1. INTRODUCTION

The largest share of tax revenue in Pacific Islands Countries (PICs) originates from customs duties although the exact share varies from country to country. Tariffs may bring in needed revenue but they are notoriously unsatisfactory because they create imbalances and distortions in the economic choices of enterprises, and ultimately reduce welfare. For all these reasons, they will gradually disappear in the Pacific, as they tend to do elsewhere. The first step will be the implementation of the Pacific Islands Countries Trade Agreement (PICTA), after the regional trade agreements have been signed and ratified by those countries that have agreed to eliminate customs duties for all commercial intra-zone trades by 2012. While the expected loss from PICTA is not too large because intra-zone trade is limited, the implementation of the Agreement on Closer Relations (PACER), that is more an economic agreement, but also includes trade with Australia and New Zealand, will have a more severe impact because PICs trade mostly with these two countries. Although PACER will only take effect in a few years after PICTA, it is time to seriously consider alternative sources of revenue.

Across the world, countries that faced a drop in tariff income have established comprehensive regimes of internal taxation that include, besides the personal income tax and corporate tax (usually already in place before tariffs were phased out), indirect taxes such as a VAT and excise duties. The main advantage is that these taxes do not constitute obstacles to trade. Indeed, they are only supported by the final domestic consumer and apply to imports as well as to the local production of similar goods and services. Although more than 120 countries in the world have already installed a VAT, and are satisfied with the results (and note that both economists and tax administrators agree on this conclusion, which is a rare occurrence indeed), one can still hear the odd voice of self-proclaimed experts who, without clearly defining the type of tax they refer to (but they say it is a VAT) argue that it is too difficult to manage for PICs and implementation costs are too high. It is also argued, rightly this time, that the tax administration is weak, not well structured or not structured at all, not well staffed, trained, computerized, or committed, badly paid, and sometimes corrupt. On the other hand, the private sector is accused, perhaps less rightly, of being unable to understand accounting, to deliver a proper invoice, let alone to complete accurately a tax declaration.

Hence, according to these critics, there is need for a substitute, and they call it “simplified VAT”, “restricted VAT”, “sales tax”, or “single stage sales tax”. In any case, according to them, a “full VAT” must be avoided. Unfortunately, the amount of explanation which appears to be required to operationalize any of these simplified proposals should in itself provide sufficient proof that these schemes are not so simple after all. They are also flawed because they usually reintroduce some of the economic distortions that constituted the reason to get rid of tariffs in the first place.

There is no denying that the tax administration is weak in most PICs, and arguably that the private sector is weak as well. But I make the case here that it is precisely because the tax administration is weak and disorganized that the VAT is the best tool for PICs. The point is not one of income generation. We already know that the VAT fares well on this front. The main point is that a VAT is the best possible catalyst to modernize the tax administration and therefore to improve its efficiency. Before moving ahead with this argument, I would like to insist on one crucial point which is that trying to implement a VAT without improving the administration would be a futile exercise and similarly, trying to implement any of the so-called “simplified” substitutes would be futile. The administration must first be improved as the VAT provides all the elements needed to systematically address the weaknesses of a tax administration. That is also why a VAT takes time to implement: it takes exactly the time required to train, in the process, the people who will administer it, and to introduce a culture of bookkeeping for the private sector if needed.

In short, and as one of my former colleagues at the IMF used to say: in developing countries, tax administration is tax policy. This also applies to PICs.

Now, I can briefly come back to the other argument which is that the VAT is a good revenue-generating instrument. All practitioners know that there are very strict limits to the buoyancy of a tax system (i.e. its ability to increase revenue from one year to the next). That is because, irrespective of changes in rates or in the definition of the size
of the net, revenue increases can only be generated if the administration becomes more efficient, i.e. if procedures are improved, the organization streamlined, and many other changes implemented through modernization. Hence, the key is that the VAT has proved itself to be a good income-generating tool because its implementation requires a concomitant improvement in the efficiency of the tax administration. And, ultimately, it is also worth remembering that it is a tax that limits economic distortions.

So, what do these self-proclaimed experts refer to when they talk about the need to avoid a “full VAT”? I suppose that they refer to the complex legal instruments used in developed countries like New Zealand or Australia where it is called a GST. We know how, particularly in Australia, the debates prior to its introduction have been difficult. They were fuelled by the complexity of the proposed GST. Obviously, PFTAC is not recommending that PICs adopt the most complex model of VAT, of the type in operation in Australia or in France (where the VAT has been implemented as early as 1954), or even in New Zealand, where it is often claimed that it is one of the best in the world. We believe this approach would be suicidal.

But neither would we recommend a “simplified” or “restricted” VAT that would reduce its scope. We believe that this form of VAT would not achieve any of the purposes this tax is intended for. In addition, this approach would also be suicidal. What we recommend is a VAT covering all sectors of activity. However, given that it should remain a manageable tool, it should only apply to a few taxpayers who are selected on the basis of their annual turnover. Thus, in doing so, we take into account the lack of capacity constraint and work on modernizing the administration so as to enable it to absorb our other requirements. We usually expect that the implementation process will take about two years.

In short, VAT is a good tax income generating product for the PICs. We will consider the five PICs that have already adopted it. Although the VAT framework has room for improvement, neither us nor, I believe, the authorities are unhappy with the tax. I will also draw some of the conclusions and arguments from The Modern VAT by Liam Ebrill, Michael Keen, Jean-Paul Bodin and Victoria Summers.

In this paper, after reviewing the possible options when customs duties were being phased out (see 2.), we will prove the fact that VAT is a major source of revenue in the five PICs where it has been adopted (3.). Lessons learnt in these countries and the vast world of VAT country members will then be discussed and the fact that the VAT is a catalyst for organizational and cultural changes will also be highlighted (4.). The main implementation issues will then discussed before conclusions will be drawn (5.), and proposals for the future tax structure and administration of PICs will be considered (6.).

2. NECESSITY TO MOVE FROM A TRADE TAX SYSTEM ORIENTED TO A MORE DOMESTIC TAX ORIENTED SYSTEM

In many developing countries, VAT adoption has been bolstered as trade tax revenues came under pressure with deepening trade liberalization commitments. In the Pacific, tariff reduction is driven by two agreements: PICTA and PACER.

PICTA is a free trade agreement whereas PACER is an economic cooperation agreement. The key component elements in achieving this trade integration are trade liberalization and trade facilitation. PICTA covers trade in goods between members (services are not included). No exports from member countries will be subject to any form of trade barrier when imported into other member countries. At this stage, PICTA has received the required minimum six ratifications and has been in force since 14 April 2003. By 2012 the tariffs should be reduced to zero for all FICs and “negative list” protection tariffs reduced to zero by 2016.

Although some preliminary studies have predicted that the effect on tax revenue will be minimal, it is expected that the small islands states will nevertheless have to adopt substantial structural adjustments by designing and implementing the tax reforms necessary to reduce reliance on tariffs with minimal disruption to government revenue. Papua New Guinea (PNG), Fiji, Samoa, Vanuatu and Cook Islands have already implemented a VAT with a single rate. They also adopted a threshold to limit the net to a number of taxpayers compatible with their administrative capacity, although this was not the case in every country at the date of implementation, an example is Samoa. Most other PICs (namely Kiribati, Tonga, Tuvalu, the Federates States of Micronesia (FSM), the Republic of Marshall Islands and Niu) have already requested additional information on the functioning of the VAT system.

The most common options to cushion the drop in revenue from customs duties include:

- adoption of a consumption tax;
- adoption or expansion of excises;
- simplification of the income tax (personal and corporate);
- limitation and monitoring of exemptions;
- modernization of customs and tax administrations.

1. As a contribution to these requests, PFTAC has organized and conducted in May 2003 in Tonga a regional seminar aimed at: (1) reviewing of the main issues in replacing customs tariffs by a broad-based consumption tax; (2) analysing of the key features of a successful implementation of a consumption tax; and (3) identifying basic recommendations from both policy and administration side for the design and implementation of a VAT or broad-based consumption tax when phasing out customs tariff. This VAT Regional Seminar was attended by seven PICs representatives, more than 56 participants, including the Tongan private sector (Chamber of Commerce, Business Associations, accountants), and the Forum Secretariat, the New Zealand and Australia representatives. The objective was to prepare an inventory of all the basic issues when designing, administering, and implementing a VAT. Two countries (Samoa and PNG) with a VAT were invited to help potential VAT adopters understand the issues, especially in the early phase of implementation and to animate the discussions. Details and conclusion of the seminar can be found on our web site: www.pftac.org.
Although international studies show that the VAT may work well in a small economy, it appears that many experts are afraid to recommend it in PICs, mainly because they do not associate the implementation of a VAT with the modernization of the tax department; if they do so, they usually conclude that the cost is too high. In other words, they propose changes in tax policy without improving the tax administration. The reason for this approach may be due to the fact that most of the experts are tax policymakers and not tax administrators.

Here is a sample of proposals and arguments I have found:

“A single-stage tax is less costly to implement”. However, in the same report, one can read that “To implement it, studies need to be carried out to design the sales tax structure, its implementation timetable and the effect on stakeholders and consumers. Some external assistance may be needed”. The report goes on: “A single-stage sales tax as a precursor to a VAT presents itself as a prudent approach to the small island states (SIS). The proposed sales tax is a VAT in transition”. The author seems to have overlooked the fact that the VAT is as far from the sales tax, both based on turnover, as the corporate tax is from wages and salary tax, both based on income.

Here is something from another report: “The single-stage sales tax stands as the easiest form of tax for SIS to administer mainly because it is collected at the customs”. This is true, but VAT can also be collected at customs. The report goes on: “Simple tax systems are attractive. A VAT or GST is probably too complicated. But a single stage tax, such as a retail sales or wholesales sales tax would probably be sensible. It may even be desirable to levy a single stage sales tax at the port, where this could be administered by Customs as per the current tariffs. The exact form of any future sales tax requires careful thought and investigation”. It surely does, but the proposal made here boils down to a custom duty, precisely the tax being replaced. While I agree that, at this stage, there is little domestic production, it is not a reason to legalize this state of affairs.

It is always possible to generate at least as much revenue from a consumption tax as from a tariff. Setting the consumption tax at a rate equal to that of the initial tariff, ensures that consumption is unaffected by the change but revenue is now collected not only on imports but also on consumption, a base that will be wider to the extent that there is domestic production. Besides it is always better to raise revenue by taxing consumption properly than by distorting trade. A properly structured VAT would be less distorting than a broad-based tariff or other forms of sales tax.

Furthermore, as an economy develops, the merit of the VAT in preserving the chain of taxation will grow in importance.

Another recommendation often found is that of a double stage sales tax at the importation and the manufacturing levels with a special tax on services. This system is very complex to administer. Moreover, as soon as a credit mechanism is operational, we are in fact closer to a VAT. The fact that “manufacturers” are few in numbers does not eliminate the complexity of the system in developing countries. This is all the more true as very often an enterprise is simultaneously an importer, a producer, a whole-saler and a retailer. Identifying the retail activity of a given enterprise is almost impossible.

There have been studies that rightly identify a difficulty but fail to derive the right conclusion. An example is one conclusion that stated that with a VAT, SIS need to pay very close attention to implementation costs and compliance issues. Firstly, these costs should be the same irrespective of the nature of the tax recommended. Secondly, most PICs face exactly that compliance problem: how can one increase voluntary compliance? In many countries, the implementation of a VAT has been the solution to this question of compliance. The reason is that taxpayers have an incentive to register in order to obtain a refund. Thus, the tax administration often finds itself in a position to have to reject applicants. It is amazing to see everywhere the large number of taxpayers who register voluntarily to the VAT in order to enjoy the credit mechanism, although their turnover is under the threshold when it is not mandatory for them to do so. Obviously, they have to respect bookkeeping requirements although they are medium or even small-size taxpayers. In Vanuatu, 38% of all VAT registered are small taxpayers who voluntarily applied to the VAT system. This ratio is a good value of a friendly VAT.

Regarding the costs of compliance, the complexity and the costs associated with most of the existing system are such that they will surely decrease with a well designed and implemented VAT. Indeed, collection costs are affected by the design of the tax (self-assessment, single-rate, high-threshold, and number of exemptions). Start-up costs aside, a VAT is usually less complicated, and hence less costly to collect and to comply with than the consumption taxes it has replaced and, for that matter, than any corporate tax.

3. THE VAT IS A MAJOR SOURCE OF REVENUE WHEREVER IT HAS BEEN ADOPTED

The VAT is a modern tax that is now in place in more than 120 countries, ranging from industrialized nations to developing countries in all regions of the world. More than ten island countries have adopted the VAT since 1990. In terms of population, the smallest countries with VATs are Cook Islands (12,000), Samoa (170,000) and Vanuatu (180,000). Tonga, with a population of 101,000, is considering implementing the Tongan Consumption Tax in April 2005.

In the countries that have adopted the VAT, VAT revenue is of the average of 27% of total tax revenue or of 5% of GDP (ranging from 1% to 10%) and rates vary from 3% to 25%, in the form of one (positive) rate up to seven rates.

2. The voluntary compliance is defined as the fact for a taxpayer to respect its tax obligations (filing and payment) on time without any reminder notice. For VAT obligations the voluntary compliance is expressed by the percentage of returns filed and paid on time compared to the total VAT registered taxpayers. This ratio suggests that the taxpayer is aware of the penalty system and believes in its severe and immediate enforcement.

3. Administration and compliance costs: Administration costs are incurred by the tax authorities and compliance costs by taxpayers. Taken together they are referred to as collection costs.
The standard rate is higher in Europe and in transition economies than elsewhere, and it is the lowest in the Asia-Pacific region. Western Europe, North Africa and the Middle East have the most complex VAT in terms of the number of rates. In contrast, it is the region in which the spread of VAT has been most recent (Africa, the transition economies and the small islands) that typically have the simplest VAT tax structures.

Countries with similar VATs (as measured by the standard rate) can have a significantly different revenue performance (as measured by the ratio of VAT revenue to GDP). In Fiji, the VAT collects over 6% of GDP and in the Philippines less than 3%, both with a standard rate of 10%. (See Table 1 for revenue performance.)

### TABLE 1

<table>
<thead>
<tr>
<th>Sub-Saharan Africa</th>
<th>Asia and Pacific</th>
<th>Americas</th>
<th>European Union</th>
<th>Central Europe</th>
<th>North Africa and Middle East</th>
</tr>
</thead>
<tbody>
<tr>
<td>efficiency ratio¹</td>
<td>27</td>
<td>35</td>
<td>37</td>
<td>38</td>
<td>36</td>
</tr>
<tr>
<td>C-efficiency² ratio</td>
<td>38</td>
<td>58</td>
<td>57</td>
<td>64</td>
<td>62</td>
</tr>
</tbody>
</table>

1. The efficiency ratio is defined as the ratio of the share of VAT revenues in GDP to the standard rate. Average 35 implies that 1 point increase in the standard rate is associated with an increase in the share of VAT revenues in GDP about 0.35 percentage point.

2. The C-efficiency ratio is defined as the ratio of the share of VAT revenues in consumption (rather than GDP) to the standard rate. A uniform tax on all consumption has a 100% C-efficiency ratio. Any other value higher or lower indicates deviation from a single rate tax on all private consumption. A uniform tax on all consumption has a 100% C-efficiency ratio. New Zealand has a C-ratio of 103% close to the benchmark of 100% and Brazil 122%.


The experience with VAT has inevitably been mixed, though most countries have implemented it with success. In the eight island countries for which data were readily available, the C-efficiency ratio averaged 79%, compared to only 64% in European countries, 58% in Asia-Pacific countries, and 38% in Sub-Saharan countries. For two of the small island countries, the C-efficiency ratio is over 100%. (See Table 2 for comparison of C-efficiencies.)

Usually the higher the C-efficiency ratio is, the greater the importance of trade in the economy. The natural interpretation of the strong revenue performance of VAT in small island countries is that the importance of international trade enables them to collect considerable amounts of VAT on imports and that geographical remoteness insulates the tax base, to some degree, from smuggling. The border is a convenient place to begin the withholding mechanism. Securing VAT collection on imports is generally a crucial part of ensuring effective collection of the tax throughout the chain of production and securing the success of the VAT overall.

Table 3 shows that VAT is clearly a major source of revenue wherever it has been adopted. The share of VAT in total tax revenue goes from 19% in PNG to 49% in Cook Islands (with the same 10% single rate). The average for the five PICs (32%) is higher than the world average (27%) and also higher than that for small islands (29%). The VAT collected compared to the GDP (with all limitations due to some errors in the measurement of the GDP) goes from 4.5% in PNG to 13% in Cook Islands with an average of 7.9%. The thresholds vary from USD 7,000 (Fiji) to USD 65 in Vanuatu. However, these thresholds (level and scope) have been modified since the introduction of VAT in many countries (Fiji, Samoa) to help fight against non-compliance.

Only five countries have ever removed a VAT, of which three small islands: Grenada (introduced in 1986 and gradually dismantled), Malta (introduced 1995, removed 1997), and Belize (introduced 1996, removed 1999), Vietnam in the 1970s, Ghana (introduced in March 1995, removed two months later). Three of these have since reintroduced the VAT: Ghana in 1998, Malta and Vietnam in 1999.
Broadly, the reasons for repealing the VAT were:
- political commitment to repealing the VAT (politicians promised to repeal the VAT if elected);
- poor performance due to poor planning of VAT introduction and operation; and
- an inadequate definition of registration threshold which resulted in an excessive number of taxpayers to be administered.

In Malta, the VAT was introduced in 1995, repealed in 1997, reintroduced in 1999. The difficulties were coming from:
- extensive zero-rating of domestic consumption; and
- no threshold. The new VAT reintroduced successfully in 1999 provides for a threshold of about: USD 38,500.

In Grenada, the VAT introduced in 1986 has been replaced in 1995 by a "general consumption tax". The failure of the VAT was due to a bad design and implementation, the main reasons being:
- many domestic goods and services were zero-rated;
- a low threshold was introduced (ECD 12,000);
- no adequate preparation for the tax administration was provided; and
- no taxpayer education programme convincing the public of the advantages of the VAT was put into place.

In Ghana, the VAT was introduced in April 1995, repealed in June 1995 and reintroduced successfully in 1999. Four main reasons have been identified for the failure:
- regulations were not published before the implementation date;
- the threshold was too low (USD 14,000);
- the VAT administration was not well prepared; and
- taxpayers and consumers were not fully informed.

The new VAT has been reintroduced in 1999 with a higher threshold of USD 75,000.

4. THE VAT IS A CATALYST FOR ORGANIZATIONAL AND CULTURAL CHANGE

I now come to one of the main, yet usually overlooked, characteristics of the VAT, which is being a catalyst for organizational and cultural change.

Experience, including in the five PICs where a VAT is implemented, shows that the introduction of a VAT provides a major opportunity to develop new tax administration systems and procedures.

These systems and procedures include:
1. using a new registration and taxpayer identification number (TIN);
2. standardizing invoices and books of accounts;
3. simplifying filing and payment obligations, based on self-assessment procedures, and implementing effective collection monitoring systems;
4. establishing a Large Taxpayer Unit to monitor the large taxpayers identified mainly as those who need to register for the VAT;
5. developing comprehensive audit programmes; and
6. developing a modern computer system to streamline the operations of the tax administration.

In reviewing each of these systems and procedures, I will show how it acts as a catalyst for change: (1) within the tax collection agencies (spearheading the modern use of IT, modernizing the organizational structure, and developing audit methods); (2) among taxpayers (developing a culture of record-keeping, establishing self-assessment and raising the level of voluntary compliance).

Tables 4A and B present the main features of the tax laws and the main characteristics of the tax administrations in the five PICs where VAT has been implemented.

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**TABLE 3**

**Performance of VAT in Island Countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (thousands)</th>
<th>Year of introduction</th>
<th>Rates (%)</th>
<th>Threshold (USD thousand)</th>
<th>% of VAT in total tax revenues</th>
<th>% of VAT in GDP</th>
<th>C-efficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>PNG</td>
<td>4,400</td>
<td>1999</td>
<td>10</td>
<td>30</td>
<td>19.0</td>
<td>4.5</td>
<td>68.0</td>
</tr>
<tr>
<td>Jamaica</td>
<td>2,550</td>
<td>1991</td>
<td>15/12.5</td>
<td>–</td>
<td>35.8</td>
<td>8.8</td>
<td>83.5</td>
</tr>
<tr>
<td>Trinidad</td>
<td>1,310</td>
<td>1990</td>
<td>15</td>
<td>25</td>
<td>23.6</td>
<td>4.3</td>
<td>46.8</td>
</tr>
<tr>
<td>Mauritius</td>
<td>1,160</td>
<td>1998</td>
<td>15 (10)</td>
<td>100</td>
<td>26.3</td>
<td>5.6</td>
<td>n.a.</td>
</tr>
<tr>
<td>Fiji</td>
<td>810</td>
<td>1992</td>
<td>12.5 (10)</td>
<td>15/8</td>
<td>27.6</td>
<td>6.2</td>
<td>84.1</td>
</tr>
<tr>
<td>Cyprus</td>
<td>770</td>
<td>1992</td>
<td>8</td>
<td>–</td>
<td>18.9</td>
<td>5.0</td>
<td>100.1</td>
</tr>
<tr>
<td>Malta</td>
<td>380</td>
<td>1999</td>
<td>15</td>
<td>38</td>
<td>23.4</td>
<td>6.5</td>
<td>67.0</td>
</tr>
<tr>
<td>Iceland</td>
<td>270</td>
<td>1990</td>
<td>25/14</td>
<td>–</td>
<td>30.5</td>
<td>9.4</td>
<td>64.8</td>
</tr>
<tr>
<td>Barbados</td>
<td>260</td>
<td>1997</td>
<td>15/7.5</td>
<td>30</td>
<td>32.7</td>
<td>9.5</td>
<td>101.2</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>180</td>
<td>1998</td>
<td>12.5</td>
<td>65/30</td>
<td>23.3</td>
<td>5.4</td>
<td>n.a.</td>
</tr>
<tr>
<td>Samoa</td>
<td>170</td>
<td>1994</td>
<td>12.5</td>
<td>20</td>
<td>40</td>
<td>10.7</td>
<td>n.a.</td>
</tr>
<tr>
<td>Tonga</td>
<td>100</td>
<td>2005</td>
<td>15?</td>
<td>50</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Cook Islands</td>
<td>12</td>
<td>1997</td>
<td>12.5</td>
<td>15</td>
<td>49</td>
<td>13.0</td>
<td>n.a.</td>
</tr>
<tr>
<td>Niue</td>
<td>1</td>
<td>?</td>
<td>?</td>
<td>?</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

n.a. = not available

Sources: Ebrill, et al. (International Monetary Fund), Countries and PFTAC.
# Table 4

## PICs: Main Features of VAT Law and Administration

### Table 4 A: Main features of the VAT laws

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cook Islands</td>
<td>Y</td>
<td>Y</td>
<td>&gt;15 (930)</td>
<td>Y (F)</td>
<td>3 weeks</td>
<td>M</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Fiji</td>
<td>Y</td>
<td>Y</td>
<td>&gt;15 (goods) and &gt; 8 (services) (16,500)</td>
<td>N</td>
<td>4 weeks</td>
<td>Q &amp; M</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>PNG</td>
<td>Y</td>
<td>Y</td>
<td>&gt;30 (8,500)</td>
<td>N (FEMeG)</td>
<td>4 weeks</td>
<td>M</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Samoa</td>
<td>Y</td>
<td>Y</td>
<td>N (92)</td>
<td>F (FEMe)</td>
<td>4 weeks</td>
<td>M</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>Y</td>
<td>Y</td>
<td>&lt;30 voluntary basis (38%)</td>
<td>F E</td>
<td>15 days</td>
<td>Q (&lt;60)</td>
<td>N</td>
<td>Y with a court order</td>
<td>Y</td>
<td>N</td>
<td></td>
</tr>
</tbody>
</table>

**Y** = Yes  
**N** = No  
**F** = Financial sector  
**E** = Education sector  
**Me** = Medical sector  
**G** = Government expenditures  
**M** = Monthly  
**Q** = Quarterly

**Source:** Countries and PFTAC.

### Table 4 B: PICs, Main administrative characteristics of VATs

<table>
<thead>
<tr>
<th>Country</th>
<th>Voluntary compliance</th>
<th>First reminder notice</th>
<th>Auditors number</th>
<th>Auditors in % of taxpayers</th>
<th>Audit programme</th>
<th>Field audit performed</th>
<th>Standard audit report</th>
<th>Computer system</th>
<th>Single TIN</th>
<th>LTU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cook Islands</td>
<td>80%</td>
<td>&lt;6 months</td>
<td>5</td>
<td>0.5%</td>
<td>31%</td>
<td>N</td>
<td>3% (30)</td>
<td>RMS</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Fiji</td>
<td>&lt;60%</td>
<td>75%</td>
<td>30</td>
<td>0.17%</td>
<td>15%</td>
<td>N</td>
<td>Y</td>
<td>In-house</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>PNG</td>
<td>&lt;40%</td>
<td>&lt;50%</td>
<td>11</td>
<td>0.13%</td>
<td>11%</td>
<td>N</td>
<td>Y</td>
<td>In-house</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Samoa</td>
<td>&lt;60%</td>
<td>&lt;2 weeks</td>
<td>11</td>
<td>0.8%</td>
<td>14%</td>
<td>Y</td>
<td>Y</td>
<td>RMS</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>&lt;60%</td>
<td>&lt;10 days</td>
<td>6</td>
<td>0.5%</td>
<td>22%</td>
<td>Y</td>
<td>Y</td>
<td>RMS</td>
<td>N</td>
<td>N</td>
</tr>
</tbody>
</table>

**Y** = Yes  
**N** = No  
**TIN** = Tax Identification Number  
**LTU** = Large Taxpayer Unit  
**RMS** = Revenue Management System

**Source:** Countries and PFTAC.
4.1. Using a new registration and taxpayer identification number (TIN)

All persons or companies operating a business should be assigned a single Tax Identification Number (TIN) used by all revenue agencies reporting to the Chief Commissioner or the Minister of Finance.

The TIN has two main objectives: (1) to facilitate the development of computer applications, such as those used for detecting stop filers and delinquent accounts; and (2) to help cross-check information on taxpayer compliance. It also acts as a key to the taxpayer record where other information, such as type of business and relevant tax office, is stored.

Although all PICs with a VAT use a numbering system to identify the VAT-registered taxpayers, only Cook Islands is using a single TIN shared between both the tax and the customs departments. All other PICs use different numbers for each revenue department and the current registration and numbering systems are excessively complex for taxpayers. They impose multiple record-keeping requirements on both taxpayers and the tax administration and can lead to confusion, errors, and poor control. They also facilitate tax evasion. Moreover, the current numbers are not compatible with the implementation of modern systems that would support enforcement programmes, based on cross-checking information.5

A single universal identifier (TIN) is the key to taxpayer control in a modern tax administration and should be developed and implemented as a prerequisite.

4.2. Standardizing invoices and books of accounts

As mentioned above, the threshold for registration should be high enough to reduce the number of registrants to: (i) a number of taxpayers that can be administered by the tax administration; and (ii) those that are able to maintain a reasonable good bookkeeping. Bookkeeping is an integral part of any business that, if neglected, presents risks for the business’ health. Too many entrepreneurs consider that they should only be engaged in their businesses’ general operations and not in their businesses’ bookkeeping. If businessmen think that books are either beneath them or operations and not in their businesses’ bookkeeping. If businessmen think that books are either beneath them or

Most people see bookkeeping as an exercise that they go through for the purpose of tax returns only. It is then understandable that no one wants to bother with accounts until the end of the year, when it is often too late. However, it is vital for businesses to keep their books in order to price products accurately, know if the business is making or losing money, check the cash flow in the short and long run, work with bankers, and pay the taxes due.

In the case of PICs, strict bookkeeping is required by the legislation in place in most cases, but compliance is not adequately enforced. Enforcing bookkeeping requires a change of attitude that should first be encouraged by tax administrations through “educative” visits aimed at explaining to taxpayers how to keep their books.

Tax auditors should also be required to check the books every time they visit a taxpayer and penalize those who do not comply with the requirements. It is sometimes argued that it is not in the culture of taxpayers to keep their accounting books in order. While I am a believer in cultural values, I do not share the view that these include accounting. Tax administrations must enforce compliance with the tax legislation and change bad accounting practices when they find them. With the exception of Vanuatu, all PICs mentioned here have a corporate tax which is also account based and requires the regular issuance of invoices. All PICs concerned have developed strict regulations regarding VAT invoices and the necessity to respect bookkeeping requirements for VAT’s audit purpose. The issue is not one of developing regulations, but one of enforcement.

The authorities of all states, irrespective of their current tax system, must enforce compliance with invoicing and book-keeping regulations in order to increase revenue.

4.3. Simplifying filing and payment obligations, based on self-assessment procedures

Modern tax administrations require their taxpayers to self-assess their tax liabilities. Details of tax returns are not examined when they are filed, but special selection techniques are used to identify appropriate cases for audit at a later time. Such systems, based on voluntary compliance, provide a more effective allocation of the scarce resources of a tax department for audit and enforcement work. They are currently being implemented in all the PICs that have introduced a VAT, but have not yet been introduced in most of the other PICs where the current procedures are particularly cumbersome.6

All PICs require monthly filing and payment. This could result in massive paperwork, which the administration could find too voluminous to administer. However, longer filing and payment periods, although they reduce the number of returns and payments to process, make control of compliance and information cross-checking more difficult. Experience also shows that longer filing and payment periods affect revenue. Nevertheless, in very small islands, quarterly filing and payment requirement would be advisable.

4. In some cases, five tax identification numbers are used: for the registrar department, the customs department, the income tax department, the VAT department and the refund services.

5. The TIN should be a unique number for each taxpayer and should replace all previous numbering systems. It should be issued sequentially and should include a check digit. All data related to tax and customs offices or to taxpayers’ characteristics should be stored in the master file and, therefore, need not to be incorporated in the number.

6. In these countries, the taxpayers are required to present their tax returns firstly to the tax inspector who will perform a first check, compute the calculation, and make sure support papers that are requested are well attached, before authorizing them to pay at the cashier window. This kind of pre-assessment procedure or “negotiation” between tax officials and taxpayers before the payment is made. limits the capacity to develop a sound audit programme, to apply penalty, encourage potential malpractices and corruption.
The level of voluntary compliance varies greatly between countries, ranging from less than 40% in PNG to around 80% in Cook Islands with an average of 60% of the taxpayers complying on time. Delays in sending a reminder to those who failed to voluntarily comply also vary, from less than one week to more than three months.

Penalty systems provide cash fees to fight against submission delays. Contrary to the general perception, administrative sanctions are quite efficient. For example, the temporary closure of business (with a maximum of 15 days) may apply. This penalty system has recently been enacted in Tonga.

The processing of refunds in relation to exports is one of the most problematic features of the VAT in developing countries because the magnitude of the refunds can be substantial, and fraud (such as overt statement of exports, falsification of invoices, production and purchase records, and underreporting of sales) is sometimes used to support claims of excess credit to be refunded. On the other hand, corrupt practices could infiltrate the tax administration (examples are favouritism and overprovision of refunds), and government could find the delaying of the payment of refunds a tempting source of cash flow.

However, without the effective treatment of excess credits, the VAT runs the risk of introducing significant distortions. An effective refund system is needed for a successful implementation. To speed up the process, if the refund claim is not selected for an audit, Vanuatu applies interest on the amount of VAT not refunded within two weeks. This acts as a self-disciplinary tool for the administration.

A refund and a set of procedures have been implemented in all PICs with a VAT. Refunds are made within three or four weeks on average, which is a reasonable period of time compared to international standards. In some cases, refunds are limited to exporters and not extended to capital goods, for which only the credit mechanism may apply.

Self-assessment procedures should be implemented, as a first step, to large taxpayers (i.e. those taxpayers who are or will be registered for the VAT). Suitable mechanisms to identify defrauders should also be developed.

### 4.4. Establishing a Large Taxpayer Unit

Most of the tax income is generated by relatively few taxpayers. Monitoring many small taxpayers who collectively pay little tax ties up administrative resources that could be better devoted to ensuring compliance by larger taxpayers. Reducing the number of taxpayers is achieved by introducing a minimum turnover as a threshold for registration. Experience in the PICs shows that a low threshold is one of the main weaknesses of a VAT, and sometimes needs to be corrected (Samoa, Fiji). All the PICs with a VAT have a threshold.

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of LTP</th>
<th>% of LTP/all taxpayers (withholder at source)</th>
<th>% collected by LTP/tax total collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cook Islands</td>
<td>19</td>
<td>2.4</td>
<td>93</td>
</tr>
<tr>
<td>FSM</td>
<td>255</td>
<td>12.0</td>
<td>95</td>
</tr>
<tr>
<td>Kiribati</td>
<td>18</td>
<td>2.0</td>
<td>95</td>
</tr>
<tr>
<td>PNG</td>
<td>500</td>
<td>5.6</td>
<td>85</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>100</td>
<td>8.3</td>
<td>93</td>
</tr>
<tr>
<td>Niue</td>
<td>6</td>
<td>5.7</td>
<td>95</td>
</tr>
<tr>
<td>Brazil</td>
<td>30,000</td>
<td>0.3</td>
<td>92</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>2,024</td>
<td>2.0</td>
<td>92</td>
</tr>
</tbody>
</table>

LTP = Large taxpayers

Sources: Countries and PFTAC.

The threshold should be calculated not by reference to an explicit computation, but rather determined by the need to adjust to the given, usually very limited, administrative capacity. The two following parameters (criteria) must be taken into consideration:

- the capacity to improve management and audit skill within the tax administration;
- the capacity of the private sector to reach a satisfactory standing for bookkeeping and records.

The rule of thumb is that about two years are required to set up a functioning VAT. Hence, it is important to estimate how much improvement can take place in that period within the administration and how many private sector operators will reach the desired capacity.

Only an in-depth study of the compliance level and administrative capacity to react against non-filers may confirm the appropriateness of the current thresholds in PICs, varying from around USD 15,000 in Cook Islands to USD 65,000 in Vanuatu.

In most modern tax administrations, special organizational units and systems are set up to monitor and control the largest taxpayers, including the state-owned enterprises. This is not yet the case in PICs. However, as shown in Table 5, the bulk of taxes (including income tax withheld

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7. In Mauritius, this penalty has been used only twice during the first year of VAT implementation, with the assistance of the media. In each case the returns have been filed on the same day and the voluntary compliance was close to 99% during the next few months. See Chengapen, Esmée, “Focus on VAT in Mauritius”, 13 International VAT Monitor, 4, pp. 287-295.

8. Also, if the penalty is based on the amount of tax due, it will do nothing to encourage VAT taxpayers with no liabilities to file their tax return on time. Approximately 30% of VAT taxpayers may have “nil” liabilities or entitlement to a VAT credit in each tax period. A minimum penalty should be provided to encourage these taxpayers to file VAT returns by the due date. For example, an article could provide for a fine “not less than US$ 500 and not more than twice the amount of the applicable tax”.

9. To limit risks, it is advisable to offset excess credits against VAT and other tax arrears, require excess credits to be carried forward for some specified time (3 to 6 months) and pay refunds only if they remain un-recovered. See Ebelh et al., Chapter 15.

10. If it were not for the costs of administering a VAT, the best threshold would be zero. The need for a threshold arises from the willingness to forsake some revenue in order to save on collection costs. The cost of coping with each taxpayer depends on such design choices as the frequency of audits, the nature of audits, and the complexity of the tax structure. The proper cost of an audit is usually higher than the authorities anticipate and as a result, thresholds are usually lower than desirable.

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at source) is paid by large taxpayers. Monitoring and auditing the largest taxpayers in a special office, staffed with a special team of a few civil servants, should help secure almost all of the income generated from the major taxes. Monitoring functions should be assigned to tax auditors who are skilled in accounting systems.

The establishment of a Large Taxpayer Unit is a cost-effective way to collect the VAT and provides the means for improving the tax administration.

4.5. Developing comprehensive audit programmes

An effective audit programme should be implemented to encourage accurate self-assessment by taxpayers. In all PICs with a VAT, a provision in the VAT law authorizes tax officials to assess additional taxes where it is discovered in the course of an audit or investigation, that the full VAT liabilities have been understated on the return(s). Table 4 shows that all PICs with a VAT appoint auditors to check the accuracy of the VAT returns (from 5 to 20). However, compared to the number of taxpayers, the number of auditors is low everywhere, and varies from 0.13% to 0.5%. Compared to the total number of Tax staff, the percentage of auditors varies from 11% to 31%. Table 4 also shows that for example the size and the number of businesses are not the same. For instance, Cook Islands and Vanuatu have about the same number of auditors. International experience suggests that the audit function should employ 40% of the total staff of a tax department. None of the current PICs with a VAT reach that number.

Tax administrations do not have sufficient resources to perform a true audit of every taxpayer during every tax period, and certainly not every year. In fact, most tax administrations can only afford to audit 20% or less of the total taxpayer population each year. However, a properly designed audit programme could cover up to 90% of the revenue and provide for enough audits to effectively deter non-compliance at all levels. Taxpayers will self-assess their tax liabilities more accurately if they feel there is a good chance that unreported liabilities will be detected (through audits) and penalized severely.11

The following types of audits are generally implemented in connection with income tax and VAT systems: desk verifications, registration checks, VAT refund audits, issue-oriented audits, comprehensive audits, and tax fraud investigations. VAT audits should be frequent, short, and targeted. Most countries have integrated the audit and enforcement of their VATs with similar functions to those performed by the income tax department. VAT inspectors should be accountants who can interpret balance sheets and profit and loss statements.12 In addition to the development of appropriate audit procedures and an audit plan for the VAT administration, any implementation project should address the need for more qualified and skilled audit resources. In the period leading to the implementation of the VAT, it may be necessary to develop a plan to recruit (or identify internally) a number of people with accounting backgrounds, and train them in the skills of auditing.

The need for more qualified, highly skilled auditors needs to be addressed in all PICs.

4.6. Developing a modern computer system to streamline the operations of the tax administration

The description of the activities performed in a modern tax office illustrates the need for a natural flow of information, beginning with taxpayers registration, to the receipt of tax returns and payments, to the collection of arrears and finally to the audit of the taxpayers. Staff in each unit should be specialized in the procedures of the unit. The computer system needs to complement this flow and support the procedures of each unit by capturing and bringing forward the information derived from other units in the flow.

As shown in Table 6, all PICs with a VAT have developed such a computer system which took place for most of them at the time of VAT implementation. Some have developed a “home-made” system and some have had the implementation of a “ready-to-wear system” – which is the Revenue Management System (RMS) developed by Data Torque Ltd, a private company from New Zealand.

| Services Provided by the Computer Systems Installed in PICs to Help Administer the VAT |
|----------------------------------|---|---|---|---|---|
| Developer | RMS | HM | HM | RMS | RMS |
| Assign TIN | N | N | N | N | N |
| Issue registration certificate | Y | Y | Y | Y | Y |
| Print blank pre-identified tax returns | Y | Y | Y | Y | Y |
| Record receipt of tax returns | N | N | N | N | N |
| Check arithmetic accuracy | N | N | N | N | N |
| Maintain ledger accounts for each taxpayer | Y | Y | Y | Y | Y |
| Identify stop and late filers | Y | Y | Y | Y | Y |
| Edit and print automatically reminder notice to late-filers | Y | Y | Y | Y | Y |

11. The successful operation of a VAT requires a strong audit and enforcement capability with broad powers. Tax administration officials should confirm that by-laws are sufficient to authorize tax officials to demand information and statements from banks regarding the accounts of taxpayers, to demand payments from those accounts and to garnish the accounts receivable of persons in default of their VAT liabilities. Otherwise, such powers should be specifically provided in the VAT law. Such retroactive assessments should be limited in time, and that limitation should coincide with the time limit for claiming refunds. In many countries the limit for both retroactive assessments and refunds is four years. This four-year limit for assessments usually does not apply where fraud is involved.

12. Most additional assessments are from audits of large taxpayers. An audit’s effectiveness should be measured by how it contributes to better compliance.
5. IMPLEMENTING A VAT

5.1. Preparation of a preliminary plan

The authorities and the VAT Project Team often underestimate the importance of preparing preliminary plans for VAT implementation. Virtually all the focus is on the policies and economic implications. There is little understanding, inside or outside the tax administration, of the implications that VAT will have on the administration, or of the magnitude of the implementation programme. Experience shows, however, that those in a position to decide on the policy aspects of the VAT often have unrealistic expectations regarding the timing of the implementation or the ability of the tax administration to undertake such a task.

Designing preliminary plans, in advance of any decision, enables the administration to assess the magnitude of the task, the resources involved, what time frames are realistic and what measures are needed for the task. It is relatively easy to estimate the number of people needed to develop the various elements of the new VAT administration. The more difficult issue is whether the administration can identify that many people with the proper experience and talents to undertake these tasks. It is possible that implementation of VAT in a particular time frame may only be possible if certain restrictions (hiring and purchasing) are waived, or if the administration is permitted to borrow qualified staff from other organizations such as the central bank or the General Accounting Bureau. If such conditions exist, it is best if the tax administration recognizes them early and plans for those contingencies as well.

5.2. The number of taxpayers

The first factor to be estimated is the likely number of taxpayers who will report and pay the VAT. Other factors, such as the number of staff required, are dependent on it. All countries with a VAT employ a threshold, expressed in terms of annual turnover, and only those taxpayers with turnover higher than the threshold are required to register and pay the VAT (see discussion above). This allows the administration to focus on the large and medium-sized enterprises, and avoid being overburdened with returns and compliance issues emanating from the bulk of the enterprises with little revenue and poor record keeping. The selected threshold should be high enough to restrict the number of VAT taxpayers to a manageable number; yet low enough to include most enterprises that regularly exchange goods and services so as to produce an unbroken flow through the production and marketing chain. Experience clearly shows that a high threshold is advisable as most countries end up, as already discussed earlier, with more taxpayers than anticipated, due to small enterprises that choose to register and improved compliance that brings previously unreported activities to the surface.

5.3. Time required for implementation

It is always advisable to schedule VAT implementation in a manner that allows the administration to address some long-term organization priorities. The Project Team should determine, for itself as well as for the decision makers, the minimum time required for a successful implementation and carefully time each step of the way towards full implementation.

A minimum of 18 months, usually 24 months, is required to implement a VAT, even by highly developed tax administrations. In many of these countries, the taxpayers were already used to self-assessment and the tax administration was experienced in broad-based consumption taxes and had effective audit and compliance programmes. In many respects it may be easier and less time-consuming to introduce VAT under those circumstances than in a community with no broad-based consumption tax and where neither the taxpayers nor the administration are familiar with self-assessment.
The development of computer systems is likely to require most of the time. Once the administration is committed to computerize taxpayer accounts, it will be virtually impossible to start the levying of the tax until these computerized accounts are fully functional. Some elements of the computer systems, such as management information and workload control, may be introduced shortly after the start of the levying of VAT, but the implementation period must be sufficient to allow development, testing and installation of the accounting, refund and audit modules before the introduction of the tax. The Project Team will have to give their most careful and detailed consideration to the time and costs associated with developing the computer systems.

Another critical element in the cost and timing of implementation is the setting up of appropriate offices with trained staff. These offices should be staffed and ready for business approximately six months before the VAT commences. This may be a challenge and the Project Team may wish to examine this issue closely.

Finally, the development of an effective audit programme should commence as soon as possible, regardless of the implementation date. Developing audit procedures and training programmes, recruiting suitable personnel and providing them both classroom and on-the-job training will likely take all the time available and more. And, the existence of a broadly visible and effective audit programme is critical to the early success of the tax.

5.4. Estimating costs

At this point, some broad estimate of the total implementation costs may be needed for Parliament and for budgeting within the Ministry of Finance. The activities involved in the implementation project and the actual resources that may be required will be much clearer to the Project Team once they have completed their pre-implementation plan.

Apart from salaries, the most costly element will be system hardware, software and systems design. In fact, the systems costs are likely to be more than half the total project costs and, in preparing preliminary estimates and plans, the Project Team should seek professional assistance. This area is so important that the Project Team may wish to request the assistance of outside consultants or a team of specialists from the government to develop a strategy and, again, to estimate the time and costs involved.

It is recommended that an international expert with experience in VAT introduction, be hired for a period of 18 to 24 months to work closely with the VAT introduction team. This person will assist the team leader and other team members to develop and put into place the tasks under their responsibility. Short-term experts may be necessary as well to perform specific tasks as training, drafting or reviewing VAT legislation, designing the audit and the refund systems, designing the IT system, etc.

6. CONCLUSION: VAT IMPLEMENTATION IN PACIFIC ISLANDS COUNTRIES IS FEASIBLE IF CERTAIN REQUIREMENTS ARE SATISFIED

Experience has shown that a successful introduction of a VAT requires careful preparation over a period of around two years. Resources need to be devoted to preparing appropriate legislation, developing administrative procedures, training staff, registering taxpayers, and educating both taxpayers and the public regarding the operation of the new tax.

The reason why it takes so long, is that the VAT acts as a tool to modernize the administration. Partly because of this, and also because of the way it is engineered, the VAT has shown it is a very effective revenue-generating instrument, both in developed countries and in the PICs.

In administrative terms, VAT implementation in the PICs is feasible if certain requirements are satisfied. Firstly, a strong and explicit political commitment from the top is needed; secondly, the preparation of a detailed implementation plan with realistic dates for the main milestones is required; and finally, the provision of necessary resources for the implementation of the tax, which should be clearly identified in an implementation budget. For all the PICs, international help in terms of technical support will be necessary to bring to the region the experience of other countries in implementing VAT.

This paper sets out facts and arguments to demonstrate what is already commonly known: the VAT is a practical and efficient revenue-generating as well as a modernizing tool for the tax administration. This is not only true for large countries but applies equally to PICs.

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