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Funding the Future

Tax Revenue Mobilization in the Pacific Island Countries

Prepared by Mouhamadou Sy (lead), Andrew Beaumont, Enakshi Das, Georg Eysselein, David Kloeden, and Katrina Williams, under the guidance of Todd Schneider and Tahsin Saadi Sedik

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Executive Summary

Pacific Island Countries (PICs) face daunting spending needs related to achieving the UN Sustainable Development Goals (SDGs) and adapting to the effects of climate change. The Pacific islands are among the world's most exposed countries to climate-related natural disasters—most notably tropical cyclones, drought, and rising sea levels. Except for a few countries out of this group, progress toward reaching the SDGs is lagging. Sizable levels of additional spending will be required to upgrade or build new climate-resilient infrastructure, reduce vulnerability to climate hazards, and meet the SDGs.

Financing options to support SDG and climate adaptation spending are limited in the Pacific. Many PICs rely heavily on grants, commodity exports, and fishing revenues to finance development needs. However, these revenue sources remain volatile and could substantially decrease in the future given risks associated to climate change. Grants—while less volatile than revenues from basic commodities and fishing—are beyond the control of PIC governments. Market-based financing options are also scarce. Virtually none of the PICs have access to international capital markets, and domestic capital markets remain shallow in the few countries where they do exist. In addition, the scope for additional borrowing is limited given that most PICs are already at high risk of debt distress.

Boosting tax revenues will need to be an essential pillar in creating the fiscal space to meet SDG and climate-adaptation spending needs. As a group, the PICs have made some progress in improving tax revenue mobilization in recent years. However, a notable share of this improvement has come through windfall gains rather than policy reforms. There has been less momentum toward more durable gains, with limited major tax policy and revenue administration reforms. The COVID-19 pandemic and the war in Ukraine have induced significant revenue losses in some countries as governments introduced a range of fiscal relief measures to mitigate the impact of the two shocks. Although necessary, these measures have diverted resources from much-needed spending on development projects and have further exacerbated already-stretched public finances.

This departmental paper assesses the additional tax revenue that PICs could potentially collect and discusses policy options to achieve such gains. The main objectives of the paper are to (1) review the critical medium-term development spending requirements and available financing options, (2) document the main stylized facts about tax revenues in the PICs and estimate the additional tax revenue that countries could raise, (3) highlight the main bottlenecks preventing the PICs from further increasing their tax revenue collection with an emphasis on weaknesses in VAT systems, (4) draw lessons from successful emerging and developing countries that have managed to substantially and durably increase their tax revenues, and (5) propose tax policy and revenue administration reform priorities for Pacific Island Countries to boost tax revenues.

The paper's main findings are the following:

- *The current revenue mix is skewed toward non-tax revenues.* On average, non-tax revenues account for about 56 percent of total revenue in the region. Tax revenues are dominated by indirect taxes although the performance of goods and services taxes has been mixed recently. As in other developing countries, the performance of goods and services taxes in the PICs has not offset losses on trade taxes.
- *PICs could collect an additional 3 percent of tax revenue in the short to medium term.* The PICs are not fully exploiting their tax potential given their economic characteristics and institutions. The relative size of potential additional tax revenue varies across countries. Fragile states and commodity exporters have among the largest potential for additional tax revenue while tourism dependent economies have the lowest.

- *Many bottlenecks are preventing the PICs from boosting their tax revenue collection.* These include but are not limited to (1) over-reliance on fishing revenue and grants, (2) lack of reform momentum, (3) policy and legislative constraints, (4) insufficient information and communication technology (ICT) support, and (5) understaffed and underfunded tax administrations.
- *The potential offered by efficient VAT systems is not fully exploited.* A good VAT system has many advantages including reducing noncompliance and boosting non-VAT taxes. However, many PICs do not yet have a VAT system, and those who have it are not exploiting its full potential. The gap between the current VAT and what they could potentially collect is on average about 50 percent. VAT rates tend to be low in the region, and VAT tax exemptions and zero rating are widespread.

This paper proposes the following reforms to increase tax revenue in the Pacific Islands:

- *Unwinding recent fiscal relief measures.* Pacific countries will need to gradually unwind tax policy and revenue administration measures introduced during the pandemic and the war in Ukraine as they recover to restore revenue streams lost in the recent past.
- *Strengthening or introducing a VAT system.* Countries that already have VAT could consider introducing a single broad-based rate while increasing their tax rates given low levels compared to international standard and improving their customs administration due to its importance for VAT collection. Countries without VAT should consider its introduction together with elimination/simplification of inefficient wholesale taxes.
- *Rationalizing tax exemptions.* Tax expenditures need to be formally and regularly assessed in annual budgets. They also need to be rationalized to limit forgone revenue—especially with the VAT. Continued use of tax exemptions to incentivize investment erodes the tax base and encourages other investors to seek exemptions as well.
- *Closing loopholes in the tax system.* Transfer pricing induces important revenue losses for some Pacific Islands. Moving together toward deemed export prices for resource stocks (for example, timber) could help to protect tax revenue. Introducing personal income tax (PIT) in some countries while increasing the tax-free thresholds in counties that already had a PIT could help improve the progressivity of the tax system.
- *Reforming tax administration.* Many Pacific Islands' tax administrations are understaffed. There is a need to reach a critical mass for them to carry out their mandate. Sufficient funding is also needed for investment in ICT support, e-tax, e-commerce, and digitalization. Tackling corruption also remains a priority.
- *Introducing a medium-term revenue strategy (MTRS).* PICs need to adopt a more holistic approach regarding tax reforms given daunting structural issues (for example, climate change). A holistic approach, rooted in the MTRS' principles, could be one of the most effective pathways to finance spending requirements related to SDGs and climate-resilient infrastructure.

Acronyms and Abbreviations

ADB	Asian Development Bank
AE	Advanced Economies
CCPA	Climate Change Policy Assessment
CD	Capacity Development
CIS	Compliance Improvement Strategies
CIT	Corporate Income Tax
DFAT	Department of Foreign Affairs and Trade, Government of Australia
DSA	Debt Sustainability Analysis
ECAL	Environment and Climate Adaptation Levy
EFD	Electronic Fiscal Devices
EMDCs	Emerging Market and Developing Countries
EMs	Emerging Market Economies
EU	European Union
FAD	Fiscal Affairs Department (IMF)
FCS	Fragile and Conflict-Affected States
FJD	Fijian Dollar
FRCS	Fiji Revenue and Customs Service
FY	Fiscal Year
GCF	Green Climate Board
GDP	Gross Domestic Product
GNI	Gross National Income
GST	Goods and Services Tax
ICAC	Independent Commissions Against Corruption
ICT	Information Communication Technology
IT	Information Technology
ITSP	Information Technology Strategic Plan
LEG	Legal Department (IMF)

LIDCs	Low Income and Developing Countries
LMICs	Low Middle Income Countries
LTO	Large Taxpayer Office
MENA	Middle East and North Africa
MFAT	Ministry of Foreign Affairs and Trade, Government of New Zealand
MTRS	Medium Term Revenue Strategy
NRPC	Nauru Regional Processing Center
NTIS	New Tax Information System
OCO	Oceania Customs Organization
OECD	Organization for Economic Co-operation and Development
PACER	Pacific Agreement on Closer Economic Relations
PACTAM	Pacific Technical Assistance Mechanism Phase
PFTAC	Pacific Financial Technical Assistance Center
PICs	Pacific Island Countries
PIT	Personal Income Tax
PITAA	Pacific Island Tax Administrators Association
PCT	Platform for Collaboration on Tax
RCF	Rapid Credit Facility
RFI	Rapid Financing Instrument
RMS	Revenue Management Systems
RMTF	Revenue Mobilization Thematic Fund
SDGs	Sustainable Development Goals
SDS	Small Developing States
SIIRD	Solomon Islands Inland Revenue Division
SME	Small and Medium Enterprise
TA	Technical Assistance
TADAT	Tax Administration Diagnostic Assessment Tool
TC	Tropical Cyclones
TIMS	Tax Invoice Monitoring System
UMIC	Upper-Middle Income Countries

VAT	Value Added Tax
WB	World Bank
WDI	World Development Indicators
WEO	World Economic Outlook (IMF)
WGI	Worldwide Governance Indicators

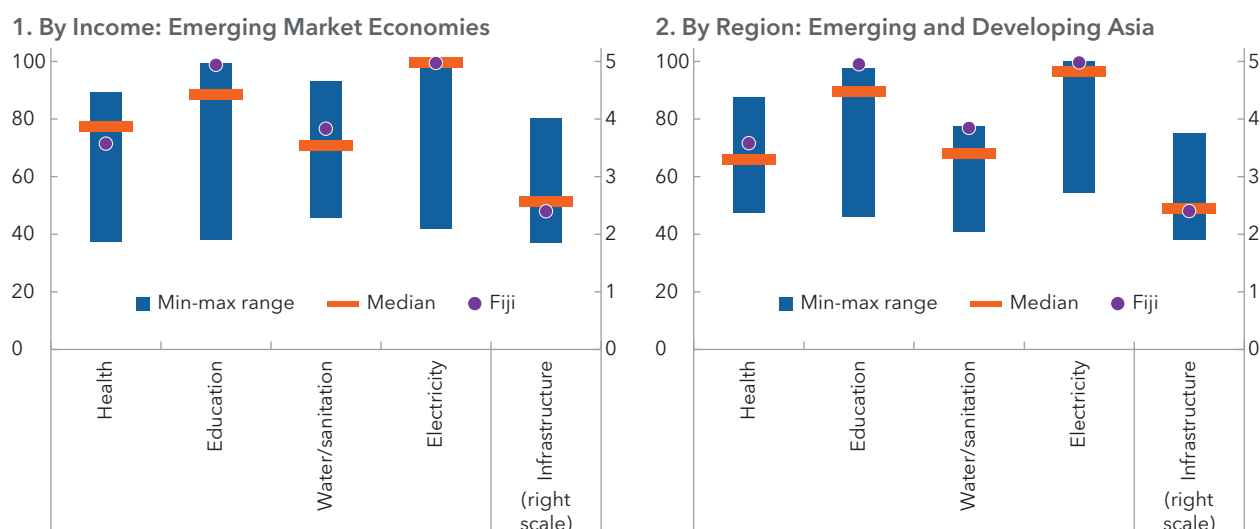
1. Pressing Spending Needs under Limited Financing Options

Critical spending requirements over the medium term highlight an urgent need to increase tax revenue collection in the Pacific Island Countries (PICs). Of particular concern are public spending challenges related to achieving the UN Sustainable Development Goals (SDGs) and adapting to climate change through enhancing the resilience of infrastructure to natural disasters. However, financing options—particularly with respect to new debt—are limited for the PICs. An increase in grant-based financing may potentially emerge. However, a concerted effort throughout the Pacific to collect more tax revenue must be a central pillar of any regional financing strategy.

A. Pressing Spending Needs Related to the SDGs and Climate Change

PICs' progress toward meeting the SDGs is below that of their peer groups and uneven across the islands themselves. For example, PICs with a relatively high GDP per capita perform well on some key SDGs (energy, water, roads, education, and health) compared to peers. As one of the most developed countries in the region, Fiji performs relatively well in areas of education, electricity and water, and sanitation compared to median emerging market economies. Fiji also performs relatively well in these sectors compared to the median emerging and developing Asian countries (Figure 1). However, the median level of progress toward meeting SDGs among the PICs is low and often below peers (Figure 2).

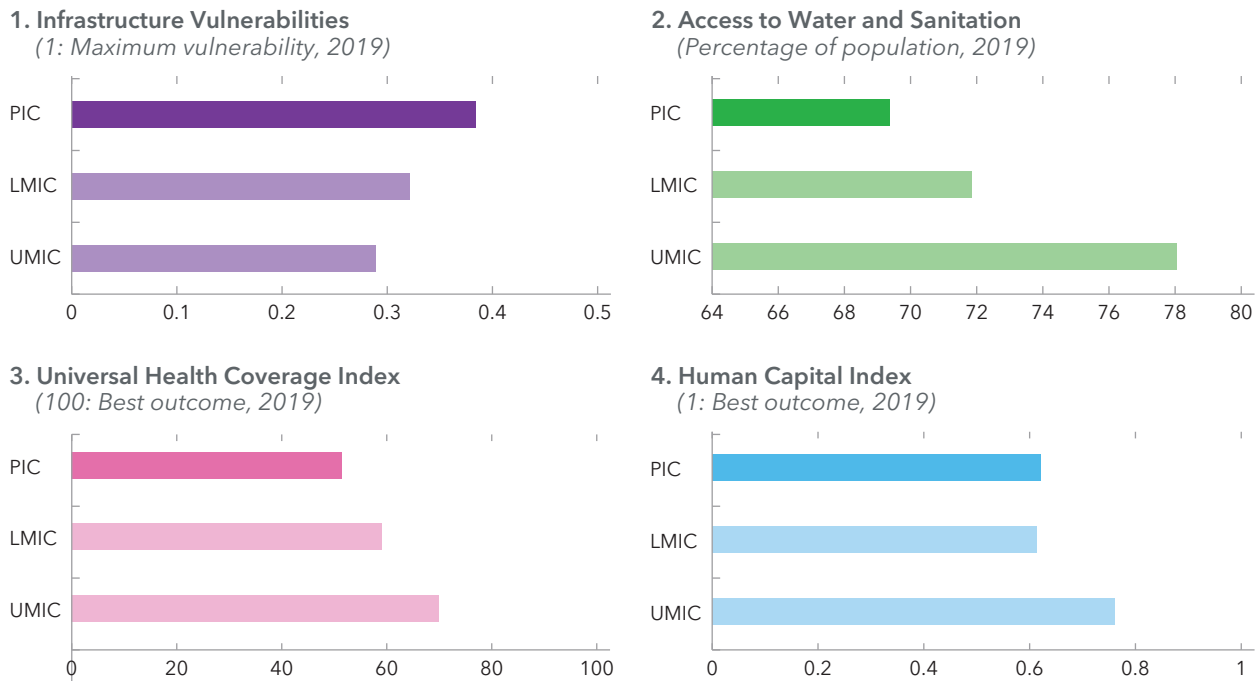
Figure 1. Fiji: Sustainable Development Goals Performance Comparison



Source: IMF staff calculations using Sachs and others (2021).

Note: SDG3 (ensuring health for all), SDG4 (ensuring education for all), and SDG6 (access to water and sanitation) are the indexes ranging from 0 to 100 (left scale); SDG7 is the access to electricity as percentage of population (left scale); and SDG9 (building resilient infrastructure) is the 2018 World Bank Logistics Performance Index Quality of Trade and Transport Infrastructure Component Score ranging from 1 to 5 (right scale) (<http://lpi.worldbank.org/international/global>).

Figure 2. PICs and Peers: Selected SDGs Performance



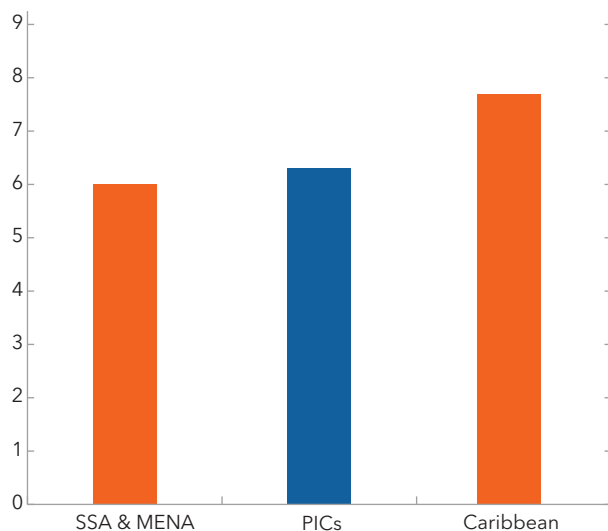
Sources: Notre-Dame Global Adaptation Initiative Index; United Nations; and World Bank.
 Note: Indices data pertain to 2019. Data for water, and sanitation vary from 0 to 100 (100 = best performance) and between 0 to 1 for infrastructure vulnerabilities (1 = worse performance). Adjusted index for health outcomes varies from 0 to 100 (100 = best performance). Human Capital Index varies from 0 to 1 (1 = best outcome). Country classification adheres to World Bank income classification FY 2021-22, wherein LMIC = low-middle income (1,046-4,095), and UMIC = upper-middle income (4,096-12,695) GNI per capita in current USD terms.

The level of additional spending needed for PICs to reach SDG targets is substantial. The additional cost to meet selected SDG targets has been estimated by Tiedemann and others 2021.¹ On this basis, the median PIC needs about 6.3 percent of 2030 GDP in annual additional spending to achieve the SDGs in the five key sectors (Figure 3, panel a). This metric compares well with estimated additional spending needs in other developing regions. However, the additional costs to meet the SDGs are uneven across sectors. PICs’ largest spending needs are hard infrastructure (electricity and roads) followed by education and spending on health (Figure 3, panel b).

Pacific Island Countries are among the world’s most exposed to climate hazards. PICs are highly vulnerable to natural disasters such as tropical cyclones (TCs), tsunamis, earthquakes, and rising sea levels (Figure 4). For example, from January 2014 to January 2021, four major natural disaster events (TC Ian, TC Gita, TC Harold, and the Hunga Ha’apai volcano) hit Tonga causing physical damages ranging from 11 percent of GDP to 38 percent of GDP. In 2016, TC Winston, the most severe cyclone ever in the Pacific region hit Fiji, resulting in damages equivalent to 30 percent of GDP. Rising sea levels and water temperatures affect fishing activities in the Pacific, and in turn, fishing revenue—a major source of income for PICs such as Kiribati, Marshall Islands, Micronesia, Nauru, and Tuvalu. The PICs face increasing pressures from natural disasters and the accelerating impact of climate change on infrastructure and public welfare. Reducing these vulnerabilities is a key policy priority for the Pacific in the medium term.

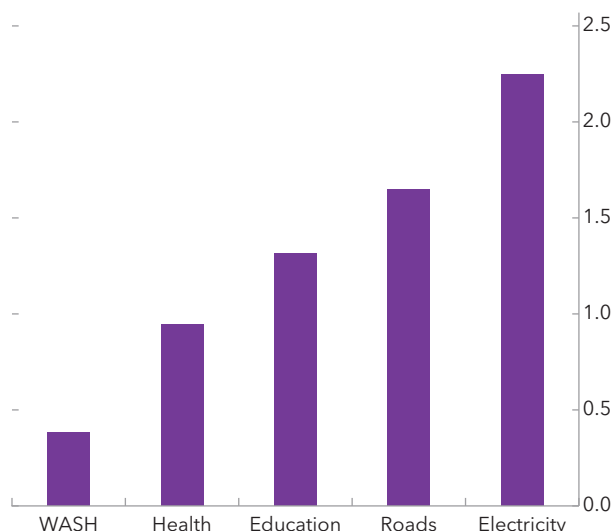
¹ See IMF (2019a) for more details about the SDG costing methodology.

Figure 3a. Developing Countries: Additional Spending to Meet the SDGs, by Region
(Percent of 2030 GDP, median)



Source: MF staff calculations (Tiedemann and others 2021).
Note: MENA = Middle East and North Africa; SSA = sub-Saharan Africa.

Figure 3b. PICs: Additional Spending to Meet the SDGs, by Sector
(Percent of 2030 GDP, median)



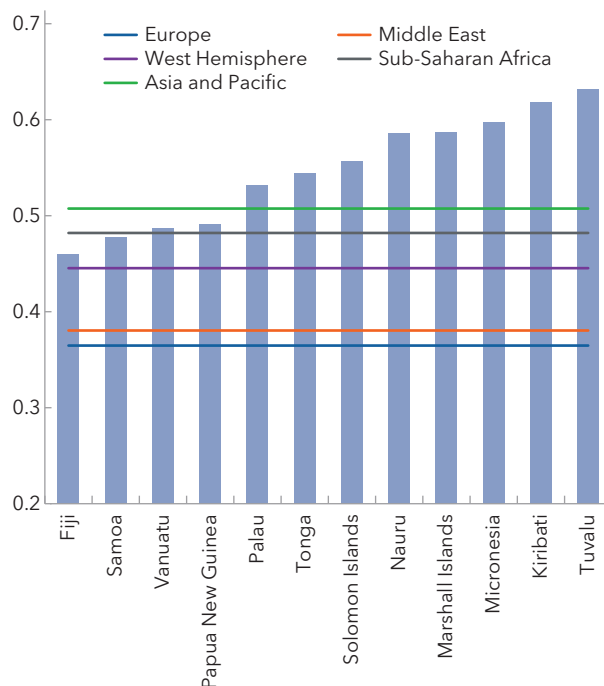
Sources: IMF staff calculations (Tiedemann and others 2021).
Note: WASH = water, sanitation, and hygiene.

Spending needs related to climate change are also estimated to be large. Spending needs vary across the islands, but the median additional spending need is estimated at 3.1 percent of GDP annually just to make the existing and planned infrastructure climate resilient (IMF 2021a). Climate-proofing infrastructure is just one element of adapting to climate change, but a critical step in mitigating the impact of climate-related natural disasters and durably raising economic growth (Figure 5). The largest spending needs are related to investment and maintenance costs to protect coastlines (3.1-4.3 percent of GDP), followed by annual adaptation costs of retrofitting existing physical assets (0.5 percent of GDP), and additional annual adaptation costs of upgrading new projects (0.1 percent of GDP²) (Figure 6).

B. Limited Financing Options

Financing options to support spending on the SDGs and climate-related projects are limited and have so far fallen short compared to needs. Virtually none of the PICs have international capital market access, and very few have domestic debt markets. Market-based

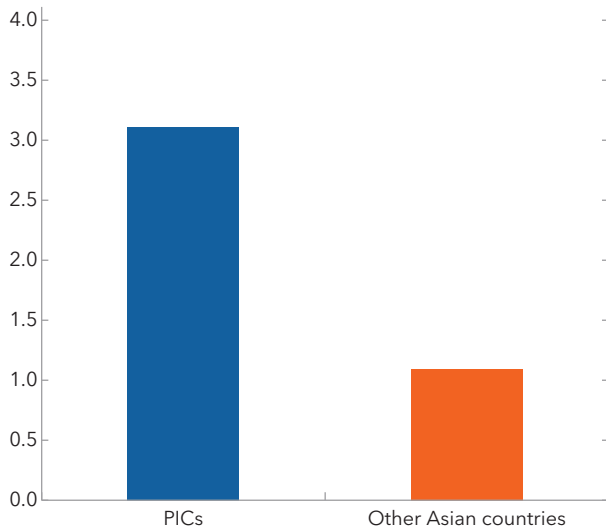
Figure 4. PICs: Exposure to Climate Change
(Index)



Sources: Notre Dame Global Adaptation Index (2018); and IMF (2021b).

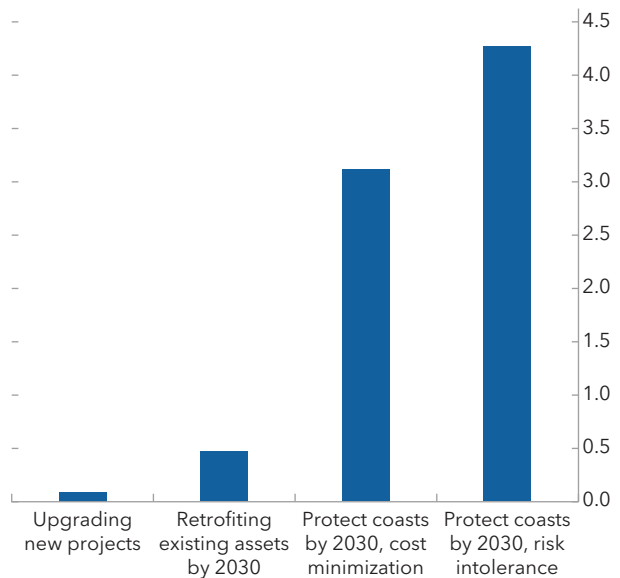
² There are synergies between the additional spending needs related to SDGs and climate change. See the case study about Tonga—a country for which these synergies have been considered in the costing of spending needs—in Annex 1, Case Study 2.

Figure 5. Asia: Public Annual Adaptation Costs (Percent of GDP, median)



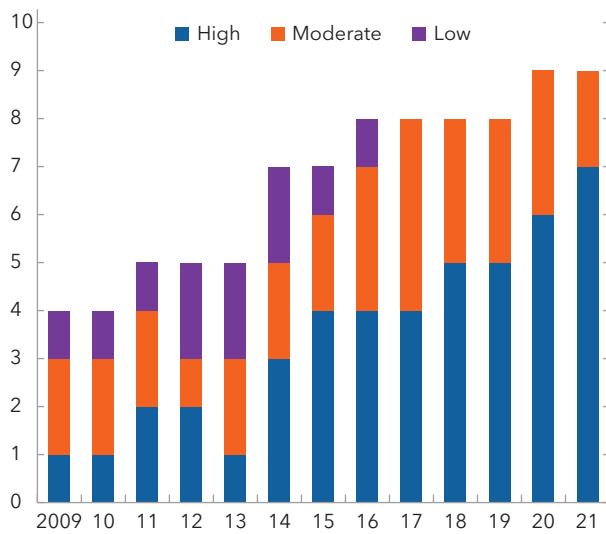
Source: IMF (2021a).
Note: PICs= Pacific Island Countries.

Figure 6. PICs: Annual Adaptation Costs, by Type of Investment (Percent of GDP, median)



Source: IMF (2021a).
Note: "Cost-minimizing" strategy aims at minimizing the sum of the expected investment costs and residual flood damage. The "risk-intolerant" aims at building coastal protection infrastructure that limits average losses below 0.01 percent of GDP.

Figure 7. PICs: Evolution of Debt Risk Rating (Number of countries)



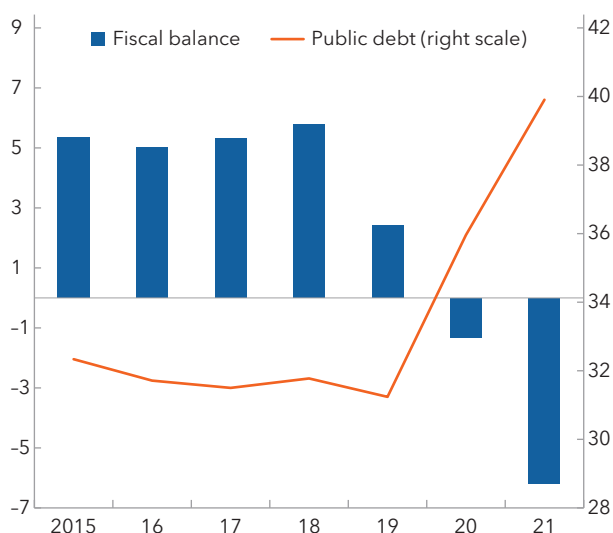
Source: IMF staff calculations using the LIC DSA database.
Note: Countries included are Kiribati, Marshall Islands, Micronesia, Nauru, Papua New Guinea, Solomon Islands, Tonga, Tuvalu, and Vanuatu.

green financing instruments (that is, Green and Blue Bonds) are typically too expensive given PICs limited revenues and debt service capacity. Given their large spending needs, PICs will need to tap a variety of financing sources to fund their development needs. However, the options are currently limited, difficult to access, or too expensive given the PICs' lack of fiscal space—particularly in the wake of the pandemic.

Scope for additional borrowing is limited. Seven out of the 12 PICs are already at high risk of debt distress according to the IMF-World Bank debt sustainability assessments (DSAs). The risk of debt distress has been on the rise over the past decade (Figure 7), partly reflecting a change in debt conditions and partly recognizing more explicit debt risks from repeated natural

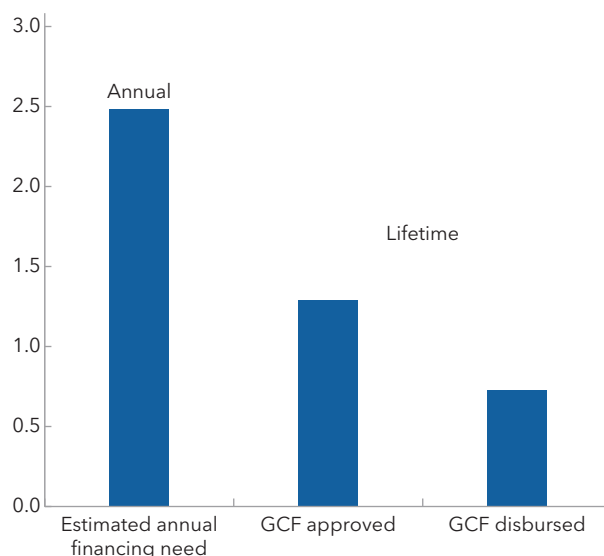
disasters. The pandemic has made the situation worse, further constraining already limited space for new borrowing to finance much-needed investments on the SDGs and climate adaptation. Public debt is rising sharply compared to its pre-pandemic level because of economic contraction and countercyclical fiscal measures which widened fiscal deficits in the region (Figure 8). PICs' development partners (both multilateral and bilateral) have provided highly concessional loans to finance these deficits, for example, to help

Figure 8. PICs: Public Debt and Fiscal Balance, 2015-21
(Percent of GDP)



Sources: Country authorities; and IMF staff calculations.
Note: Nauru is excluded because it has recorded large fiscal surpluses of more than 20 percent of GDP since 2016.

Figure 9. PICs: GCF Financing vs. Estimated Annual Adaptation Needs
(Percent of GDP)



Sources: Green Climate Fund; and IMF (2021b).
Note: GCF data are as of May 2021.

countries in the region weather the pandemic, the IMF has provided total emergency financing amounting \$424.1 million at zero percent interest rates through the Rapid Credit Facility and the Rapid Financing Instrument (IMF 2021f).

Financial disbursements for climate adaptation-related projects remain well below needs. PICs rely to a significant extent on grants and concessional loans to finance projects related to climate adaptation. However, the gaps between spending needs, the amount of financing that has been approved by international climate funds, and the amount that has actually been disbursed remain large (IMF 2021b) (Figure 9). Additional financing through grants remains possible but is partly beyond the control of PICs governments. With space for additional debt constrained, mobilizing domestic revenue sources to finance investment in climate adaptation will be essential.

Expected revenue losses from implementation of the PACER³ Plus trade agreement could further exacerbate the already-stretched public finances. The PACER Plus agreement came into force since December 2020. Three PICs (Samoa, Solomon Islands, and Tonga) have already ratified the agreement and Tuvalu and Vanuatu have signed and are expected to ratify. Because PACER Plus is a free trade agreement, it is expected to induce revenue losses over a long horizon—particularly from trade tax revenue.

³ Pacific Agreement on Closer Economic Relations with Australia and New Zealand (PACER) Plus.

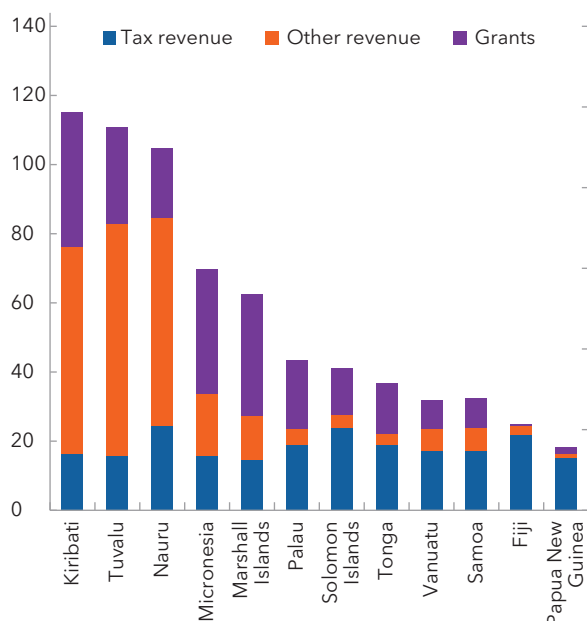
2. Tax Revenue and Tax Potentials in the Pacific Region

Like many low-income and upper middle-income countries, the PICs are not fully exploiting their tax revenue collection potential. However, pressing spending needs related to the SDGs and climate change, combined with future revenue losses associated with the PACER Plus trade agreement suggest that boosting domestic tax revenues will need to be a policy priority in the region. The current revenue structure, dominated by non-tax revenue in many PICs, needs to give more weight to tax revenue. Narrowing the gap between the tax potential and current tax collection—estimated at an average of about 3 percent of GDP in the short to the medium term—could contribute to this objective and partially finance additional pressing spending needs.

A. Tax Revenue in the Pacific: Key Features

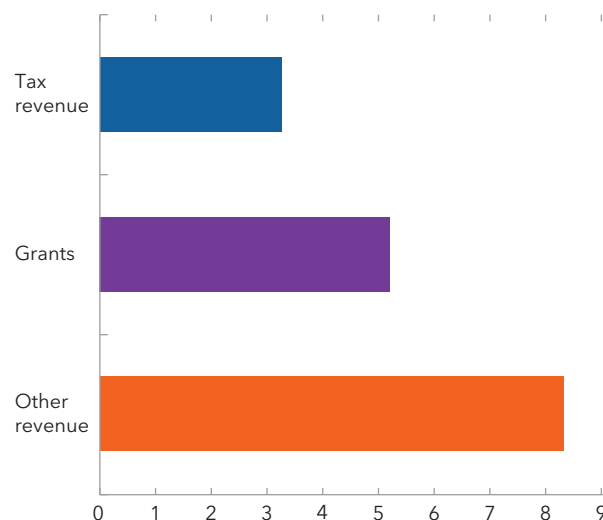
PICs rely heavily on grants and non-tax revenue, which tend to be volatile compared to tax revenue. Grants and other non-tax sources of revenue (mostly fishing license fees) dominate the government revenue mix in the Pacific region—except for a few countries. Fiji, Papua New Guinea, Samoa, and Solomon Islands rely more on tax revenue than on non-tax revenue (Figure 10, panel 1). Non-tax revenue (including grants) accounts for about 56 percent of PICs’ total revenue with some six island countries out of the 12 discussed here (Kiribati, Tuvalu, Nauru, Micronesia, Marshall Islands, and Palau) having more than 50 percent of non-tax revenue in their revenue mix. Domestic tax revenue mobilization should thus be an essential part of the strategy to finance SDGs—especially for climate adaptation given the constraints and limitations associated with other sources of financing.

Figure 10a. PICs: Government Revenue Mix, 2010-21
(Percent of GDP)



Sources: Country authorities; and IMF staff estimates.

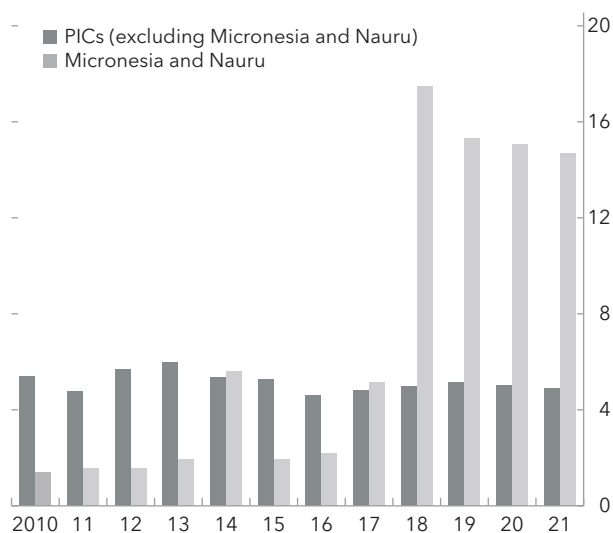
Figure 10b. PICs: Government Revenue Volatility, 2010-21
(Standard deviation)



Sources: Country authorities; and IMF staff estimates.

Figure 11a. PICs: Tax Revenue Mix, 2010-21
(Percent of GDP)

Sources: Country authorities; and IMF staff calculations.

Figure 11b. PICs: Income Tax Revenue, 2010-21
(Percent of GDP)

Sources: Country authorities; and IMF staff calculations.

Tax revenue collection in the Pacific has improved in recent years, but partially due to large windfalls—from corporate income tax. The ratio of tax revenue to GDP in the Pacific increased by about 4.4 percentage points during 2010-2019 to reach about 21 percent of GDP prior to the pandemic (Figure 11, panel a). However, the increase in tax revenue is uneven across tax categories and countries. Income taxes experienced a large increase in the last decade but driven by large windfalls (Figure 11, panel b) in Micronesia and Nauru.⁴ Indeed, between 2017 to 2019, Micronesia received corporate income tax windfalls from occasional sale of foreign assets.⁵ Most of the other PICs have had stable income taxes during this period, while some recorded a decrease in their income tax collection, notably, Papua New Guinea.

Tax revenues are dominated by indirect taxes. Indirect tax revenues represent an average of about 68 percent of PICs total revenue (Figure 12). Vanuatu has the highest share of indirect tax revenue among the PICs given the absence of any form of income tax. Papua New Guinea has the lowest share (about 38 percent). The dominance of indirect tax revenue in the revenue structure is common in low-income and developing countries, particularly small island states and is well-documented by the literature.⁶ As countries develop, their tax structure changes, and direct taxes become more prominent (Martinez-Vazquez and others 2009 and Abdel-Kader and De Mooij 2020).

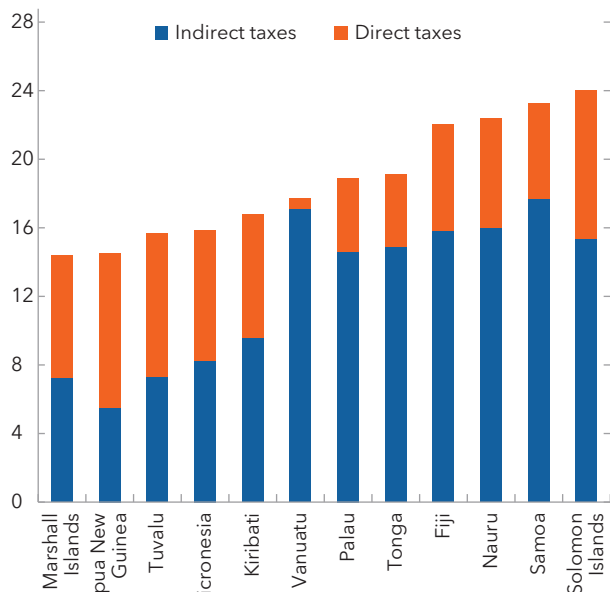
The performance of goods and services taxes is mixed. Goods and services taxes account for about 46 percent of total tax revenue and about 69 percent of indirect taxes in the Pacific region (Figure 13). Goods and services tax collection increased in the early 2010s but has been stagnant for PICs as a group since 2014. Besides the group average, some countries (Fiji, Nauru, Samoa, Tonga, and Tuvalu) experienced significant increases in goods and services tax collection in the last decade.

⁴ Nauru experienced large increases in its corporate income tax (called “business profit tax”) collected from the Nauru Regional Processing Center (NRPC) since 2018 following an increase in the CIT rate. However, income taxes from the NRPC are expected to decrease from July 2022 because the NRPC could reach its maximum capacity. See IMF Country Report No. 22/28.

⁵ See also IMF Country Reports No. 19/288 and 21/237 for more details. Micronesia also experienced another increase in income taxes in 2014 following a sale of foreign assets (see IMF Country Report No. 15/128 for more details).

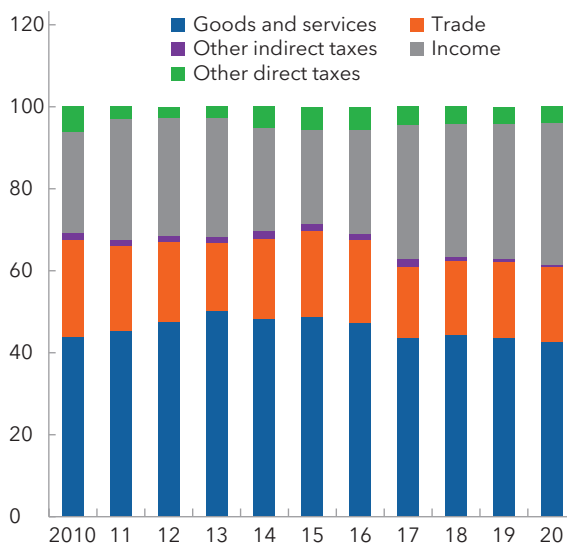
⁶ The literature dates back at least to Hinrich (1966) and Musgrave (1969). See also Ahmad and Stern (1989).

Figure 12. PICs: Indirect vs. Direct Taxes, 2010-21
(Percent of GDP)



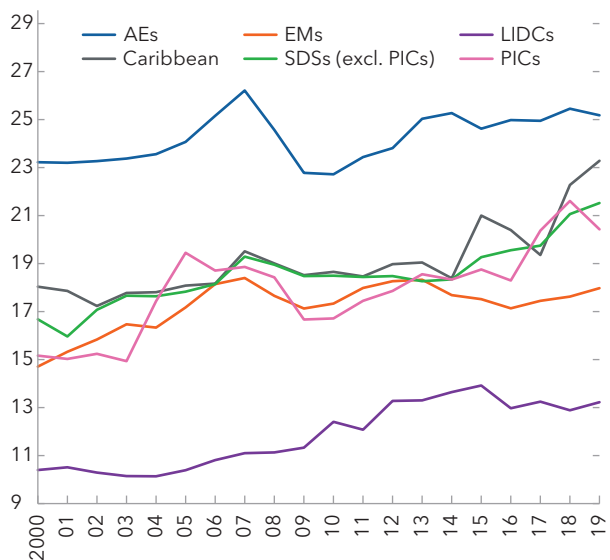
Sources: Country authorities; and IMF staff calculations.

Figure 13. PICs: Tax Revenue Mix, 2010-21
(Percent of total tax revenue)



Sources: Country authorities; and IMF staff calculations.

Figure 14. Tax Revenue, by Region and Income
(Percent of GDP)



Sources: World Revenue Longitudinal Database (WoRLD); and IMF staff calculations.

Revenues from goods and services are failing to compensate losses on trade taxes. The share of tax revenue from international trade (customs, export duties, trade related VAT, etc.) decreased by about 8 percentage points in about a decade to reach about 18 percent of total taxes in 2021 (Figure 13). The same phenomenon (called fiscal transition) is observed in other developing countries. Indeed, many developing countries have introduced value-added taxes to compensate for the decrease in non-trade-based taxes (Keen and Lighthart 2002) following the liberalization of international trade in the end of the 1980s and the early 1990s. This particularly affected tax collection in low-income and developing countries (Baunsgaard and Keen 2010). The implementation of PACER Plus is expected to follow this trend,⁷ and this necessitates boosting of non-trade-based taxes.

PICs' tax revenue collection compares favorably with peers. Between 2000 and 2019, the median tax revenue ratio increased by 5.3 percentage points of GDP in the Pacific region (Figure 14). The level of tax-to-GDP ratio compares well with those of other small states (SDSs excluding PICs) and Caribbean countries. The levels of tax collection in the PICs, other small states, and the Caribbean are below those of advanced economies but experienced a higher average annual increase (1.3-1.5 percent vs. 0.4 percent) than those of advanced economies. All income categories experienced overall increases in their tax revenue collection. However, the level of tax collection in low-income and developing countries remains the lowest.

⁷ However, the timeline for loss of trade taxes due to PACER Plus is over a very long horizon.

B. Tax Potentials in the Pacific: An Estimation

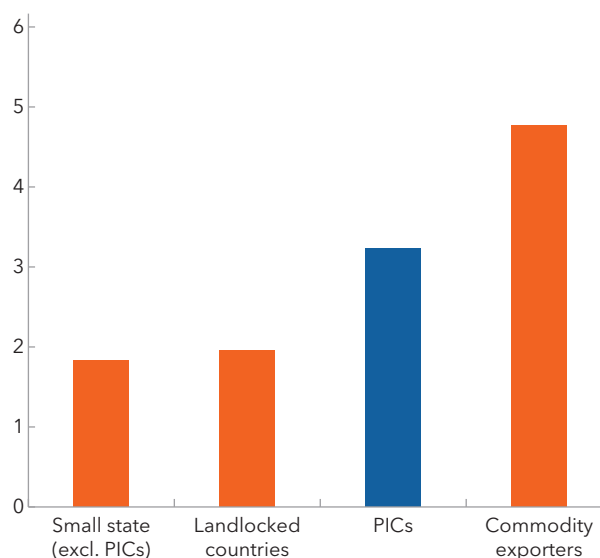
Small developing states (SDS) could be constrained in narrowing their tax gap and sustaining increased tax collections. Small states include a large number of fragile states⁸ (reflecting lower levels of capacity), small populations that are frequently highly dispersed, weak absorptive capacity, and lower levels of economic diversification. But because of these constraints, small states tend to receive important support (for example, in a form of capacity building) from donors and, technical and financial partners, for example, PICs receive significant capacity building from the IMF's Fiscal Affairs Department and the Pacific Technical Assistance Center (Annex 3). When small states implement key tax policy and revenue administration reforms, they have the potential to collect additional tax revenue to finance their development needs.

Tax frontier analysis allows for an estimate of unexploited tax potential in the Pacific. To estimate the additional tax revenue that the Pacific Island Countries can collect over the short to medium term, we use the approach developed in the literature on tax capacity. The concept of tax capacity was first introduced by Lotz and Morss (1967) to quantify the maximum tax revenue a government could raise conditional on its characteristics (economic and institutional). The level of tax revenue that a country could raise is constrained by its administrative, monitoring, and enforcement capabilities and the nature of its economy, structural, and institutional characteristics (Stotsky and WoldeMariam 1997, Bird and others 2008, and IMF 2018).

PICs could potentially collect an additional 3 percent of tax revenue to GDP in the short to medium term. Despite the recent improvement in domestic resource mobilization (albeit partially driven by large windfalls), the PICs are not fully exploiting their tax potential. Given their economic characteristics (for example, degree of openness and level of development) and economic institutions (for example, government effectiveness), it is estimated that the PICs could collect an additional 3 percent of GDP (Figure 15) in the short to medium term by implementing key tax policy and revenue administration reforms (see Annex 2 for more technical details). The average tax potential in the Pacific region is above the estimated numbers for other small states (1.8 percent of GDP), and landlocked countries (2.0 percent of GDP) but far below the estimated tax potential of commodity exporters. Indeed, commodity exporters often have subsequent tax potential but do not fully exploit it because of over-reliance on commodity revenue.

The size of the tax gap is uneven across PICs. For example, tourism-dependent economies have the lowest gap for additional tax revenue. One explanation could be that this group includes countries that are performing relatively well in terms of domestic resource mobilization (for example, Fiji⁹ and Samoa). Compact countries (Marshall Islands, Micronesia, and Palau) have a potential for additional tax revenue

Figure 15. PICs and Peers: Potential Additional Tax Revenue (Percent of GDP)

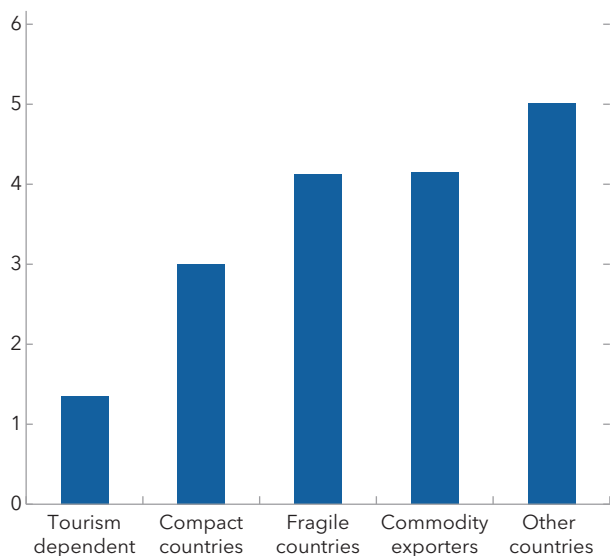


Sources: World Bank, World Development Indicators; IMF, *World Economic Outlook*; and IMF staff estimates.

⁸ About a fifth of IMF members are classified as fragile and conflict-affected states. In the countries, fragility, conflict, and low levels of administrative capacity contribute to macroeconomic instability and hinder the development of productive resources.

⁹ However, tourism dependent economies have been hit hard by the pandemic compared to other Pacific Islands. See Case Study 1 about Fiji. The country has had a strong revenue performance prior to the pandemic but will need to implement bold tax reforms to recover its strong tax revenue performance and reduce its tax gap.

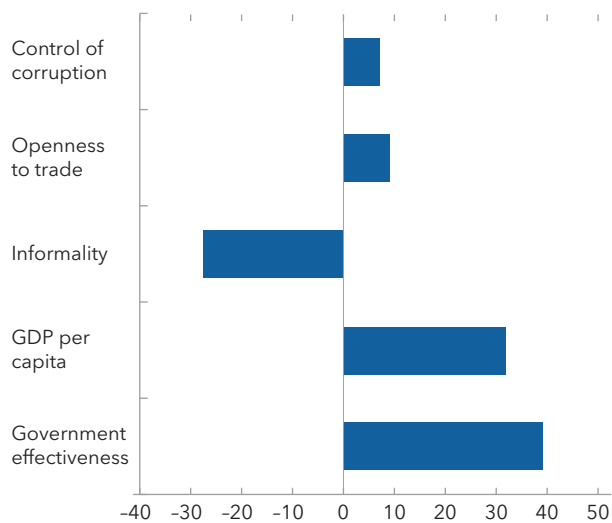
Figure 16. PICs: Potential Additional Tax Revenue
(Percent of GDP)



Sources: World Bank, World Development Indicators; IMF, *World Economic Outlook*; and IMF staff estimates.

Note: Tourism economies include Fiji, Palau, Samoa, Tonga, and Vanuatu; commodity exporters include Papua New Guinea and Solomon Islands; compact countries include Marshall Islands, Micronesia, and Palau; fragile countries include Kiribati, Marshall Islands, Micronesia, Papua New Guinea, Solomon Islands, and Tuvalu; and others include Kiribati, Nauru, and Tuvalu.

Figure 17. PICs: Tax Capacity and Structural Factors Nexus
(Percent, correlation)



Sources: World Bank, World Development Indicators; IMF, *World Economic Outlook*; and IMF staff estimates.

also face daunting challenges and have a relatively large tax gap. Like commodity exporters in other regions of the world, commodity exporters in the Pacific region also have a large unexploited tax potential. This is particularly the case for Papua New Guinea. The group of “Others” includes a set of heterogeneous countries (Kiribati, Nauru, and Tuvalu) with a relatively low tax-to-GDP ratio except Nauru (Figure 16) and an over-reliance on non-tax revenue.

Key characteristics explain PICs’ potential revenue. Consistent with the literature (for example, IMF 2018), GDP per capita, openness to trade, the share of agriculture in GDP, control of corruption and government effectiveness are important determinants of tax capacity. For the Pacific region, the most important determinants seem to be government effectiveness, GDP per capita and the size of the informal sector (proxied by the share of agriculture in GDP). Our measure of government effectiveness reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies (Kaufmann, Kraay, and Mastruzzi (2010)). Improving government effectiveness can help PICs to considerably reduce the gap between their tax capacity and their actual tax revenue level. Other important determinants of tax capacity for the PICs are the openness to international trade and control of corruption (Figure 17).

Can PICs and should PICs raise more revenue? Closing the tax gap is not only a tax (policy and administrative) issue but also a political economy question because it relates to whether and how to raise more revenue by taxing people and businesses to finance pressing spending needs. Country authorities also need to keep in mind that every tax gap does not have to be closed. There is the question about the appropriate tax level in every economy (Box 1). The tax potential is not necessarily the optimal level of tax, but it provides information about the potential room for higher taxation in the context of country’s characteristics.

that is at par with the regional average. Compact countries often rely heavily on grants and tend to have a relatively low tax revenue to GDP compared to other countries in the region (Palau being the exception). Fragile states in the Pacific

Box 1. Want to Close the Tax Gap? Mind the Appropriate Tax Level

An important threshold question when examining revenue mobilization in any country is what should be the appropriate revenue level of the economy. Too little revenue makes it challenging to provide critical government services. Similarly, low revenues leading to insufficient capital expenditures and a lack of infrastructure can constrain long-term economic growth. Likewise, spending on education to ensure a literate and numerate population is also a necessary pre-cursor for sustained growth.

Conversely, too high a level of taxation risks stifling private sector growth. Businesses may be discouraged from undertaking further investment, and individuals with transferable skills may seek lower tax jurisdictions in which to sell their labor.

A further consideration is the intertemporal trade-off faced by households. Higher tax revenue will reduce short-term consumption possibilities, though hopefully lead to higher long-term consumption outcomes in the future due to the greater provision of growth inducing government services. In low-income countries this tradeoff, if weighted too heavily toward future consumption, could imply current household consumption levels that engender significant hardship. For example, a country with a household sector that is reliant largely on subsistence agriculture may appropriately wish to only tax this sector lightly, even if it means a lower provision of government services, to avoid widespread hardship in the short term.

In addition, an important macro-fiscal consideration is debt sustainability. Ensuring timely payment of debt obligations and a sustained downward trajectory for the debt to GDP ratio are of primary importance.

Asking whether more can be done is not the same as asking whether more should be done (IMF 2013). Making a judgement about the appropriate revenue level for the government of any country should be made on a case-by-case basis, taking account of the unique circumstances of that country, each of the trade-offs considered above and the country's tax potential.

3. Bottlenecks in Pacific Islands' Tax System

Administrative and policy bottlenecks have prevented the PICs from raising tax collections to a level fully equivalent to their tax potential. The bottlenecks include but are not limited to: (i) the gap between tax legislation and the available tax base; (ii) weak compliance; (iii) weak capacity and ICT systems; and (iv) inefficiencies in the tax system—particularly in VAT systems.

A. A Myriad of Constraints in the Tax System

Several constraints are preventing the PICs from reducing their tax gap. They range from unadapted legal frameworks to weak and understaffed tax administrations. Overcoming these challenges could help the PICs to raise more tax revenue and reduce their tax gap.

Lack of reform momentum. The review of the tax system by IMF staff highlights that tax policy reforms in PICs over the past four years have been limited—other than some recent reforms in response to COVID-19—with most PICs relying on indirect taxes for revenue. Some PICs have expressed interest in a small business tax, as a simplification measure, but there has been little progress in introducing such taxes. Recent VAT reforms have been modest, with rates (other than in Vanuatu) and thresholds remaining unchanged. There has been an increasing use of excises in PICs to raise revenue and to address the negative impact of certain goods. The ongoing implications of COVID-19 pandemic for revenue administrations should be a priority for the next few years, especially for countries with large tourism sectors such as Fiji, Palau, Samoa, and Vanuatu. Administrations will need to reinvigorate revenue collections post-COVID and ensure that they have business continuity plans to safeguard continued revenue administration operations in the event of major disruptions such as pandemics, epidemics, and natural disasters.

Policy and legislation constraints. Unwinding tax policy measures post COVID-19 also presents a challenge on top of the need for tax policy measures to reverse revenue declines. Tax policy and legislative reforms should have a focus on VAT, especially exemptions, zero-rated items, and refunds for countries with VAT. Non-tax revenues such as fishing and compact grants are currently a significant revenue source for many PICs but are also volatile or have a limited future. Consequently, there is a need to strengthen traditional taxes due to their stability. Countries must also address EU and OECD requirements to be removed from the EU 'black' or 'grey' lists and need to have a full understanding of the legal, compliance, and revenue implications of adopting a tax system to satisfy EU and OECD requirements before introducing such a system. Access to revenue forecasting expertise is a high priority.

Few PICs have good ICT support. With limited or no functionality for management reports, data analysis, risk, and case management, as well as for e-tax for electronic filing and payments, many PICs face challenges in managing the system, effecting changes, and ensuring business processes support underlying system design. A major challenge is also the fact that a key technology platform (RMS 7), used by several PICs, will reach end of life support by 2024. Data integrity, internet connectivity and infrastructure limitations also present challenges. Weak ICT systems in other government departments and institutions limit information exchanges. Moving to e-tax for electronic filing and payment is constrained by under-developed e-banking infrastructure and limited taxpayer access to fast, reliable, and affordable internet services – both of which are beyond the power of the tax administrations to change. These challenges are compounded by limited funding and investment in revenue administrations (Customs and Tax) by governments in the Pacific region. This means that optimizing revenue by modernizing and reforming the tax administrations has a ceiling in terms of what is realistic and achievable.

Tax administrations are severely constrained in terms of capacity. The review of the tax system also highlights a lack of critical mass in tax administrations. PICs compared poorly to comparable tax administrations, for example the Caribbean countries, in resourcing compared to populations.¹⁰ Most of the PICs face staff shortages, high vacancy rates and low skill levels. The smaller island countries have great difficulty in attracting and retaining talented and suitably qualified staff. Most PICs have a lack of in-house training capacity and rely on capability development through donor agencies, but this is often generalized and does not meet individual technical learning needs. Notwithstanding a high number of training interventions by Pacific Financial Technical Assistance Centre (PFTAC) in partnership with Pacific Island Tax Administrators Association (PITAA) as well as efforts from other development partners, the skill level remains low. Longer-term assistance to provide on-the-job training and coaching are needed to upskill staff, but current IMF CD delivery is not geared towards this. The larger countries also have difficulties to deal with tax avoidance and evasion, as well as international tax and other complex tax issues that require specialized expertise. It is also important that the absorptive capacity of the tax administrations in the context of assistance provided by PFTAC (Annex 3) and other development partners such as Asian Development Bank (ADB), EU, World Bank, DFAT, and MFAT must be carefully considered when new projects are launched.

Other administrative constraints include inaccuracies with the tax registers and deficiencies in the management of outstanding tax returns and tax arrears. Implementation of Compliance Improvement Strategies and risk management is at an early stage in the PICs with implementation progress often unclear with many of the approved strategies yet to be implemented. Although progress has been made in terms of the compliance management of large taxpayers, the small and medium enterprise (SMEs) segment is typically less developed. Poor data and an inability to reliably identify sector participation and monitor tax compliance by industry appear to be key inhibitors to establishing baselines for compliance improvement strategies and effective monitoring and evaluation of progress.

Transfer pricing and lack of an efficient personal income tax are other factors that are eroding the tax base in some Pacific countries. Transfer pricing¹¹ encourages the unsustainable usage of important, and often environmentally sensitive, resource stocks. Transfer pricing also induces significant revenue losses for public finances. Regarding the personal income tax, the relatively low tax-free threshold puts the tax burden on low-income earners, and could discourage businesses from hiring lower skilled workers.

B. VAT Potential Is Not Fully Exploited

In many emerging and developing countries, the VAT has been a centerpiece of domestic resource mobilization reform strategies. Emerging and developing countries can leverage on VAT to leapfrog good performers in terms of revenue collection. If the VAT system is properly designed and implemented, VAT can not only enhance the revenue stream on its own but also boost other taxes such as corporate income tax. Successful tax reforms programs (Akitoby and others 2018) that enhanced revenue collection up to 0.5 percent of GDP per year over three years or more relied primarily on VAT reforms (Figure 18).

An effective VAT system should help to improve compliance by reducing informality. A well-designed VAT system offers an incentive to enterprises to become formal given the VAT refunds on their inputs. Boadway and Soto (2009) but particularly Keen and Smith (2006) provide the analytical framework that allows to understand the effect of VAT on tax compliance. VAT refunds and credits make the system (at least in theory) self-enforcing, that is, a purchaser can claim VAT refunds if and only if its supplier is formally registered for VAT. This assumption is backed up by empirical evidence showing that VAT should help formalize the economy

¹⁰ The tax administration staff-to-population ratio in the Caribbean was 1:1701. This ratio was 56 percent lower than the comparable ratio in PICs of 1:3894.

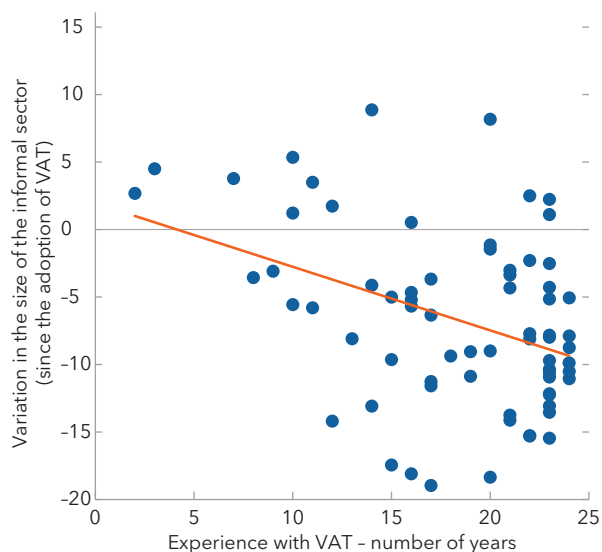
¹¹ Transfer pricing refers to the prices that are charged for transfers of goods and services between enterprises that are under common ownership

Figure 18. Emerging and Developing Countries: Tax Reforms
(Frequency of policy measures percent)



Source: IMF staff calculations using Akitoby and others (2018) data sets on large tax revenue mobilization.
 Note: CIT = corporate income tax; GST = goods and services tax; PIT = personal income tax; VAT = value added tax. The chart shows the frequency of four types of main tax policy and revenue administration reforms (new taxes, rate changes, threshold changes, and changes to exemptions) by category of taxes. Each type of reform sums to 100 percent.

Figure 19. The Adoption of VAT and Informality



Sources: IMF staff calculations using IMF FAD Tax Policy Database and Medina and Schneider (2018) database.

and fight fraud and evasion. Rios and Seetharam (2017) documented that VAT generated incentives for small enterprises to operate in the formal economy in India while Agostini and others (2014) and Pomeranz (2015) documented the self-enforcing mechanism of VAT in Chile. Figure 19 seeks to establish a link between the size of the informal sector and the VAT. The x-axis represents the number of years since VAT was adopted. This is a proxy of a country’s experience with VAT. The y-axis represents variation in the size of the informal sector since VAT was adopted. There is a negative correlation suggesting that VAT could affect (that is, reduce) informality.

An effective VAT system should boost other taxes. An efficient VAT system should positively impact the whole tax system as it helps reduce overall noncompliance and facilitate a fair and competitive environment for all businesses. By improving VAT management, tax compliance dynamics can

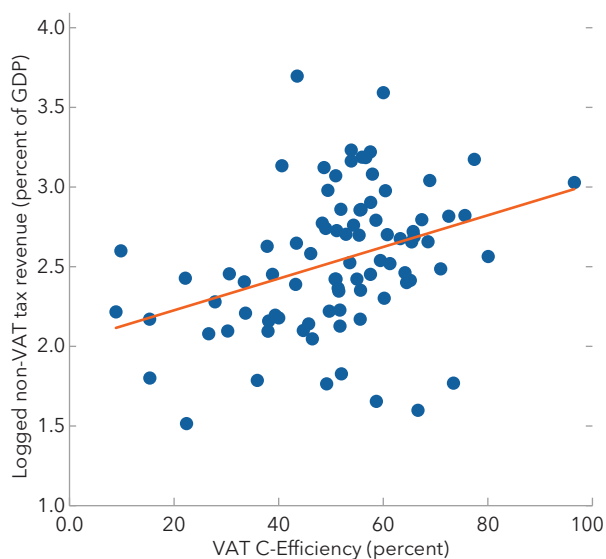
be entrenched within the taxpayer population and the whole tax system can be improved. Bodin (2012) reported that, as VAT is an accounting-based tax and its control involves a reconciliation of data that is also needed to calculate the tax on profits, it could help to support corporate income tax because they have the same base (the turnover). Figure 20 illustrates the ratchet effect of VAT. On the y-axis are taxes other than VAT. On the x-axis is the VAT C-efficiency to capture limited exemptions and good compliance in each country. On average, countries with a more efficient VAT system—proxied by higher VAT C-efficiency ratio—collect more non-VAT taxes.

VAT is not fully exploited in the Pacific region despite all the above-mentioned advantages. Five out of 12 PICs currently have no VAT system.¹² However, research has shown that countries with a VAT system are better off than those without (Ebrill and others 2001, Keen and Lockwood 2010, Ufier 2014, and Akitoby and others 2018). This is also true for PICs (Figure 21). In addition, PICs with VAT are not fully exploiting their potential (Figure 22). The average PIC collects about 50 percent of its potential VAT. This shows that for the Pacific region, there are large potential gains for countries without a VAT system to adopt it (for example in Marshall Islands) and for countries with a VAT system to improve it.

Inefficiencies in tax policy systems and weaknesses in tax administration are preventing the full exploitation of VAT systems. For PICs that already have a VAT system, a closer look at the data (Figure 23) shows that some countries already have relatively high tax rates (Samoa, Tonga, and Vanuatu). For these countries, the gap between current VAT collection and its potential seems to be mostly due to tax administration issues. For other countries, the gap is due to a mix of tax administration and tax policy issues. The efficiency of customs administrations also plays a role. Customs collect up to 80 percent of VAT but are subject to undervaluation, smuggling, ghost exports, round tripping, etc. In addition, even countries with relatively high VAT rates among PICs have room to further increase their VAT rates given standard VAT tax rates in other countries. Indeed, all PICs have VAT rates that are below world's average VAT rates (Figure 24). Finally, the lack of timely VAT refunds in PICs, which hinders the effectiveness of the VAT, remains a concern.

There are widespread tax exemptions and zero rating in the region. The PICs rely heavily on tax exemptions to achieve development goals, incentivize investment, and support the vulnerable. However, many tax exemptions are often costly, both economically and financially. They complicate revenue administration and encourage higher tax rates, which decreases the efficiency of the tax system, reduce tax compliance (by making the tax system even more complex), and generally, undermine transparency. Tax exemptions also lead to large foregone tax revenues. Tax exemptions are frequently not subject to a formal estimate in the PICs (as an estimate of tax expenditures in the annual budget). However, a review of available country legislation shows that there are many tax exemptions and zero ratings (beyond justified ones such as on exports). A few available estimations illustrate sizeable forgone revenues. For example, tax exemptions account for 24 percent and 30 percent of total tax revenue in Fiji and Tonga, respectively. This shows how they could improve their VAT C-efficiency ratios and easily reach their full potential by prioritizing the rationalization of their tax exemptions.

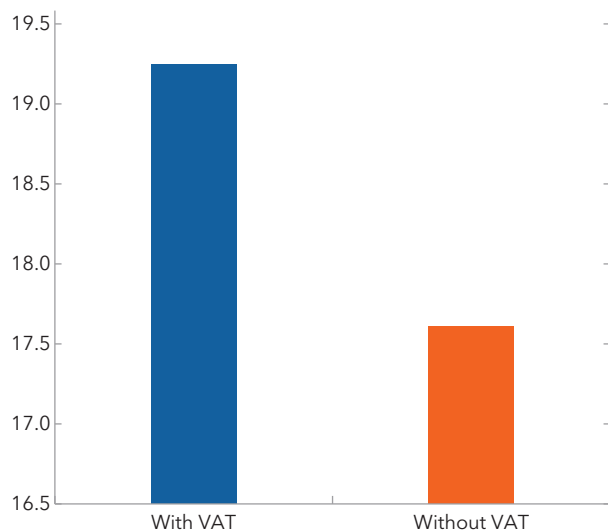
Figure 20. Ratchet Effect of VAT



Source: IMF staff calculations using IMF FAD Tax Policy Database.

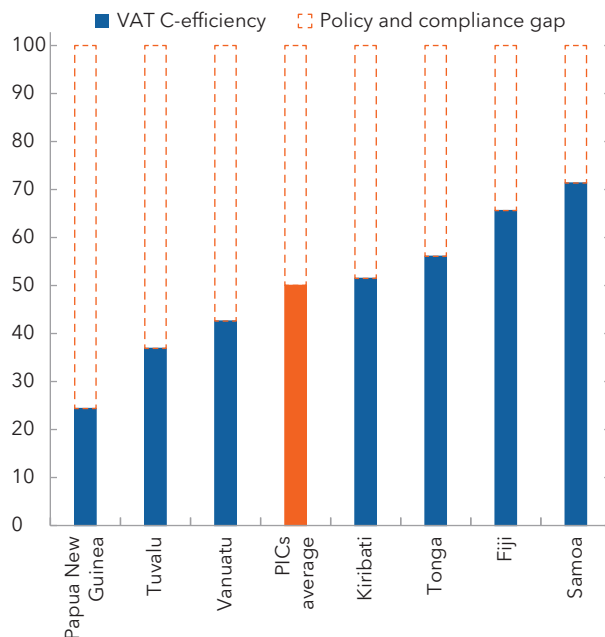
¹² Palau recently adopted a VAT system. See Case Study 3 in Annex 1 for more details.

Figure 21. PICs: Tax Revenue with and without VAT System
(Percent of GDP)



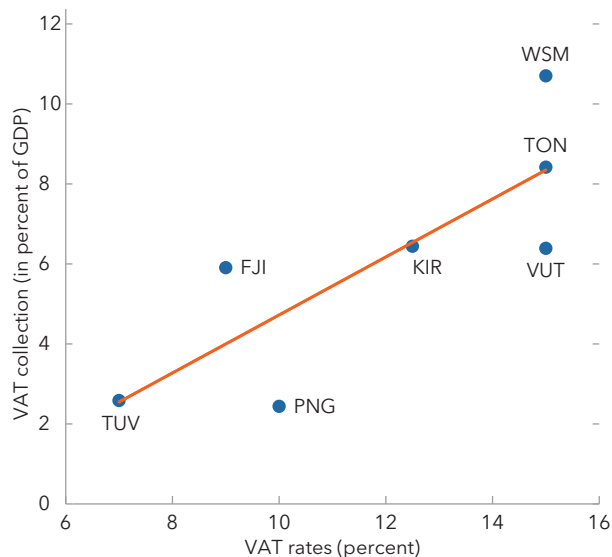
Source: Country authorities ; and IMF staff calculations.
Note: The average tax-to-GDP ratio of countries without a VAT system is much lower once large (three-off) corporate income tax payments from 2017 to 2019 in Micronesia are factored out. Micronesia does not have a VAT. Data is average 2010-20.

Figure 22. PICs: VAT C-Efficiency Ratios
(Percent)



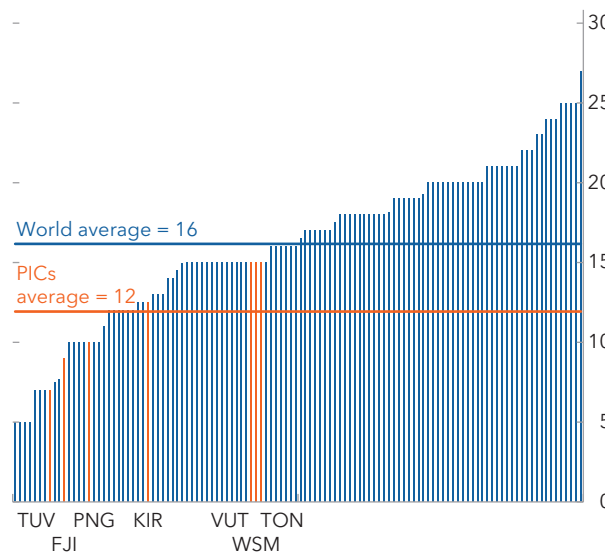
Sources: Country authorities; and IMF staff calculations.
Note: VAT C-Efficiency conveys the additional percentage of potential VAT a country can collect. See Keen (2013) for more technical details. Data pertains to 2020.

Figure 23. PICs: VAT Rates and VAT Collection Nexus



Sources: Country authorities; and IMF staff calculations.
Note: Data pertains to 2020 or latest year available. Data labels use International Organization for Standardization (ISO) country codes. FJI = Fiji, KIR = Kiribati, PNG = Papua New Guinea, TON = Tonga, TUV = Tuvalu, VUT = Vanuatu, WSM = Samoa.

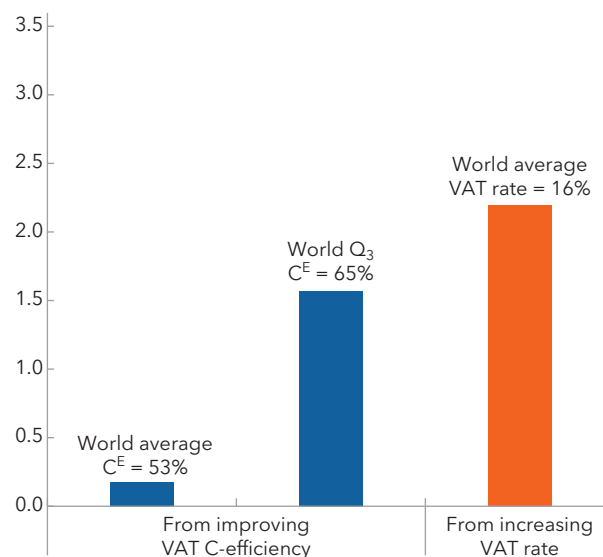
Figure 24. VAT Rates across Countries
(Percent)



Sources: Country authorities; IMF, FAD Tax Policy Database; and IMF staff calculations.
Note: Data labels use International Organization for Standardization (ISO) country codes. FJI = Fiji, KIR = Kiribati, PNG = Papua New Guinea, TON = Tonga, TUV = Tuvalu, VUT = Vanuatu, WSM = Samoa. Data pertains to 2021.

There is major VAT revenue gain by improving C-efficiency and/or increasing standard VAT rates.¹³ Figure 25 and Table 1 illustrate potential revenue gain for PICs with VAT from improving their C-efficiency (for example, by rationalizing tax exemptions, improving tax compliance, or upgrading their tax administration) to world's threshold values while keeping their current standard rates constant. They also illustrate potential revenue gain by retaining current C-efficiency but increasing standard rates to the world average. Countries with a relatively low C-efficiency and low rates (for example, Papua New Guinea and Tuvalu) have large potential gain from both improving C-efficiency and rising rates. Fiji has its largest revenue potential from rising its standard VAT rate while Vanuatu from improving its C-efficiency ratio.

Figure 25. PICs: Potential Additional Revenue from VAT Reforms
(Percent of GDP)



Sources: Country authorities; and IMF staff estimates.

Note: The threshold values represent the world average and Q₃ for VAT C-efficiency ratios and world average standard VAT rates.

Table 1. PICs with VAT: Potential Gains in VAT Revenue from Increasing C-efficiency or Standard Rates

Country	VAT rates (percent)	Actual C-efficiency (C^E) (percent)	Revenue Impact of Increasing VAT C-efficiency (percent of GDP)		Revenue impact of Increasing VAT Rate (percent of GDP)
			$C^E = 53$	$C^E = 65$	World average VAT rate (16 percent)
Fiji	9.0	65.6	-	-	4.7
Kiribati	12.5	51.5	0.2	1.6	1.9
Papua New Guinea	10.0	24.4	2.8	4.0	1.5
Samoa	15.0	71.3	-	-	0.9
Tonga	15.0	56.1	-	1.3	0.7
Tuvalu	7.0	36.9	1.1	1.9	3.4
Vanuatu	15.0	42.6	1.5	3.3	0.5

Sources: Country authorities; and IMF staff estimates.

Note: The threshold values represent the world average and Q₃ for VAT C-efficiency ratios and world average standard VAT rates.

¹³ PICs can learn from New Zealand which is close to the region and has one of the most effective and successful VAT system in the world.

4. Raising Tax Revenue: Lessons from Successful Experiences

This section is built on studies focused on selected episodes of tax revenue gains in low-income countries (LICs) and emerging markets (EMs) that achieved substantial tax revenues during selected periods. Successes were identified by increases in tax-to-GDP ratios by a minimum of 0.5 percentage points of GDP each year for at least three consecutive years. A holistic view of the countries' course of achievement was taken, ranging from tax policies and measures of revenue administration implemented to the social and political positioning of governments to ensure that tax revenue gains achieved were sustained over a long period. The chapter draws out a strategy roadmap for policymakers taking economic, social, and political scenarios under consideration that would make it possible for countries to learn from successful experiences provided there is sufficient political commitment.

A. Background

This section builds on Akitoby and others (2018, 2019), which delved into empirical and case study analyses of selected LIDCs and EMs that were able to achieve significant and sustained improvements in domestic tax revenue mobilization and drew out lessons and policy reforms that helped in their achievement.¹⁴ While the studies recognize the uniqueness of LIDCs in terms of their background and the political and economic challenges that confront them and might not allow the policies to be exactly replicable, the novelty of these studies lies in underlining the generalized trends that yielded success and set out a roadmap for future policymakers to approach the problem of tax collection. Following Akitoby and others (2020), Box 3 discusses the pronounced challenges of raising tax revenues in fragile states, and how their fragility constrains their capacity to sustain the momentum of revenue recovery beyond three years.

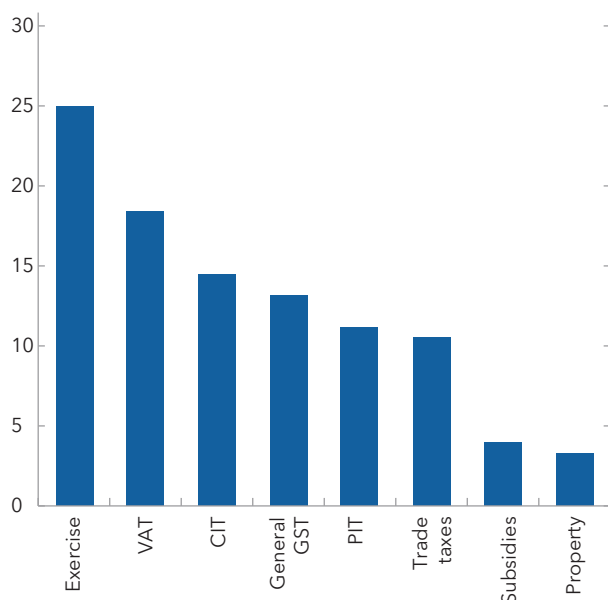
Key lessons from successful experiences. Some of the trends that were observed over the course of tax revenue mobilization in the LIDCs were (1) the most common tax policy measures were in the areas of indirect taxes (for example, rate increases, broadening tax base, lowering exemptions and simplifying the taxation system to reduce compliance costs and maximize tax revenues amidst weak institutions); (2) while many LIDCs could achieve increases in tax revenues, sustaining these increases were challenging and were accompanied by improvement in the quality of institutions (for example, government effectiveness and control of corruption) along with political will and international support; and (3) revenue administration and tax policy complemented each other and reforms in tax administration—especially in key areas of compliance—helped consolidate revenue gains.

B. Tax Policy Measures and Fiscal Reforms

Improving policy measures related to indirect taxes—such as introduction and rate increases for VAT and excise, reduction of exemptions, and a focus on large taxpayers—were found to help countries collect significant tax revenues and put those starting off at very low tax-to-GDP ratio at a higher revenue footing considerably early on. They were the low-hanging fruits that delivered significant gains and helped countries build up high momentum at the onset.

¹⁴ These studies do not establish causal link between tax policy and revenue administration reforms and performance.

Figure 26. Frequency of Tax Policy Instruments (Percent)

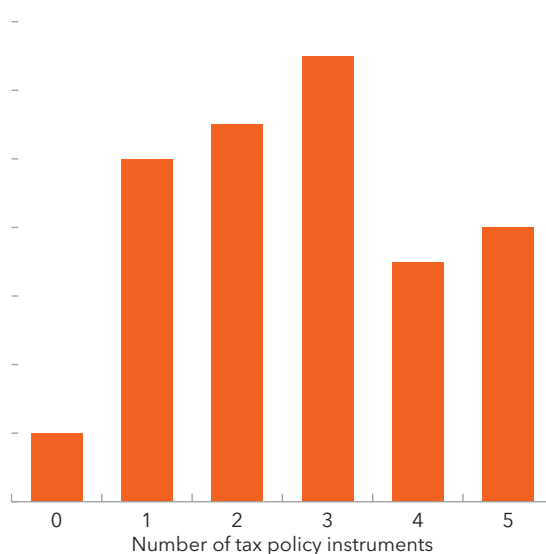


Source: IMF staff calculations (Akitoby and others 2018).
Note: Ratio of observations in a specific category to total identified tax policy measures.

Periods of large tax revenue were often found to be associated with high revenue earnings from indirect tax instruments, frequent of them being VAT and sales tax and excise taxes as can be seen in Figure 26. Countries such as The Bahamas, Bosnia and Herzegovina, Dominica, The Gambia, Guyana, Barbados, and Tuvalu saw substantial revenue increases following the introduction of VAT, rate, and threshold changes and curbing exemptions. Many countries under observation assumed gains from excise taxes because excise taxes were easily implementable and could be levied on a multitude of products such as fuels, tobacco, alcoholic and non-alcoholic drinks, and cars, and on the telecom sector. Many countries that achieved substantial tax revenue gains were seen to generally follow a combination of multiple indirect tax instruments such as in Belize, 2013-14 (GST and excise taxes), Kyrgyz Republic, 2011-12 (CIT, VAT, excises, and other GST), and Seychelles, 2008-11 (PIT, CIT, VAT, excises, other GST, trade taxes and subsidies), wherein two or more tools were used in conjunction as observed in Figure 27.

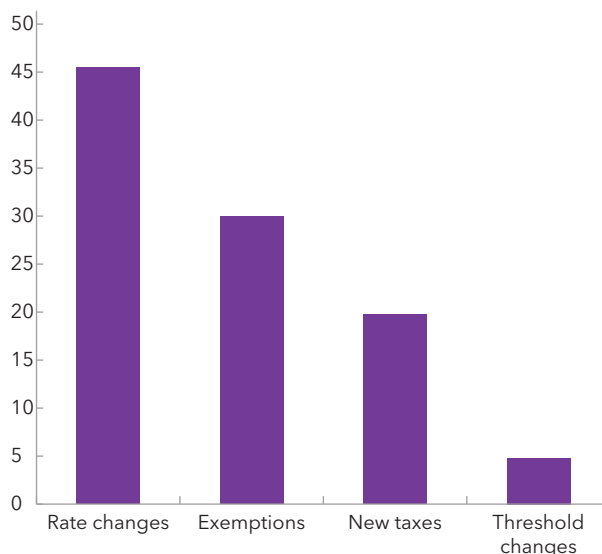
Some of the common indirect taxation strategies included rate changes and reduction of exemptions. Rate increases were amongst the most observed measures that brought about higher revenues from indirect taxes such as general VAT, excise and trade taxes as depicted in Figure 28. This was followed by curbing of exemptions related to VAT, general GST, and CIT. Specific measures included reducing statutory and discretionary

Figure 27. Number of Tax Policy Instruments Used for Episode (Number of countries)



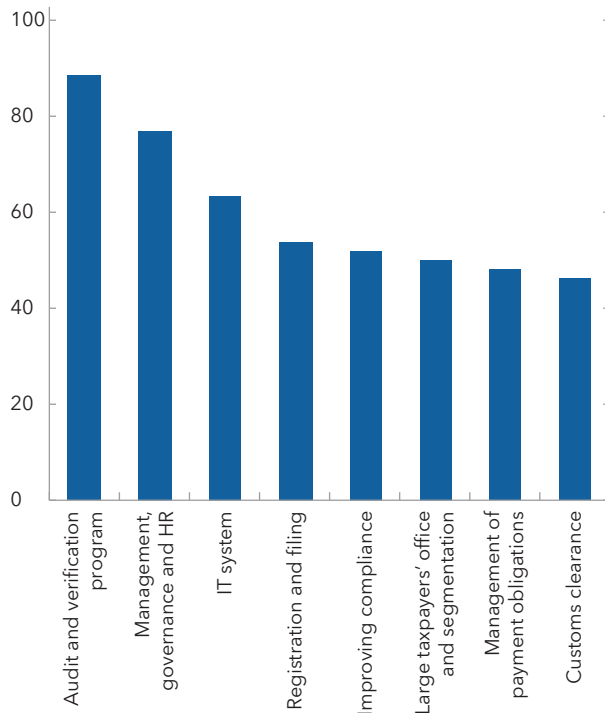
Source: IMF staff calculations (Akitoby and others 2018).
Note: "0" tax policy instruments indicate revenue administration was the primary reform-driver.

Figure 28. Frequency of Introductions, Rate, and Base Changes (Frequency)



Source: IMF staff calculations (Akitoby and others 2018).

Figure 29. Revenue Administration Measures (Percent)



Source: IMF staff calculations (Akitoby and others 2018).

exemptions (for example in Guyana and Solomon Islands); ending tax holidays (Burkina Faso); ending CIT exemptions (Mauritania); and eliminating VAT exemptions (Uganda).

Many countries found substantial gains from broadening the tax base and reducing the number of taxes involved. By broadening the tax base, countries could consolidate and focus on large taxpayers that contributed to a significant amount of revenue collection to the tune of up to 80 percent in certain cases. Reducing the number of taxes helped to simplify the tax system, induced voluntary compliance on the part of taxpayers and reduced administrative and compliance costs on the part of the revenue collection agencies.

C. Revenue Administration Measures

While it was difficult to quantify the impact of revenue administration measures, the studies underlined the importance of implementing strong measures of revenue administration such as enhanced capacity building, streamlining tax

systems, and controlling corruption, in conjunction with tax policies to enable countries to achieve sustained and sizeable revenue gains.

Revenue administration measures accompanied tax policy measures in 90 percent of the episodes, regardless of the country's income group or tax revenue level. The most common measures included audits and verification programs to reduce incidences of tax evasion and corruptive practices (Figure 29). Other efforts included strengthening governance, hiring qualified staff to oversee planning and monitoring, capacity development to develop technical skills of personnel, empowering revenue collection agencies with improved IT systems by way of implementation of strategic IT plan, enhancement of existing systems, and computerization of tax and customs administration to support tax payments, filing and use of third-party information. Most countries followed a multi-pronged approach for revenue administrative measures, and automating systems helped in the acceleration of tax payment procedures leading to faster revenue earnings, standardization of processes, improved voluntary compliance through creation of one-stop shop for tax payments and reduced corruption that helped countries sustain their revenue gains in the longer run.

Streamlining of tax payment processes helped in management of payment obligations by managing and recovering tax arrears in countries such as Burundi, Comoros, and Dominica. Many countries, such as Cabo Verde and Uruguay, strengthened taxpayer segmentation by focusing on large taxpayers accounting for up to 80 percent of tax revenues.

Tax reforms can be ensured to yield sustained long-lasting revenue gains by improving government effectiveness and controlling corruption. Akitoby and others (2020) observed that even as LIDCs made recovery of their tax revenues at the peak of their tax troughs, their efforts lasted for only 2-3 years. Government

effectiveness can be enhanced through better management of revenue institutions and implementation of stronger administrative reforms, while controlling corruptive practices such as receiving bribes by customs officials that undervalue goods at customs.

D. Political Will, Social Awareness, and International Support

Political will is key to sustained tax policy reform. Even countries with initially weak institutions such as Burkina Faso, could witness sustained improvement in tax revenue over 10 years under strong political commitment. Thus, in countries with weak institutional capacity, improving governance and political stability go hand in hand with effective tax reforms.

Buy-in from stakeholders helped secure political and social support for tax reforms. Effective communication with stakeholders emphasized the benefits of reform, increased awareness and voluntary compliance, while dissipating doubts and opposition—as was the case in Senegal.

Support from international partners was important. It was observed that in about 58 percent of the analyzed episodes of tax revenue mobilization, support from international partners like the IMF played a key role. IMF programs tended to have a positive effect on tax revenue mobilization (Crivelli and Gupta, 2014). This was especially the case where revenue conditionality was applied in the context of an IMF-supported program, and most strongly in those LIDCs where the tax revenue to GDP ratios were below the group average.

E. Policy Lessons

The observation of tax revenue mobilization episodes sheds light on the following common underlying policy and administrative measures that helped these economies assume significant tax revenue gains:

- Tax policy measures are most frequently supported by a combination of (1) rationalization of exemptions, (2) implementation of or adjustments to a broad-based VAT and other goods and services taxes, (3) rate changes to or introduction of excises on a few selected goods, (4) strong revenue administration management and governance arrangements, and (5) improvements in core tax administration functions.
- Institutional factors such as government effectiveness and the control of corruption are found to be highly correlated with performance of revenue-specific institutions and revenue administration, and hence play a key role in sustaining realized tax revenue gains.
- Tax revenues require political commitment and buy-in from key stakeholders.
- International support plays a key role in developing policies for tax revenue mobilization.
- Countries with weak institutions can pursue tax reforms and sustain long-lasting gains provided they have strong political commitment.
- While these countries have enhanced their tax collection over a long period, there is still further scope to increase their tax revenues and strengthen their revenue performance.

Box 2. Tax Revenue Mobilization in Fragile and Conflicted-Affected States

About half of fragile states are LIDCs and are distinguished by high levels of institutional and social fragility, measured by quality and policy of institutions, and manifestations of their fragility, measured by a threshold number of conflict-related deaths. Among the Asian and Pacific small states, the countries that feature in the updated FY 2022 list of FCSs¹ are Kiribati, Marshall Islands, Micronesia, Papua New Guinea, Solomon Islands, and Tuvalu.

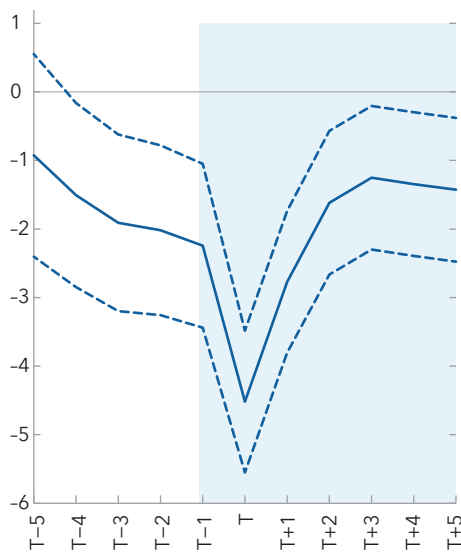
Need for tax revenue mobilization. The need becomes more predominant as countries, especially FCSs with inherently weak tax capacities, combat a socioeconomic crisis of a massive scale, such as the ongoing COVID-19 pandemic, when tax yields reach abysmal levels, and governments grapple to put economies back on the track to recovery. The need for tax revenues is more pronounced for FCSs that are already more prone to natural disasters as governments find themselves strained to meet the SDGs to support their spending needs arising thereof.

Pronounced challenges of raising taxes in FCSs. FCSs face inherent structural and economic challenges such as poor governance, weak institutional capacity, political and social instability, which

make it challenging to attain sustainable growth and macroeconomic stability needed to attain development goals. They are trapped in a low-level equilibrium that make transition out of fragility difficult (Akanbi and others 2021) and hence, with greater need to raise sufficient tax revenues to help them depart from years of political and economic limbo and empower themselves to create fiscal space in responding to conflicts and crises.

Fragility has a detrimental impact on tax revenue mobilization. A tax revenue trough was identified as the peak of fragility during a period of weak institutional and administrative capacity and inability of tax reform implementation, leading to much lower-than-normal level of tax collection (Box Figure 2.1). Tax recovery following such a tax revenue trough was found to have sustained for up to 2–3 years, with a steady increase of 3.5 percentage points of GDP over a three-year window. Even as tax policy and revenue performance were seen to coincide during recovery years, causality could not be established due to lack of control groups. Momentum of recovery was not sustained beyond three years and was a common reason behind weak tax revenues in FCSs.

Box Figure 2.1. Recovery of Tax Revenue in FCSs
(Percent of GDP, before and after the peak of fragility)



Sources: IMF staff calculations (Akitoby and others 2020) using WEO and WoRLD.

Note: Dotted lines denote the 95 percent confidence interval. FCSs = fragile and conflict-affected states.

¹ See [IMF strategy for fragile and conflict-affected states](#).

5. Raising Tax Revenue in the Pacific: The Way Forward

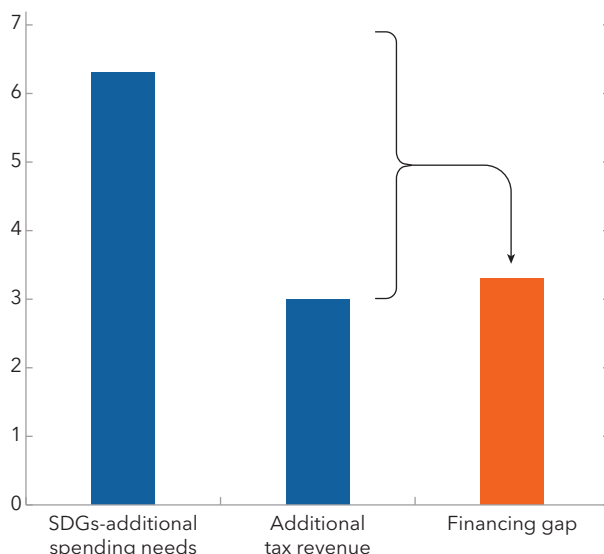
Post COVID-19 pandemic, the Pacific Island Countries will need to make domestic resource mobilization a priority to bring down public debt levels, restore fiscal space and finance spending needs related to the SDGs and climate change. Key reform priorities are: (i) tackling transfer pricing; (ii) seizing the opportunities that VAT offers; (iii) rationalizing tax exemptions and further investment in their tax administrations.

A. Background

Reducing the tax gap could help financing additional spending needs related to the SDGs. A review of additional spending needs related to the SDGs and climate change and the assessment of the tax gap in the Pacific region shows that part of the spending can be domestically financed by boosting tax revenue mobilization (Figure 30). However, this requires implementing bold tax and revenue administration reforms to reduce or close the tax gap. This chapter describes such policy measures.

Gradually unwinding tax relief measures introduced during the pandemic and measures to mitigate the impact of rising prices. Pacific countries introduced a range of fiscal measures in response to the pandemic (Figure 31, panel a), which generally included cuts to some taxes. It will be important for this temporary reduction in revenue collections to be gradually unwound as countries recover from the effects of COVID-19. This unwinding, though, need not involve an exact restoration of previous taxes. Rather it should aim to restore the lost revenues via the most efficient manner possible, even if this means raising taxes that were not part of the COVID response, or indeed, introducing entirely new taxes. Some Pacific countries also introduced tax measures to mitigate the impact of rising prices particularly following the beginning of the war in Ukraine (Figure 31, panel b). For example, Fiji introduced zero rating on VAT for 21 essential consumer items¹⁵ while Papua New Guinea removed the fuel excise and GST on fuel products and raised the income tax threshold. The new tax measures need to be time-bound and removed as soon as the increase in prices fades.

Figure 30. PICs: SDGs, Tax Revenue, and Financing Gap
(Percent of GDP)

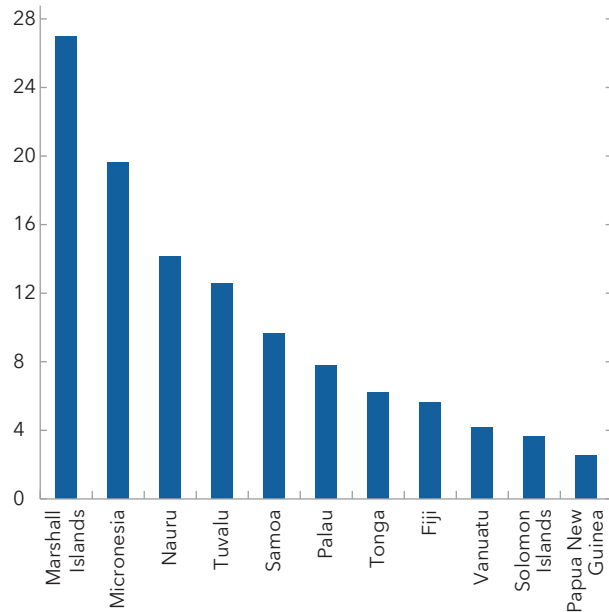


Source: IMF staff calculations.

¹⁵ Fiji also raised the VAT rate from 9 to 15 percent on a list of other goods to maintain revenue neutrality.

Figure 31a. PICs: Measures in Response to COVID-19

*Additional spending or foregone revenue
(Percent of GDP)*

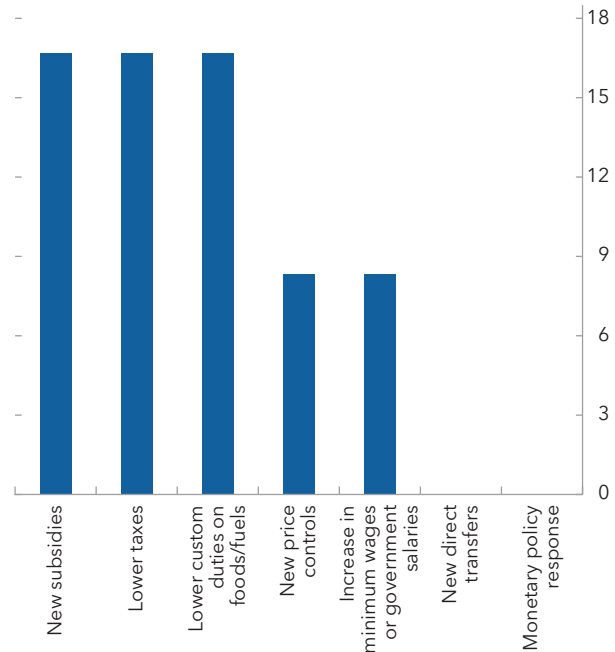


Sources: Country authorities; and IMF staff estimates.

Note: Fiscal measures include above-the-line measures and liquidity support from January 2020 to June 2021.

Figure 31b. PICs: Measures in Response to Increase in Commodity Prices

*Due to the war in Ukraine
(Percent)*



Source: IMF staff estimates.

Note: IMF staff survey of twelve Pacific Island Countries as of July 2022.

B. Value Added Tax

VAT is considered one of the least economically distortionary taxes. This is because it covers the final products and services consumed in a country, not the inputs, if well designed and administered. Its economic incidence is also likely to fall on both consumers and businesses, depending on the elasticity of demand for any given product. In addition, if applied without significant industry exemptions, VAT will have a minimal distortionary impact on business investment decisions.

Despite these and other advantages, only seven of the 12 countries within the scope of this paper have introduced VAT. Countries without VAT, even those with low levels of administrative capacity, should move toward its implementation as soon as possible. While implementation does carry with it, a significant cost in terms of training, IT systems and business and taxpayer education, the longer-term efficiency gains make this tradeoff very worthwhile.

The implementation of VAT also often entails the abolition/simplification of several inefficient wholesale taxes. The introduction of VAT also represents an opportunity to increase overall revenue collections to modernize and improve the efficiency and effectiveness of revenue administration. Countries with low VAT rates may also wish to consider raising them while introducing a single broad-based rate, should their overall tax mobilization strategy entail an increase in the tax revenue level of the economy or the elimination/simplification of other less efficient taxes.

C. Personal Income Tax

Personal income tax often represents a sizeable share of many countries overall revenue and is a feature of most modern tax systems. If applied appropriately, personal income taxes can also have a beneficial redistributive effect, while keeping distortionary impacts to a minimum. Some Pacific countries do not tax income at all, whether personal or corporate (for example in Vanuatu), meaning the loss of a potentially large revenue base.

The enactment of moderately high tax-free thresholds will reduce the tax and administrative burden on low-income earners. This will also not discourage businesses from hiring lower skilled workers. Likewise, a progressive tax scale that does not unduly discourage higher income earners from maintaining their employment in the taxing jurisdiction, will mean higher tax collections overall when compared to an approach where extremely high personal income tax rates encourage workers to migrate to lower-taxing jurisdictions.

D. Tax Exemptions

Many Pacific countries continue to offer sizeable tax exemptions to foreign and domestic investors in the often-mistaken belief that doing so can increase economic development and create jobs. A key risk of this approach is that it instead encourages legal and illegal rent seeking practices to develop. These practices can then erode confidence in a countries' entire investment climate, leading to a permanently lower economic growth path. If, overall, a country finds that businesses are failing to invest unless granted sizeable tax holidays or other tax exemptions, this may indicate that the tax regime facing businesses is too punitive and needs to be relaxed for all potential investors, not just those that have pressed for an exemption.

The precedent set by the issuance of the tax exemption is likely to encourage other investors to seek exemptions, further undermining the tax base. It also means that businesses granted exemptions will have an unfair competitive advantage over businesses that were not granted such treatment—potentially allowing inefficient businesses to prosper at the expense of more efficient rivals and leading to lower long term economic growth. Where tax exemptions are issued, it is important that formal analysis and reporting be carried out, showing any economic or employment benefits arising from the issuance of the tax exemption.

E. PACER Plus

Pacer Plus promises to improve trade efficiency across the Pacific, and in doing so raise living standards for participating countries. However, for some countries, import duties that have been or are due to be abolished under PACER Plus represent a sizeable share of overall revenue. These countries will need to look into alternate sources of revenue to offset these losses (although the expected increase in export-oriented activity in affected countries could provide some offsetting increases in revenue collections). Whether a particular country is a signatory to PACER Plus or not, the elimination of distortionary import taxes and their replacement with much more efficient taxes such as VAT and excise, is still an important step toward a higher growth economy.

F. Transfer Pricing

Transfer pricing continues to erode important revenue sources in some Pacific countries. For example, in the case of timber exports from some Pacific Islands, timber products are sold to parent companies in a second country well below the going market rate, with this being done to reduce the amount of excise and other taxes payable on these exports. To combat this common practice, all countries should move to a deemed export price for timber and other products subject to export taxes, irrespective of the actual price paid upon

export. The introduction of deemed export prices, regularly reviewed by authorities to ensure it reflects market realities, has the potential to greatly transform total revenue collection. This approach would have the advantage of ensuring that countries are appropriately compensated for the loss of natural resources, reduction in taxation pressure on other sectors of the economy as well as protection of environmentally sensitive resource stocks.

G. Tackling Corruption

Corruption within the customs and tax administration systems of some PICs continue to undermine not only the revenue base, but also the overall confidence in affected countries' investment climate.¹⁶ This could significantly lower the long-term economic growth path a country is able to follow, further reducing the revenue available to governments to deliver vital public services. Customs processes can often be a source of significant rent seeking risks, including in the Pacific.

The creation of independent agencies in charge of fighting corruption can help. While administrative procedural processes, including internal integrity units, and organizational cultural change are likely to have a positive effect in reducing corruption, perhaps the most potent impact can be caused by the introduction of independent integrity agencies such as independent commissions against corruption.¹⁷ Given appropriate powers, independence from government, and funding, these bodies can be a powerful tool in greatly reducing corrupt behaviors, within not only revenue administrations, but also in the economy more broadly. Both effects lead to higher overall government revenue collections as well as simultaneously reducing tax pressures on the broader tax base due to a fairer distributed incidence of actual tax paid.

H. Tax Administration Reforms

Critical mass for tax administrations to carry out their mandate is vitally important. Some tax administrations in the Pacific do not appear to have enough critical mass to carry out their mandates and even less ability to invest in future planning. Support for tax administrations is needed to successfully implement tax reforms with sufficient funding to enable implementation of strategies and reforms. Investment in tax administrations by the respective governments should include critical mass of capable staff, ICT support and e-tax as well as the capability to deal with the challenges of digitization and e-commerce. A lack of effective ICT support in future will have severe implications for revenue administrations. With pressure on revenue due to the pandemic, strategies and support to ensure revenue systems are robust and fair should be a key priority.

Compliance risk management should be enhanced and supported by compliance improvement strategies and revenue activation plans. This should enable tax administrations to overcome the pandemic impact and counter trade revenue losses due to PACER Plus. Risk management and data analysis that makes full use of the increasing data volumes flowing to tax administrations should be improved with a strong focus on the large taxpayer segment. Increased participation in Exchange of Information protocols and the capability to deal with the challenges presented by international tax issues, including transfer pricing issues are needed.

Core tax administration functions should be further strengthened to optimize revenue collections. This includes (1) developing a "post-crisis revenue collection action plan" to help revenue administrations re-establish compliance and revenue collection as quickly as possible in the post-pandemic, but with due consideration of the economic impact that COVID-19 has had on businesses and individuals; (2) improving the taxpayer registration process and accuracy of the taxpayer registers through implementation of robust taxpayer registration policies and procedures, cleansing the register of duplicate records, and introducing

¹⁶ For example, 67 per cent of businesses in Papua New Guinea reported that corruption had negatively affected them ADB and INA (2012).

¹⁷ Fiji created one in 2017.

proof of identity and physical location; (3) getting tax administration foundations right through development of standard operating procedures; (4) improving on-time filing and payment and the management of outstanding returns and tax arrears; (5) supporting voluntary compliance through taxpayer services and communication initiatives; (6) improving audit techniques and implementing improved mechanisms to increase the capability to audit large and international corporations.

Medium-term revenue strategies (MTRS) should be designed and implemented. This action should be supported by (1) developing tax policy capacity and assisting with review and rationalization of the widespread use of tax exemptions and incentives (especially with the VAT and CIT) and reviewing the tax policy measures introduced in response to COVID-19 once the pandemic passes, (2) reviewing and updating tax legislation, (3) modernizing tax administrations, (4) supporting the adoption of TADAT measures, and (5) raising awareness of human resource management good practice and developing a minimum level of good practices that support effective tax administration. The Platform for Collaboration on Tax (PCT, 2021) highlights that regarding MTRS in small states: (1) Political economy issues have been less problematic, and consensus-building appears less of a challenge or concern than in many larger, more diverse and fragmented countries; (2) Despite the small size and associated capacity constraints, awareness of critical issues and challenges is high, and there is a good reason to believe that the MTRS approach could be introduced successfully. Technical assistance from the IMF Fiscal Affairs Department on MTRS has been and should continue to be a valuable resource in this regard.

Annex 1. Case Studies in the Pacific Island Countries

Case Study 1. Fiji: The Standard Setter

Fiji has had a strong revenue performance over the last decade following tax reforms which increased tax revenue to 24 percent of GDP by 2018-19. However, the loss of tourism revenue following the onset of the pandemic and significant reductions in taxes, tariffs, and excises in 2020-21 significantly reduced Fiji's overall revenue envelope.

Pressing Spending Needs Related to the SDGs and Climate Change

Exposure to climate shocks has impact on economy, infrastructure, and macroeconomic stability. Like its Pacific Island peers, Fiji is affected by natural disasters and climate-related vulnerabilities that affect livelihood, economy, and infrastructure, and building climate-resilient infrastructure would entail larger investments to reach SDG goals. The Tropical Cyclone Winston, for instance, is estimated to have caused damage to Fiji's economy and infrastructure to the tune of 30 percent of GDP and slowed down growth to 0.4 percent.

Cost of adaptation to develop climate-resilient infrastructure has been estimated at about 10 percent of GDP over the next 10 years. It would require an increased capacity to evaluate and create a pipeline of environmental projects, with a realistic approach to access climate finance, Fiji's borrowing constraints and debt sustainability. The estimate includes health, education, water, energy, housing, transport, hazard management, as recognized by Fiji's National Adaptation Plan. Based on about one-fourth of its estimated needs, this quantum of funding would make Fiji dependent on its access to climate funds. Fiji Development Bank has already gained access to the Green Climate Board (GCF).

Tax Policy and Revenue Administration Reforms

Fiji's impressive pre-pandemic tax revenue declined sharply due to the effects of the pandemic on tourism and policy measures to reduce a wide range of taxes, tariffs, and excises. Fiji's major tax revenues came from goods and services, namely customs, and sector-specific taxes, particularly on tourism. The impact on the tourism sector following the COVID-19 pandemic, combined with the impact of tax policy measures aiming at economic relief, such as rate reductions and exemptions, are estimated to have reduced tax revenue by around 5 percent of GDP in 2021 to 15 percent in 2020-21. This was mainly attributable to the decline in goods and service tax (customs duties) revenue from above 10 to about 8 percent of GDP and income taxes from 7 to 4 percent of GDP as shown in Annex Figure 1.1.

Tax revenue in Fiji has been heavily reliant on indirect taxes like VAT, rather than on income taxes. VAT revenues were seen to contribute to about 34 percent of the total tax revenue and concentrated among large taxpayers. In view of this, VAT Act was rewritten in 2018 to make it more user-friendly, clearly delineating substantive, procedural and administrative provisions. Some of the direct tax policy reforms included increase in the PIT tax-free threshold, rate increase and base broadening of the Environment and Climate Adaptation Levy (ECAL), which helped offset the reduced tax revenues from exemptions extended in other taxation categories. Several tax reductions and exemptions were introduced to provide tax relief to selected industries.

Revenue administration reforms were given an emphasis in Fiji. This included advances in governance and business strategy and in particular, the adoption of information technology. Fiji saw a peak in administration reform expenditures (tax administration operating budget increased by 30 percent), particularly in IT, in addition to undergoing changes in organizational structures, such as development of units for Productivity Enhancement, integrated roles for revenue management, debt collection and dispute resolution. As a notable measure, Fiji implemented a fully-online taxpayer registration process with identity verification to combat issues related to identity mismatch and duplication. They also implemented the New Tax Information System (NTIS) for VAT and Withholding Tax to transition from paper-based tax administration to a digital system.

Tax compliance measures were enhanced.

Fiji implemented compliance improvement strategies (CIS) in a number of focus areas such as taxpayer segmentation for sectors such as agriculture, construction and wholesale and retail, while embracing methodology and implementation in new CIS areas such as fishing, logging, customs, and agriculture, to identify and mitigate compliance risks. Moreover, Fiji established new tax audit unit for large taxpayers and a SME support center for advisory and audit services. Additionally, Fiji was the only country to have developed a CIS to specifically manage international taxpayers through the establishment of a dedicated tax audit unit for detection of profit-shifting practices and transfer pricing audits.

Way Forward

Determine medium-term revenue target to ensure fiscal sustainability and rationalize budget expenditure. The authorities should determine a fiscal target (such as a primary surplus) to be sustained over the medium term to reduce public debt. This can be achieved through a combination of policy measures aiming to raise selected tax and excise rates, reduce exemptions (estimated at 24 percent of total revenue), broaden the tax base, and increase compliance and efficiency of revenue collection. For example, given the considerable share of VAT in tax revenues, a single broad-based VAT rate should be imposed equally across all sectors of the economy, and be applicable to all producers. CIT being the second most significant source of tax revenue for Fiji, there is a strong case for increasing the rate (over the current 20 percent) and broadening the base. Fiji could also consider other reforms such as increasing excise rates and expanding its purview over fuel and motor vehicles, raising departure tax, imposing withholding tax on dividends paid to nonresidents and developing a Model Tax Treaty for selection of tax partners to safeguard Fiji's economic benefits at negotiations.

Adopt a forward-looking tax policy reform strategy to achieve desired revenue target over medium term such as rationalization of tax incentives and exemptions. Fiji had implemented an extensive range of tax exemptions and incentives such as tax holidays, export incentives, custom exemptions, and film tax rebates, to provide economic relief following COVID-19, leading to forgone tax revenues, estimated at FJD 127 million, and complication in tax administration. Some mechanisms to confront this could include well-targeted incentives with clear eligibility criteria over a limited timeframe accompanied by continuous review, rationalization, and phase out.

Annex Figure 1.1. Fiji: Tax Revenue Mix, 2010-21
(Percent of GDP)



Sources: Fiji authorities; and IMF staff calculations.

Simplification of tax structure. It brings down administrative cost and increases voluntary compliance amongst taxpayers. Some steps have already been taken in this area—for example, the repeal of the ECAL in favor of higher VAT rates (although the use of multiple VAT rates has introduced a new distortion and reduced the simplicity of the tax regime).

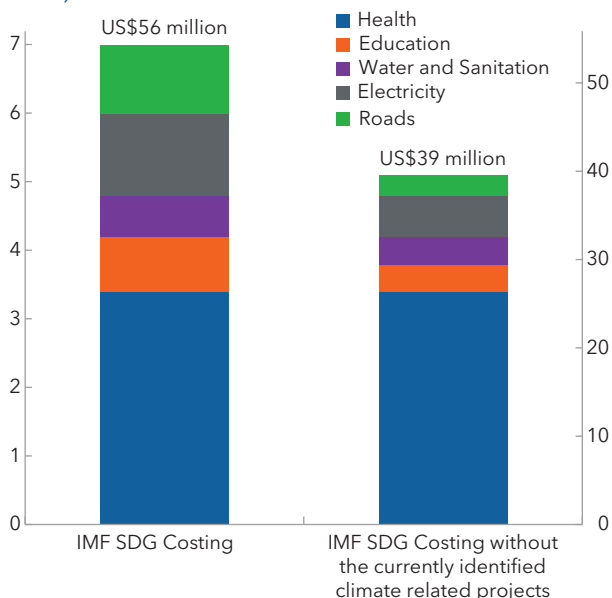
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Case Study 2. Tonga: Revenue Mobilization in a Natural Disaster-Prone Country

Tonga is one of the world’s most exposed countries to climate change and natural disasters. These climate vulnerabilities affect lives, livelihoods, economy, and infrastructure, making it more crucial for the country to improve its domestic revenue mobilization to meet its SDG and climate adaptation agenda. The additional annual spending needs to meet Tonga’s selected SDGs and currently identified climate plans have been estimated to be around 13 percent of 2030 GDP and closing this gap would require continued efforts in tax policy and revenue administration reforms, alongside financing support from climate funds, donors, and the private sector.

Annex Figure 1.2. Tonga: Estimates of Additional Annual Spending Needs for SDGs in 2030
(Percent of 2030 GDP; millions of US dollars, right scale)



Sources: IMF SDG Costing (Gaspar and others 2019); and IMF staff estimates.
Note: Left bar shows additional spending needs to meet SDGs and climate resilience estimated using IMF SDG costing methodology. Right bar excludes currently identified climate-related projects from these additional spending needs.

Pressing Spending Needs Related to the SDGs and Climate Change

Need for additional efforts to improve Tonga’s SDGs performance. The Tonga Climate Change Policy Assessment (CCPA) 2020 mission (Daniel and others 2020) has identified climate adaptation investment needs mainly in the areas of resilient transport, resilient public building, coastal protection, water and waste management and renewable energy. It has also identified need for additional efforts in public health and education to meet Tonga’s SDGs as shown in Annex Figure 1.2. Like its peers, Tonga has limited human resource and financial capacity to implement SDG and climate-adaptation strategies and given the current level of domestic private sector capacity, meeting Tonga’s needs would take time.

Exposure to climate shocks induce important economic damages. Tonga is highly exposed to the adverse impacts of natural disasters and climatic changes which affect its economy (Annex Table 1.1). In recent years, Tonga has experienced the largest climate-related loss globally (in percent of GDP) which has major repercussions on its macroeconomic growth.

Annex Table 1.1. Tonga: Cost of Recent Natural Disasters

		Damages and Losses	
		US\$ million	Percent of GDP
Cyclone Ian	Jan-2014	50.0	11.0
Gita	Feb-2018	164.1	37.8
Harold	Apr-2020	111.0	22.5
Hunga Ha'apai	Jan-2022	90.4	18.1

Sources: Tonga authorities, World Bank, and IMF staff calculations.

Note: The January 2022 estimates do not include economic losses.

Spending needs to develop climate-resilient infrastructure and meet SDG targets have been identified to be substantially large. Out of the total identified spending needs of about US\$671 million, only about 57 percent of the climate-related projects have been committed through external financial agreement. The financing gap is estimated at about US\$289 million or 60 percent of 2018 GDP. Thus, the combined additional costing to meet the selected 5 SDGs (estimated at about 7 percent of 2030 GDP) and the currently identified climate-related plans amount to an annual cost of 13 percent of 2030 GDP as shown in Annex Figure 1.3.

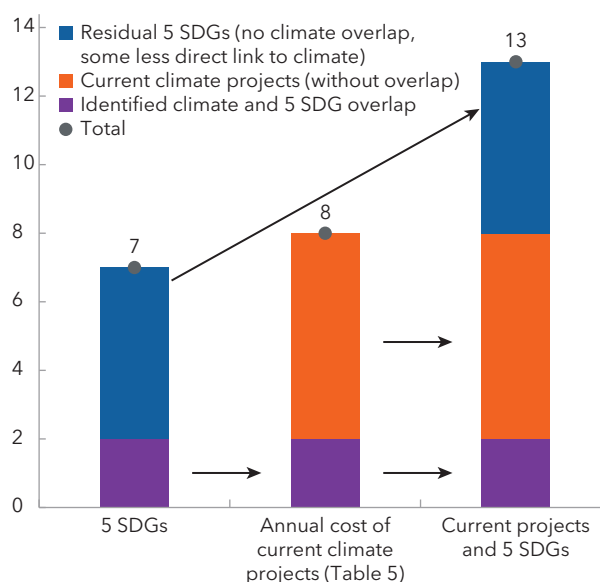
Tax Policy and Revenue Administration Reforms

Tonga's tax revenue remained relatively stable during the COVID-19 pandemic. This was mainly due to its reliance on indirect tax at the border, given its modest VAT revenue (about 40 percent of total tax revenue) and stable level of imports. Revenues from VAT accounted for about 13 percent of its GDP, followed by the contribution of income taxes to about 4.4 percent of the GDP. VAT revenue was seen to have increased from about 10 percent to 15 percent between 2010 to 2021, whereas revenues from income tax and trade tax remained relatively stable at 4 percent and 2 percent respectively as shown in Annex Figure 1.4.

Tax reforms implemented by Tonga included continued and heavy reliance on indirect taxes like VAT, rather than on PIT and CIT. While VAT rates remained at 15 percent and 84 percent of the filings were timely, some VAT reforms were strengthened, which included base broadening, reviewing VAT exemptions and VAT refund management. Some other reforms included increasing PIT tax-free threshold and top-PIT rate from 20 to 25 percent, introduction of small business tax for easier compliance and simplified administration, and review of excise tax rates (for example, increase in motor vehicle excises).

Revenue administration reforms were given an emphasis in Tonga. This included improvement in governance, organization, and strategic planning, introducing information technology (IT) and data management capabilities to manage volumes, and enhancing audit capability. Tonga increased its budget for tax

Annex Figure 1.3. Tonga: Annual Additional Spending Needs to Meet SDGs and Improve Climate Resilience
(Percent of GDP in 2030)



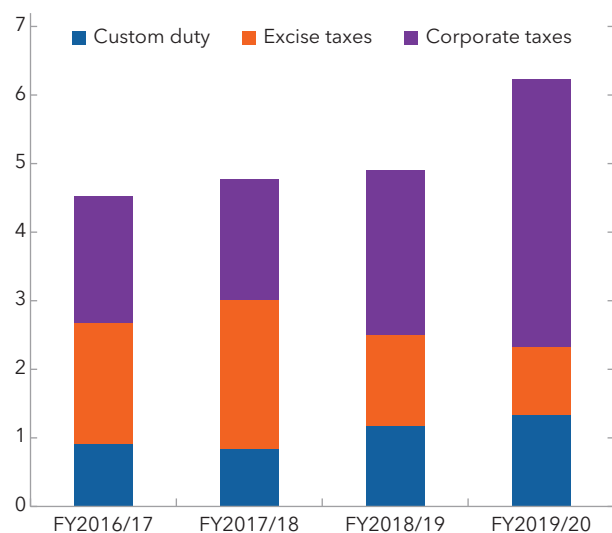
Sources: Daniel and others (2020); and Gaspar and others (2019).

Annex Figure 1.4. Tonga: Tax Revenue Mix, 2010–21
(Percent of GDP)



Sources: Tonga authorities; and IMF staff calculations.

Annex Figure 1.5. Revenue Cost of Tax Exemption by Type
(Percent of GDP)



Sources: Tonga authorities; and IMF staff estimates.
Note: Partial FY2019/20 data up to January 24, 2020.

This could be countered by significant reduction of VAT and CIT exemptions, enhancing capacity to control origin-fraud risk from non-PACER countries through capacity development of customs officials, setting a time limit of carrying forward tax losses, phasing out of tax holidays and enhancing risk management.

Selected Literature

Daniel, J. A. Banerji, R. Neves, D. Prihardini, C. Sandoz, A. Zdzienicka, A. Blackman, S. Esler, N. Palu, V. Piatkov, T. Moeaki. 2020. "Tonga: Climate Change Policy Assessment." Technical Assistance Report, International Monetary Fund, Washington, DC.

administration significantly by about 20 percent and its staffing capacity by 30 percent between 2017 to 2020 to increase tax administration efforts and improve compliance.

Tax compliance measures were enhanced. This involved establishment of baseline compliance levels for large taxpayers under compliance improvement strategies (CIS) in focus areas for VAT in industries such as construction, rental, whale watching, retail and wholesale, with an operational Risk Management Unit in place. Tonga further saw reforms such as establishment of Tax Compliance and Improvement Division, tax segment management (such as prioritizing taxpayer services for SMEs), usage of electronic fiscal devices (EFDs) and integrating headquarter roles under a single agency.

Way Forward

There is need for continuous review and rationalization of tax exemptions, especially VAT and CIT. Tonga depends on these taxes as means of recovery for tax revenue losses and safeguarding of fiscal sustainability. Tonga's tax exemptions accounted for about 30 percent of total tax revenue in FY 2019/20, given the gaps in coverage of VAT (17 percent), customs (7 percent), and excise duties (5 percent), in total amounting to a loss of 6.5 percent of GDP as shown in Annex Figure 1.5. The authorities could consider reviewing and potentially removing exemptions granted to the electricity sector, namely Tonga Power, tourism, transport, and to specific projects, thereby reducing market distortions and administrative complications.

Revenue loss from PACER Plus could be offset by gains from VAT, excise, and CIT revenues and by effective enforcement of anti-avoidance measures. The expected revenue loss from PACER Plus would account for 1-1.3 percent of GDP, owing to removal of import duties and shift out of profits from Tonga.

Gaspar, V., D. Amaglobeli, M. Garcia-Escribano, D. Prady, and M. Soto. 2019. "Fiscal Policy and Development: Human, Social, and Physical Investment for the SDGs." IMF Staff Discussion Note, 19/03, International Monetary Fund, Washington, DC.

International Monetary Fund (IMF). 2020. "Tonga: 2020 Article IV Consultation and Request for Disbursement Under the Rapid Credit Facility." IMF Country Report No. 21/26, International Monetary Fund, Washington, DC.

Martens, Paul, John Middleton, Kosugi Naofumi, and Robert Woods. 2021. "Tonga: TADAT Performance Assessment Report." Technical Assistance Report, International Monetary Fund, Washington, DC.

Case Study 3. Palau: The Birth of a VAT System

While Palau has been successful in containing COVID-19 community spreads, border closure and containment measures brought about a strain on the economy, the near-term improvement of which remains challenging, especially in the face of a real GDP contraction of 9.7 percent in FY 2020—the lowest in over two decades—drop in exports and widening fiscal and current account deficits to the tune of about 11 percent and 48 percent of GDP, respectively, in FY 2020. This necessitated the implementation of a comprehensive fiscal consolidation strategy centering on domestic revenue mobilization alongside expenditure rationalization to rebuild fiscal resilience. On the revenue mobilization side, a comprehensive tax reform was introduced in 2021 that included a law that will take effect in January 2023, marking the adoption of a new value-added tax regime for Palau, referred to as the Palau Goods and Services Tax (PGST).

Current Gross Revenue Tax (GRT) Regime and Its Drawbacks

The GRT is a tax paid at the rate of 4 percent on gross sales by businesses. The Palau National Congress or Olbiil Era Kelulau (OEK) observed that the country's current Gross Revenue Tax (GRT) system is outdated and unsuitable for the service-based high-value tourism economy that Palau strives to be, and therefore, needs optimization. The GRT "cascades" because the tax is on the gross amount of any transaction and does not take into account the taxes already paid along the production or supply chain. The cascading tax rate substantially raises prices of goods in Palau, impacting those with low incomes, thus making the tax structure in Palau more regressive. It discourages economic growth by disproportionately favoring large, established, vertically integrated businesses while disadvantaging new and small startups, family businesses, and boutique operations. It further penalizes businesses with large turnover and low profit margins.

GRT discourages foreign investment because of its incompatibility with the VAT. Most of Palau's trading and investment partners such as Japan, Korea, and the Philippines adhere to the VAT system of taxation. Using GRT, thus, introduces instances of double-taxation and disqualifies investors from tax benefits in their home jurisdictions.

Finally, GRT encourages evasion, especially by small businesses due to lack of a system of financial data reporting. Under GRT, businesses are not obligated to financial reporting, and hence, are not required to maintain and submit their financial statements, cash flows or any documentation regarding their financial performance. This makes it difficult for lenders to correctly assess the creditworthiness of these businesses. Hence, GRT has inculcated an inefficient method of assessing taxes, managing records, and measuring the country's economic output.

Key Features of the PGST Law

The PGST Bill (RPPL 11-11) was signed into law on September 28 and 29, 2021, and will take effect on January 1, 2023. The law will impose a 10 percent PGST tax upfront, with rules for exempt and zero-rated supplies, and a registration threshold of \$300,000 in taxable supplies over a 12-month period. With the introduction

of the PGST, non-registered persons engaged in business with annual gross income exceeding \$50,000 but less than \$300,000 will continue to pay the current 4 percent GRT or the same tax as is collected currently. Small businesses with gross annual income of less than \$50,000 will be subjected to an additional annual business license fee of \$100.

Business Profit Tax (BPT) on net profit. In addition to the above, the law also includes the introduction of a new BPT of 12 percent on net profit payable by businesses exceeding the \$300,000 income threshold for PGST. Commercial banks, however, will be subjected to a 20 percent rate. Businesses with lower annual gross income will also be allowed to opt-in for BPT instead of GRT, which will automatically require registration for PGST.

Excise and Carbon Taxes. The law introduces an excise tax on certain goods imported to or manufactured in Palau, replacing the current taxes on alcohol and tobacco products as well as on a number of other products. A carbon tax will also be levied at a new rate of \$0.03 per gallon on individuals or businesses importing liquid petroleum-based products, with the exception of butane and propane gas.

Exemptions and Refunds. No tax will be assessed on exports, fixed capital, investment goods and financial services. With the introduction of the PGST, which may be levied on imports, the current 3 percent general import duty and special import duties would be removed. The law also mandates refunds of income tax assessed of people earning \$15,000 or below per year.

Expected Gains from PGST Implementation

The PGST is part of a comprehensive tax reform intended to improve the efficiency of the overall tax system and generate additional potential revenue. With potential revenue gains estimated at about 1 percent of GDP, the tax reform is expected to improve fiscal balance and cover the first year (or one-fifth) of the five-year fiscal adjustment from FY 2024. PGST is identified in the FY 2022 national budget as an important revenue source, without which the budget would be reduced by 18 percent of the originally submitted budget for FY 2022. The BPT will align with the agreed global minimum corporate tax rate along with streamlined exemptions, while the carbon tax will reinforce Palau's commitment to climate change. Mandatory and timely refunds under the PGST are expected to prevent abuse of tax refunds and support investments.

Financial Reporting Requirements. Enhanced financial reporting requirements under PGST would give an opportunity to authorities to address data gaps and lenders to have comprehensive data on business performance and hence increase credit creation. While the introduction of the PGST Bill was initially perceived to bring about a one-off upward pressure on prices, the positive impact would be long-lasting. It would modernize Palau's tax regime into a fair, equitable, and inclusive one, in line with international taxation systems while promoting the growth of business and commerce to fund essential government services.

Selected Literature

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International Monetary Fund (IMF). 2018. "Republic of Palau: 2018 Article IV Consultation." IMF Country Report No. 19/43, Washington, DC.

International Monetary Fund (IMF). 2021. "Republic of Palau: 2021 Article IV Consultation." IMF Country Report No. 21/263, Washington, DC.

Senate Bill Number 11-15 for Palau Goods and Services Tax, RPPL 11-11, Eleventh Olbiil Era Kelulau, Republic of Palau, First Special Session, 2021. <http://www.palau.gov.pw/2021/05/Senate-Bill-11-15.pdf>

Annex 2. Estimating Tax Potentials in the Pacific Island Countries

The capacity of the state to collect tax revenues to finance economic development is at the heart of state building. However, many LIDCs cope with difficulties to collect enough tax revenue to fill their financing needs.

Econometric methodology: The literature estimates tax capacity using stochastic frontier analysis in which panel data techniques are applied to regressions of tax revenue on a range of potential determinants. The following equation is estimated:

$$\left(\frac{T}{Y}\right)_{it} = f(X_{it}; \beta) \cdot \xi_{it} \cdot e^{v_{it}}$$

where $\left(\frac{T}{Y}\right)_{it}$ is the observed tax revenue to GDP ratio for country i at time t . $f(X_{it}; \beta)$ is an expression for the tax production function by which a vector of inputs (X_{it}) is transformed into tax revenue, in line with parameter vector (β). In line with the literature, X_{it} represents the explanatory variables considered in this paper that might affect the tax capacity: GDP per capita, trade openness, share of agriculture in GDP, and institutional variables (for example, control of corruption and government effectiveness), etc. Trade openness is measured as the sum of exports and imports of goods and services as percentage of GDP. Both control of corruption and government effectiveness indices range from -2.5 (high corruption, low effectiveness) to 2.5 (low corruption, high effectiveness). ξ is tax effort or efficiency of tax collection and is restricted to being between 0 and 1. v_{it} represents random shocks. Our specification closely follows IMF (2018).

Econometric results: Annex Table 2.1. presents the results of the stochastic frontier. The specification A includes all variables while the specification B excludes the institutional variables for example, control of corruption and government effectiveness. Consistent with other studies (for example, IMF (2018)), the analysis finds that higher income level is associated to higher tax collection but the effect of higher income on tax collection is non-linear. Strong control of corruption, government effectiveness and openness to international trade are also associated with higher tax collection. However, a higher share of agriculture in GDP (associated with more informality) is associated with lower tax collection. The estimated coefficients are used to estimate the tax capacity for each country and aggregated across groups. Annex Figure 2.1. shows that the explanatory variables are strong predictor of country's tax capacity. Annex Table 2.2. shows country group estimation of tax capacity depending on the specification in Annex Table 2.1.

Annex Table 2.1. Tax Frontier Regression Results
(Dependent Variable: Log of Tax-to-GDP)

Explanatory Variables	Dependent Variable: Log of Tax-to-GDP							
	All sample				EMDCs ¹			
	A		B		A		B	
	Coefficient	Std. err.	Coefficient	Std. err.	Coefficient	Std. err.	Coefficient	Std. err.
Log of real GDP per capita	0.580	0.061	0.004	0.004	0.829	0.087	0.638	0.076
Log of real GDP per capita squared	-0.031	0.003	0.015	0.004	-0.053	0.005	-0.036	0.004
Trade openness	0.001	0.000	0.002	0.000	0.001	0.000	0.001	0.000
Share of agriculture in GDP	-0.011	0.001	-0.005	0.001	-0.015	0.001	-0.013	0.001
Commodity exporters dummy	0.316	0.340	0.284	0.354	0.255	0.429	0.343	0.368
Control of corruption	0.039	0.016			0.024	0.021		
Government effectiveness	0.030	0.016			0.111	0.023		
Sigma_u	0.145	0.005	0.141	0.006	0.159	0.008	0.163	0.007
Sigma_v	0.053	0.003	0.063	0.005	0.071	0.006	0.062	0.005
No. of observations	2566		2566		1972		1972	
No. of countries	167		167		129		129	

Sources: World Bank, World Development Indicators; World Bank, Worldwide Governance Indicators; IMF, *World Economic Outlook*; and IMF staff estimates.

Note: Specification B excludes institutional variables (control of corruption and government effectiveness). EMDCs = emerging markets and developing countries.

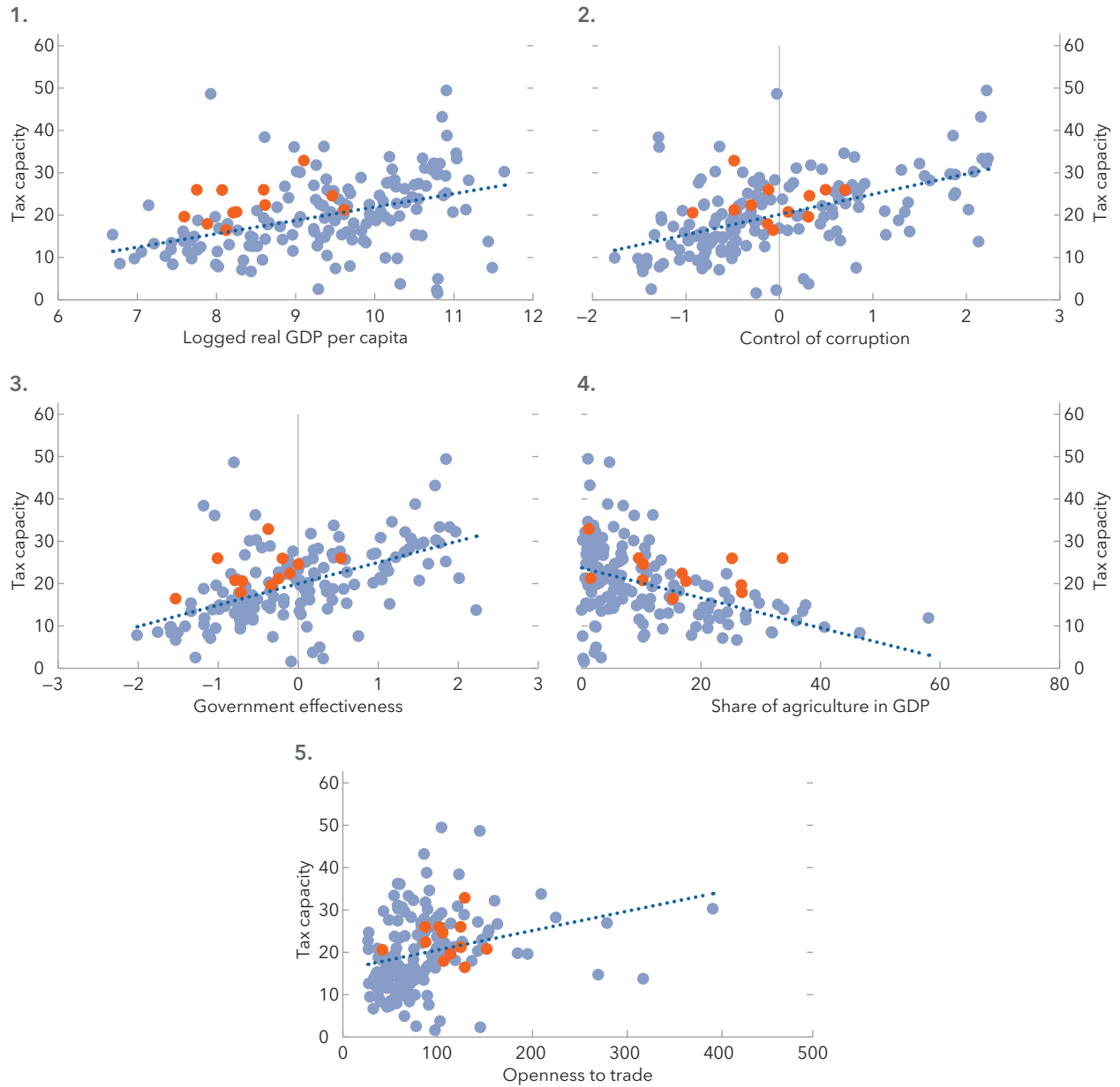
Annex Table 2.2. Tax Potential in the Pacific Region*(Percent of GDP)*

Country Group	Tax to GDP	All Sample		EMDCs	
		A	B	A	B
Tourism dependent	21.2	22.4	22.5	22.7	22.5
Commodity exporters	19.0	23.3	23.1	23.3	23.3
Compact countries	18.2	21.2	21.1	20.6	21.1
Fragile countries	17.4	21.6	21.2	21.1	21.5
Other countries	19.5	24.5	23.8	23.6	24.5
PICs (unweighted avg.)	19.7	22.9	22.7	22.6	22.9

Source: IMF staff calculations.

Notes: Model B excludes the institutional variables (control of corruption and government effectiveness). Tourism economies include Fiji, Palau, Samoa, Tonga, and Vanuatu; commodity exporters include Papua New Guinea and Solomon Islands; compact countries include Marshall Islands, Micronesia, and Palau; fragile countries include Kiribati, Marshall Islands, Micronesia, Papua New Guinea, Solomon Islands, and Tuvalu; others include Kiribati, Nauru, and Tuvalu. EMDCs = emerging markets and developing countries.

Annex Figure 2.1. Tax Frontier and Its Determinants



Sources: World Bank, World Development Indicators; World Bank, World Governance Indicators; IMF, *World Economic Outlook*; and IMF staff estimates.
 Note: Pacific Islands Countries are denoted in red.

Annex 3. Capacity Development Delivered to PFTAC Member Countries

The IMF provides DRM capacity development (CD) assistance to PICs through the Tax Policy and Revenue Administration divisions in its Fiscal Affairs Department (FAD) and through the revenue workstream in PFTAC. This CD helps PICs strengthen their tax systems and their institutional capacity to mobilize domestic revenue needed to finance development and achieve the Sustainable Development Goals, improve taxpayer compliance, and promote the role and contribution of citizens as taxpayers towards fiscal sustainability.

Revenue Program Objectives

The Tax Policy Program focuses on (1) providing technical advice on designing and implementing tax policy to raise revenue in an efficient, fair, and simple manner and (2) developing capacity on tax policy analysis. The program scope extends to all major taxes used by PICs. Most countries in the region collect a large share of revenue from VAT and other consumption taxes. Advice has focused on broadening the tax base for the VAT while discussing policy options for countries that are considering introducing a VAT. An emerging issue in some countries relates to the taxation of e-commerce. In general, income taxes in PICs continue to have many tax expenditures including corporate tax incentives targeted at investment. Policy advice focuses on broadening the tax base without discouraging investment. Some countries also seek to have a fairer tax system by reforms that make the personal income tax more progressive. In countries that have only more recently started import tariff reforms, including through the PACER Plus agreement, policy advice has been guided by the need to adapt tax policy to gradually replace customs revenue.

The Revenue Administration Program focuses on two key objectives: (1) strengthening revenue administration management and governance arrangements and (2) improving core tax administration functions. To achieve these objectives tailored advice is provided on administration of a wide range of tax types including, customs duties, excises, income taxes, and social contributions and VAT and specialist regimes (for example, administering fiscal revenues from the extractive industries). CD advice also covers strengthening taxpayer compliance management, including tax gap and compliance risk analysis, as well as strengthening core operational processes (registration, filing payment, and reporting) and strengthening synergies between collection of trade taxes and customs' responsibilities in trade facilitation, regional integration, and implementation of trade policies.

Revenue Program Modality

Support to the PICs in recent years has been delivered using a blended approach combining headquarters missions and visits, appointment of a long-term resident advisor (PNG), short-term expert visits and PFTAC activities and remote engagements during the COVID pandemic. The CD assignments comprise a tailored mix of strategic guidance and operational hands-on implementation advice focused with the former largely delivered through FAD and the latter through the PFTAC.

Direct support from the IMF headquarters has included strategic reviews, for example, Third Review of Tax Reforms (2021), development of a MTRS in Papua New Guinea (2018-2021), and identification of tax administration reform priorities in Samoa (2020). Tax policy diagnostic assessments have been undertaken by a mix of headquarter-based teams and short-term experts often based in the region. Indirect support through the PFTAC consists of backstopping of the Revenue Administration Advisors' and short-term experts' work on

the PICs. This CD delivery model is critical for tailoring the CD program to the PICs revenue administration needs and ensuring technical advice consistency throughout the Pacific region and its alignment with international good practice.

The PFTAC financed CD delivery covered a range of revenue topics including the following: (1) policy advice on the design and implementation of tax reforms including by rationalizing tax expenditures, (2) legislative drafting, (3) implementation of new taxes, (4) international tax (territorial) and base erosion and profit shifting (BEPS), (5) diagnostic reviews and modernization roadmaps, (6) corporate strategies and operational plans, (7) business plans for greater investment and support for tax administrations, (8) organizational arrangements including functional structures and large taxpayer segment, (9) CIS and revenue activation plans, (10) data analysis and risk management, (k) information technology system assessments, support and strategies, (11) taxpayer services and communication, (12) tax return and tax arrears management, and (13) tax audit.

Training workshops and webinars are presented in cooperation with the PITAA and is based on their annual training needs analysis. The following topics have been covered over the past three years: (1) leadership, integrity, and governance; (2) operational management, including separate workshops for the management of core tax functions; (3) data analysis and compliance risk management; (4) compliance model and the large taxpayer segment; (5) taxpayer services and communication; (6) tax arrears and tax return filing; (7) tax audit including tailored workshops for groups of countries and individual countries; (8) VAT-implementation and compliance risks; and (9) managing the impact of COVID-19. A similar partnership with the Oceania Customs Organization is envisaged for the future, also with a focus on joint training workshops covering, for example, the VAT compliance risk as well as technical assistance to customs administrations in the PFTAC region.

CD Volumes and Financing

Since the start of the 2018 financial year, CD for PICs has been provided with funding from the IMF, Revenue Mobilization Thematic Fund (RMTF) and the PFTAC Revenue program, with the largest contribution coming from the PFTAC program. Several of the tax policy missions delivered by headquarters-based tax policy staff and short-term experts have been financed by PFTAC. The RMTF financed the MTRS implementation program in PNG from 2018 to 2021 providing a resident long-term expert and a series of advisory visits (summarized further below).

The PFTAC revenue program delivered 238 missions and activities totaling 3,482 workdays (Cook Islands included) up to the end of the third quarter of the 2022 financial year. The breakdown per financial year is shown in Annex Table 3.1.

Annex Table 3.1. PFTAC-Financed Assistance

	FY18	FY19	FY20	FY21	FY22 up to end of third quarter	Total
TA missions	28	53	50	48	30	209
Training events	7	5	7	6	4	29
Number of TA days	482	726	799	877	598	3,482

Source: IMF staff calculations.

A brief summary of CD delivered to the PIC member countries as well as revenue risks are as follows.

Fiji

CD Delivered:

There has been strong commitment to reforming and strengthening revenue administration in Fiji. Over recent years PFTAC support for reforms include (1) renewing FRCS' Corporate Strategy and Business Plan; (2) redrafting income tax, VAT, and tax administration legislation and regulations; (3) incorporating a strategic review of FRCS' information technology processes and assistance to design user requirements and a governance framework for the implementation of the new IT system; (4) strengthening the management of outstanding tax returns and tax arrears; (5) strengthening the tax audit function; (6) facilitating the design of a compliance improvement strategy; (7) incorporating a plan to introduce a public and private rulings program; (8) improving the taxpayer services function; (9) incorporating skills development for tax auditors and investigators; and (10) incorporating quality reviews of the New Tax Information System implementation. At the request of the authorities, PFTAC financed a remote tax policy mission from FAD in April 2021 to explore short- and medium-term tax policy options to rebuild and recover from the large decline in tax collections resulting from the COVID-19 economic contraction and the initial government response through tax concessions and rate reductions.

Outcomes/Achievements:

Fiji has undertaken a major system development to modernize tax administration along with other reforms. The New Tax Information System (NTIS) was procured, and the first of two phases of implementation completed. The implementation of NTIS enables the tax administration to move away from paper-based processing with registration now a fully online process along with filing of VAT and Pay As You Earn returns. Other improvements include better management of compliance risk and debt, implementation of standard interpretation guidelines, implementing a joint tax and customs audit function, and additional compliance

Revenue Risks:

Turnover of CEOs (three acting CEOs during period of two years, newly appointed CEO from January 2022), instability of the workforce including 25 percent staff reduction, and three-year contracts for all staff. Outstanding returns and tax arrears remain high. The impact of COVID-19 has been significant, both for revenue administration, and particularly with significantly lower collections from reduced economic activity and rate reductions and concessions.

Kiribati

CD Delivered:

PFTAC assistance with the drafting and implementation of laws that included VAT, excise tax, and a Revenue Administration Act (introduced on April 1, 2014). Further PFTAC support was provided to review the organization structure and to transition to a functional model, standardizing work processes, strengthening audit—including skills development, improving taxpayer compliance management, strengthening risk-based approaches as well as improving taxpayer services. An FAD short-term expert conducted a comprehensive tax policy review in FY 2021.

Outcomes/Achievements:

The key administrative reforms have been in the areas of tax arrears, VAT compliance and registration. This was framed by the development of three compliance improvement plans for each area and supported by CD provided through PFTAC. Improved debt management through a top 10 debtor program and introduction

of a tax clearance process followed. A taxpayer services strategy was developed, and a taxpayer outreach program successfully launched during 2019, but put on hold due to the COVID-19 pandemic until late 2020. Internal performance measurement based on TADAT indicators has been adopted.

Revenue Risks:

Low compliance culture, lack of resources.

Marshall Islands

CD Delivered:

PFTAC provided substantial TA to Marshall Islands in recent years. This included drafting Bills for a new Revenue Authority, Net Profits Tax, Excise Tax and Consumption Tax, which have yet to be passed. Assistance focused on developing a strategic and operational plan, improving on-time filing and payment, strengthening audit and improving taxpayer services. Progress on implementation of recommendations and action plans have been slow. There have been discussions on tax reforms, including the introduction of Consumption Tax, but this is unlikely to move forward in the near future.

Outcomes/Achievements:

With no ICT support, progress has been made in gaining access to real-time filing and payments data from the Ministry of Finance 4Gov accounting system. This enables the tax office to follow a structured risk management approach and better manage filing and payment compliance activities. PFTAC has assisted in enhancing this Excel-based system. Progress on other recommendations from PFTAC and the ADB-funded resident advisor has been very slow due to resource and capacity constraints.

Revenue Risks:

Lack of capacity, no tax information system, high non-compliance culture.

Micronesia

CD Delivered:

Incremental improvements facilitated through PFTAC TA have shown that potential exists to improve overall efficiencies, but sustainability remains a challenge. A diagnostic review was planned for September 2019 but postponed several times in preference for in-country assistance not possible given COVID-19 border closures. This review will identify potential future TA. The FSM President has established a National Tax Reform Commission to complete a tax review and submit a report on tax reforms, including the introduction of VAT, originally by the end of 2021. Currently it is unclear whether the tax reforms will proceed. Assistance was requested for revenue modeling of reform options, and this TA is being delivered.

Outcomes/Achievements:

No evidence of notable achievements. A World Bank funded assistance program to procure a new ICT system started two years ago and is slowly moving forward.

Revenue Risks: Fragmented field operations across four island states, outdated business processes, the lack of IT system support and poorly trained staff are serious challenges.

Nauru

CD Delivered:

TA provided by PFTAC assisted the introduction of wide-ranging reforms. This included (1) the introduction of Revenue Administration Act and Employment & Services Tax Act (effective October 1, 2014); (2) the introduction of a small Business Tax Act (effective July 2016); (3) assistance to develop processes for registration, filing, and payment of taxes; and (4) assistance in the development of a roadmap for the merger of the Customs and Revenue agencies, including a new organizational structure and development of technical guides. Assistance has also been provided to implement a Design and Monitoring function, compliance improvement strategy and monitoring compliance of large taxpayers. Recent assistance delivered remotely includes a tax policy review and assistance with drafting tax legislation.

Outcomes/Achievements:

The Compliance Improvement Plan (CIP) was approved and is operational. The CIP addresses identified risks and treatment strategies with a focus on improving large taxpayer compliance by addressing registration, filing and payment risks. On-time filing and on-time payment for large taxpayers has improved but remains lower than planned CIP targets. Tax arrears remains a relatively low risk.

Revenue Risks:

Lack of resources have an impact on successful reforms. Nauru faces one of the largest adjustments from lost trade tax collections given obligations under the PACER Plus free trade agreement—however, recent information suggests that the Nauru government will not ratify the agreement. Had Nauru become a signatory to the agreement, the ability to replace this revenue source is challenged by the extent to which the authorities are willing to tax domestic consumption and/or income. Uncertainty regarding DFAT-funded contracts for Nauru Ministry of Finance positions of Deputy Secretary and Resident Adviser is having impact on the administration. The Refugee Processing Centre (RPC) has an uncertain future with extension by Government of Australia only until 30 June 2022. The RPC is the major contributor to revenue and employment in Nauru.

Palau

CD Delivered:

PFTAC assistance over recent years provided for (1) developing Strategic and Business Plans; (2) implementing new function-based structure; (3) developing the taxpayer services function; (4) providing overview of how VAT system operates and potential impact on the operations; and (5) managing outstanding returns and tax arrears. Progress has been relatively slow on implementation of recommendations. In December 2020 the president-elect sought PFTAC assistance to fast-track ambitious tax reforms including the introduction of VAT and profits tax that previous TA had failed to get political traction. Support from the IMF Legal (LEG) Department was immediately mobilized to update a legislation package that was enacted early in the new administration paving the way for ambitious reforms that entails extensive TA from PFTAC and other providers. Support is now being provided on preparation for the implementation of the tax reforms, including the implementation of a new organizational structure. An IT system assessment provided options to be considered for successful implementation of the tax reform.

Outcomes/Achievements:

The tax reform legislation developed with assistance from PFTAC was passed into law in September 2021 and will be implemented on January 1, 2023. The new tax system replaces existing import taxes and the gross revenue tax (GRT) with a 12 percent business profits tax, excise taxes applying to select imported and locally produced goods, and a 10 percent broad-based goods and services tax. The Palau authorities acknowledged the contribution that PFTAC made to get the tax reform legislation passed into law. The Palau

Bureau of Revenue and Taxation (BRT) incorporated PFTAC advice into a 2020 to 2025 BRT Operational Roadmap document to align and further develop all aspects of its operational capabilities and tax reform implementation plans and this was approved by the Minister of Finance in August 2021.

Revenue Risks:

Capacity and management capability as well as great difficulty in recruiting staff for new structure. Tax information system deficient in many areas and will not provide good support for the tax reforms.

Papua New Guinea

CD Delivered:

The medium-term revenue strategy program funded by the RMTF that started during 2018 ended in April 2021, with revenue administration support now being provided by PFTAC while tax policy support continues with a mixture of IMF and bilateral funding. Assistance provided through the RMTF focused on tax policy design and capacity building, designing, sequencing and integrating the MTRS implementation program, governance arrangements, large taxpayer management, and taxpayer services. Assistance during the past year focused on the implementation of a new organization structure that will support effective and efficient operations consistent with a modern tax administration. Papua New Guinea had a good performance with revenue collection in the past year with a target of K9.2 billion and collecting K9.5 billion, notwithstanding COVID-19 impact. Good progress has been made with the PFTAC support for implementation of the new organization structure. Implementation and detailed action plans have been developed and guidance provided on transitioning people from the current structure and roles to those in the new structure, along with revised charters for each of the new business groups. A governance committee framework was developed to support the new organization design. The tax policy program supported a rewrite of the antiquated and complex Income Tax Act, provided guidance on the design and implementation of tax policy, and initiated a capacity development program with the Treasury Revenue Policy Division.

Outcomes/Achievements:

The Papua New Guinea Internal Revenue Commission (IRC) executive and project team have strongly engaged in furthering the detailed design of the structure and maintained commitment to move forward with the implementation of the new organization structure. The IRC confirmed its support for the key design principles of the organizational design developed in previous CD assignments. The IRC Commission approved the high-level structure design on February 10, 2022. The Commission have finalized the high-level structure. The key design element to separate the operational tax administration activities from the design and monitoring role of the IRC is maintained. On the tax policy front, the Treasury together with IRC has made substantial progress on modernizing and simplifying the income Tax Act. The Treasury revenue policy team, supported by a legal expert, has conducted comprehensive stakeholder consultations to get public feedback on the draft legislation. It is expected that this will be completed following the national elections in mid-2022.

Revenue Risks:

Capacity, IT systems support, the depth of leadership capability to fill the additional leadership positions and sufficiently resourcing the new structure within reasonable time are concerns. Revenue performance remains vulnerable to commodity price volatility, with natural resource revenue foregone from concessions provided in contract negotiations and compliance challenges.

Samoa

CD Delivered:

The tax administration's performance has been good with tax revenues peaking in 2019 and relatively stable during 2020 and 2021 notwithstanding the COVID-19 impact on the economy, mainly due to stepped-up taxpayer services initiatives impacting on improved voluntary compliance and the rollout of the Tax Invoice Monitoring System (TIMS)—an electronic system for monitoring tax collected on the sale of goods and services. PFTAC assistance included a review of current compliance improvement plan (CIP) and development of a renewed CIP that addresses the most significant compliance risks with a focus on the COVID-19 impact, managing tax debt and returns, improving taxpayer services, strengthening audit and TIMS, development of BCP, development of an IT strategy and legal assistance on territorial tax and BEPS. An FAD tax policy mission financed by PFTAC advised on options to replace revenue losses from future import tariff reforms.

Outcomes/Achievements:

Samoa has continued to strengthen core tax administration and build risk-based compliance capability. The Ministry of Customs and Revenue (MCR) has focused efforts on strengthening core tax functions, particularly filing and payment. Despite investments in auditor capability improving large and international reporting compliance is constrained by internal capability. It has also expanded scope of compliance improvement plans and is developing industry partnerships to tackle compliance problems in high risks industries. In response to cash economy concerns, a strategy to mitigate the risk through EFDs has been developed. The management continues to exercise strong governance. An Information Technology Strategic Plan to guide future path for key IT decisions has been commissioned and nearing completion.

Revenue Risks:

Inadequate IT system support is a constraint to improving core tax functions and management of operations. Samoa seeks to be removed from the EU blacklist of non-cooperative tax jurisdictions and is weighting the pros and cons of a territorial tax system, which could result in a small reduction in revenue. The intended organizational split between Customs and Tax and Outsourcing of debt collection also poses risks to the continuity and efficiency of revenue collection.

Solomon Islands

CD Delivered:

Several modernization initiatives were undertaken during the last few years supported by PFTAC including: (1) improving the management of tax debt and outstanding returns that is showing positive results, (2) renewing Strategic and Operational Plans that provides a modernization roadmap, (3) implementing a function-based organizational structure, (4) setting up a Large Taxpayer Office (LTO), (5) developing a first generation audit plan, and (6) developing a strong set of core documents addressing the interests of stakeholders and representing key pillars of the underway tax reforms that includes the introduction of VAT. The implementation of these initiatives is being supported by a committed management team that is intent on improving tax administration in the Solomon Islands and is receiving significant support and financing from the Asian Development Bank.

Outcomes/Achievements:

The Solomon Islands is preparing to modernize the Solomon Islands Inland Revenue Division (SIIRD). Efforts have been undertaken to develop a comprehensive modernization strategy and work with donors to secure its financing. In addition to the policy reforms the strategy will include a revised organization structure, new business processes and a new information technology system for tax administration to make it easier for taxpayers to comply and to reduce SIIRD costs.

Revenue Risks:

Human resource capacity, current COVID-19 impact.

Tonga

CD Delivered:

Revenue collections remained strong notwithstanding the COVID-19 impact on the economy. PFTAC TA has contributed to the revenue collections through the successful implementation of a wide range of reforms, including: (1) facilitating the design of a compliance improvement strategy, (2) strengthening taxpayer services, (3) improving the audit function, (4) improving tax arrears and returns management, (5) facilitating the establishment of a Large Taxpayer Office (LTO), (6) legal assistance to modernize the Revenue Services Administration Act (RSAA) and a rewrite of the Consumption Tax Act, (7) tax audit skills development, (8) implementing Industry Partnership with a focus on the whale watching industry, and (9) developing guidelines for the Point of Sale System. A TADAT assessment undertaken during May 2021 reflected the good progress being made by the Ministry of Revenue and Customs (MoRC). PFTAC also financed an FAD-delivered tax policy mission to help the authorities prepare tax policy reforms to replace the anticipated revenue loss from future import tariff reforms.

Outcomes/Achievements:

MoRC has made good progress on several administrative reform initiatives covering structure, capability technology and people. MoRC moved to a functional structure in 2017 and has since established an LTO building on the Heilala initiative. Improving audit capability has been a focus along with continued attention to improving debt recovery. Building partnerships with industry groups has also featured strongly on MoRC's compliance improvement agenda which aims to share identified compliance risks and develop industry responses. Strategic planning aligned to the government planning cycle is in place with annual plans developed from the strategic plan. Improved services to taxpayers making use of technology are a priority, but this will require an update to the existing system.

Revenue Risks:

Slow pace of filling vacant positions and lack of funding for the tax administration. Also lack of capability to deal with multinational company tax avoidance/evasion.

Tuvalu

CD Delivered:

The assistance by PACTAM, an Australian-supported TA program reduced reliance on PFTAC TA over past years. PFTAC assistance, however, restarted with a June 2018 modernization plan, and continued with assistance on the tax information system, compliance improvement strategy and plan, large taxpayer framework, taxpayer service unit, small design and monitoring function, implementation of the VAT audit methods. Recent assistance included the development of a corporate strategic plan, business continuity plan and renewed compliance improvement strategy.

Outcomes/Achievements:

The draft 2021- 2023 Inland Revenue Department (IRD) Strategic Plan has been adopted and is guiding the work of the IRD and measurable progress has been made with implementation of the 2021 Operational Plan. The IRD has completed several of the key activities included in the plan, such as steps taken to improve the accuracy of large taxpayer data in the IRD taxpayer register. The Taxpayer Services Unit (TSU) has updated large taxpayer contact details and has started the review to ensure each of the 22 large taxpayers are registered for all correct tax types. Improvements have been made in the information that is being captured from tax returns. The IRD has adopted previous PFTAC recommendations including: (a) capturing all information from returns into Excel spreadsheets as previously only select information was being captured, and (b) using a new format for the filing Excel spreadsheet that would make it easier for the Debt Management Unit (DMU) to detect tax returns that have not been filed by the due date and would allow auditors to easily see the history of tax returns submitted and view information that is changing from across tax periods.

Revenue Risks:

Resources and funding, low skills levels.

Vanuatu

CD Delivered:

Steady reform progress has been made over recent years, including (1) the development of a new strategic and business plan, (2) a risk-based CIS, (3) implementation of performance standards, and (4) a review of the IT system service agreement and options for the future what support of the current version of the IT system may cease. Recent assistance focused on debt and returns management, taxpayer services, renewal of the compliance improvement strategy and improving tax audits.

Outcomes/Achievements:

A new Corporate Plan has been developed and implemented for 2021 to 2025, identified core initiatives to meet each of the strategic priorities and the proposed year of completion of the initiative. The implementation of the Tax Administration Act (TAA) represents a major policy reform. The TAA of 2018 implemented from January 1, 2020, is a significant step that introduced important changes impacting both the business community and DCIR. Segments have been redefined and simplified. To streamline and ease compliance management three segments of large, medium, and small have been introduced which included merging large and very large taxpayers in one group, retaining the medium segment, and merging small and micro taxpayers into a small segment, allowing for improved planning of service and enforcement activities and strengthen overall risk management. The new CIS also includes a strong focus on the large segment which contributes around 80 percent of total tax revenues. A proposal for the full staffing of the function-based structure has been submitted to the Director General of the Ministry of Finance and Economic Management. The Taxpayer Services function is making good progress and actions to improve on-time filing, on-time payment and the management of tax arrears showed significant progress over the past two years with debt almost halved—from VT10.8 billion to VT6 billion.

Revenue Risks:

Lack of capacity and funding for the administration. Vanuatu is one of very few PICs without income tax given reliance on revenues from citizenship/passport fees, but which places significant burden on the indirect tax system. The DCIR is trying to proceed with a "Tax Week" to promote tax awareness and provide taxpayer awareness, notwithstanding the fact that there is no budget for this initiative.

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