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# Lessons from donor effort to support taxation reform in the Pacific

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31 March 2014



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# 1. Summary

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## **A synthesis of our evaluation**

This paper provides a synthesis of our evaluation of tax revenue reform in the Pacific. It gathers, in summary form, the key outcomes of the evaluation, from the following papers:

- Evaluation of tax reform in the Pacific, dated 31 March 2014 (“the evaluation”).
- Topography of tax reform in the Pacific Islands in the Period 2002-2012 dated 8 October 2013 (“The Topography Report”).
- Evaluation of tax reform in the Pacific – detailed evaluation plan dated 9 June 2013 (“The Evaluation Plan”).

## **What we observed**

In very broad terms our evaluation found that:

- Donor countries have made considerable efforts in supporting taxation reform in the Pacific.
- This effort to support taxation reform has produced improved tax systems consistent with good international practice.
- Inevitably there are some weaknesses in the processes adopted by donors.
- However, in general, the processes adopted by donor countries have followed good international practice and have provided for effective dialogue at each stage of the reform process. In particular, it was clear that taxation reform had not been imposed on host countries by donors but in general was owned by the host countries. This is a strong indicator of an effective policy dialogue between host countries and donors.

Despite the efforts made, and reform processes that seemed to follow international good practice to a high degree, we nevertheless identified that taxation reform in the Pacific remains fragile. That is, the reforms and administrative improvements put in place over the past few years appear to have insufficient depth to be sustainable into the future. A critical aspect of sustainability is establishing an environment in which incremental improvements in tax policy and administration become business as usual.

## **Why are the reforms fragile despite following good processes?**

Our answer to this question draws upon recent thinking on taxation reform generally. This perspective views taxation as a system, not just a set of rules. The tax system needs to be considered holistically and must be internally consistent and coherent, both in terms of the tax rules and its administration. Taxation is also fundamentally about moulding the behaviour of the population - that is voluntary compliance with tax obligations.

## **Is there room for a more systematic involvement from donors?**

Applying this line of thinking in the context of development assistance led us to the view that donor interventions are more likely to produce sustainable and robust taxation reform where donors are involved in reform in a systematic way over a longer period of time. A

more systematic response by donors is not just committing to a longer timeframe. It would involve a greater partnership and more in depth policy dialogue with host countries so that the strengths and weaknesses of host country tax systems are periodically considered and appropriate responses agreed between them. Donor countries would bring to that engagement their expertise in running tax systems and assist with identifying factors that could be hindering the tax system. For example, to buttress or provide support for more strategic policy initiatives in the future, donors might assist with a more technical reform programme that would meet these concerns and build support from the private sector. It might be decided that building tax compliance (reducing the underground economy) might be the best means of building the credibility of the tax system. Such measures would be built into an overall programme to improve the management of the tax system.

**Table 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.

This systematic approach to donor intervention contrasts with our observation that donor taxation reform interventions in the Pacific have tended to be episodic in nature. Interventions have tended to be based on specific projects agreed upon between the donor and the host country. Examples have included: the move from tariffs to VAT; the move to a self-assessment system for income tax; and the implementation of information technology systems. This episodic approach insufficiently takes into account the need to manage tax systems as a whole, the complexity of such systems and the need to see taxation as a matter of managing and moulding behaviours.<sup>1</sup>

<sup>1</sup> See for example the 2011 Mirrlees Report on the United Kingdom tax system: 'Tax by Design – The Mirrlees Review, Oxford University Press, 2011. While written in the context of tax reform in the sophisticated economy of the UK, the comments about the need to think about the tax system as a whole have general application to tax reform everywhere.

## 2. Evaluation scope

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The New Zealand Ministry of Foreign Affairs and Trade asked us to evaluate the efforts of donors to assist taxation reform in the Pacific over the period 2002 to 2012. Sixteen countries were within the scope of the evaluation.<sup>2</sup> 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. Our evaluation delved deeper into the experiences of Kiribati, Samoa, Solomon Islands, and Tonga, as case studies.

The evaluation sought insights into the process of reform to inform improvements to how donor countries 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. Based on the extensive literature on taxation reform we accepted, for the purpose of the 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. The ‘standard package’ comprises a relatively comprehensive Value Added Tax (“VAT”), reduced trade taxes, and an income tax that is relatively comprehensive, and administrative upgrading. 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.

Our evaluation focused on the reform process – the process of taxation reform that if adopted by donors and host countries would most likely achieve the developmental objectives. A good and well-functioning tax system is critical to all countries. It provides the means by which governments 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 the government and tax-paying citizens. Important as it is, tax reform is nevertheless extremely difficult to bring into effect.

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<sup>2</sup> 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.

### 3. Evaluation methodology and process

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A good tax system reflects a combination of good tax policy and good tax administration. Failings in either administration or policy will make a system vulnerable. Taxation reform would bring about sustainable improvements in institutional capacity and in tax policies and administration, consistent with international good practice. However, 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.

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. 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.’”

The evaluation commenced with a review of development and taxation reform literature to identify the factors that could be expected to give rise to successful donor intervention in this area. From the literature review, we anticipated that taxation reform initiatives by donors following good international practice would involve:

- Clarity as to the objectives for reform.
- Informed and reasonable expectations as to what can be achieved.
- Shared and credible evidence base.
- Taxation advice consistent with good tax design principles and accounting 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. These outcomes are summarised below.

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, 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 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. The feedback from that meeting confirmed our views on good processes but fragile outcomes. It led us to consider more deeply why this seems to be the case beyond the obvious issues of the development challenges facing Pacific Island countries, including a legacy of inefficient tax systems, weak capacity for tax compliance, inconsistent patterns of business taxation, and limited local expertise to respond to changes in the tax environment.

The following sections summarise our main findings.

## 4. Considerable effort in assisting tax reform in the Pacific

Donors have provided considerable assistance to tax reform efforts in the Pacific over the period 2002 to 2012:

- We estimate donor support over the period 2002-12 to total around NZ\$55 million.
- PFTAC has been supported and has become the central assistance agency supporting the “standard package” of removal of tariffs, comprehensive VAT, low broad income tax, and administrative upgrading.
- Most jurisdictions in the region have received assistance, though the activities supported have varied, as shown in table 1 below.

**Table 2: Brief summary of reform activities**

Region	Country	Primary reform activity
Polynesia	Cook Islands	Administrative support
	Niue	Standard policy package and administration
	Samoa	Standard policy package and administration
	Tokelau	Little reform initiated
	Tonga	Standard policy package and administration
	Tuvalu	Standard policy package and administration
Melanesia	Fiji	Standard policy package and administration
	PNG	Standard policy package and administration
	Solomon Islands	Administrative support
	Vanuatu	Administrative support
Micronesia	Kiribati	Undertaking standard policy package and administration
	Marshall Islands	Undertaking standard policy package and administration
	Federated States of Micronesia	Undertaking standard policy package and administration
	Nauru	Administrative support
	Palau	Administrative support
Wider Pacific	Timor Leste	Administrative support

## 5. Evident improvements in tax systems

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The efforts to support taxation reform have resulted in substantial improvements in the operation of most tax systems in the region. This is evident by considering outcomes against a range of intermediate and longer-term outcome indicators:

### 5.1 Intermediate indicators

- **Policy consistent with international good practice:** Most jurisdictions have implemented, or are implementing, PFTAC's standard policy package. Since this package accords with international good practice, it is reasonable to conclude that this should make tax systems fairer and more efficient.
- **Administration consistent with international good practice:** Most countries have seen upgrades in PFTAC administration baselines.<sup>3</sup> The greatest progress has been made in the areas of administrative framework, corporate strategies and core processes. Weaker progress has been made in the areas of automation, human resources and support processes. These outcomes accord with a strategy of upgrading administrative areas most critical to basic administration.
- **Institutional capacity mixed:** Our case studies showed that key person risk and institutional capacity constraints remain prevalent in the region.

### 5.2 Longer term indicators

- **State building:** Anecdotal evidence suggests the links between paying taxes, the government and the provision of public services remains weak in the region. The exception is Samoa, which has focused on building this linkage in its reform programme.
- **Revenue adequacy:** Increased revenue raising results have been mixed to date. However, we note that increasing revenue is not necessarily the key objective of taxation reform.
- **Efficiency:** It is reasonable to assume that a more efficient tax system is an outcome from implementing PFTAC's standard policy package.
- **Equity/public acceptability:** Anecdotal evidence and our case studies suggest there is a reasonable level of public acceptability of the reforms. Equity should also flow from implementing the standard policy package and from the upgrading of tax administration that has taken place. This is because, in the Pacific context, fairness in the tax system is largely the product of ensuring that elites, significant local businesses and foreign enterprises pay tax.

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<sup>3</sup> See 'Baseline Assessment Framework, PFTAC, 2011.

- **Cohesion:** A cohesive tax system should be the product of implementing the standard policy package.
- **International commitments:** Countries in the region have managed to use taxation reform to reduce tariffs as required by World Trade Organisation requirements. Pacific countries have also met the requirements of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes.

### 5.3 Donor funded projects have followed good international practice

We found that donor funded projects in the region have generally adopted reform processes that follow good international practice:

- Process generally has followed what we identified as the necessary phases of a good reform process. These are: agenda setting (diagnostic analysis, clear and realistic objectives); consideration of policy options; and policy implementation (administrative capacity building). Samoa and Tonga are examples of this reform process; Kiribati less so.
- We identify weaknesses in the policy options phase especially around the political interface. In particular, there is a need for Technical Advisors with political/Ministerial interface skills. Tonga brought in external advisors and the apparent absence of these skills in the Solomon Islands is one possible reason why there has been little reform in that country even of a technical nature (whereas there has been technical reforms to customs legislation suggesting the political hurdles to reform are not absolute).
- A theme of reform in the region has been that reform requires longer timeframes than is generally expected but this does not seem to have led to reform failure.
- We identified a weakness in donor co-ordination over projects. This is understandable and again we did not identify this weakness as causing programme failures.
- Our evaluation and the case studies identified that projects were agreed to and owned by the relevant host country. This was clearly the case in Samoa and Tonga, two of our case studies. In the other two case studies, policy reforms did not proceed in Kiribati and Solomon Islands until they gained host country support. This is a strong and unexpected finding and demonstrates that reform projects are not being imposed by donors on reluctant host countries.
- We found that donors and their agents generally recognised that in most cases technical support has to be on an on-going and committed basis.

### 5.4 Tax reform still fragile

Despite finding that the donors have put considerable resources into tax reform, and that reform packages have generally followed good international practice in terms of processes, reform outcomes still seem fragile. It seems unlikely that the positive reform outcomes achieved will be sustainable over time without considerable on-going donor investment. The evidence for this is that:

- Assistance projects undertaken have been more about structures than changes in taxpayer behaviour on which well-functioning tax systems rely. An example is the case

study of Tonga where self-assessment for income tax has been introduced but behaviours still operate as if the income tax was based on assessment by the revenue authority.

- Throughout the region we found weak links between taxation and state building. The common refrain from interviewees in case studies was that “taxes fund public sector salaries; aid provides for hospitals, schools and roads”.
- Key person risk remains a major issue in revenue authorities throughout the region (the Tongan case study is an example) and reliance on expatriate advisors remains evident (for example in the Solomon Islands case study). All countries showed limited internal capacity building.
- For small isolated countries networks, other revenue authorities seem to be key to accessing skills and experience that are inevitably in short supply. However, despite some improvements, we found that these networks remain largely ad hoc especially with Australia and New Zealand.
- Relatively small technical issues seemed to be unnecessarily consuming scarce administrative resources, inhibiting automation and alienating private sector support for taxation reform throughout the region.

## 5.5 Evaluation 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.

## 5.6 Reasons for fragility of the reforms

If donors have put considerable effort into taxation reform assistance and if they have followed best international processes in doing so, why do the outcomes still seem fragile? Obviously, to some extent the fragility is the product of small, isolated, poor economies with underdeveloped infrastructure in terms of public sector and financial management generally. But the issue seems deeper than that. The judgment we reached is that building a well-functioning tax system requires managing reform of the tax system as a whole in a systematic manner. It requires donor countries to bring to the engagement their own expertise in running tax systems and more in depth policy dialogue with host countries so that the strengths and weaknesses of host country tax systems are periodically considered and

appropriate responses agreed between them. By contrast donor support for tax reform in the Pacific has been episodic and not systematic.

Our evidence for this judgment is that:

- The link between tax evasion/underground economy and credibility of the tax system (including reforms) is not a donor focus. Nevertheless, we found that evasion in the small business sector (especially the retail sector) is undermining the credibility of reforms.
- In Samoa, Tonga and Solomon Islands we found that the private sector were strong advocates of reform but disillusioned and struggling to find the resources to make an adequate input into reforms. We found that donors provided little donor support for this sector.
- We found that technical legislative problems often consume scarce administrative resource and alienate the private sector but are not being fixed. Donor funded projects do not seem to regard these technical issues as being within the ambit of funded development projects. An example is the problems with PAYE and penalties outlined in the Tonga and Solomon Islands case studies. The importance of these technical issues in terms of managing and building an overall tax system should not be under-rated. Such problems, as well as consuming scarce administrative resources and alienating the private sector, can also disrupt the employment of modern IT systems. There is no point in automating more efficiently unreliable data.
- More generally, we found that there is a lack of donor support for technical policy changes that would improve the tax system especially if improvement comes at a revenue cost. An example is the lack of progress in introducing more coherent withholding taxes outlined in the Solomon Islands case study.
- Networks with revenue authorities throughout the region remain somewhat ad hoc especially with Australian and New Zealand tax administrations that are the most resourced and experienced authorities in the region.

## 6. Implication for donors

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### **The implication for donors is that more systematic donor support is required to achieve sustainable reform.**

Our answer to the central evaluation question is that donor country support for taxation reform in the Pacific has provided for effective dialogue but of an episodic nature. To bring about sustainable taxation reform in the Pacific would require a move to a more systematic approach to supporting for taxation reform.

A more systematic response by donors is not just committing to a longer timeframe. It would involve donors entering into a long-term relationship and continuous and more in depth dialogue with host countries on incrementally improving the management of the host countries overall 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 this expertise, 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 on-going taxation reform.

A move to a more systematic approach to assistance by donors, while challenging for donor countries, would in our view be more likely to lead to less fragile and more sustainable reform outcomes than we currently observe in the Pacific. There is a central role in this for PFTAC. PFTAC is a key tool for donors in delivering international best practices in terms of both tax policy and administration, but donors cannot effectively delegate to such organisations the in-depth dialogue between donor and host country that builds understanding and partnership in managing systematic tax reform.

Clearly a 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.

## 7. Improvements to current approach

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The alternative to supporting a more systematic approach would be to accept the fragility of tax reform in the Pacific but still focus on improvements to how donor support is currently provided. The improvements to current processes identified in our evaluation 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; the ability of PFTAC to respond quickly is a strength in this regard.
- 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 on-going complex technical skills such as in the area of transfer pricing.

## 8. Conclusion

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In summary form, the main themes of our evaluation of donor support of taxation reform in the Pacific over the period 2002-2012 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 behaviours. This 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. The alternative is to accept the fragility of tax reform in the Pacific but focus on the improvements to current processes listed above.