Strategy Labs

LEWBEN GROUP

Vanuatu Revenue Review

Consultation Feedback

2016 November

V.2

Document purpose

The purpose of this document is to provide feedback to the Revenue Review Committee on proposed Vanuatu Revenue and Administration Modernisation reforms by presenting key issues and arguments in a structured and fact-based way.

It is important to acknowledge the need for modernisation of tax laws and administration in Vanuatu. Fine-tuning of the tax system could help increase public revenues to support sustainable economic growth, particularly through infrastructure development and improved education and health, and achieve higher standards of living. At the same time, tax system adjustments should ensure overall efficiency and minimize market disruptions.

The consultation process should not be one-sided. Instead, it should be an open discussion among all key stakeholder groups about the alternative means of reaching the goals and objectives set by the government. However, there are some critical issues with the current process which need to be highlighted:

- **The Review Committee did not seek broad input during Review process.** Information sessions were organized after Review Processes had ended. Consultations were presentation of the conclusions and of the decisions already taken by the Review Committee
- **Lack of involvement of independent economists in the process.** Introduction of corporate and income taxes is a decision that has many implications for the economy and requires a comprehensive expert evaluation. Impact study should be conducted and evaluated by at least three independent economists to ensure process transparency and well-informed decision making process

With this in mind, it is expected that the document will support and facilitate an open public discussion by illustrating major concerns of some key stakeholder groups which are currently not being fairly represented.

It also presents alternative ideas as suggestions for tax reform improvements aimed at achieving the common goal – helping Vanuatu progress toward success, modernity and life quality enhancement for all, by using innovative means.

Executive Summary (1/2)

Key Issues of the Proposed Tax Reform

- The proposed tax reform does not adhere to the Guiding Principles for a Good Revenue System:

Equity and Fairness	Nearly all (97%) of PIT tax burden would be borne by just 9% of the working population. The distribution is far more skewed compared to AU and NZ, where top-earners bear ~45% of PIT burden.
Neutrality	The proposed CIT structure does not provide any lower tax thresholds meaning that effective rates for entrepreneurs will be higher than employees on payroll
Economy of collection	CIT collection process would be inefficient as a large share of businesses would contribute insignificantly to CIT collections, while the cost of administration would have to be borne by all taxpayers. Alternative business tax structures (e.g. special licenses) would be more reliable, transparent, and cost-effective to administer
High tax compliance	PIT and CIT are considerably more complex to monitor and ensure compliance. Based on regional comparison, shadow economy in Vanuatu could reach as high as 30-50%
Simplicity, certainty and convenience	PIT and CIT are the most complex and impose enormous challenges for both public and private sector in a low-developed country with scarce human capital. It is questionable whether a country where three quarters of the population live without electricity will be able to perform administrative, planning, avoidance, and enforcement activities associated with exponentially increasing tax complexity.
Meet the needs of the community	As a tourism-dependent economy (estimates of up to 60% GDP), Vanuatu could benefit from maintaining a consumption-based tax system as by doing so it would shift a large share of tax burden on foreign visitors rather than the local community. Implementation of income taxes would be counter-productive as it would mostly affect profitable businesses which create value for tourists, while poor-performing entities would remain unaffected.

- The proposed tax reform is not expected to achieve the desired outcomes:

Reduce the cost of doing business	The introduction of PIT and CIT will increase the cost structure of businesses as net tax burden (new taxes less offsets) will increase.
Lower the cost of living	Compensating for lower profitability, business will increase prices, leading to higher prices for all. The majority of reduced import duties are expected to be absorbed by large retailers and importers
Progressive tax rates	Household data shows that the majority of households spend all of their income on consumption, thus consumption taxes (VAT) are already progressive. Furthermore, lower-income households tend to pay relatively less VAT as they purchase most of their supplies in open markets where goods are not subject to VAT. Increasing VAT and introducing VAT rebates or VAT exemptions on first-necessity supplies could further enhance VAT progressivity without causing as much economic disruption as the introduction of income taxes.

Executive Summary (2/2)

Understanding the Effects on Economy

- Projected economic transfers under the proposed tax reform show considerable issues that need to be highlighted:
  - The top 10% largest companies will be less affected by the reform as due to low competition they will be able to absorb the effects of import duty reductions without passing them onto consumers
  - All consumers will experience diminished purchasing power due to increased inflation
  - Vanuatu will become less attractive to investors, causing flight of foreign capital and FDI investments and hindering long-term economic growth
- Revised Revenue Review model estimates show shortfalls of at least 3.2 bn VT in 2022:
  - 0.9 bn VT in PIT and 1.0 bn VT in CIT due to low compliance (30% shadow economy in optimistic scenario)
  - 1.3 bn in additional tax collection costs which are unaccounted for (to bring the number of tax staff estimates in line in with international benchmarks, 325 additional staff will have to be hired)
  - Additional shortfalls could result from other economic disruptions (Loss of FDI, Reduced economic growth, Labor market disruptions, Indirect compliance costs, etc.), but are not estimated
- Based on OECD research, the expected loss of FDI could be as high as 4 bn VT annually, which is equivalent to income from over 8.700 jobs and could be detrimental in a country with high population growth and in critical need of job creation

Recommendations for the Committee

- An alternative approach to tax reform is recommended:
  1. Increase VAT to 17.5%. (+4.0 bn VT)
  2. VAT exemptions on first necessity supplies (-2.0 bn VT)
  3. Introduce Land Value Tax. (+2.8 bn VT)
  4. Reduce import duties (as assumed in the Revenue Review model) (-2.3 bn VT)
  5. Reduce offsets by 50% (+0.7 bn VT)
  6. Sale of unproductive gov't assets (Net zero)
  7. Infrastructure development

  NET EFFECT: +3.2 bn VT (comparable to 3.0 bn VT proposed by Revenue Review)
- The main concern of such system would be tax progressivity, which can be addressed by implementing a range of VAT exemptions on first necessity items. As the largest share of household consumption (~56%) is allocated to food, exemptions on milk, rice, fruits and vegetables, meat, and similar supplies would be most effective
- A similar effect could be achieved by introducing direct VAT rebates to poorest households. This would allow to shift effective VAT rates (as % of income) from close to zero in poorest households all the way up to ~9% in richest households
- Proposed offsets are mostly comprised of business fees and taxes which should be maintained as they generate significant revenue while there are no clear benefits to removing them. It is therefore assumed that at least 50% of the proposed offsets should not be implemented
- Spending structure should be seriously reconsidered as only 21% will go to priority sectors of health and education
- Increasing minimum wage could be considered as a potential mechanism to help raise consumption and VAT collections

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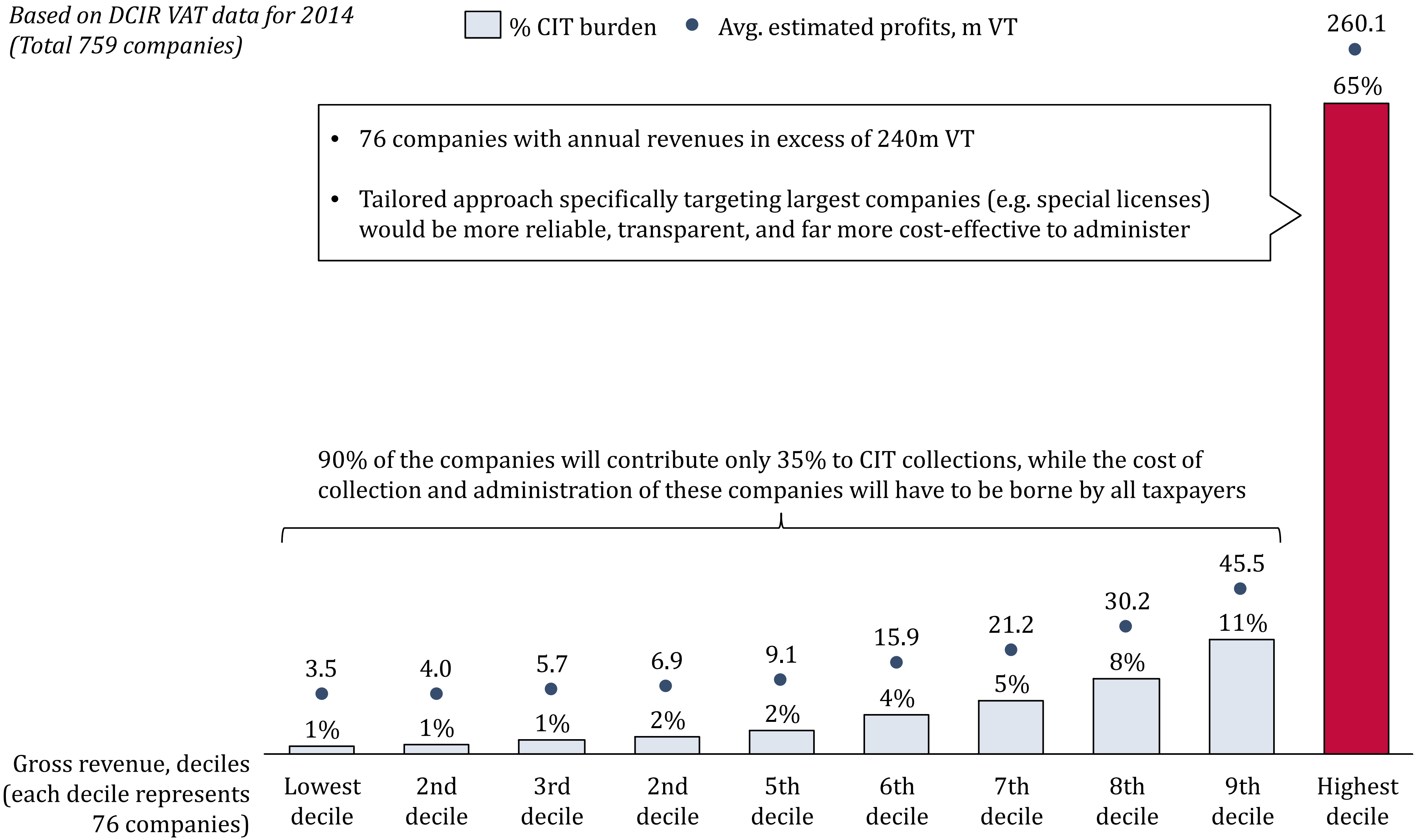
To ensure efficiency, largest companies should be taxed directly instead of imposing CIT and control mechanisms on all entities operating in Vanuatu

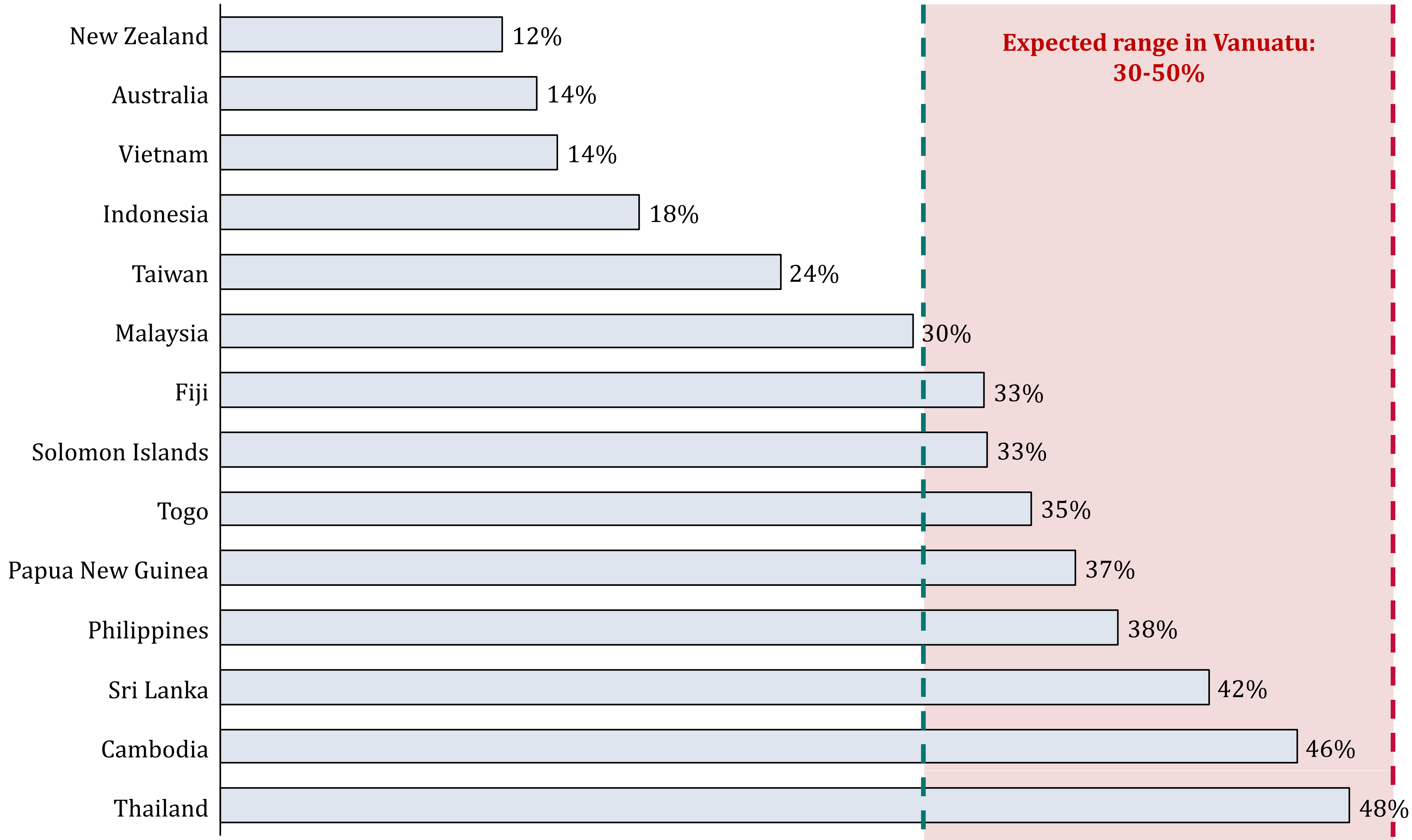
Distribution of companies by size and their profitability and expected CIT burden under proposed tax reform



Source: DCIT VAT data, Information Paper – Empirical Analysis Of Revenue Reform Options, Strategy Labs team analysis

High level of tax compliance is required to achieve fairness, which is unlikely in the case of Vanuatu

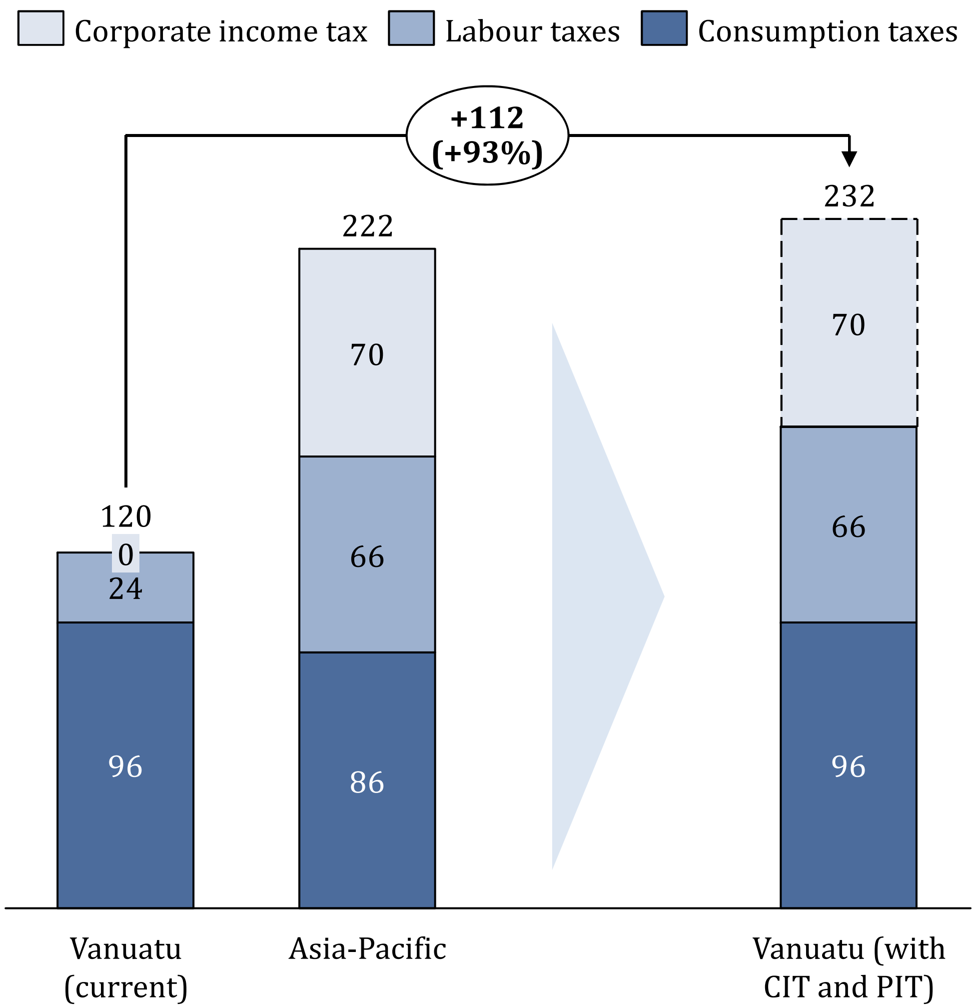
Size of the Shadow Economy in Asia-Pacific region (as % of GDP), 2007



Source: Shadow Economies All over the World (World Bank), Strategy Labs team analysis

Proposed tax reform imposes enormous challenges for both public and private sector in a low-developed country with scarce human capital

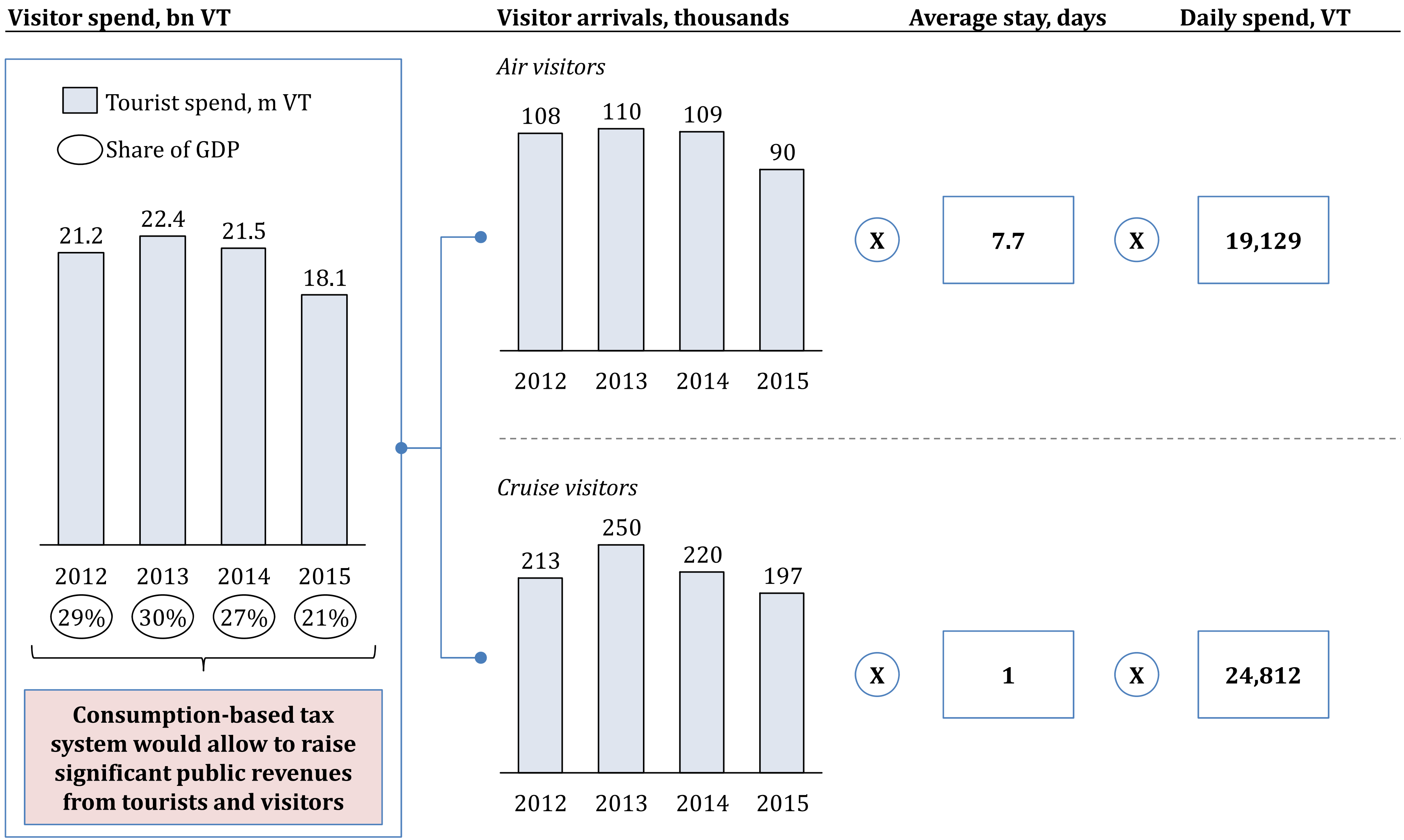
Time to comply for an average business, man-hours per year



- It is questionable whether a country where three quarters of the population live without electricity will be able to perform administrative, planning, avoidance, and enforcement activities associated with exponentially increasing tax complexity
- A number of local businesses are already struggling with existing legislation, are not registered for VAT
- Using time to comply as a proxy, the indirect compliance costs on businesses will double, and are not accounted for by the Revenue Review
- Accounting only for 759 businesses with revenues of 10m Vatu and above (2014 data), the additional compliance workload is over 85 thousand man-hours per year
- Given scarce resources of skilled labor, it is not socially desirable that competent workers move into administrative fields as opposed to priority fields like health or education

Source: Paying Taxes 2016, Strategy Labs team analysis

As a tourism-dominated economy, Vanuatu should focus on consumption taxes as a tool to shift tax burden on visitors rather than locals

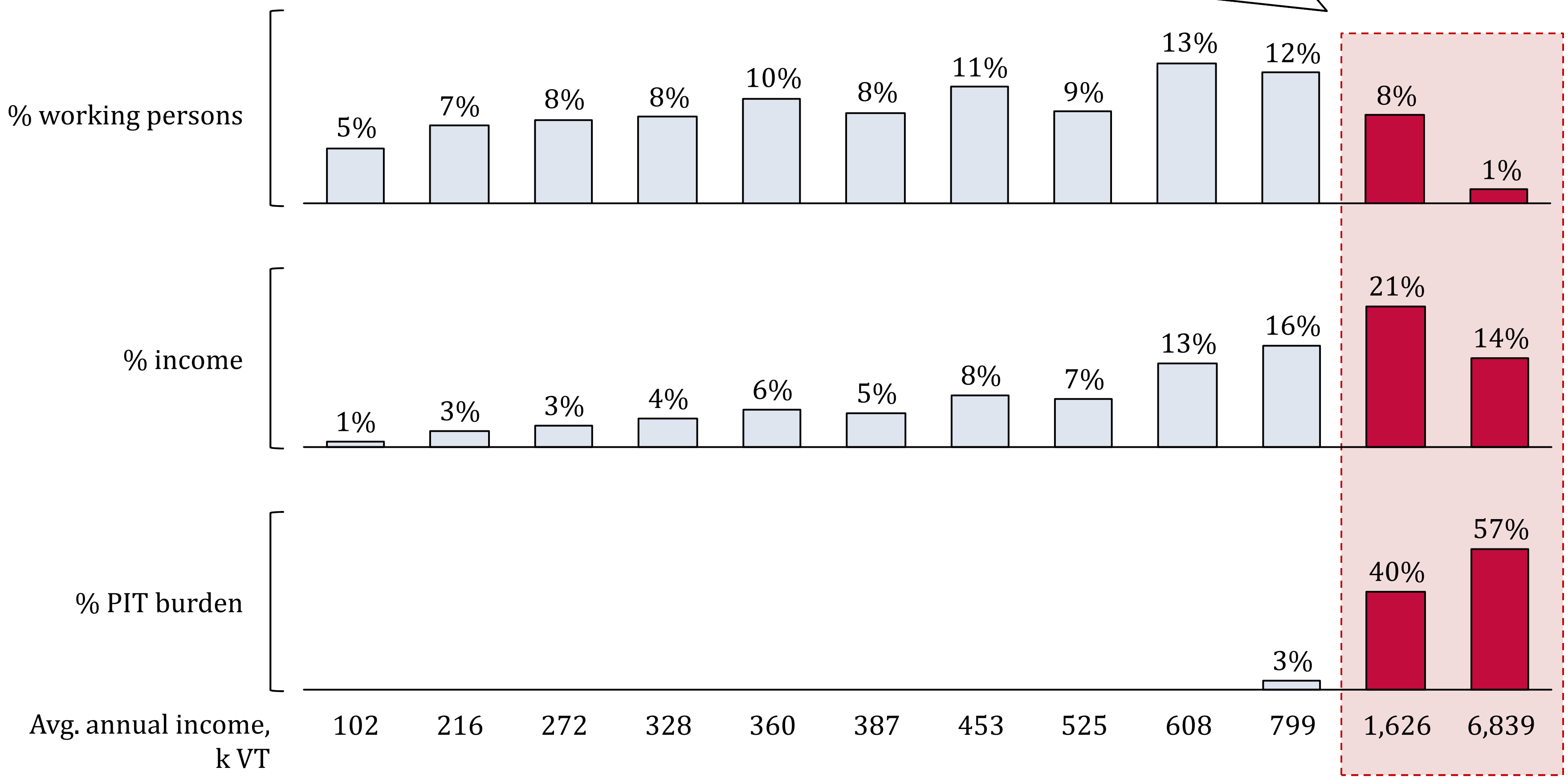


Source: Jonathan Pryke and Matthew Dornan, Information Paper – Empirical Analysis Of Revenue Reform Options, Strategy Labs team analysis

Proposed tax reform is not fair as only 9% of working persons will bear 97% of total personal income tax burden

Distribution of working persons, income, and PIT burden under proposed tax reform

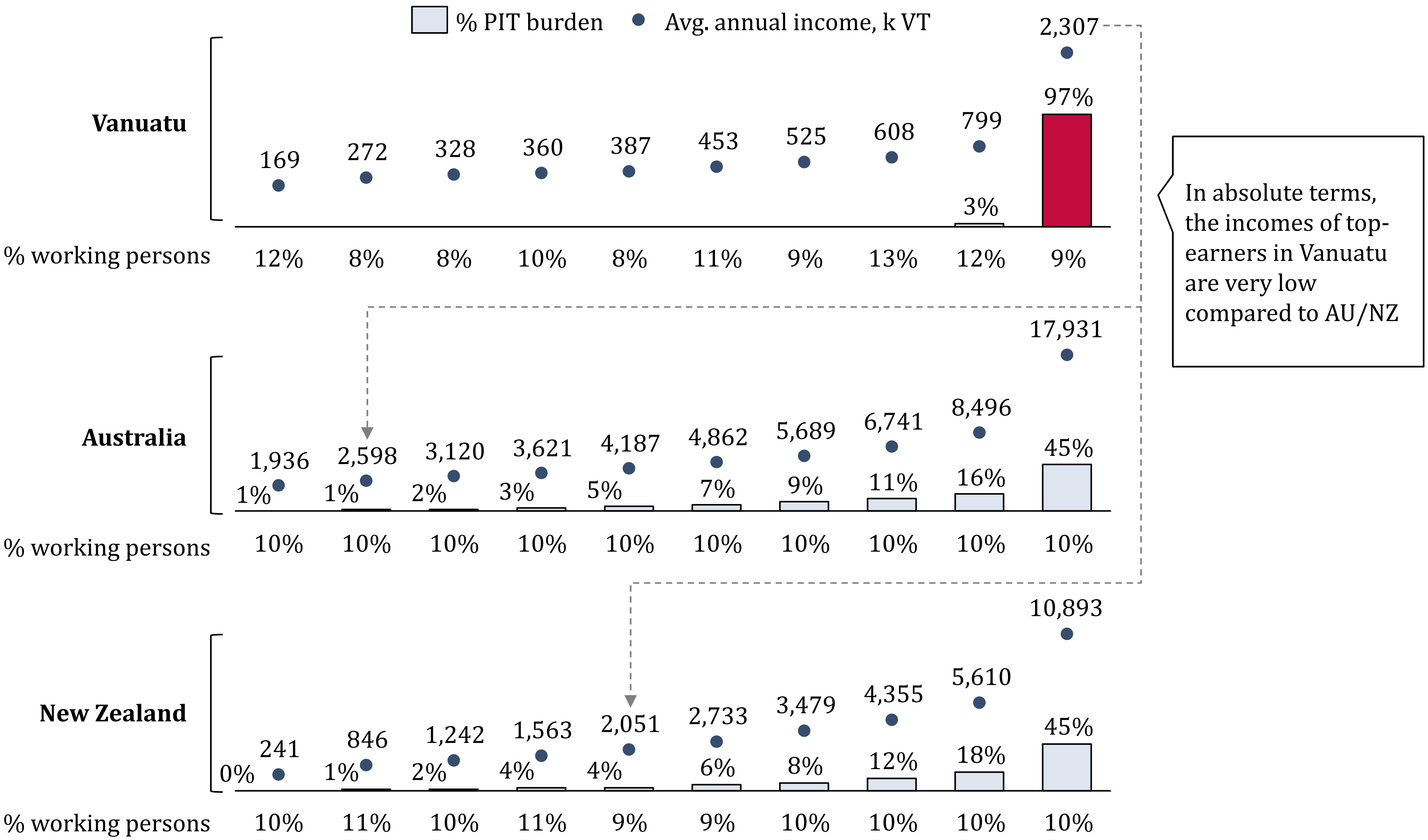
Based on proposed PIT thresholds, the PIT burden is drastically skewed towards the 9% of top-earners who account for only 35% of incomes but are expected to pay nearly all of the personal income tax



Source: Revenue Review Project Team, MFEM estimates based on data from RBV, VNSO, VNPF, Strategy Labs team analysis

Proposed distribution of PIT burden is considerably less proportional in Vanuatu compared to advanced economies in the region

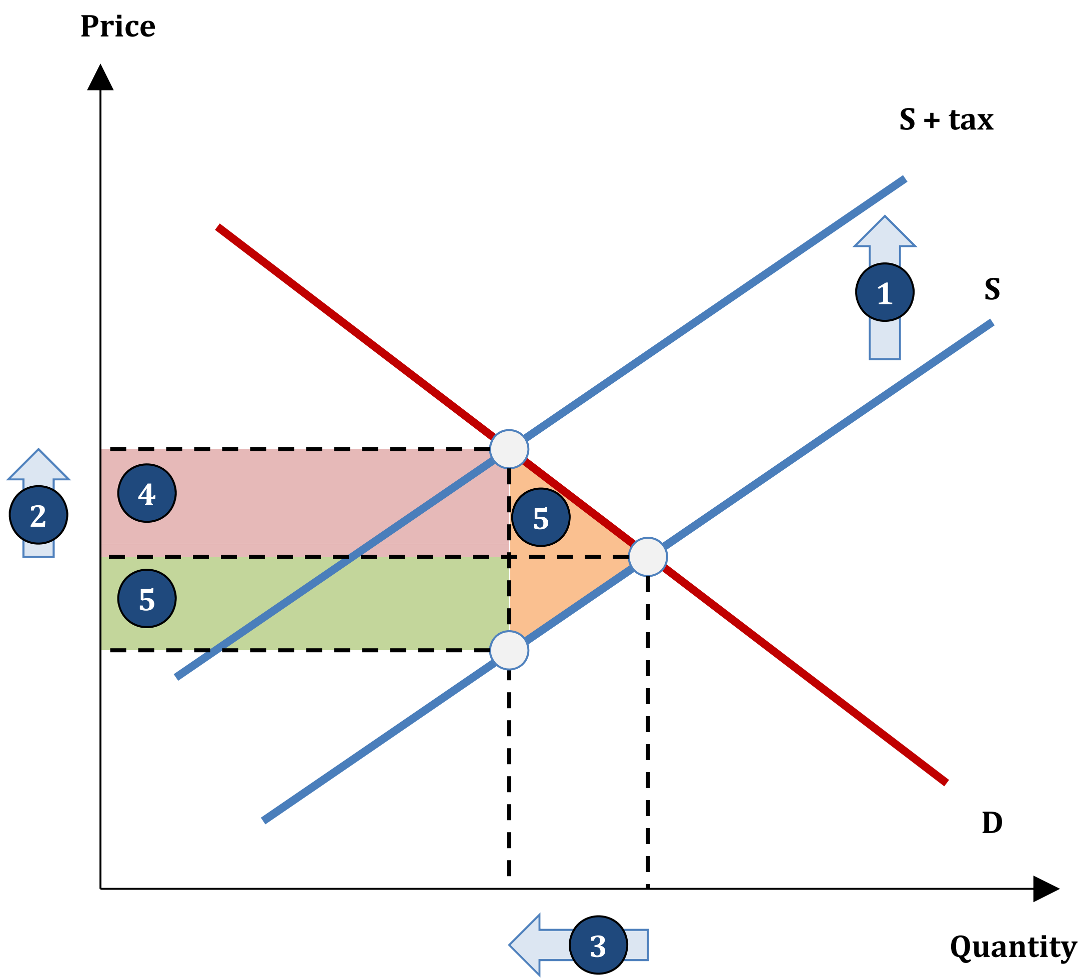
Distribution of working persons, income, and PIT burden



Source: NZ Inland Revenue Agency, NATSEM, Revenue Review Project Team, MFEM estimates based on data from RBV, VNSO, VNPF

Introduction of PIT and CIT will increase the cost of doing business, increase unemployment, and cause inflationary pressures

Illustration of expected market disruptions with the introduction of PIT and CIT



1. Introduction of PIT and CIT will **increase the cost structure of businesses** as net tax burden (new taxes less offsets) will increase.
2. Businesses will be forced to raise prices to compensate for increased cost structure and sustain profitability. This also implies **inflationary pressures in the economy**
3. At higher price levels and stable incomes, sales volumes will decline. Inevitably, some **businesses will be forced to shut down**, potentially causing further **unemployment issues**
4. Cost of taxation will be at least partly borne by consumers as their **purchasing power decreases** – at stable incomes and higher prices they cannot afford as much
4. Another share of taxation costs will be borne by corporations as **cost of doing business increases**
5. Taxation also implies economic **deadweight loss**, as total tax collections will be lower than the overall economic disruption

Source: Strategy Labs team analysis

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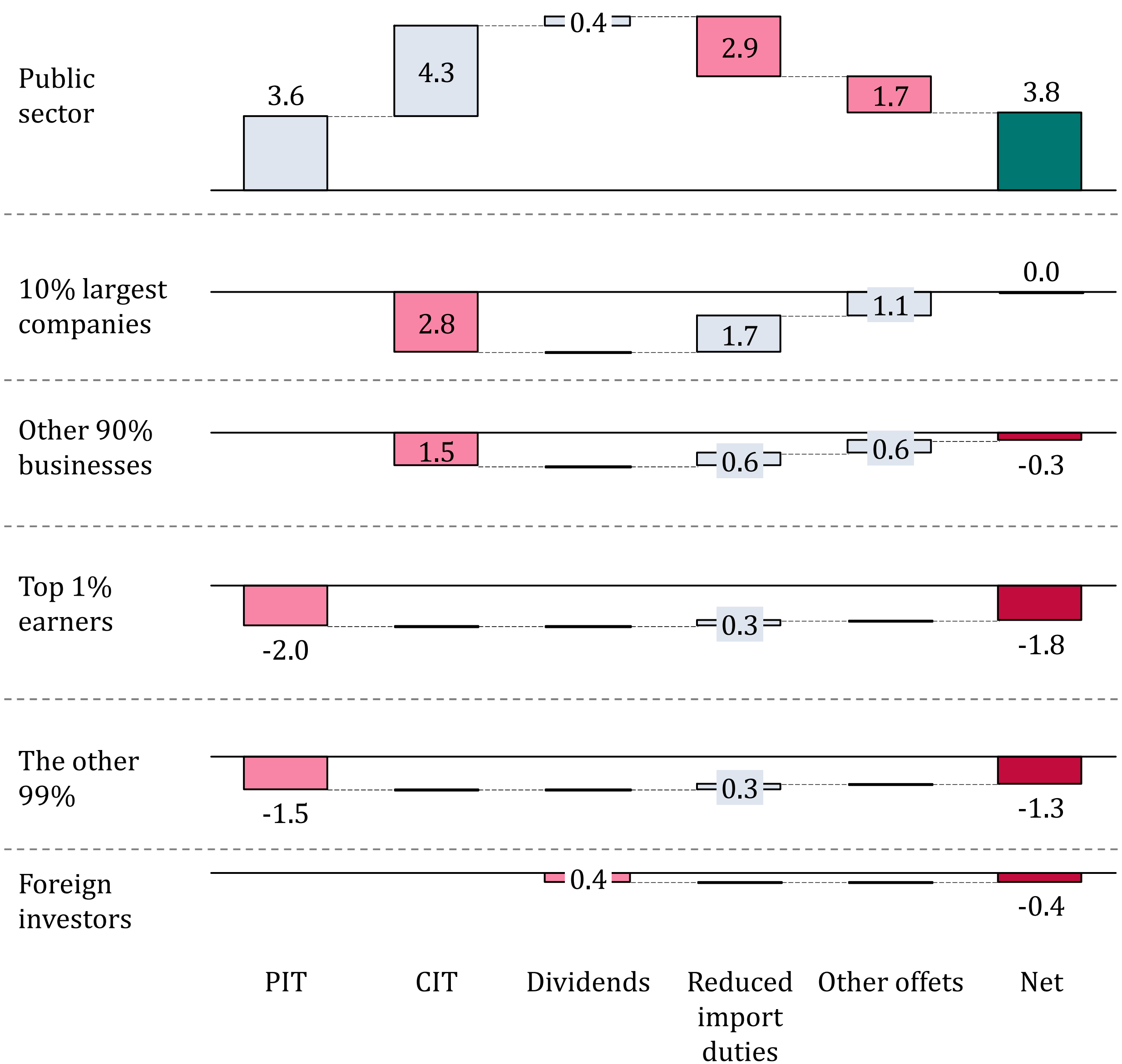
Smaller companies will be affected more than large businesses

Evaluation of potential income transfers in the year 2026, bn VT



Socio-economic implications

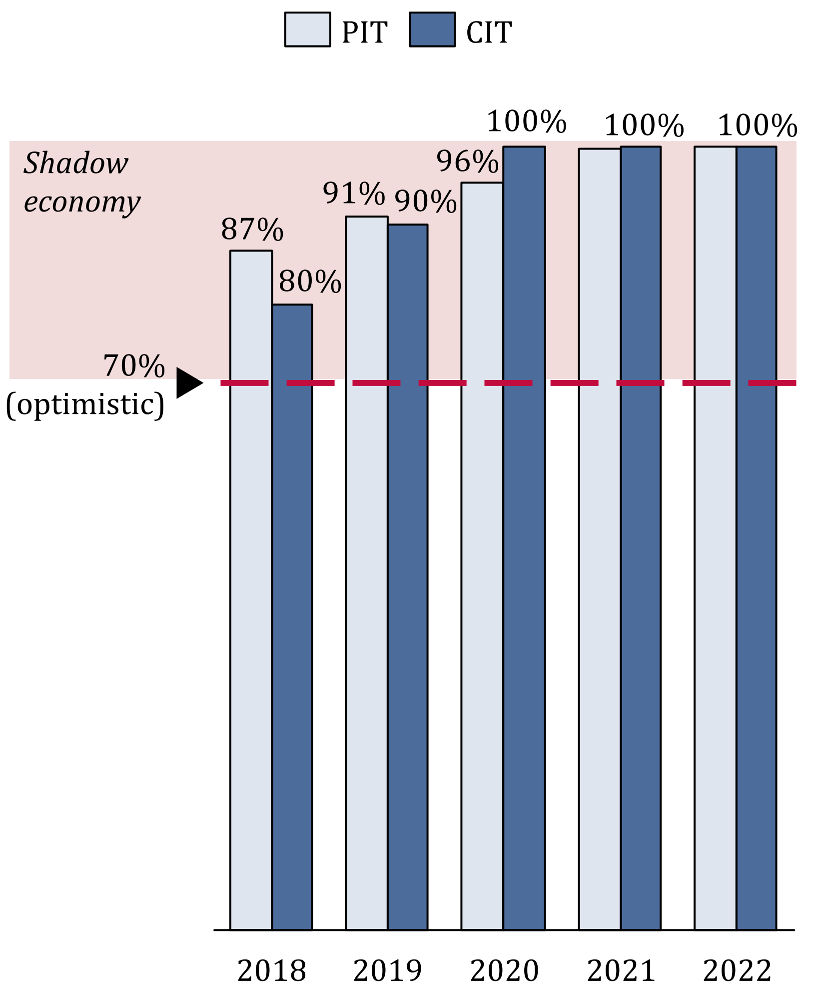
Because of market dominance of the 10% of the largest companies, competition will not fully play its role. Large companies are expected to absorb a large share of reduced import duties. The tax reform will affect smaller businesses considerably more than large ones.

Consumers will experience diminished purchasing power as import duty effect will be absorbed by businesses. This does not incorporate the expected inflation effect on domestic goods resulting in further transfers from consumers to businesses

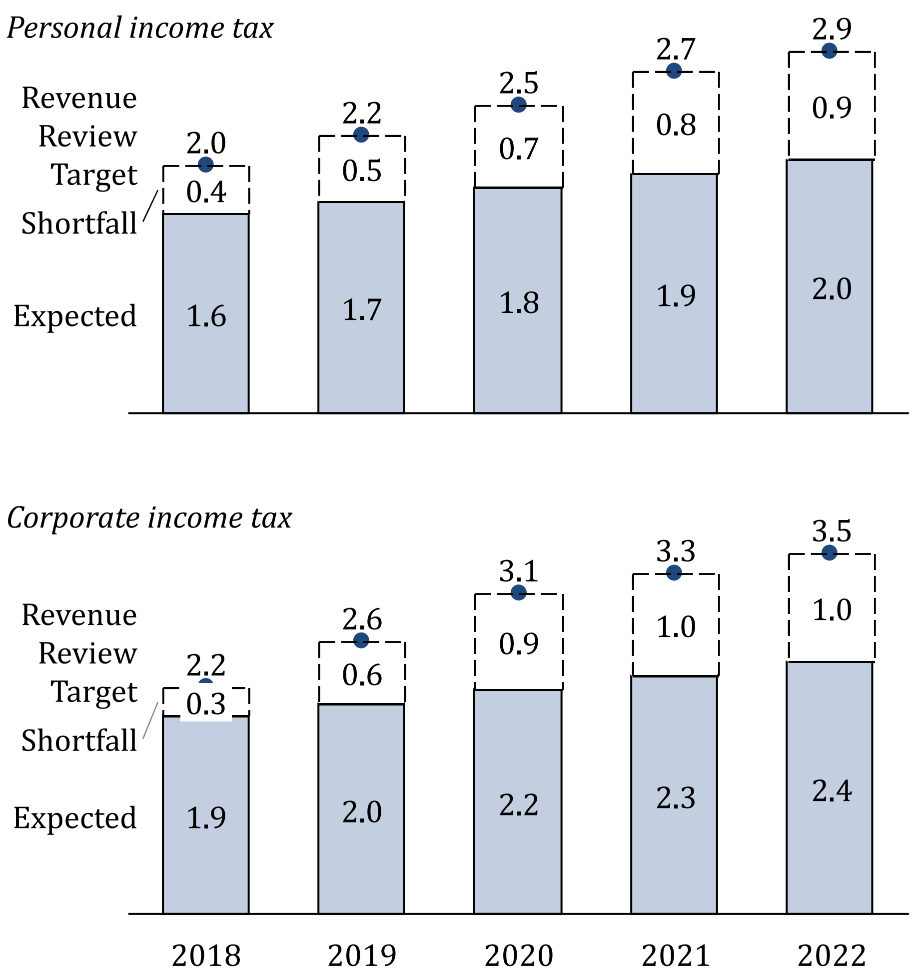
Vanuatu will become less attractive to investors, causing flight of foreign capital and FDI investments and hindering long-term economic growth

Even in an optimistic scenario annual revenue shortfalls of at least 2 bn VT are expected due to shadow economy

Compliance: Revenue Review and actual expected

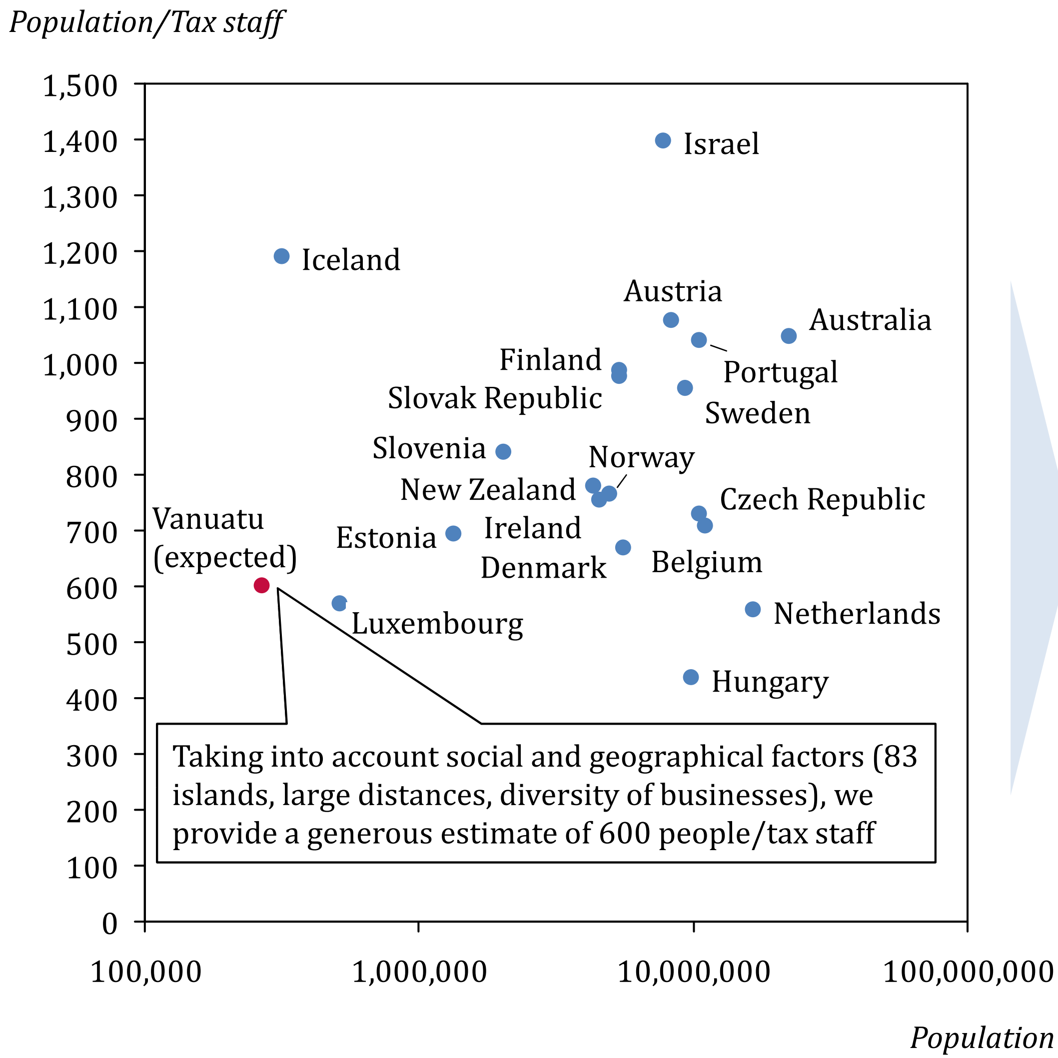


Revised PIT and CIT collections, bn VT

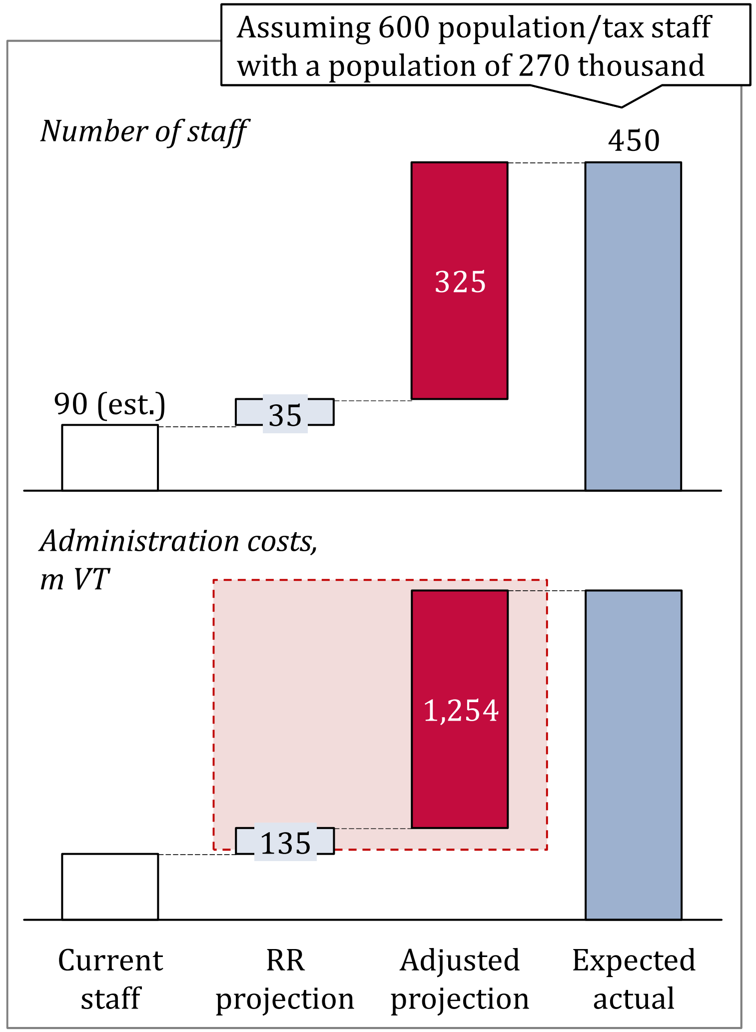


Introducing new complex taxes will incur significant tax administration costs of nearly 1 bn VT per year

Tax staff needs in economies with advanced taxation systems, 2011



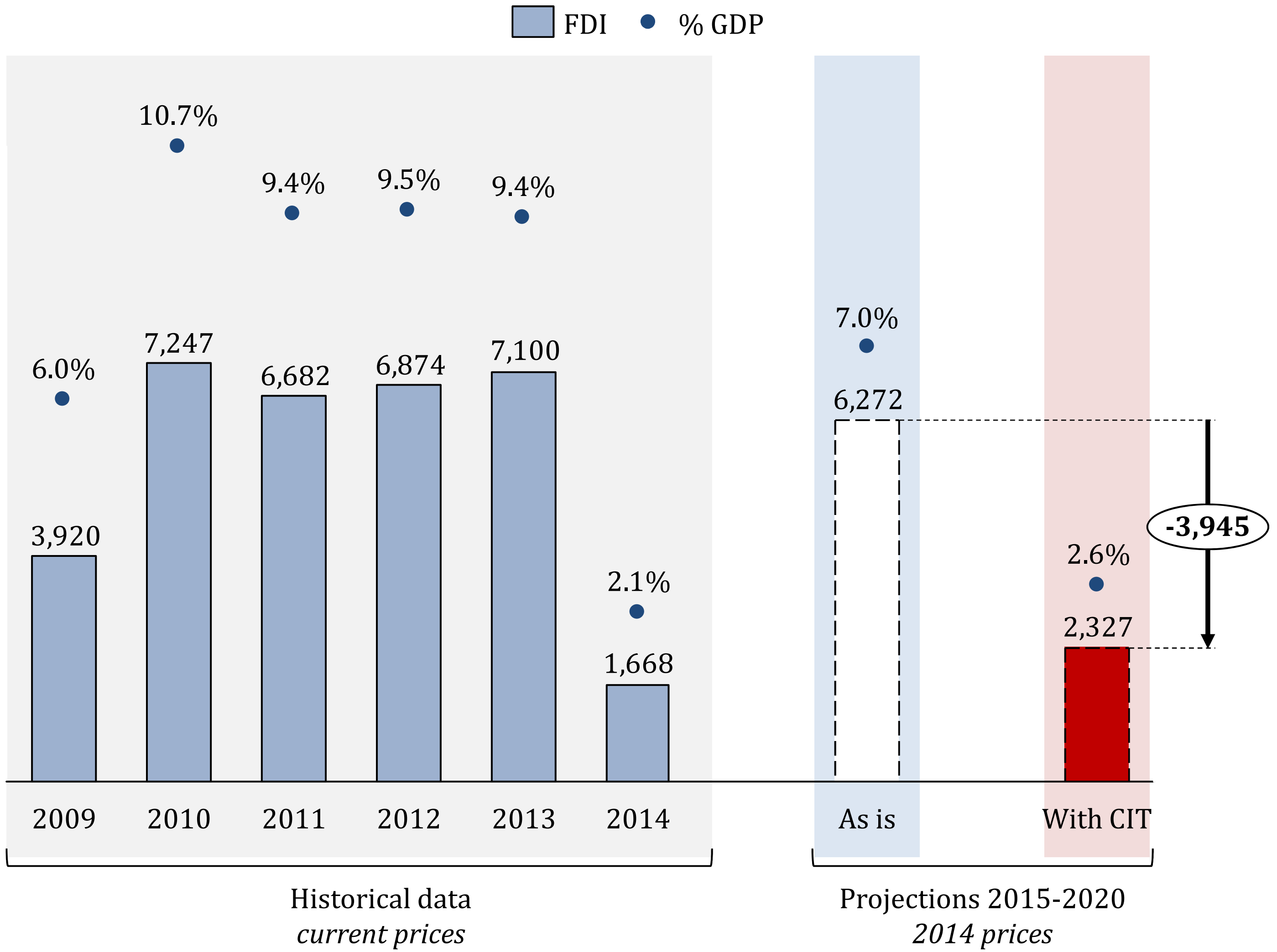
Revised change in tax administration costs



Source: Vanuatu Revenue Review Consultation Paper, OECD Tax Administration Database, OECD Stat, Vanuatu Customs and Inland Revenue Department

Introduction of CIT will have a detrimental effect on FDI which is expected to fall by up to 4 bn Vatu annually

Foreign Direct Investment (FDI) in nominal terms (m VT) and as a share of GDP (%)

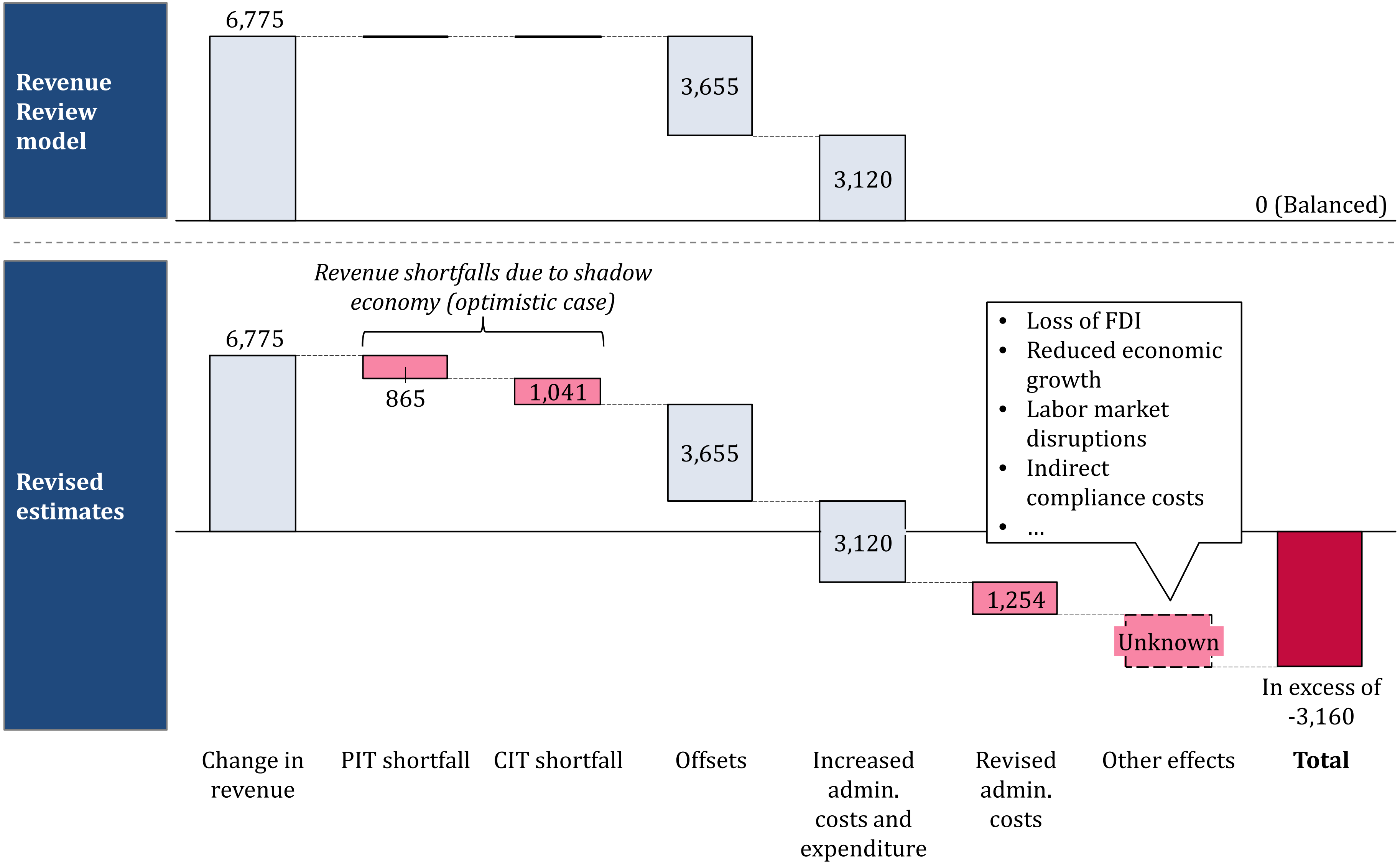


- Studies examining cross-border flows suggest that on average, FDI decreases by 3.7% following a 1 percentage point increase in the tax rate on FDI
- At 17% CIT rate, this implies a decrease of 63%, or nearly 4 billion vatu annually
- At a median annual salary of ~450 k VT, this is equivalent to income of over 8.700 jobs

Source: Tax Effects on Foreign Direct Investment, OECD Policy Brief

Overall, the Government will collect less revenues than targeted and the economy as a whole will lose if proposed tax reforms are implemented

Revenue Review model for the year 2022, m VT



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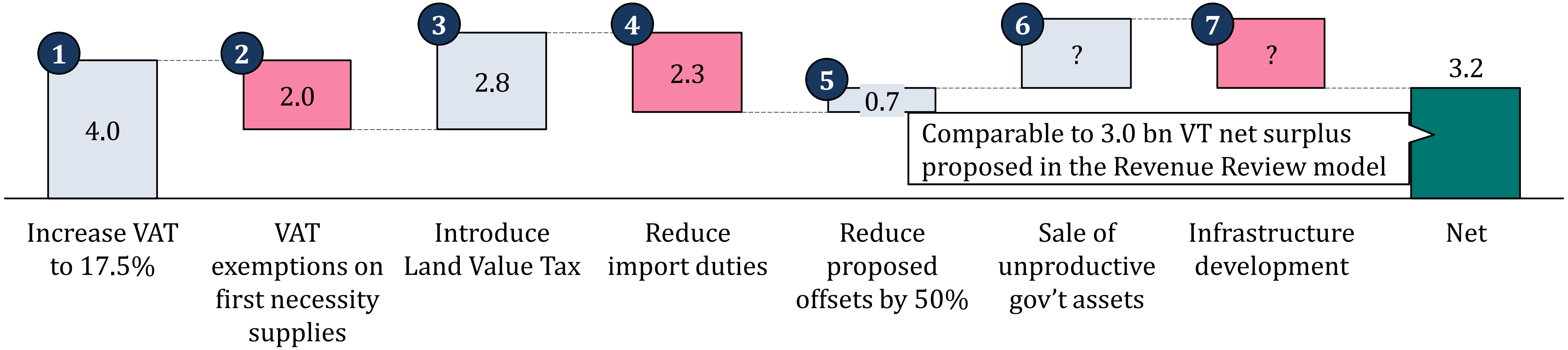
Instead of introducing income taxes, revenue reform should focus on VAT adjustments, introducing LVT, and restructuring of fixed asset portfolio

Recommended alternative revenue reform (based on year 2022), bn VT

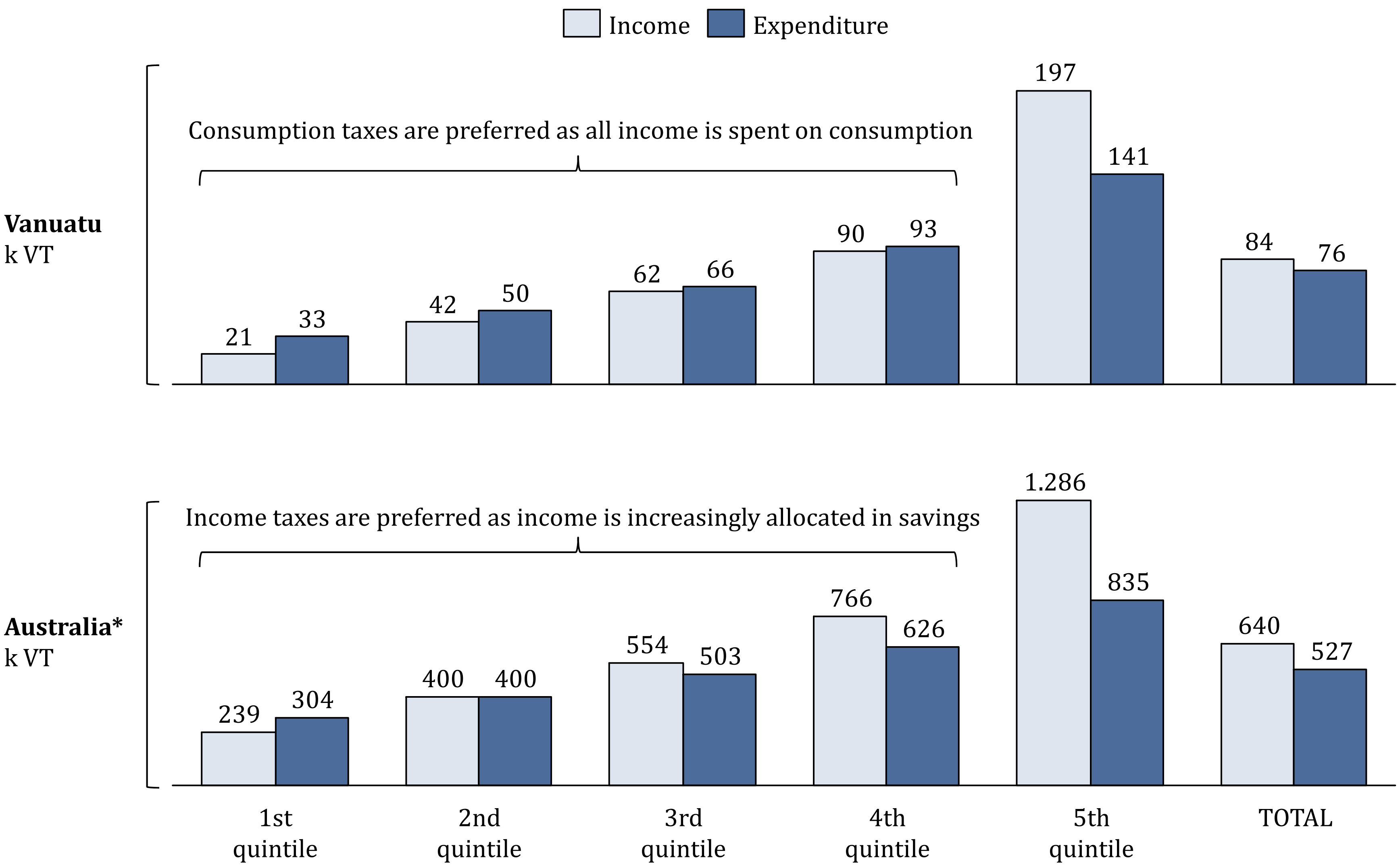


1. **Increase VAT to 17.5%.** The major driver for public revenue growth should be VAT increase, bringing in ~4 bn Vatu annually.
2. **VAT exemptions on first necessity supplies.** Increasing VAT rate to 17.5% would also result in average consumer price increase of 2.5%. To mitigate the increase in cost of living VAT exemptions on basic items could be introduced, resulting in up to 50% offset to new VAT collections (2 bn VT)
3. **Introduce Land Value Tax.** Property valuation experts agree that LVT tax system would be very simple for the government to implement and collect. In Port Vila alone, 1.4 million square meters of commercial and industrial property could bring in additional 2.8 bn VT if taxed at a modest rate of 2,000 VT/m^2.
4. **Reduce import duties.** Assumes loss of tax from reduced import duties as in the Revenue Review model.
5. **Reduce offsets by 50%.** Assumes that at 50% of the proposed offsets (0.7 bn VT) will remain in place as there are no clear benefits to removing most of existing fees and taxes.
6. **Sale of unproductive gov't assets.** The government should dispose of assets that are non-productive. A number of buildings and other assets are not being maintained and could generate considerable economic value if they were sold and managed by private sector entities.
7. **Infrastructure development .** Sale of assets should be matched by long-term infrastructure development projects (e.g. building schools, hospitals), restructuring public portfolio of assets to ensure their productivity.

Source: Information Paper – Empirical Analysis Of Revenue Reform Options, Strategy Labs team analysis

VAT is the superior taxation mechanism for Vanuatu as it maintains progressivity in a largely consumption-based economy

Monthly household income and expenditure, 2010

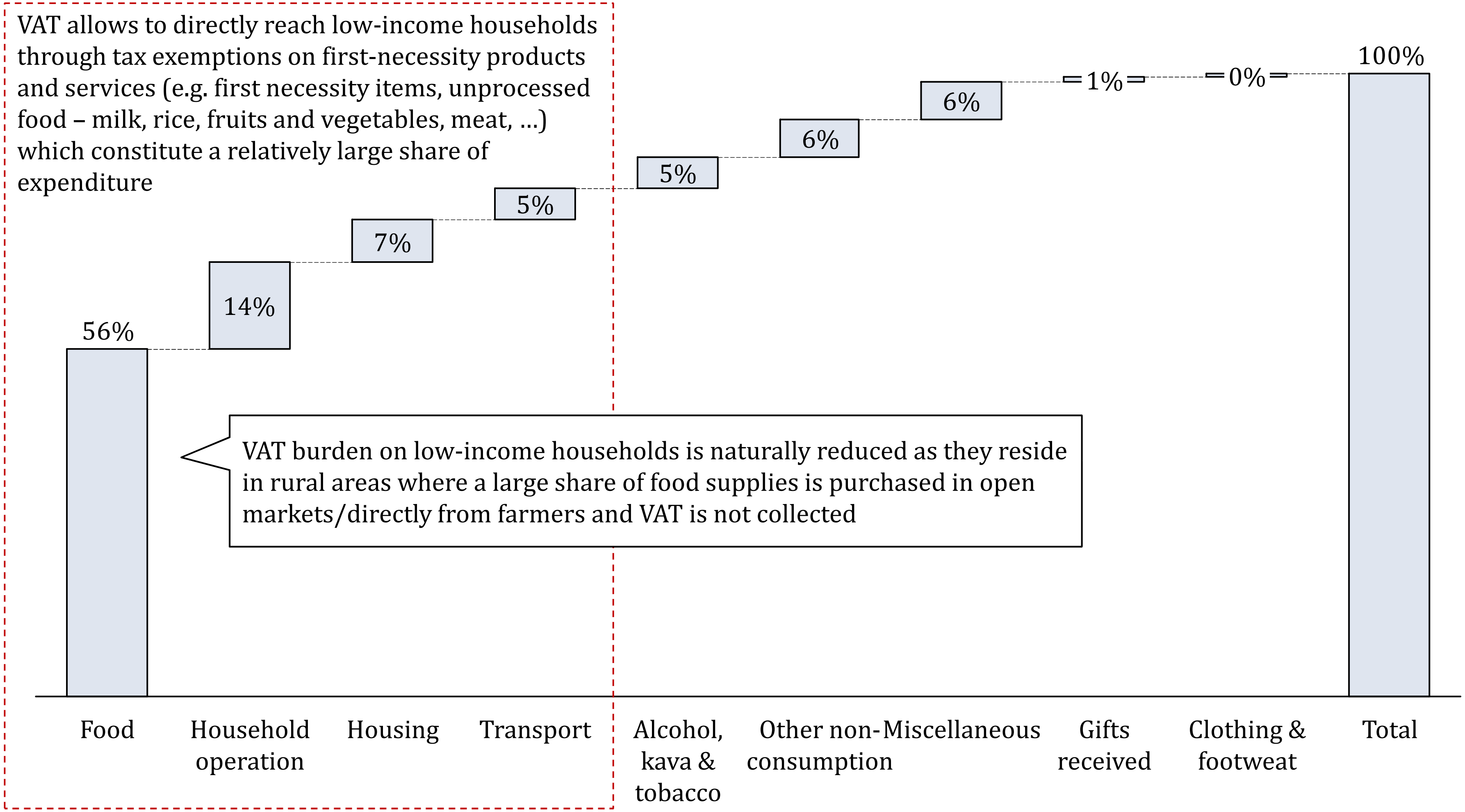


Source: Vanuatu Household Income and Expenditure Survey 2010, The Distribution of Household Spending in Australia

*Equalized income

VAT exemptions on first-necessity items could help increase purchasing power of poor households and enhance tax progressivity

Type of household expenditure (%), 2010

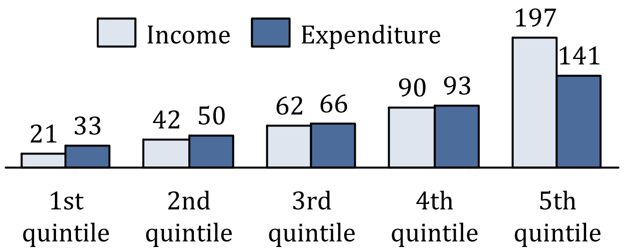


Source: Vanuatu Household Income and Expenditure Survey 2010

Alternatively, VAT rebate system could help achieve desired tax progressivity levels through direct public transfers to poor households

INTRODUCING VAT RETURNS SYSTEM FOR POOREST HOUSEHOLDS…

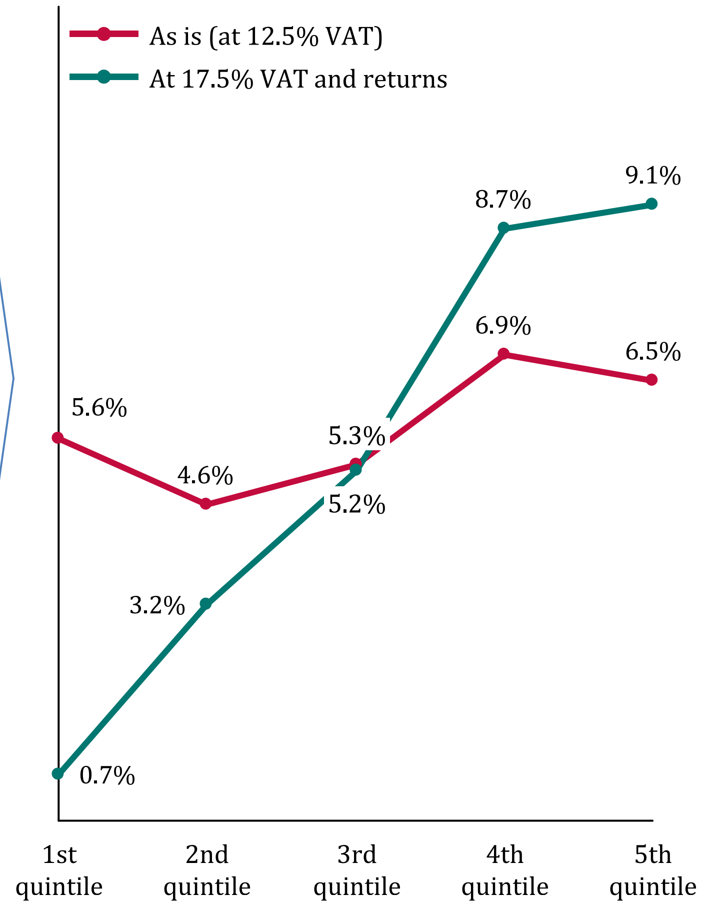
Household income and expenditure
k VT, monthly, 2010



	1st quintile	2nd quintile	3rd quintile	4th quintile	5th quintile
Goods and services subject to VAT* Percent of consumption value	30%	33%	42%	57%	80%
VAT paid @ 12.5% k VT	1.2	2.0	3.3	6.2	12.8
Increase VAT to 17.5%					
VAT paid @ 17.5% k VT	1.6	2.7	4.6	8.6	17.9
Introduce VAT returns *(50% of revenue increase)*					
VAT rebate k VT	1.5	1.4	1.4	0.8	0.0
VAT paid @ 17.5% less VAT returns k VT	0.1	1.3	3.2	7.8	17.9
Net effect k VT	**+1.0**	**+0.6**	**+0.1**	**-1.7**	**-5.1**

… WOULD ENSURE VAT PROGRESSIVITY

Household VAT paid less returns
% of income



*Assumes that lower-income households purchase a large share of supplies in open markets/directly from farmers where VAT is not collected. Overall average is at 57%, in line with Revenue Review estimate

Source: Information Paper – Empirical Analysis Of Revenue Reform Options, Vanuatu Household Income and Expenditure Survey 2010

Introducing LVT to commercial, industrial, and residential properties in Port Vila and Luganville could help raise 2.8 bn VT in public revenues

What is Land Value Tax (LVT)?

Land Value Taxation is a method of raising public revenue by means of an annual charge on the rental value of land.

Although described as a tax, it is not really a tax at all, but a payment for benefits received. It would replace, not add to, existing taxes.

Properly applied, Land Value Tax would support a whole range of social and economic initiatives, including housing, transport and other infrastructural investments. It is an elementary fiscal measure that would go far towards correcting fundamental economic and social ills.

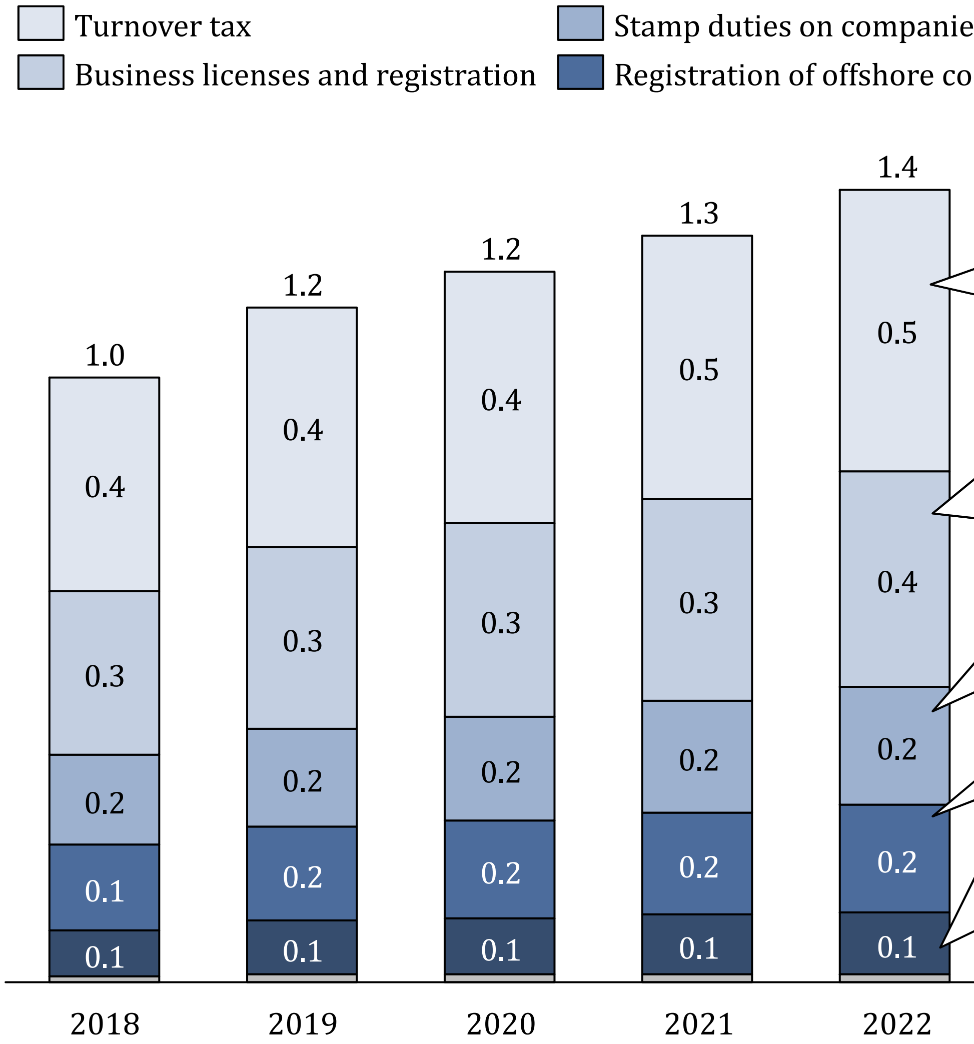
Potential public revenues from LVT

Location	**Property type**	**Area** Thsd. m^2	**Avg. tax rate** VT/m^2	**Government revenues** m VT
Port Vila	Commercial	1,211	1,500	1,817
	Industrial	227	1,500	340
	Residential	4,366	80	349
Luganville	Commercial	136	1,400	191
	Industrial	0	N/A	0
	Residential	1,080	60	65
TOTAL		**7,021**	**393**	**2,762**

Source: Land Value Taxation Campaign, Vanuatu Property Valuations, Strategy Labs team analysis

Existing fees should be maintained as they could generate 1.4 bn VT while there are no clear benefits to removing them

Projected offsets, bn VT



The turnover tax is paid mostly by banks and is not opposed by the public or the banking industry

By removing the fees on business licenses and registration, but keeping the registration, the government does not reduce the monitoring workload and costs while removing the income

The advantages of stamp duty reductions are ambiguous and have questionable benefits while the monitoring and accounting workload stays the same for the government

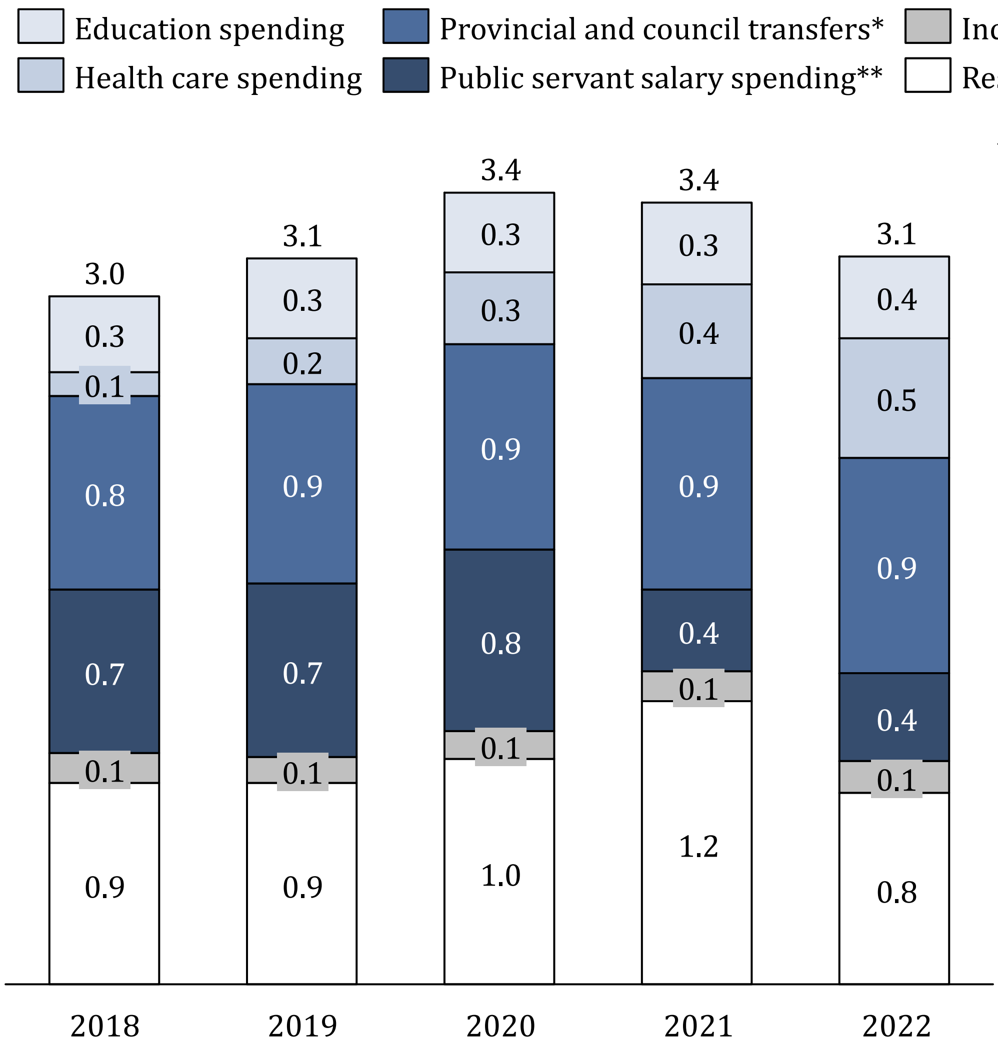
Removing registration tax of offshore companies will not benefit Vanuatu community in any way

The removal of rent tax would result in economic disruptions because the rent tax is setup to match the size of the VAT tax as to impact both businesses and renters similarly. Also, the introduction of income tax would allow renters to claim additional deductions, further reducing the income from the tax.

Source: Information Paper – Empirical Analysis Of Revenue Reform Options, Strategy Labs team analysis

Proposed spending structure should be seriously reconsidered as only 21% will go to priority sectors of health and education

Proposed spending of the revenue generated from new taxes, bn VT



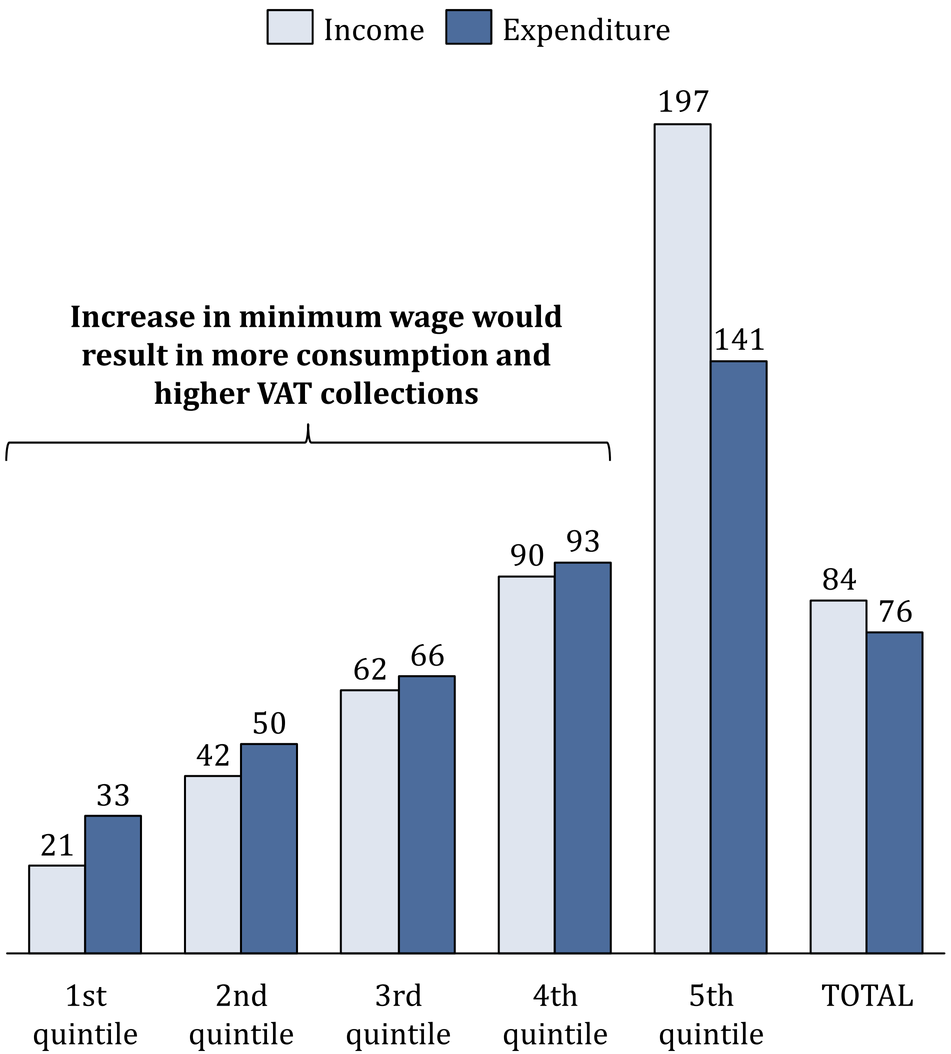
Avg. share 2018-2022	Implications
11%	• **Only 11% of the newly generated revenues will be spent on education**
10%	• On average, **just 10% of newly generated income will be spent on health care**
46%	• 28% of the income, **more than the total of healthcare and education combined**, will go to provincial and council transfers, which have **little to no spending accountability** • Over 18% of income will be spent on the **salaries of public servants**

*The figure includes Grants to provinces for forgone business license revenue and Fiscal transfer to councils and provinces
**The figure includes Future severance payments and Cost of living adjustment for public servants
***The figure includes Additional cash reserve requirement and Contribution to fiscal responsibility/development fund

Source: Information Paper – Empirical Analysis Of Revenue Reform Options, Strategy Labs team analysis

Increasing minimum wage could help fuel consumption and raise public revenues through additional VAT collections

Monthly household income and expenditure, k VT in 2010



- As four out of five households in Vanuatu are spending more than their income, the Government could consider increasing minimum wage
- Minimum wage increase would directly impact public revenue collection as a proportion of increased household spending would be collected as VAT
- Additional collections could then be used to finance investments and infrastructure development in public health and education
- In the medium and long-run, increasing the availability of skilled labor would further contribute to public finances as economy and income growth would fuel consumption and additional VAT collections

Source: Vanuatu Household Income and Expenditure Survey 2010