example the Chamber told us that they appreciated that reform needed to focus on the priority issues and they had surveyed members to see if they could focus on projects that were important, a priority also for the government, and that were doable. They were not interested in pushing for changes that had no realistic chance of being implemented. The Chamber had also taken the initiative to collect data as to who was paying tax and how much. This reflected its concern with the underground economy. Overall the private sector view seemed to be that the tax system in Solomon Islands is a significant impediment to the development of its business sector.

The private sector and the Chamber would be an important support group for any tax reform in Solomon Islands. We were informed that the Chamber had received some funding support from DFAT and we consider this to be a worthwhile investment in the overall reform process. MFAT indicated that its preferred approach is to support the IRD, and for the IRD to engage with the private sector and that New Zealand Aid Programme would be unlikely to directly support civil society to engage in taxation reform.

The private sector interviewees expressed consistent concerns about the underground economy and its frustrations with the seeming inability to fix many of the problems with tax laws as noted above. They appreciated the efforts over recent years for IRD to engage with them on administrative issues but saw policy as more distant.

As one interviewee put it:

It is hard to find out what is happening regarding any policy issues. The departments tend not to speak to each other let alone us.

Another said that he had a number of mining clients. A new mining tax was proposed but he was never informed about it. He wrote in with his views but heard nothing.

The economists have their agenda. They are not really interested in talking about practical matters.

Conclusions

Donor funding of assistance to Solomon Islands has resulted in significant improvements in its tax administration. This improvement is off a low base but Solomon Islands now has a functioning tax administration and system, which it did not seem to have previously. Nevertheless progress made seems to be fragile:

- The administration remains heavily dependent on temporary expatriates at the senior level.
- Modern processes and systems remain work in progress.
- Non-compliance and the underground economy remain a challenge.
- Structural tax policy reform is “off the agenda”, but, in addition, there is no coherent programme of technical/remedial reform.
- Faults in the legislation consume key administrative resources and inhibit progress on IT systems.
- A key support base for reform, the private sector, is frustrated with the above.
- The important linkages between the State and tax collection is weak.

We are of the view that a more sustainable and less fragile tax system would have resulted from a systematic approach to the reform process by donors and the government. This would involve seeing the tax system as a whole with a more integrated approach to administrative modernisation and legislative changes and how these can best be used to manage and change taxpayer behaviours. To a considerable extent this more systematic approach seems to have been adopted with Customs reform but not in the areas of income tax and sales and goods taxation. Instead, the focus of donors seems to have been on specific reform projects (especially aspects of tax administration modernisation) with the prime objective of increasing revenue raising capacity even if this were at the cost of retaining weaknesses in the overall tax system.

We stress that we have not concluded that Solomon Islands should have adopted structural tax reform along the lines of the PFTAC standard package – including the introduction of VAT. A strength of the Solomon Islands process is that the host government was in the position to decide itself that such a reform would not be suitable for it at this time. However, a weakness of the Solomon Islands process in our view has been that rejection of

this template reform package has tended to default into a do-nothing option being adopted with respect to taxation legislation and this has had evident costs in terms of the functioning of the overall system.

Lessons to be learned from Solomon Islands

Reflecting on Solomon Island experience, several lessons can be learned:

- Successful tax reform requires both good tax policy and good administration. Tax reform is a mix of policy and administrative change processes. Significant gains have been made in tax administration - Solomon Islands now has a functioning tax office which it did not have in 2003 - but there is little evidence that donors have entered into a systematic and strategic engagement with Solomon Islands as to how to manage the long, complex, location-specific journey involved with successful and sustainable taxation reform.
- The comparatively narrow focus of the engagement in the Solomon Islands taxation reform seems to contribute to the perceived fragility of the achievements to date. The tasks that have been accomplished were very clearly needed, but they also need to fit within a systematic approach to reform to bring about ongoing change to the tax system as a whole, which is not yet occurring in Solomon Islands.
- Addressing social and equity concerns about taxation are central to achieving a tax system that is acceptable to the public. We found no evidence that donor support for Solomon Islands has involved appropriate assessments of the social context and likely effects (positive and negative) on different stakeholders and social groups of greater enforcement of the existing tax regime; the clear objective set for the administrative reforms is increased revenue.
- Donors appear to have placed priority on reforms that increase revenue though there are other, possibly higher, priority issues in terms for reform of the wider tax system.
- Tax administrations undertaking reform are likely to need important support for the doing the basics right (registering, advising and auditing) on an ongoing basis. If the basics of tax administration are not carried out well, that will ultimately undermine the wider reform programme.
- The experience of Solomon Islands appears to support a frequent comment from interviewees concerning the limited value of “fly in fly out” technical advice. Such short term assistance generally had difficulty understanding the complexity of the reform process and the location specific nature of that reform.
- Technical and remedial issues can be a major impediment to gaining private sector support for reform. While these issues may be of lesser significance in terms of economic policy, they cause ongoing difficulties with operating within the tax system on a day-to-day basis. The importance of dialogue with and support from such key influencers, and their role in making the tax system work in practice, means that their practical concerns should be given considerable priority in a wider reform process. Donors should consider adopting more widely the precedent set by DFAT in providing direct assistance to strategic private sector groups such as the Chamber of Commerce.
- The experience of Solomon Islands confirms that problems with technical tax rules (in particular payment and penalty rules) can tie up scarce administrative resources, create high compliance costs for business and alienate private sector support for the reform programme.

- The increased enforcement of tax obligations on tax payers already in the system places more emphasis on the ongoing presence of the underground economy, especially from the private sector view point - the private sector view the underground economy as undermining the legitimacy of tax reforms (parties attempting to comply with the tax system in Solomon Islands are having taxes, widely accepted as distortionary, more rigorously imposed on them while significant sections of the community pay no tax at all).
- The link between taxation and the provision of government services seems to continue to be weakly held by the general population; the popular view expressed to us seems to remain that roads, schools, hospitals and other government services are provided by aid whereas tax funds an excessively expensive public service.
- Tax concessions for donor country activities and advisers can be seen as inconsistent with reforms initiatives to implement broad based taxes and reduce exemptions.
- Solomon Island experience shows that where political constraints preclude major policy changes considerable progress can be made with increasing the capacity of the tax administration in isolation of a wider tax reform programme.
- The Solomon Island experience also shows, importantly, that technical changes that substantially improve outcomes for taxpayers or tax administration is generally feasible even where severe political constraints exist that would preclude moves to adopt 'model reforms'. Changes in these technical areas do not require the difficult, complex political trade-offs required under a wider reform programme. This seems to have been the case with Solomon Islands with the introduction of a new Customs Act. However, similar gains in technical income tax rules do not appear to have been progressed.
- Technical reforms along these lines require their own specific range of skills. It requires a detailed understanding of existing tax codes, and an ongoing conversation with Ministers as to what can be achieved and with taxpayers as to what would be broadly supported. It is thus likely that a technical reform programme along these lines would require donor support.
- Our observation is that such donor support has not been forthcoming under the current programme, though there has been more recent work on some aspects of technical rules. This may be because donors do not view technical taxation changes as leading to the overarching goals for the Solomon Islands IRD, and especially revenue raising. However, such a view would not seem to give due weight to the economic and administrative benefits and longer term foundations for wider tax reform such a programme can deliver. It is thus similar to the need for tax administrations to continue get the basics of auditing and tax administration right in order to bed in and support wider more recognized taxation reforms
- A key challenge of taxation reform is to implementing changes in practice and behaviour, and not just in legislative rules. No tax reform will take root unless it changes modes of behaviour and this is seldom achieved by simple legislative change. A sustained effort is required to bring about behavioural change.
- Many tax issues are common across jurisdictions (including New Zealand and Australia); though vary in scale and capacity of tax administration and taxpayers. These commonalities of good tax administration strategy and policies means the NZIRD advisers have played an important role in assisting with skills and knowledge transfer.

- Capacity building within the tax administration is important objective for the reforms in the Solomon Island, but there are limits to capacity building potential. The reform programme in the IRD remains vulnerable to key person risk.