

SOLOMON ISLANDS: THE CASE FOR TAX REFORM

The Solomon Islands Government has given its approval for a review of the current national tax system as part of Government fiscal reforms. This paper provides an overview of the current tax system and outlines the rationale for tax reform.

Executive Summary

The current tax structure in Solomon Islands constrains economic growth and limits the pace of development. The current tax system imposes a very high tax burden when compared to other Pacific countries (with tax revenue accounting for 32 per cent of GDP in 2016) and the structure of the tax system is outdated, inefficient, complex, expensive to administer and anti-competitive. The tax system imposes high compliance costs on taxpayers and encourages unproductive tax avoidance and evasion activities. Moreover, it does not actively support growth - for example, it does not systematically support exports and instead relies upon distortionary exemptions for exporting industries.

The inherent weaknesses in the tax system will only be exacerbated over the medium term by the expected challenges likely to put mounting pressure on the current tax system. The likely dramatic decline in logging exports (currently accounting for around 22 per cent of total tax revenue), the implementation of free trade agreements and increase in exemptions which further erode the tax base in the coming years, all add impetus to the need for tax reform.

A better tax system would raise revenue in an economically efficient manner without discouraging individuals and businesses from contributing to the national economy by working, earning income, saving and investing. It would also need to be strong enough to withstand the challenges the economy will face in the next few years, while being less costly to both administer and comply with.

It is timely to focus on reforming the current tax system. Reforming the tax system is the important driver to improving and stimulating private sector growth and encouraging economic growth by supporting local businesses and attracting foreign investors.

A comprehensive tax review will seek to deliver a fair, simple and broad-based tax system, which ensures everyone who is liable to pay tax, pays the correct amount.

The tax review will be undertaken in a staged approach over three years.

Stage 1: Review of Tax Administration Arrangements and Consumption Taxes

Stage 2: Review of Income Tax

Stage 3: Other Taxes

Accompanying discussion papers have been developed to canvass specific issues related to Stage 1 of the Tax Review, being the current tax administration arrangements and consumption taxes in Solomon Islands. Initial recommendations on Stage 1 and on the future path for tax reform will be provided to the Government at the end of September 2017.

Government Commitment

The Solomon Islands Government has given its approval for a review of the current national tax system as part of Government fiscal reforms.

Solomon Islands' economic success will depend critically on its ability to attract foreign investment and promote private sector activity. It is necessary to have a transparent and clear regulatory environment that would reduce uncertainties to investors, as well as establishing a level playing field for business.

Reforming the tax system is the important driver to improving and stimulating private sector growth and encouraging economic growth by supporting local businesses and attracting foreign investors. A comprehensive tax review will seek to deliver ensure a fair, simple and broad-based tax system, which ensures everyone who is liable to pay tax, pays the correct amount.

Principles for good tax policy

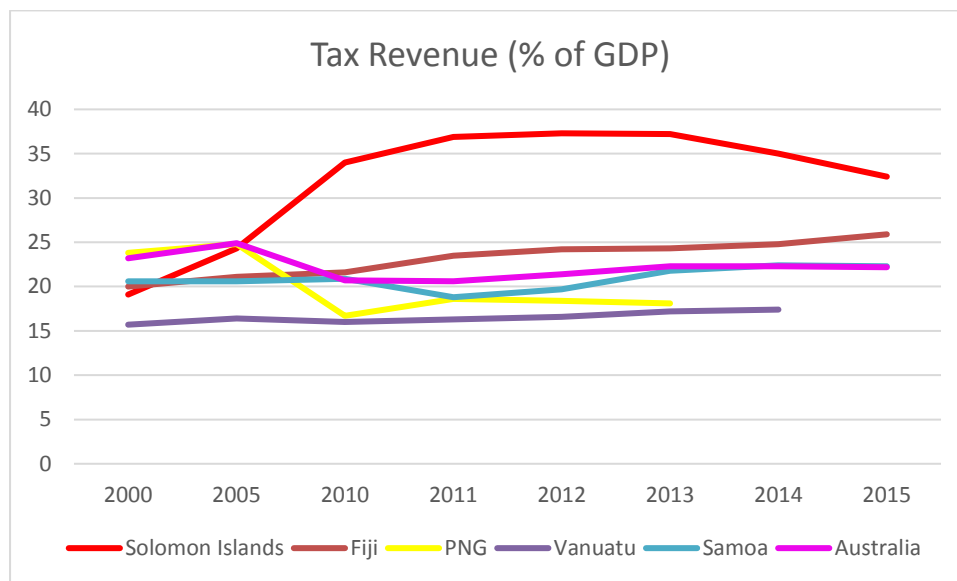
The review will be conducted using the five generally accepted principles that guide the design, implementation and administration of a good tax policy:

1. *Protect Government Revenue*: the aim is to ensure that the right amount of tax revenue and at the right time is paid to the government when it is due.
2. *Fairness*: A good tax system should be fair and create a level playing field for businesses and it should make sure that all taxpayers pay their fair share. The fair share should be based on concepts of equity:
 - a. *horizontal equity* which means that those in similar circumstances pay a similar amount of tax;
 - b. *vertical equity* which means that those who earn more, pay more tax; and,
 - c. *intergenerational equity* which aims to make sure that we don't leave problems for our children and grandchildren, i.e. we don't accumulate long term debt through inadequate levels of taxation or spending beyond our means.
3. *Efficiency and competitiveness*: A well designed tax system tax policy should make sure that resources are used as efficiently as possible and that costs are minimised. It should promote greater economic growth and result in more jobs, higher incomes, lower prices and reductions in poverty.
4. *Simplicity*: A good tax system should be simple for taxpayers to understand and help them to meet their tax obligations without unnecessary compliance costs. It should also minimise the administrative costs for government and for the taxpayer.

5. *Accountability*: A good tax system and an effective tax administration should build trust and confidence in government. The system should be transparent and encourage greater government accountability and reduce corruption.

Overall Levels of Taxation

Although there are problems with the current tax system, it has nevertheless delivered an adequate level of revenue to the Government over recent years. But revenue is a very high share of national income, measuring 32% of Gross Domestic Product (GDP) in 2016. This is significantly higher than other countries in the Pacific where tax to GDP ratios range in the high teens to low twenties.



Source: Key Indicators for Asia and the Pacific 2016, ADB, Manila

High levels of taxation dampen economic growth and there seems to be little scope for increasing the overall level of taxation without risking growth. ***The review of the tax system is aiming to have tax policies that will encourage economic growth, as this is the best means of providing a sustainable basis for the long term increases in tax revenues that will be needed to support the growing population.***

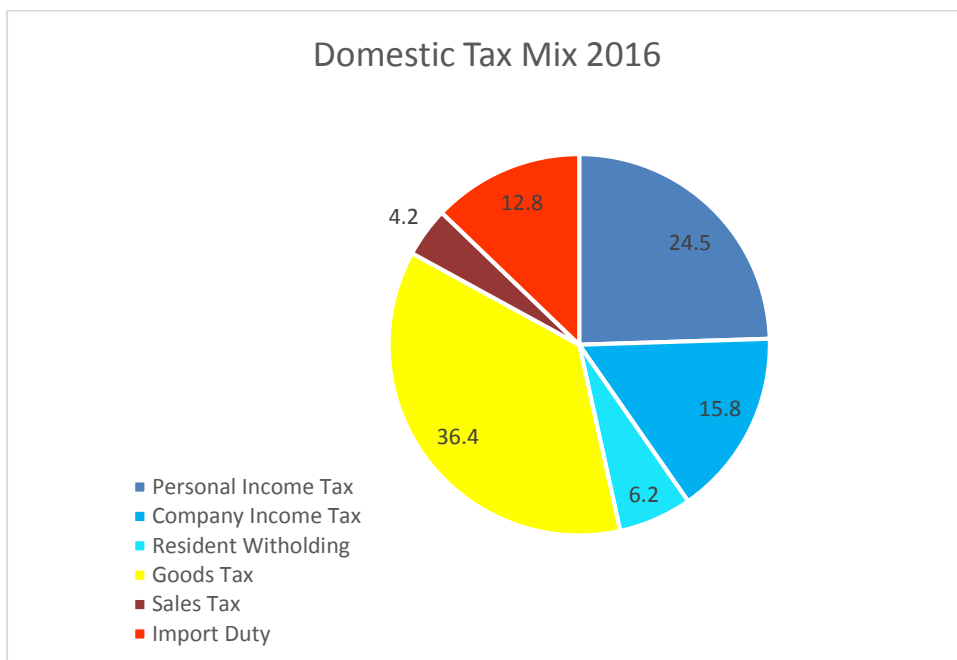
Economic growth will increase the opportunities for Solomon Islanders to improve their standard of living and work towards a better future for their children. Tax receipts are generally related to levels of economic activity. Growth in the economy will lead to increased revenue to provide funding for public services and infrastructure including education, health care and security which are critical to the welfare and productivity of both individuals and businesses.

Structure of the Tax System

The structure of the current system is outdated and, for decades, policy has focused on short-term repairs and maintenance, rather than addressing the core tax issues. The system

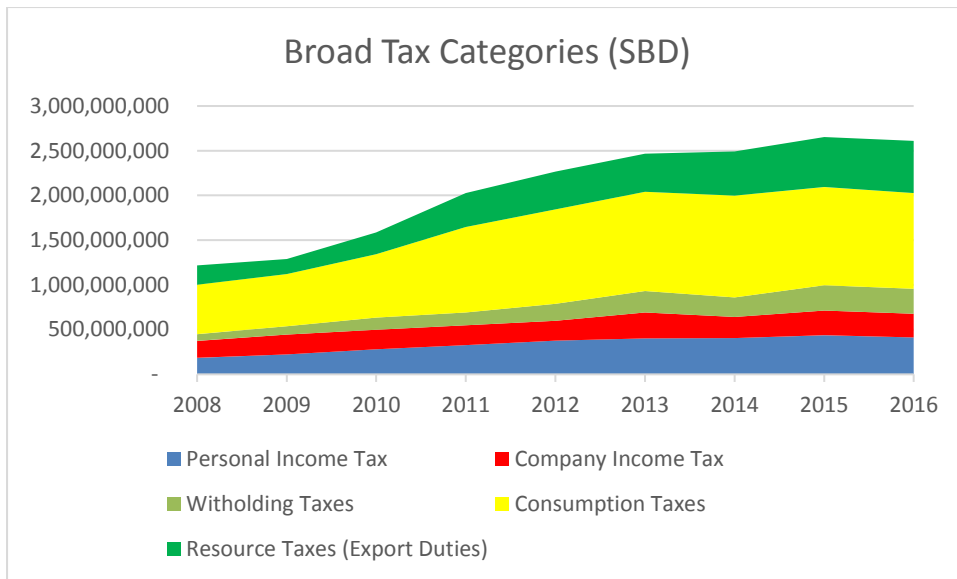
is complex, expensive to administer and anti-competitive. It imposes high compliance costs on taxpayers and encourages unproductive tax avoidance and evasion activities. Moreover, it does not actively support growth - for example, it does not systematically support exports and instead relies upon distortionary exemptions for exporting industries.

The system is heavily biased towards taxes on consumption: Goods Tax, Sales Tax and Import Duty, which together account for 53.4 per cent of taxes raised on domestic taxpayers. This largely reflects the relatively small proportion of the population in formal employment and business and the heavy dependence of the economy on imports.



Source: IRD and Customs data

The tax mix has varied significantly over recent years. Export duties have increased, reflecting the growth in logging and these now account for about 22 per cent of total tax revenue. The consumption tax share has declined slightly since 2007 from 45 to 41 per cent of total tax revenue, while personal income tax is largely unchanged over that period, increasing slightly from 15 to 16 per cent. The company tax share has declined significantly from 15 to 10 per cent of the total, although this has been partially offset by an increase in withholding tax from 7 to 10 per cent.



Source: IRD and Customs data

Future Challenges

The tax system is expected to encounter a number of challenges in the coming years, such as

- substantial declines in logging exports which will reduce both employment and tax revenue;
- exemptions continuing to erode the tax base and undermine competition, especially with consumption taxes and many businesses also receiving income tax breaks;
- the implementation of free trade agreements, such as PACER Plus, will also decrease revenues as customs tariffs will need to be reduced.

A better tax system would raise revenue in an economically efficient manner without discouraging individuals and businesses from contributing to the national economy by working, earning income, saving and investing.

It would also need to be strong enough to withstand the challenges the economy will face in the next few years, while being less costly to both administer and comply with.

The tax system should also assist trade but both the current company tax system and the consumption tax arrangements are incompatible with tax practices adopted internationally and can reduce the competitiveness of exports.

The Tax Review Process

The tax review will be undertaken in a staged approach over three years. The first stage will be a review of tax administration arrangements and consumption taxes. This would then be followed by a review of income tax, and other taxes after that.

Tax Administration Arrangements

Starting with a review of tax administration arrangements will ensure a strong foundation on which to build other tax reforms and will also help ensure effective compliance once other reforms are implemented. The administration review will consider:

- the operating relationships between Ministry of Finance and Treasury, IRD and Customs;
- the legislative frameworks under which taxes are collected by examining opportunities for modernising collection and compliance arrangements;
- electronic payment and lodgement systems;
- self-assessment, information exchange and risk based compliance.

Development of these would be critical to the ongoing effective implementation of other reforms. In addition the Ministry will have to make sure that the current tax system has integrity so that taxpayers will comply with any new tax system.

Consumption Taxes

A review of consumption taxes will also be undertaken as the current system is complicated, inefficient and anti-competitive. The Solomon Islands system does not integrate with those of our trading partners and is a barrier to the development of exports, e.g. all countries in the Pacific have a single tax for goods and services.

The review would examine a range of existing taxes including Goods Tax, Sales Tax, Import Duties and taxes in other ministries such as the accommodation levy. These taxes are not comprehensive and are anti-competitive and complex – petroleum products, for example, are subject to all three. There also appears to be significant non-compliance.

The review will be seeking to simplify the current arrangements. Reforms could seek to replace or extend some or all of the consumption taxes to eliminate several layers of complexity and help to create an easier environment for business to flourish, thus increasing economic growth and in turn revenue collections.

Settling the longer term consumption tax arrangements will provide a better basis for decisions about revenue targets for income and other taxes.

Other taxes

The final stage of the review would examine a range of other tax issues including excise, resource taxes, gambling taxes and taxes in other ministries, including fishing levies, departure tax, etc.

Income Taxes

The current Income Tax Act is over 50 years old. Key problems areas with income tax are:

- its high marginal rates and narrow base;
- inconsistencies in the withholding arrangements, particularly between local and non-resident taxpayers;
- personal tax for people with dual incomes;
- tax arrangements for small business, particularly in the bus and taxi sectors; and,
- international tax arrangements which need to be better developed, particularly to support tax treaties and information exchange.

The relationship between personal tax, company tax and consumption taxes also needs to be resolved as does the overall revenue raised between the various tax products.

It seems likely that there will be a need for a complete re-write of the income tax law.