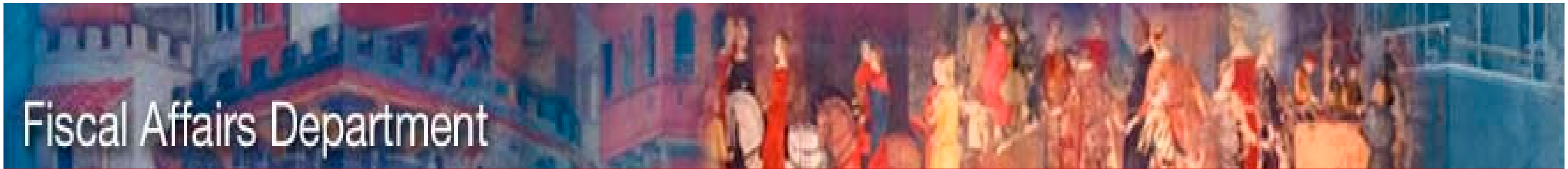

PACER Plus: Options to Replace Expected Revenue Loss from Trade Taxes in Pacific Forum Island Countries

Fiscal Affairs Department and PFTAC

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Agenda

- Trade liberalization in Pacific Island Countries (PICs) and revenue implications
- The Pacific Agreement on Closer Economic Relations (PACER Plus)
- 2016 FAD study: expected revenue loss from PACER Plus and general responses
- Specific tax policy options for selected countries
- FAD-PFTAC 2017 Tax Policy and Revenue Administration review in Pacific Islands

TRADE LIBERALIZATION IN PICS AND REVENUE IMPLICATIONS

Increased interest in international trade agreements…

- Pacific Island Countries (PICs) have entered into various trade agreements in recent years
- The underlying objective is a greater integration into the global economy via trade liberalization
- Main expected outcome is to secure easier access by their exporters to foreign markets
- While exporters will benefit from lower or removal of tariffs, tariffs on imports, which are source of government revenue, will also be impacted

… which are likely to have negative revenue impacts for some PICs

- Tariffs have been a key instrument of PICs' trade policies, as well as a major source of revenues
- Policy strategies are then needed to compensate for the possible revenue loss
- Moreover, if exporters are to take advantage easier access to markets, this opportunity should not be vitiated by policies that impair their competitiveness

Possible responses

- Expenditures cuts, but these are unlikely given development needs in the region
- On the revenue front, an initial step is to convert non-tariff trade barriers into tariffs, and align tariff rates as much as possible
- In some countries, it may be possible to match a decrease in tariffs with a similar increase in excises. The idea is not to extend excises to other products, though.
- For other countries, however, simply replacing some tariffs with excises is unlikely to be sufficient so a different tax policy mix should be considered
- Other options include broadening the tax base and improving revenue administration

THE PACIFIC AGREEMENT ON CLOSER ECONOMIC RELATIONS (PACER PLUS)

Brief background on PACER Plus

- Economic cooperation agreement between the 14 Forum Island Countries (FICs) and Australia and New Zealand
- For most FICs, Australia and New Zealand are their biggest trading partners, so impact on tariff revenue could be substantial
- Key features of the agreement are trade liberalization and facilitation, and regional cooperation
- Negotiations commenced in 2009 and concluded in 2017, so far 11 out of the 16 countries have signed it

Key trade provisions

- Improved customs procedures that would cut red tape and result in more efficient trading practices
- More flexible rules of origin requirements that will enable FICs firms to flexibly source inputs from other countries in the region
- Clearer and more transparent rules on sanitary and phytosanitary measures, and other barriers to trade
- The agreement also contains a chapter on development assistance to increase FICs' capacity to fully take advantage of market access opportunities

FAD 2016 STUDY: EXPECTED REVENUE LOSS FROM PACER PLUS AND OPTIONS TO REPLACE THOSE LOSSES IN SELECTED COUNTRIES

Background on FAD November 2016 study

- Request made in 2015 by the Chairman of the Governing Board of the Office of the Chief Trade Adviser (OCTA) for the FICs
- Three objectives:
  - Review the expected revenue loss analysis done by the FICs' OCTA for each member state
  - Review the tax regimes of the FICs
  - Offer different revenue-neutral tax policy options to replace the potential revenue loss from eliminating trade taxes under the PACER Plus

A word on methodology

- The OCTA provided FAD with static (2014) estimates of expected revenue loss in percent of government revenue for each country
- Estimates were based on actual final tariff offer, which was under negotiation for many countries
- The estimates reflected the eventual annual revenue impact after full liberalization, which for some FICs will be 25 or more years after the agreement has entered into force

Other assumptions

- For most countries a single tax rate was used to calculate the tax base
- The assumed elasticity for corporate taxes was -0.25, while for VAT and turnover taxes was -0.15
- For excise taxes, which are levied goods with relatively inelastic demand, the assumed elasticity was 0
- An elasticity of -0.25 can be interpreted as a 1 percentage point increase in the tax rate leads to a 0.25 percent decrease in the tax base

IMF general approach on responses to lost trade tax revenues

- Broaden the tax base by reducing exemptions
- Excises are usually the first line of defense
- Direct and indirect taxes should also be included in the mix…
- … but indirect taxes should not be misused as de facto tariffs
- Value added tax (VAT) is ideal among indirect taxes
- And eliminating incentives on direct taxes is key

General revenue-neutral responses

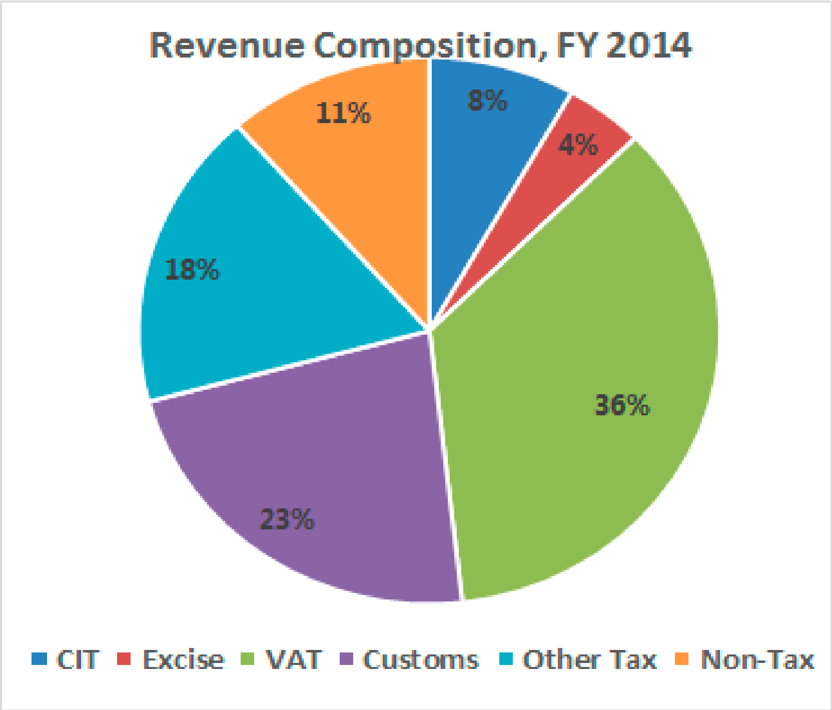
- A few FICs have already abolished most import duties, so adjustments are not needed
- FICs that rely on indirect taxes, such as a broad-base and well-functioning VAT, may favor increases in rates of such taxes over increases to rates of CIT or PIT
- FICs without a VAT or sales tax may favor increases in excises, which normally tax goods that impose negative externalities on society such as alcohol, tobacco and fuel
- Others may prefer increasing CIT or PIT rates, although increases in PIT may be less progressive
- Finally, in some FICs the expected revenue impact is so low that it could be met with improvements in administration

OPTIONS FOR SELECTED COUNTRIES

Options for Fiji

OCTA estimates Fiji could lose up to 1.9% of revenue or USD 23 million, which could be offset by:

- Increasing excise rates by 44%; the impact on prices of affected goods will be offset by the elimination of tariffs
- A 1 and 6 percentage point increase in CIT and VAT
- An increase in the CIT rate of 5 percentage points

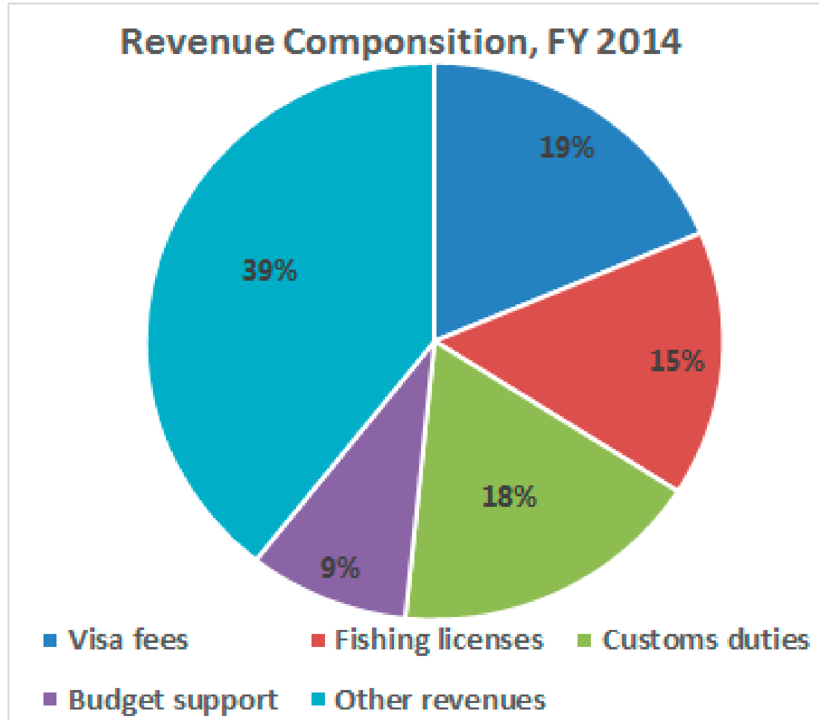


Fiji relies on indirect taxes, with VAT and customs duties making up over 50% of revenue in 2014

Options for Nauru

OCTA estimates Nauru could lose up to 14% of revenue or USD 11 million

- With Nauru's limited tax mechanisms and data, estimates of revenue neutral options cannot be made
- However, in addition to introducing a business and personal income tax, a VAT and/or excise taxes on (at least) alcohol, tobacco, fuel, and vehicles should help

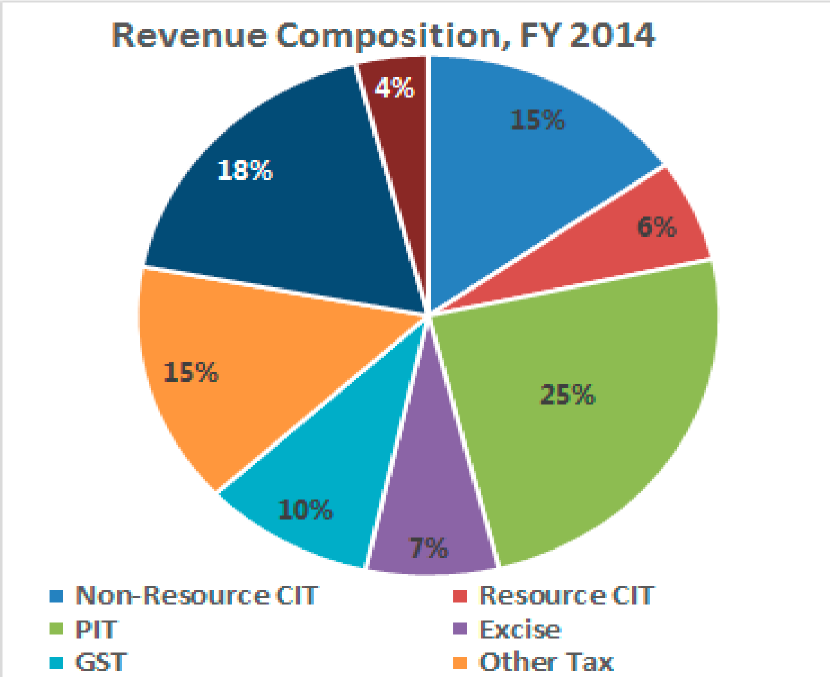


Nauru is heavily dependent on grants, visa fees, custom duties and fishing licenses

Options for PNG

OCTA estimates PNG could lose up to 0.3% of revenue or USD 14 million, which could be offset by:

- A one percentage point increase in the CIT rate
- A 0.5 percentage point increase in the GST rate, resulting in a final rate of 10.5 percent.
- An increase in excise rates by around 4 percent

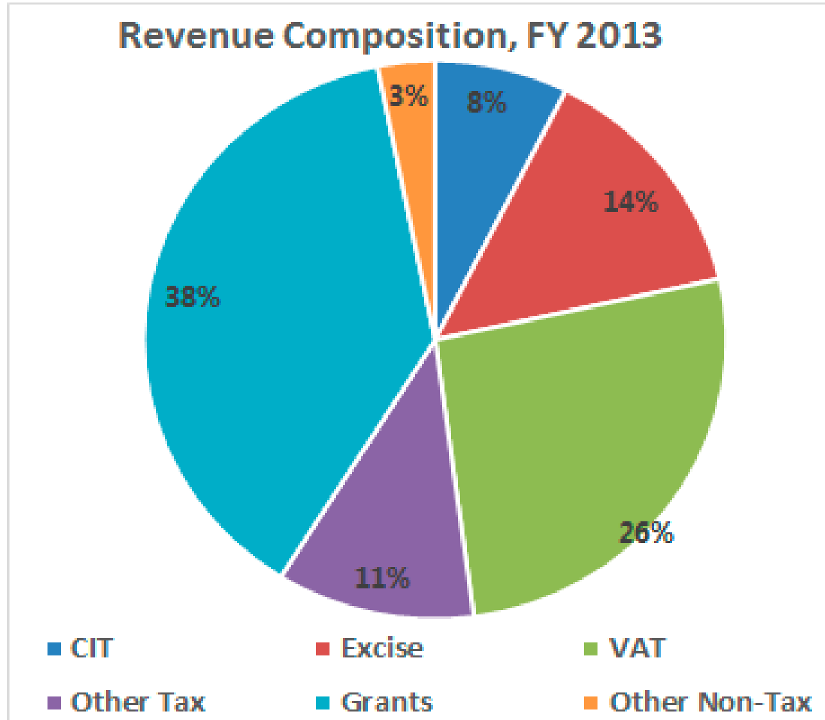


PNG tax collections are diversified, with the largest receipts coming from CIT, PIT, and indirect taxes

Options for Samoa

OCTA estimates Samoa could lose up to 4.6% of revenue or USD 10 million, which could be offset by:

- Increasing the VAT rate by 2 percentage points to 17%
- Increasing excises by 23%, which would offset the decline in the price of excisable imports from the elimination of tariffs
- Increasing both CIT and VAT by 2 percentage points

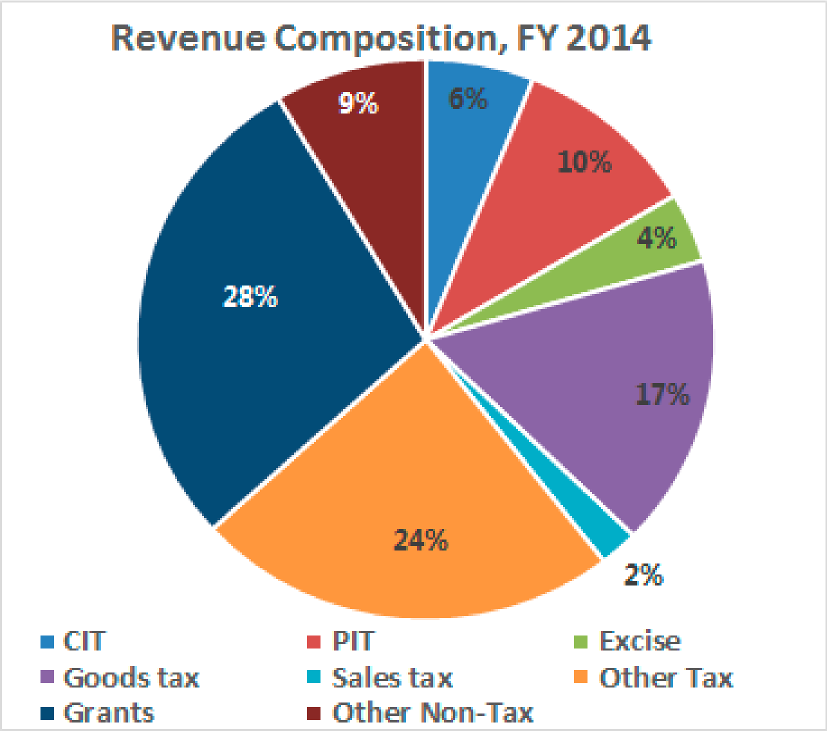


Samoa tax collections are largely dependent VAT and excises

Options for Solomon Islands

OCTA estimates Solomon Islands could lose up to 1.4% of revenue or USD 5.4 million, which could be offset by:

- A 26% increase in excise rates
- Increasing the CIT rate by 7 percentage points to 37%
- A one percentage point increase in the Goods Tax rate to 11% for domestically produced goods, and 16% for imported goods

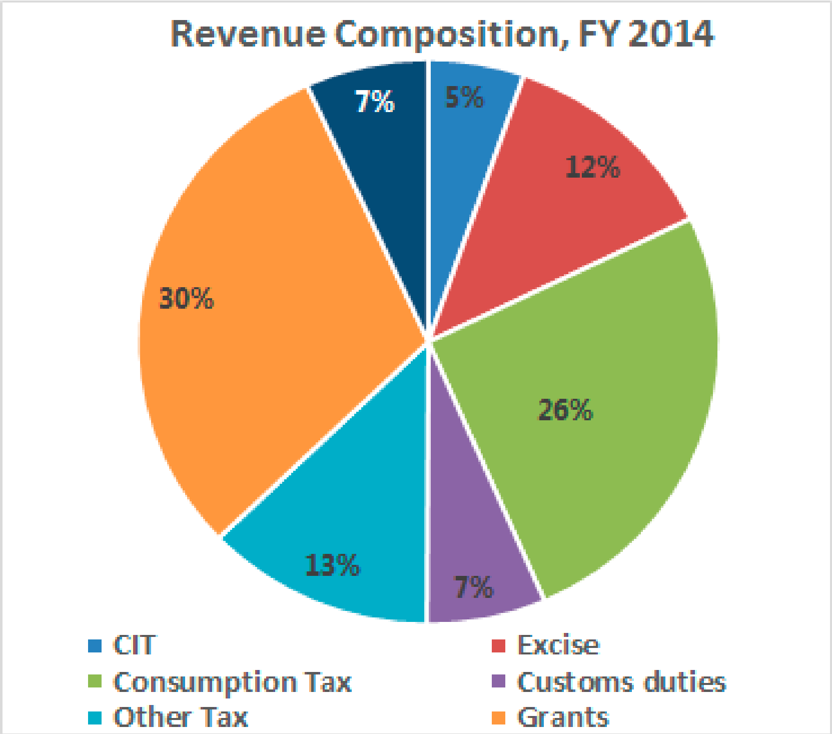


Solomon Islands is fairly dependent on grants, and until recently, natural resource revenue

Options for Tonga

OCTA estimates Tonga could lose up to 4.1% of revenue or USD 3.8 million, which could be offset by:

- Increase excises by 23% or the CT rate by 2 percentage points, to 17%
- Increase the CIT rate by 15 percentage points to 40%
- An increase in the CT and CIT of 1.5 percentage points each, which may strike a better balance.

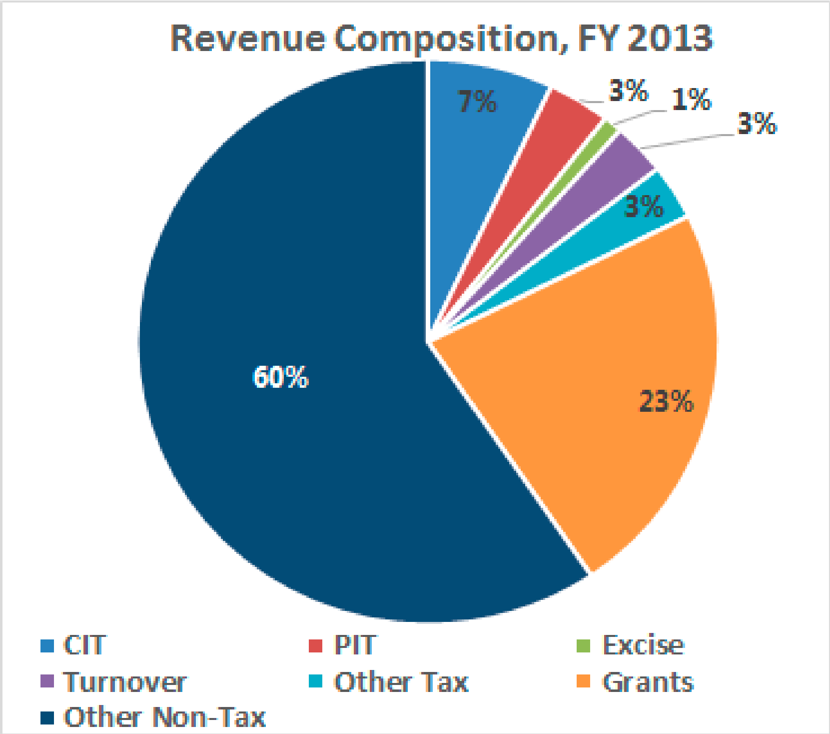


Tonga underwent a structural tax reform in the early 2000s, resulting in the introduction of a VAT

Options for Tuvalu

OCTA estimates Tuvalu could lose up to 1.8% of revenue or USD 0.84 million, which could be offset by:

- An increase in the TCT of 5.5 percentage points, to 12.5 percent
- An increase in both the CIT and TCT rates of 3.5 percentage points
- Increasing excise taxes, which are low to regional standards, by 206 percent

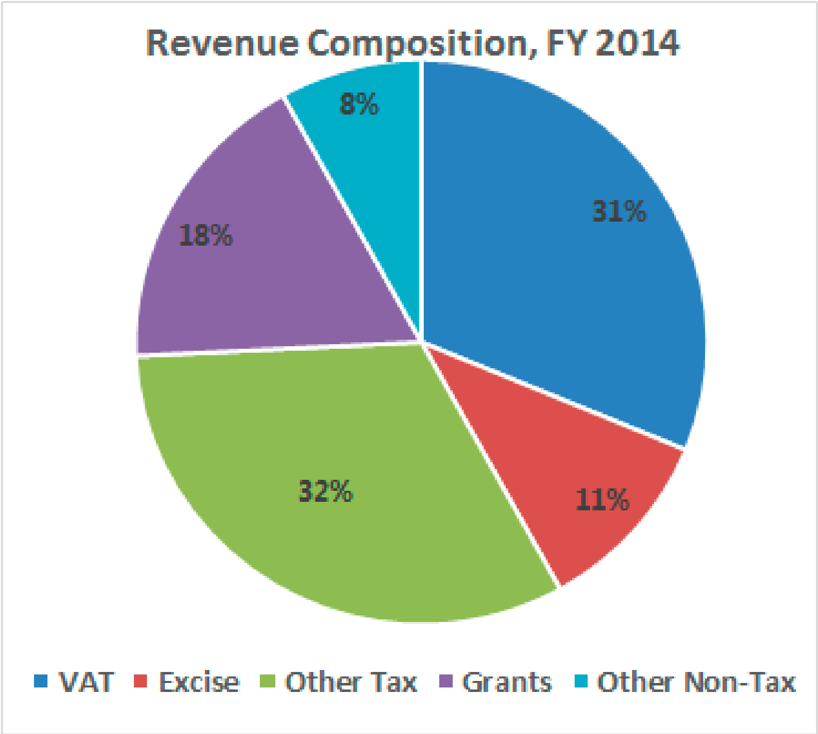


Tuvalu has a trust fund, which provides government with a reliable buffer and delivers interest income

Options for Vanuatu

OCTA estimates Vanuatu could lose up to 5.4% of revenue or USD 8.5 million, which could be offset by:

- A VAT rate increase of 2 percentage points to 14.5 percent (since the study was done VAT has been increased to 15%)
- An excise tax rate increase of 42 percent



Vanuatu collects tax revenues solely through indirect taxes, with VAT being its largest source of revenue

Impact in other FICs

- **Cook Islands**: 0.01% of government revenue or USD 0.012 million. No adjustment needed
- **FSM**: 2.7% of government revenue or USD 2.3 million. The revenue loss estimates are related to the MFN clause in the COMPACT agreement with the US, not PACER Plus, and there is a fiscal package in place to offset the revenue loss.
- **Kiribati**: PACER Plus is not expected to lead to any revenue effects, as most import duties have already been abolished
- **Niue:** 0.1% of government revenue. No adjustment needed
- **Palau:** 1.5% of government revenue or USD 1 million. The revenue loss estimates are related to the MFN clause in the COMPACT agreement with the US, not PACER Plus

FAD-PFTAC 2017 TAX POLICY AND REVENUE ADMINISTRATION REVIEW IN PACIFIC ISLANDS

Background

- A 2017 FAD-PFTAC study reviewed tax policy and administration reforms in PICs over the past 8 years
- The study identified possible areas for future reform, which could also help address revenue loss from trade deals
- Other challenges that came up during the review include:
  - The need for good data for tax policy analysis and for reviewing tax administration performance;
  - The difficulty in getting small businesses to comply;
  - The slowness in implementing complex reforms that have been legislated;
  - The ongoing erosion of the tax system by exemptions; and
  - The potential for PIT bracket creep

Areas for further tax policy work

- For countries without a VAT, this should continue to be a key consideration, especially in addressing potential revenue losses from trade agreements
- Remove inefficient tax exemptions
- Pursue alternative revenue sources, such as natural resources to ensure the country gets a fair share of the resources
- Presumptive taxes could be considered to address compliance and simplicity concerns with small businesses
- Review PIT rates and tax brackets to ensure there is not an unintended increase in the tax burden

Areas for further revenue administration work

- Increase staff numbers and other resources
- Improved data collection and analysis can help identify weaknesses and monitor progress
- Develop managerial skills and allocate staff to headquarters' functions
- Improve administration of core tax functions (registration, services, filing, payment, audit) to increase compliance
- Develop regional initiatives to improve audit, such as a regional training program and/or regional audit team
- Make greater use of technology should be made for compliance purposes and to improve efficiency

Questions?

BACK-UP SLIDES ON METHODOLOGY

A word on methodology (2)

- Two approaches were taken to calculate the tax rate increase needed to recover the expected revenue loss
- The primary approach estimated the base for each tax and the increased rate required for the additional revenue to equal the revenue loss estimated by the OCTA
- Since the tax base is likely to react to changes in rates, we assumed price elasticities of demand to take into account changes in the base resulting from rate increases

A word on methodology (3)

- An alternative approach was taken for excise rates, where the tax is normally levied as a specific charge (instead of a percentage of the price) and/or the rate varies greatly across products
- In these cases we calculated the percentage increase in the tax rate that would make up for the expected revenue loss.
- Therefore, the results imply a similar percentage change to all excise rates for all goods