2016

VANUATU REVENUE REVIEW

CONSULTATION FEEDBACK

BY VANUATU CHAMBER OF COMMERCE AND INDUSTRY

NOVEMBER 2016

The Vanuatu Chamber of Commerce & Industry

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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.

1. KEY ISSUES OF THE PROPOSED TAX REFORM

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

Revenue Review Committee has identified the following **Guiding Principles for a Good Revenue System**:

- Appropriate Government revenues
- Support economic growth and efficiency and higher living standards
  - Economy of collection – low cost of collecting revenues
  - High tax compliance
- Fairness – responsibility to contribute
  - Equity and Fairness
  - Neutrality
- Simplicity, certainty and convenience
  - Convenience of payment
  - Ease of complying with tax obligations
- The revenue system must meet the needs of the Vanuatu community

The proposed Vanuatu Revenue and Administration Modernisation reforms should therefore be, as suggested by the Revenue Review, an *acceptable balance of these principles*.

VCCI/VFCA/the Private Sector representatives **agree with the Guiding Principles**. However, thorough review and analysis suggest that the proposed tax reforms are in conflict with most of these principles. A summary table is presented below:

PRINCIPLE	IDENTIFIED CONFLICT
Appropriate Government revenues	Revised Revenue Review model estimates show shortfalls of at least 3.2 bn VT in 2022, largely due to shadow economy and administrative cost overruns. A more detailed analysis of expected shortfalls is presented in Section II.
Economy of collection – low	CIT collection process would be inefficient as a large share of businesses would contribute insignificantly to CIT collections, while cost of

cost of collecting revenues	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. See Figure 1 in the Appendix for more information.
High tax compliance	PIT and CIT are considerably more complex to monitor and ensure compliance. Based on comparison of other countries in the Asia-Pacific region, shadow economy in Vanuatu could reach as high as 30-50%. See Figure 2 in the Appendix for more information.
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. See Figure 3 in the Appendix for more information.
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.
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 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.

1.2. The proposed tax reform is not expected to achieve the desired outcomes

Another core issue with the proposed introduction of Corporate and Personal income taxation is that it is not expected to achieve the desired outcomes, as shown by our analysis:

- Reduce the cost of doing business – Abolish fees and charges that are costly to collect and comply with

  Identified issue: 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 and cost of capital to support investment and economic growth – Reduce import duties over five years

  Identified issue: Compensating for lower profitability, business will increase prices, leading to higher cost of living for all. The majority of reduced import duties are expected to be absorbed by large retailers and importers

- Introduce a fair and effective income tax for individuals (with a tax-free threshold) and businesses where higher income earners contribute more through progressive tax rates (meaning that tax rates increase with income)

  Identified issue: Household data shows that the majority of households spend all of their income on consumption (see Figure 4 in the Appendix for more information), thus consumption taxes (VAT) are already progressive. Furthermore, lower-income households tend to pay relatively less VAT as they purchase most of supplies in open markets where goods are not subject to VAT. Increasing VAT and introducing VAT exemptions of first-necessity supplies or direct VAT rebates to poorest households could further enhance VAT progressivity without causing as much economic disruption as introduction of income taxes would

1.3. Hidden agenda

Revenue Review claims that the tax reform is focused around the improvements to the financial system of Vanuatu and collection of additional funds for development of infrastructure, and health and education systems.

In reality, we feel that the reform is primarily driven by the hidden agenda of the Government and OECD countries. While not openly mentioned in the Revenue Review, there is a clear push for Vanuatu to, through the tax reform, adopt Common Reporting Standard (CRS) system that is used in OECD countries. This would include collection of names, addresses, dates of birth and Taxpayer Identification Numbers (TIN) of Vanuatu citizens, as well as the transactions and the balances of their accounts.

As currently Vanuatu is not collecting this information, the third parties are interested in pushing through this reform. The collected information would have to be shared with other OECD countries that are part of the system to identify and prevent potential capital and wealth movements to Vanuatu. While such reform would be very costly to implement and administer for Vanuatu, the benefits would be borne primarily by other countries through CRS tracking.

We would therefore like to express our concern that the improvements of Vanuatu tax system and potential future developments are only secondary issues that are used to mask the implementation of CRS.

1.4. Alternative set of measures

Proposed Vanuatu Revenue and Administration Modernisation neither adheres to the Guiding Principles nor achieves its desired outcomes, and is designed around the hidden agenda. This is the main reason why **VCCI/VFCA/the Private Sector representatives do not support the modernisation its current form**.

Instead, an **alternative set of measures are proposed** for consideration. These measures are based on a number of key strategies, namely:

1) Increase VAT to 17.5%. (+4.0 bn VT)
2) Introduce 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 & 7) Finance infrastructure development by selling unproductive assets (Net zero)

We firmly believe that these proposed reforms are within the Guiding Principles. In addition to this, they take into account local and international context, and are therefore a more reliable way of raising public revenues while limiting economic disruptions and other negative effects on key stakeholders. A more detailed presentation of the proposed adjustments is presented in Section III.

2. Understanding the Effects on Economy

2.1. Implications of economic transfers

An analysis of key economic transfers under the proposed tax regime was carried out to highlight major changes and their socio-economic implications.

Net effects were highlighted for six major stakeholders: the Public sector, 10% largest companies, other 90% of businesses, Top 1% earners, the other 99%, and foreign investors.

- Our review shows that not all companies will be affected equally – 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, which will increase the cost of living. This effect is in conflict with targeted outcomes of the Revenue Modernisation.
- Finally, economic transfers of foreign investors suggest that Vanuatu will become less attractive to investors, causing flight of foreign capital and FDI divestments hindering long-term economic growth.

For more information, please see Figure 5 in the Appendix.

2.2. Proposed tax structure will lead to significant revenue shortfalls

To illustrate the potential revenue shortfalls, we have revised the Revenue Review model estimates for the year 2022. The adjustments are mainly based on two key assumptions:

1) **Significant decline in PIT and CIT collections are expected due to low tax compliance**. Expected full compliance with PIT and CIT is unrealistic as even advanced countries with years of experience struggle with shadow economy. Based on comparison of other countries in the Asia-Pacific region, shadow economy is expected to be in the range of 30-50% GDP in Vanuatu with the introduction of PIT and CIT.

2) **Introducing new complex taxes will incur significant tax administration costs which are currently underestimated**. International benchmarking shows that a single tax office employee serves a population of 430-1400. Taking into account social and geographical factors (83 islands, large distances, diversity of businesses), we expect that Vanuatu will need 1 tax staff to serve 600 people, which would further increase the costs of tax administration. It is also a concern of the local business community that the level of productivity in Vanuatu is considerably lower than in many other countries, and the actual number of additional staff to administer PIT/CIT system could be even higher.

Expected PIT and CIT shortfalls are 0.9 and 1 bn VT respectively. Unaccounted administration costs are in the range of 1.3 bn VT. In total, they amount to 3.2 bn VT, or 2.4% GDP – a considerable gap.

This does not account for additional negative economic effects, such as loss of FDI, reduced economic growth, labor market disruptions, indirect compliance costs, etc. The total shortfall will be far in excess of 3.2bn VT.

For more information, please see Figure 6 in the Appendix.

2.3. Introduction of CIT will have a detrimental effect on FDI

Another dimension that is strategically important for Vanuatu is foreign direct investment (FDI). FDI benefits are significant, and include the following:

- Technology spillovers
- Human capital formation support
- Enhancement of competitive business environment
- Contribution to international trade integration
- Improvement of enterprise development

For the period of 2015-2020, estimated FDI in Vanuatu is around 6 bn VT, or 7% 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. This is extremely detrimental in a country with high population growth and in critical need of job creation.

For more information, please see Figure 7 in the Appendix.

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3. Recommendations for the Committee

3.1. An alternative approach to tax reform

Instead of introducing income taxes, we propose an alternative tax reform which is based on these strategies:

1) **Increase VAT to 17.5%.** The major driver for public revenue growth should be VAT increase, bringing in ~4 bn Vatu annually.

2) **Introduce VAT exemptions on first-necessity items**. Increasing VAT rate to 17.5% would also result in average consumer price increase of 2.5%. To mitigate the effects of consumer price increase on poor households and ensure VAT progressivity, government could implement VAT exemptions on first-necessity items (or, alternatively, direct VAT rebates for poorest households) for a total of 50% of additional VAT collections, or 2 bn Vatu.

3) **Introduce Land Value Tax.** Introducing LVT to commercial, industrial, and residential properties in Port Vila and Luganville could help raise 2.8 bn VT in public revenues.

4) **Reduce import duties**. Assumes loss of tax revenue from reduced import duties as in the Revenue Review model.

5) **Reduce unnecessary offsets by at least 50%**. Majority of the offsets proposed by the government are unnecessary as they provide no clear benefits for the public and the business community. Instead, we propose to reduce the denoted offsets by at least 50%, which could save as much as 0.7 bn VT in tax revenues.

6) **Sale of unproductive Government 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. This would help ensure that sale of public assets is not a one-off revenue stream.

The net effect of proposed strategies is 3.2 bn VT, which is comparable to the 3.0 bn VT net surplus proposed in the Revenue Review model.

For more information, please see Figure 8 in the Appendix.

3.2. Ensuring VAT progressivity

The main concern of such VAT-based system is income progressivity. This can be addressed by introducing VAT exemptions on first-necessity items.

Household survey identified that Vanuatu households allocate ~56% of their spending to food (see figure 10 in the Appendix for more information). This implies that VAT exemptions on unprocessed food items and other first-necessity items could considerably reduce VAT burden on poor households. We would recommend applying VAT exemptions to:

- Milk
- Rice
- Fruits
- Vegetables
- Meat
- Other first-necessity items

An alternative proposal would be to allocate up to 50% of additional revenues from increased VAT rate for VAT rebates to poorest households. This allows direct redistribution of wealth to most marginalized population groups while at the same time ensuring a stable, reliable, and cost-efficient taxation system.

VAT rebates could be transferred via Provincial transfers (as already proposed in the reform). Alternatively, technology could be leveraged (e.g. transfers a mobile cash application as even people in remote areas have mobile access) to ensure a cost-effective solution.

Our calculations suggest that VAT is already progressive, as lower-income households purchase a large share of supplies in open markets/directly from farmers where VAT is not collected. VAT returns could help increase the effect, allowing to shift effective VAT rates (as % of income) from close to zero in poorest households to ~9% in richest households (see figure 9 in the Appendix for more information).

3.3. Introduction of 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.

The territories in Port Vila and Luganville have already been zoned and evaluated by the Lands Department:

- **Port Vila:**
  - Commercial: 1,211 thousand square meters
  - Industrial: 227 thousand square meters
  - Residential: 4,366 thousand square meters

- **Luganville:**
  - Commercial: 136 thousand square meters
  - Industrial: none
  - Residential: 1,080 thousand square meters

Due to this, local property valuation experts agree that LVT tax system would be very simple for the government to implement and collect, as the underlying valuation and calculation models are already in place.

We estimate that 2.8 bn VT in Government revenues could be raised annually if the following average tax rates were implemented:

- **Port Vila:**
  - Commercial: 1,500 VT/m^2
  - Industrial: 1,500 VT/m^2

  - Residential: 80 VT/m^2

- **Luganville:**
  - Commercial: 1,400 VT/m^2
  - Residential: 60 VT/m^2

While LVT would be partly transferred to tenants, people with higher incomes tend to reside in high-end homes, thus LVT would introduce further progressivity into the tax system.

For more information, please see Figure 11 in the Appendix.

3.4. Existing fees should be maintained

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. We propose that at least 50% of the offsets should be reconsidered, improving the budget by 0.7 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
- As the rent tax is easy to calculate and administer, there would be little to no reduction in government workload if it was abolished. Moreover, 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. It is also important to note that if rent tax was replaced with the income tax, property owners would be able to claim additional deductions, in such way further reducing the potential tax revenue.

For more information, please see Figure 12 in the Appendix.

3.5. Reconsider proposed spending structure

Tax collection is not the only problematic area of the Revenue Review as proposed expenditure structure offers little to no value for the taxpayers:

- Only 11% of newly generated public revenue will be allocated to education, one of the most critical areas of long-term growth and sustainability;
- Similarly, only 10% is planned to be used for health care;
- The largest share of newly generated revenue will go to provincial and council transfers, which have little to no spending accountability;
- Additional 18% is allocated for salaries of public servants, which will not bring better service to the public or increase government administration quality.

This will also result in detrimental effects to tax compliance, overall taxpayers' morale, and satisfaction with the Government. We would therefore like to request the Revenue Review Committee to reconsider the planned use of additional tax collections and come up with a more compelling value proposal.

For more information, please see Figure 13 in the Appendix.

3.6. Increasing minimum wage

As four out of five households in Vanuatu are spending more than their income, the Government could consider increasing minimum wage. This 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.

Appendix

Figure 1

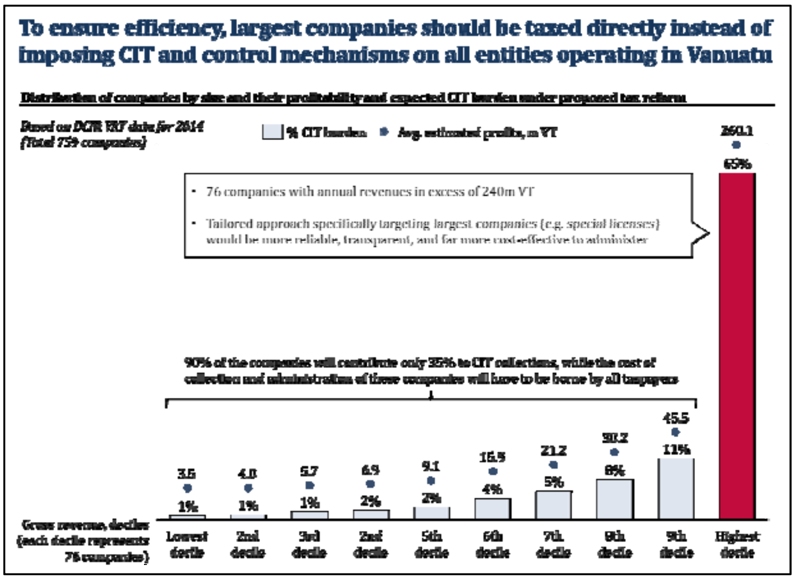


Figure 2

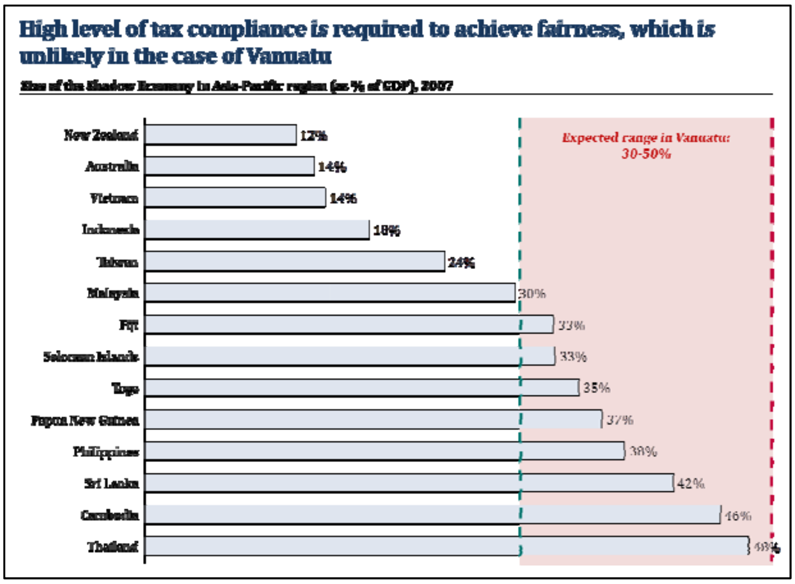


Figure 3

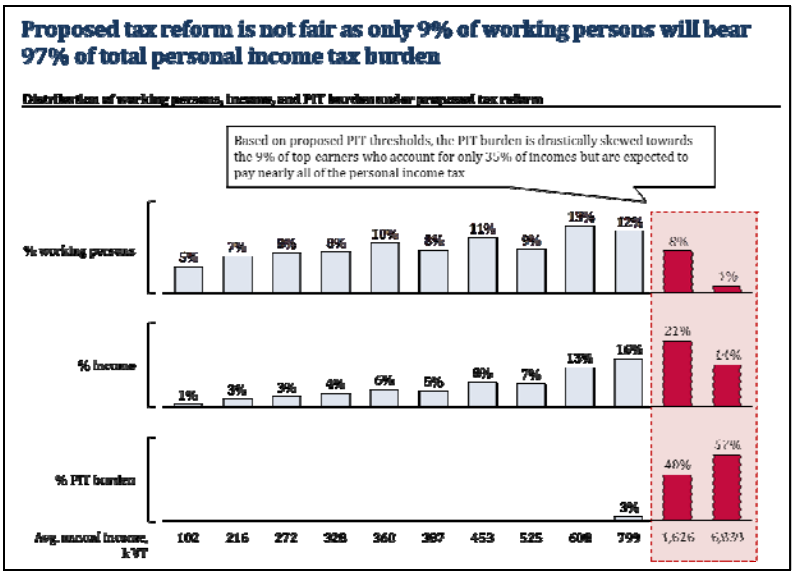


Figure 4

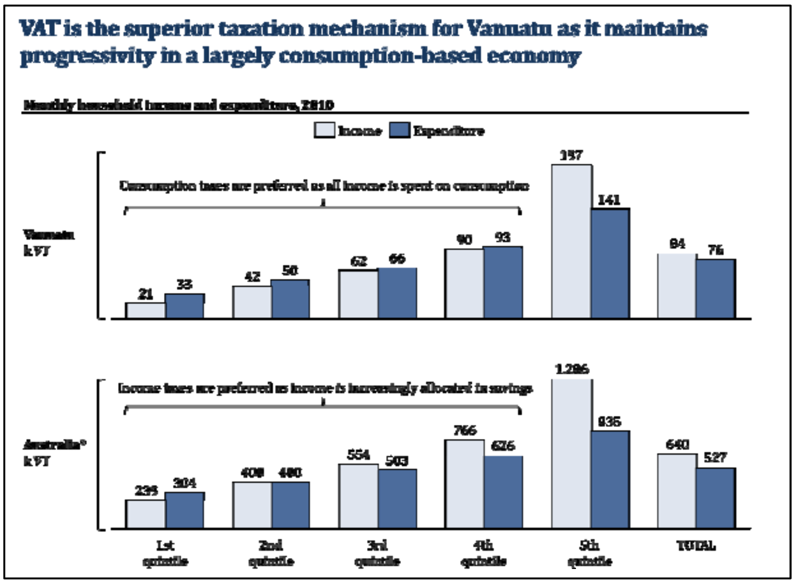


Figure 5

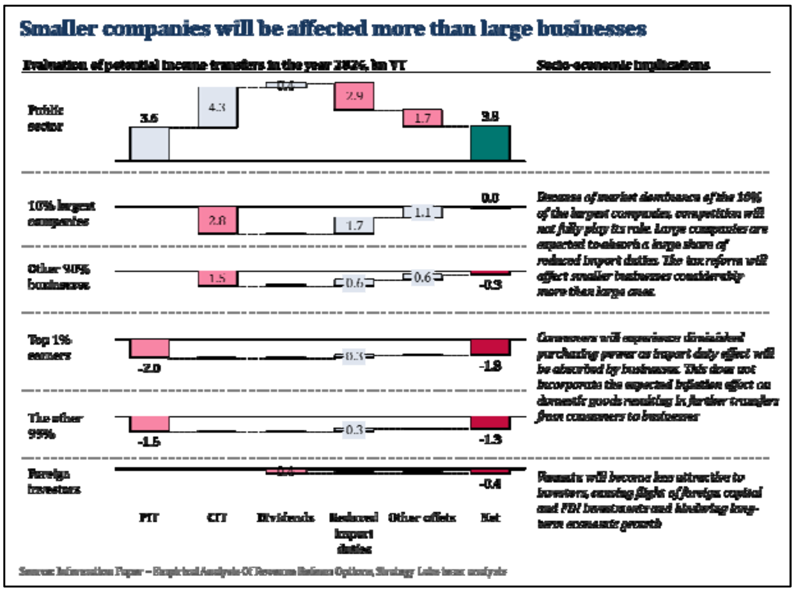


Figure 6

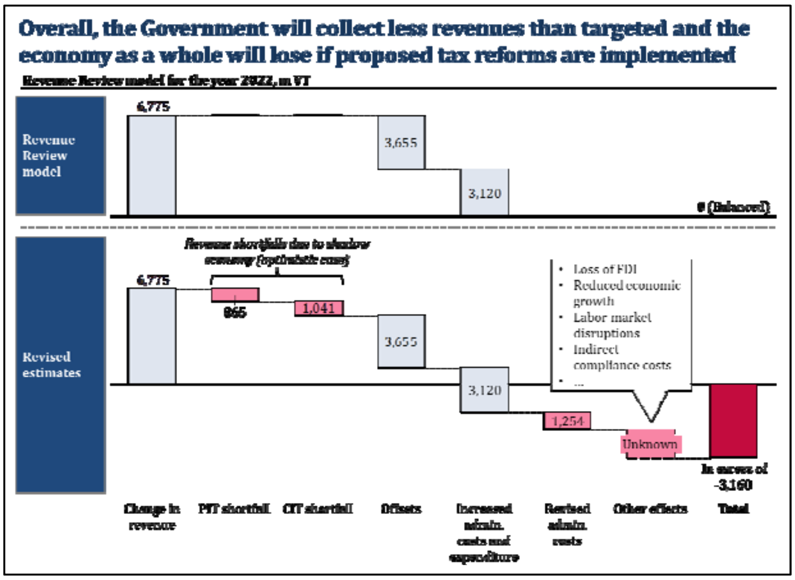


Figure 7

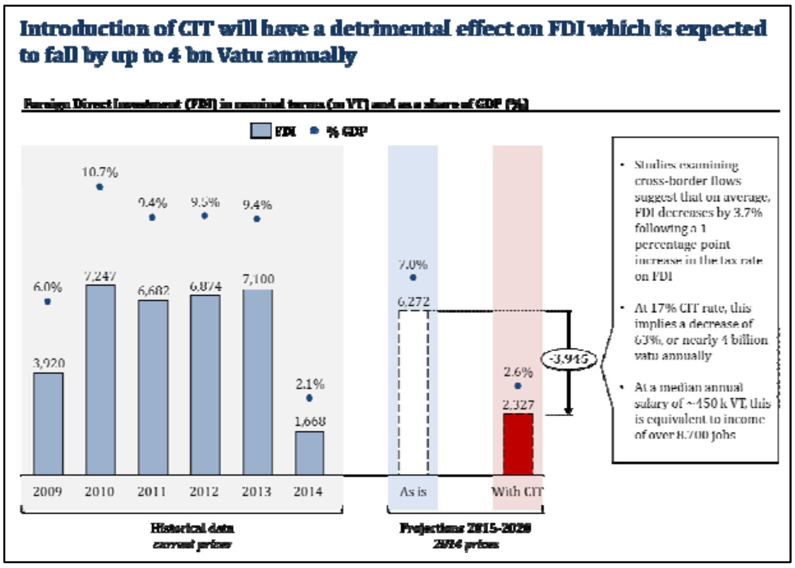


Figure 8

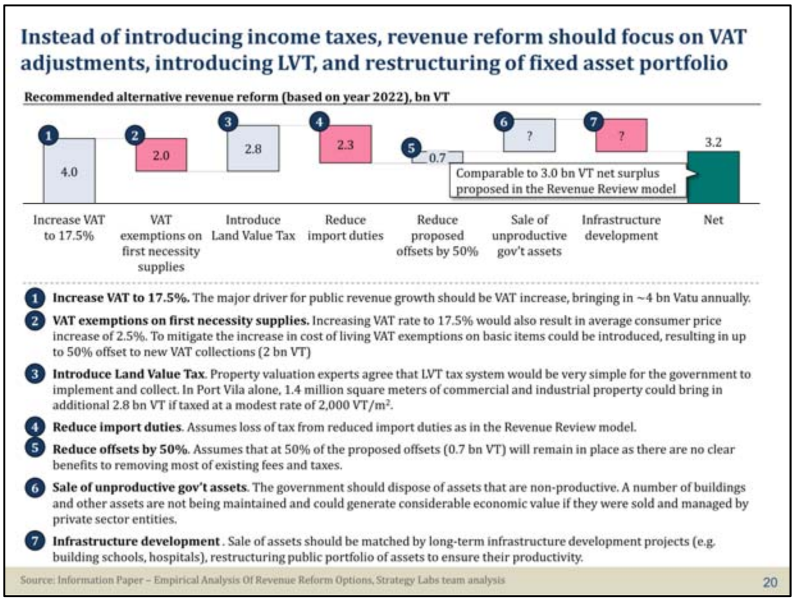


Figure 9

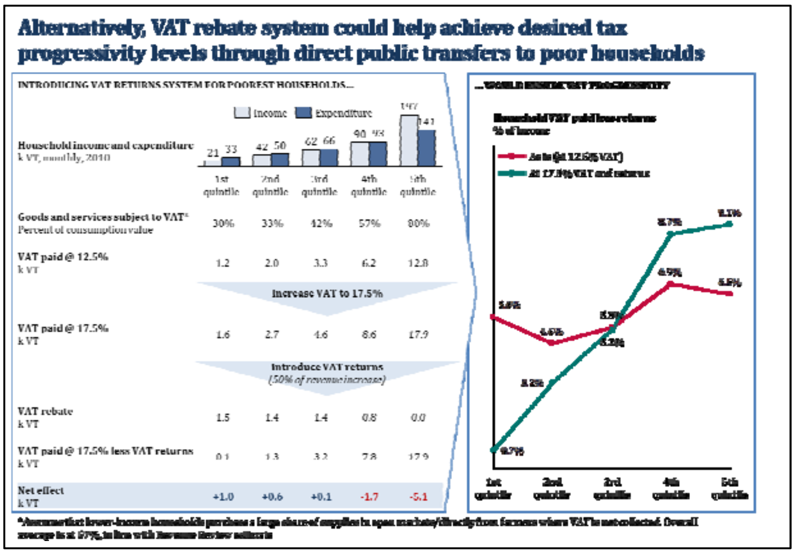


Figure 10

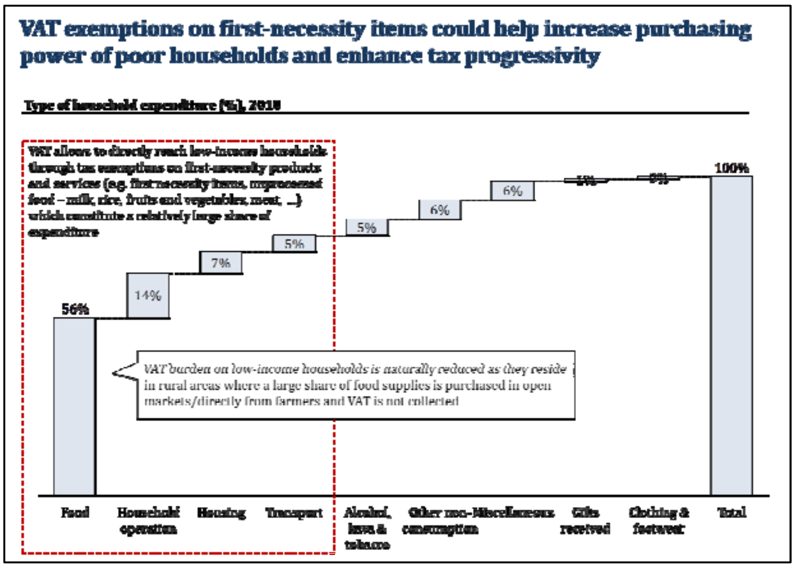


Figure 11

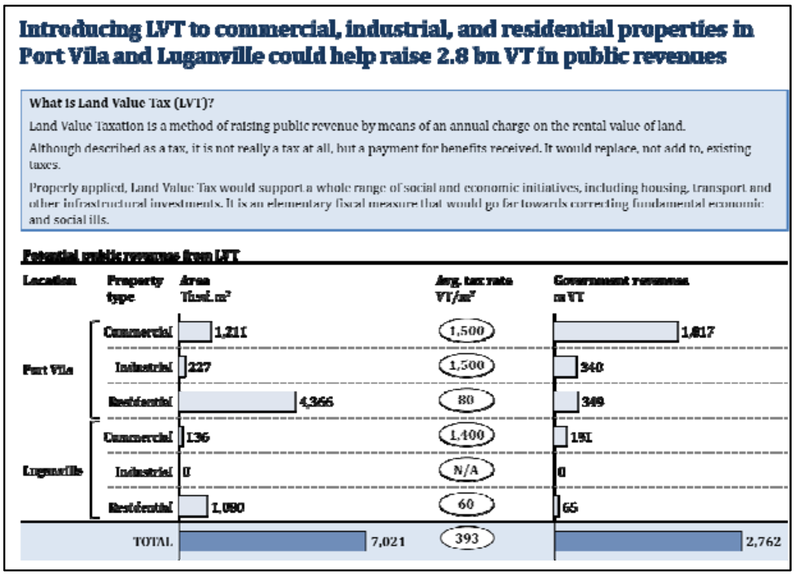


Figure 12

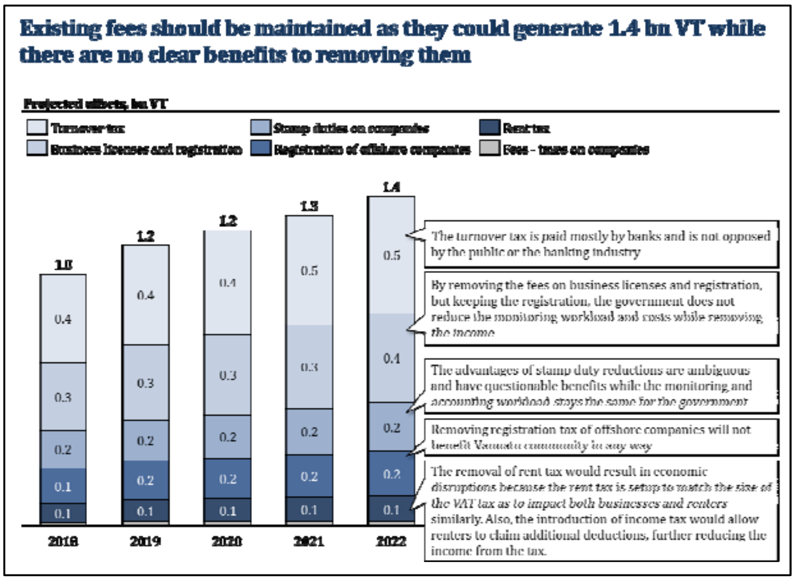
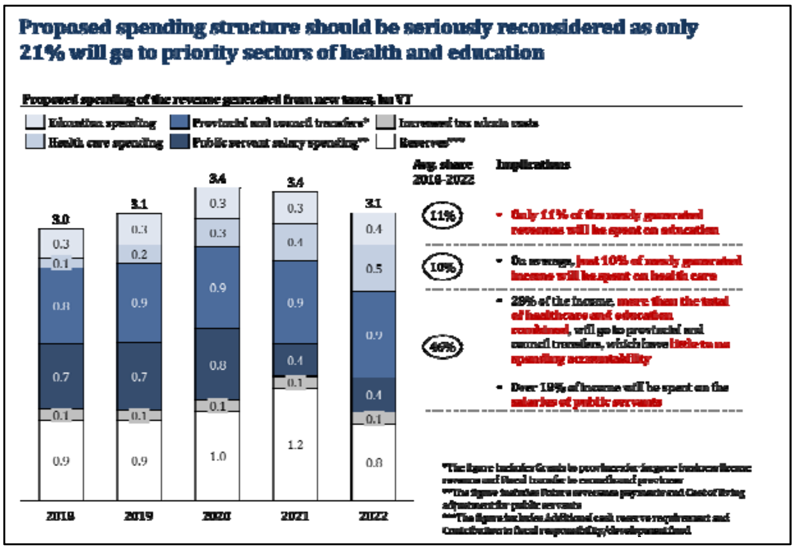


Figure 13


Proposed spending structure should be seriously reconsidered as only 21% will go to priority sectors of health and education
Education spending
Health care spending
Provincial and council transfers*
Public servant salary spending**
Increased tax admin costs
Reserves***
Avg. share 2018-2022
Implications
3.0
3.1
3.4
3.4
3.1
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0.8
2018
2019
2020
2021
2022
11%
10%
46%