

THE CHANGING DYNAMIC OF REVENUE POLICY FOR SMALL DEVELOPING COUNTRIES

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Suva, 13 March 2008

Context of tax reform

- Most countries have undertaken major tax reforms in the last 20 years
- Usually part of a broader economic and financial reform
 - ... such as: trade liberalization; privatization; transition; fiscal decentralization

Context of tax reform (cont'd)

- Typical drivers for reform:
 - Tax system consistent with evolving economic system
 - Pressure for revenue mobilization and to lessen aid dependency
 - Replace declining revenue sources (e.g., tariffs, natural resource revenues)
 - Plateaus in levels of compliance and high levels of noncompliance and corruption
 - Increasing tax competition in the region
 - Need to facilitate trade flows, and promote foreign investment

Context of tax reform (cont'd)

- No magic formula, no one-size-fits-all
- Tax reform in broader policy context
- But there are best international practices that are relevant even for small island economies ...

Tax Reform Trends

- Decreased dependence on trade taxes
- Increased reliance on VAT
- Competition for foreign direct investment (FDI)
+ portfolio investment
- Lower top tax rates under PIT and CIT
- Reducing social contributions

Trade Liberalization - PICs

- Range of trade and regional agreements are likely to reduce revenue in Pacific island countries (PICs)
.... PICTA, PACER, WTO
- Studies show revenue losses of between 2% to 27% for some islands – average around 12%

Options for replacing trade tax revenues

- Reduce tariff/excise exemptions
- Replace tariffs with excises
 - Usually little impact on price although must be applied to both imports and domestic goods
 - Evidence that scope in most PICs for excise reform
- Introduce some form of consumption tax – such as a VAT or sales tax
- Reform of income tax

A VAT for small islands?

- Argument that it is: too complex; difficult to administer; crediting mechanism is unnecessary as no exports; and, in any case, does not recover enough revenue
- Findings of recent IMF mission in PIC is that it appears a VAT can be a success in small island countries
 - ... for example Tonga and Samoa – good revenue performance (more than lost trade taxes) and other flow on benefits (such as better business practices and improved compliance)

Factors for a VAT to succeed

- Political leadership
- Introducing as part of a broader economic reform
- Simple VAT – keep exemptions to a minimum (not a more developed country VAT)
- Set registration threshold to match administration capability
- Develop tax administration capacity at same time
- Good taxpayer education

Income Taxes

- International trend in recent times to lower rates and broaden tax bases
- Personal income tax (PIT) – flat tax is becoming popular especially in small developing countries
- Corporate income tax (CIT) – many countries are reducing rates (is it tax competition?)

What is the flat tax?

- Classic Hall-Rabushka flat tax is single rate tax on wages and a cash-flow tax on business income all levied at the same rate – effectively, a single rate consumption tax
 - ... not adopted by any country
- So called ‘flat taxes’ used in various countries – usually a single rate of tax on labor income ... in some cases corporate tax rate is the same
- Mainly found in Eastern Europe, but a few countries, such as Jamaica, have had a flat personal tax for some time

Flat tax countries (2007)

Country	Year of Reform	Rates at Reform (now)		Previous Rates PIT / CIT
		PIT	CIT	
Estonia	1994	26 (22)	26 (22)	16 – 33 / 35
Lithuania	1994	33(27)	29 (18)	18 – 33 / 29
Latvia	1997	25	25 (15)	10 – 25 / 25
Russia	2001	13	37 (24)	12 – 30 / 35
Ukraine	2004	13(15)	25	10 – 40 / 30
Slovakia	2004	19	19	10 – 38 / 25
Georgia	2005	12	20	12 – 20 / 20
Romania	2005	16	16	18 – 40 / 25
Kyrgyz Rep.	2006	10	10	10 – 20 / 20
Macedonia	2007	12 (10)	12 (10)	15 – 24 / 15
Kazakhstan	2007	10	30	5 – 20 / 30

Country	Year of Reform	Rates at Reform (now)		Previous Rates PIT / CIT
		PIT	CIT	
Mongolia	2007	10	10 – 25	10 – 30 / 10 – 25
Iceland	2007	35.72	18	36.72 – 38.72 / 18
Albania	2007	10	20	1 – 20 / 20
Montenegro	2007	15	9	15 – 23 / 15 – 20

Source: M. Keen, Y. Kim and R. Varsano, *The Flat Tax(es): Principles and Experience*, Forthcoming Paper in International Tax and Public Finance.

Arguments for/against the flat tax

- Arguments for:
 - Simple
 - Encourages supply-side effects such as improved compliance ... although more due to low level of rate rather than flatness
- Arguments against:
 - Equity concerns from loss of progressivity
 - Not much evidence of increase in revenue effects
 - Still complexity due to exemptions and exceptions

Alternative PIT Reform – (Nordic) Dual Income Tax

- Progressive tax on labor income + flat tax on capital (divdends and interest) and corporate income

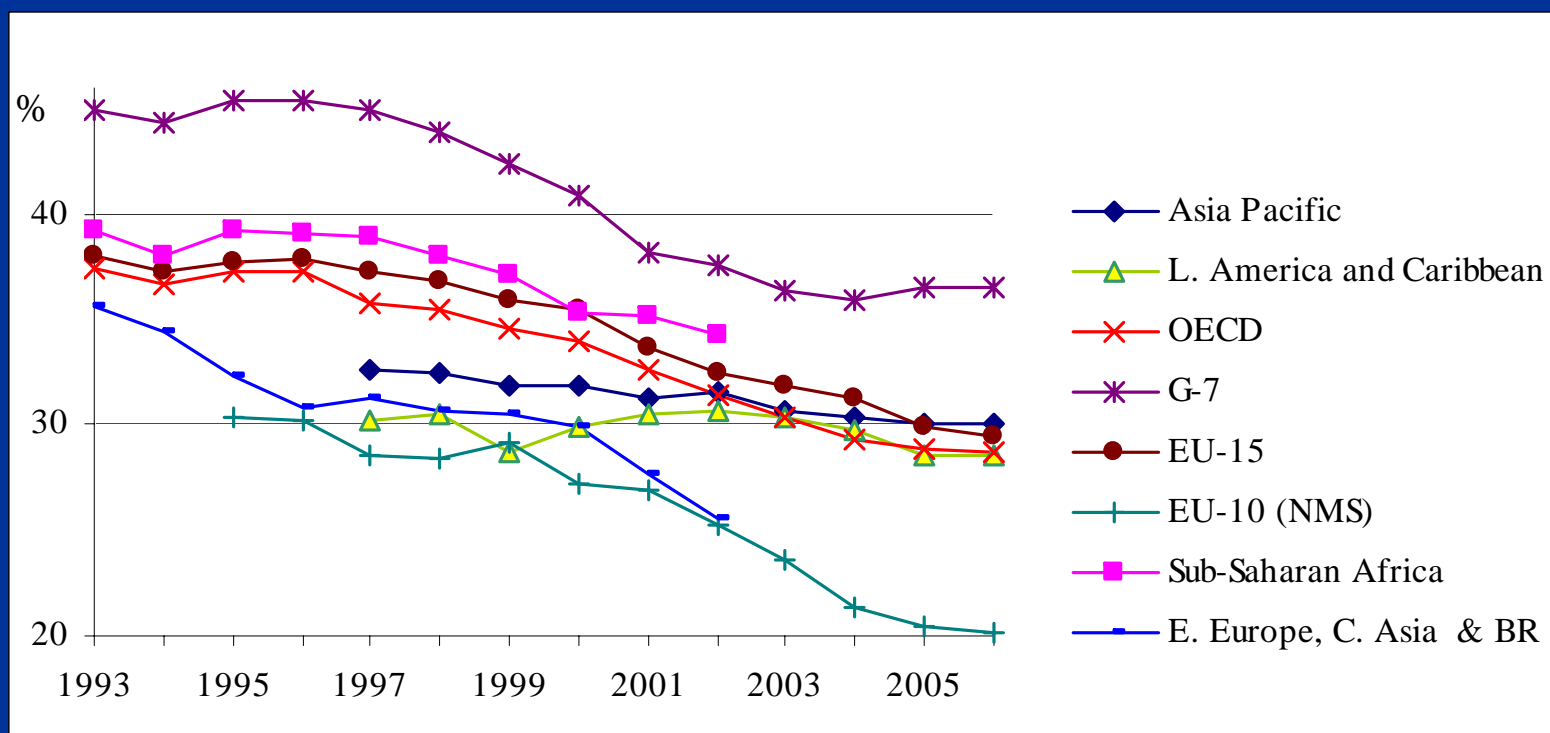
Country	Labor tax rates	Capital rate	CIT Rate
Norway	28-47.5	28	28
Sweden	31.5-56.5	30	28
Finland	29.2-52.8	28	26

Corporate Taxation (CIT)

- Worldwide trend towards lower rates (e.g., Ireland to 12.5 percent, zero in Estonia on retained earnings)
 - ... significant concern in EU and OECD that corporation tax liable to erosion from international tax competition
- What has actually happened?

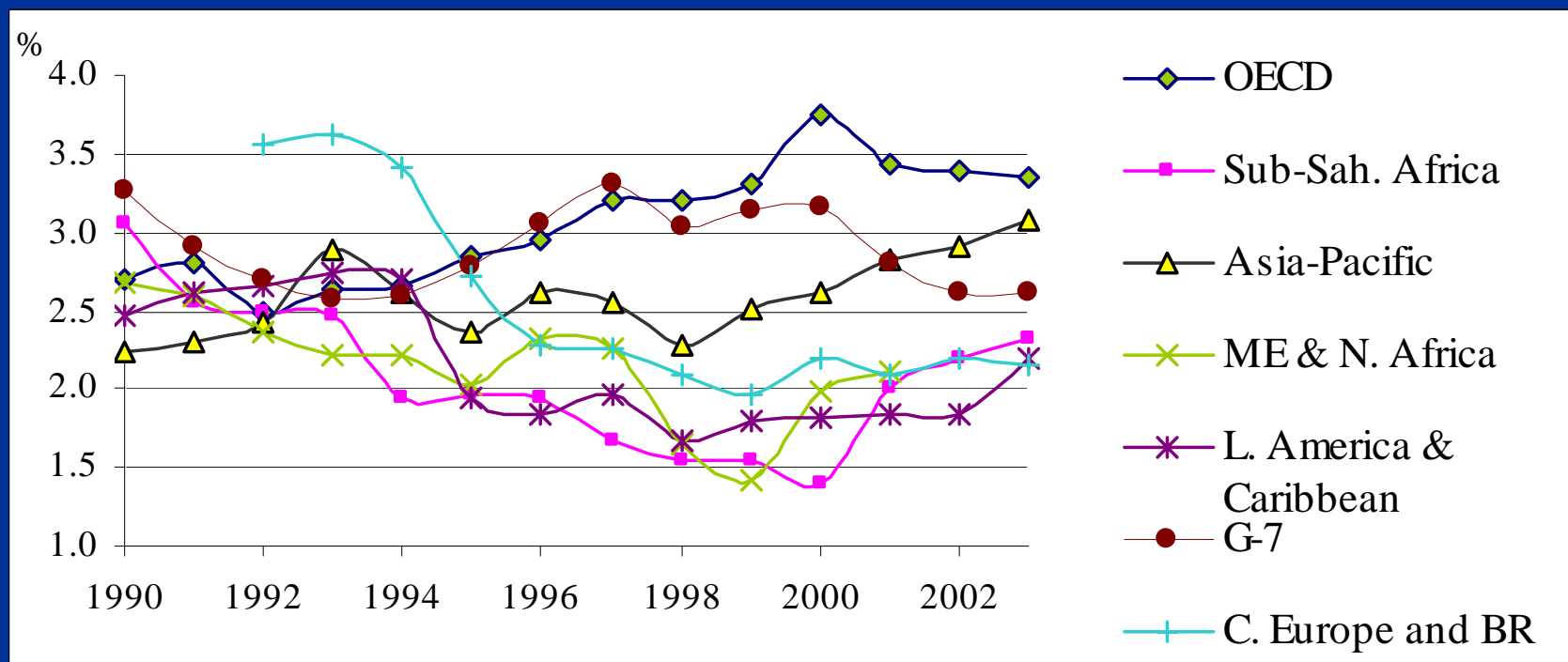
Is competition happening?

- Evidence is that statutory rates have fallen dramatically...
 - PIC rates tend to be higher than Europe but similar within region – no signs of tax competition



Source: J. Norregaard and T. Khan, *Recent Tax Policy Trends in a Global Perspective*, IMF Working Paper.

- But revenue performance is mixed with it remaining stable in many countries
 - Likely due to base broadening measures – in particular removing incentives which is a general trend worldwide



Source: J. Norregaard and T. Khan, *Recent Tax Policy Trends in a Global Perspective*, IMF Working Paper.

Is tax competition a bad thing?

- Some presumption that it is, where (as in many small developing countries) fiscal consolidation is a priority
- Concern with **'race to the bottom'**
 - One country's cut in rate/base makes others worse off – loss in revenue, investment and/or profits
 - As each country responds then tax rates end up too low and bases too narrow in collective interest

but ...

- May be good for a small country as not much to lose from a low rate due to small domestic tax base – mechanism for encouraging FDI
- Limits size of government

Investment incentives

Attracting investment—especially from abroad—is clearly a key concern which often leads to *investment incentives*

... Tempting and proliferating in many regions but not necessarily a good idea, for each country and collectively:

- Tendency to proliferate, eroding each other's advantage
- Become avoidance devices, transferring pricing/profits to low-tax related companies
- Evidence shows that businesses care more about stability in their affairs and good workers

While taxes can matter, a key lesson is that other things matter more...

...so there is a risk in offering generous incentives of losing revenue to little effect

Better policy to offer a stable, moderate tax regime (low rate, broad base)—but this can be hard to do, given pressure from neighboring countries

Income tax reform for PIC

- Some countries are reducing rates, but not significantly
- Appears to be much scope for reducing incentives (not just income tax but also at the borders)
... and eventual rate reductions once fiscal outlook can afford it