CONSUMPTION TAXES

This paper focuses on Consumption Taxes in Solomon Islands. The paper outlines the current consumption taxes, provides a country comparison of key consumption taxes in the region and canvasses possible ways forward to resolve some of the problems of the current regime.

Executive Summary

The current tax system is made up of many taxes that are considered consumption taxes (including Goods Tax, Sales Tax, Import Duties and taxes in other ministries such as the accommodation levy). The consumption tax regime is inefficient, anti-competitive and includes multiple narrow tax-based taxes. As consumption taxes are applied to most business inputs, they increase the cost of doing business in Solomon Islands and increase the costs borne by consumers. The current consumption tax regime does not integrate with those of our trading partners and is a barrier to the development of exports, as exporters compete with companies in other countries that effectively face no consumption tax on their business inputs and export of their products.

Exemptions from consumption taxes create an unlevel playing field and erode the already narrow consumption tax base. While significant non-compliance seems to be an issue for those who are liable to pay consumption taxes. Therefore, while consumption generally presents an efficient and sustainable tax base that is more predictable than income, the structure of the current consumption tax regime in Solomon Islands renders it unsustainable and weaknesses in the base have been exposed in recent years.

Improvements can be achieved by reforming the current system. However, improvements to the existing system will only go so far in terms of improved revenue collections, it would not have the economic benefits that could be achieved through modernizing the arrangements with a new efficient, fair, broad based and transparent alternative. A new regime could achieved consistency with trading partner, reduced compliance costs for business, relief from tax on business inputs, and no need for distorting exemptions.

Fundamentally reforming consumption taxes is vital to the sustainability of the overall tax system given the challenges that will likely deplete other tax bases over the medium-term and the heavy reliance on consumption taxation largely reflecting the developing nature of the Solomon Islands' economy (relatively small proportion of the population in formal employment and business and the heavy dependence of the economy on imports).

Settling the longer term consumption tax arrangements during the first stage of reform, will provide a better basis for decisions about revenue targets for income and other taxes in later stages of the reform.

Consumption Taxes in Solomon Islands

Consumption Taxes are most readily applied as a tax on goods and services consumed. Consumption Taxes therefore essentially tax people when they spend money on goods and services, unlike a tax on incomes earned or a tax on the return on investments (like personal income tax and company taxation).

Current consumption taxes in Solomon Islands primarily include Goods Tax, Sales Tax and Import Duty. However, other types of taxes and levies could be considered consumption taxes, such as: Excise, Stamp Duty and the Accommodation Levy.

Excise in Solomon Islands is levied on alcohol and tobacco. Excise is levied on these products for the specific purpose of correcting for negative outcomes (including, health problems) associated with the consumption of these products. Given the specific rationale for imposing excise, it is not being reviewed in this paper.

Summary of Key Consumption Taxes in Solomon Islands

Import Duty: applies generally at one of four rates: 0%, 5%, 10% or 15% of the Cost-Insurance-Freight (CIF) price – the most common rate is 10%. Import Duty is almost universally applied to imports, rather than on a selective basis. As such, import duty can be seen as a consumption tax collected at the border for convenience, rather than a trade tax used for trade protection of certain industries.

Tobacco and alcohol are subject to different, specific rates of import duty (determined by the local excise regime for tobacco and alcohol). Like excise on domestically produced tobacco and alcohol products, it is in recognition of the costs imposed on society and consumers.

Goods Tax: applies to wholesale sales of imported and locally produced goods. Domestically produced goods are taxed at a rate of 10%. Imports are taxed at 15% at the border, on their implied wholesale price (which is assumed to be 130% of the CIF plus import duty price) – the effective rate on imports is therefore 19.5% on the CIF plus import duty price.

Sales Tax: applies at a variety of rates (ad valorem (usually 10%) and specific ($)) to a limited number of services sold in Solomon Islands. This is in contrast to Goods Tax, which applies to sales of goods generally. The list and some specific rates are extremely outdated.

Consumption generally presents an efficient and sustainable tax base which is normally more predictable than income, wealth and investments, providing a more stable revenue source for Government. When consumption taxes are spread over many goods and service and where all people and businesses are required to pay, they are considered to have a broad base – meaning that the tax burden is spread across a broad range of consumed items and paid by all. A *broad base* allows for a *lower rate* of tax to be charged in order to

collect the same amount of money as a narrow-based tax which may only apply to certain goods and services and be only paid by a few.

A majority of all tax collections are raised from consumption-type taxes, however the tax base is narrow and fragile, and effective tax rates are high

High effective tax rates are imposed on inputs to business

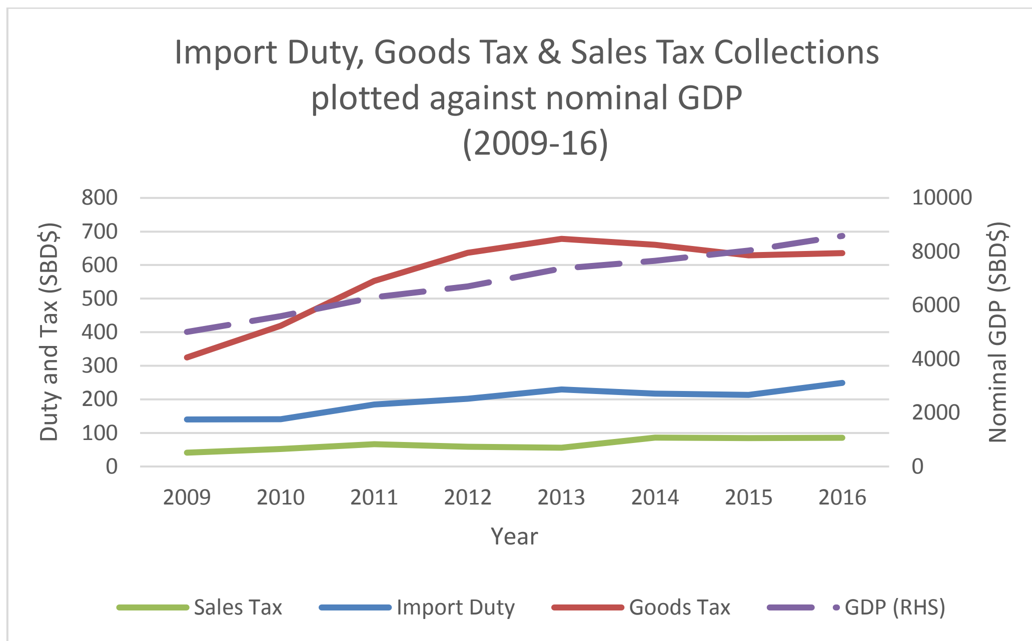
Import Duty, Goods Tax and Sales Tax (in certain cases) are applied to imports which results in an overall high effective tax rate. Most imported goods are subject to an effective tax rate of around 31%[1]. High effective tax rates increase costs for business and consumers, can discourage new business from commencing operation and can ultimately encourage tax avoidance.

Weaknesses in the goods tax base have been exposed in recent years

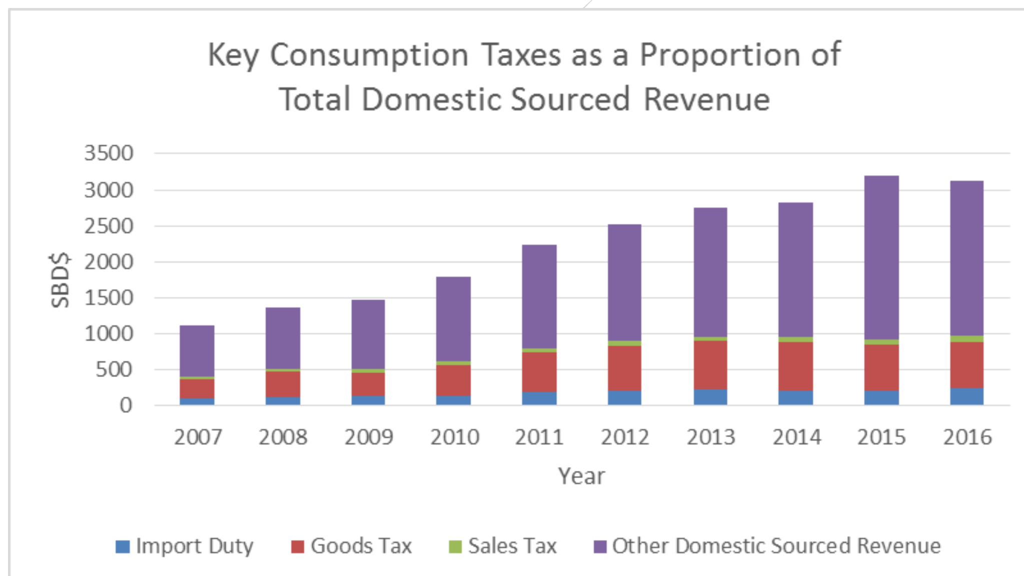
Solomon Islands currently collects around 40 per cent of domestic source revenue (revenue collected by the Government rather than aid/grant related funding) from consumption taxes.[2] However, *Goods Tax* collections as a proportion of domestic source revenue has been relatively low in recent years.

While nominal GDP has been steadily increasing since 2009, Goods Tax collections have dropped to pre-2012 levels over the last two years. In fact, since 2012, Goods Tax as a proportion of total domestic source revenue has dropped from a high of 28% to currently 23% of domestic source revenue. This highlights the potential vulnerability of the current Goods Tax base and possibly illustrates the ability for people to avoid taxation through exemptions and other means.

[1] Most imports are subject to a 10% import duty levied on the CIF price. Goods Tax is then levied at 15% on the CIF price inclusive of the import duty, all uplifted by 30%.
[2] This figure includes Goods Tax, Sales Tax, Import Duty, Excise and Stamp Duty collections for 2016.



Goods Tax is collected from a relatively small group of businesses, which also exacerbates the vulnerability of the Goods Tax base. In 2015, there were 90 active Goods Tax registrants. Of the active registrants, 96% of collections came from manufacturers/wholesalers with a turnover of over $10million. While 70% of Goods Tax collection came from manufacturers/wholesalers with a turnover of over $50million.



Other consumption-type taxes collect a modest amount of revenue on narrow bases

Sales Tax has an extremely narrow base, with an outdated list of a limited number of listed activities attracting the tax. Sales Tax accounted for around $70m last year and has represented a steady 2-3% of domestic sourced revenue since 2009. Although not a key consumption tax, it is worth noting that *Stamp Duty* collections amounted to $17m last year.

Unlike the other taxes and duties canvassed in this paper, the *Accommodation Levy* (otherwise known as the Bed Levy) is levied on business establishments providing accommodation and other services to tourists at a rate of 10% of total room charges. The levy was first established in the Solomon Islands Visitors Bureau Regulations in 1999, nearly 20 years ago. The Levy raises around $9m per annum and this money goes to the Solomon Islands Visitors Bureau, outside the yearly Budget process. There is a general lack of transparency in regards to the levy – its imposition, collection, and accounting of its use by Solomon Islands Visitors Bureau. The Levy is an impost for business, increases prices for tourists and can create unfair outcomes as some accommodation providers pay and others do not.

There is a need to reconsider the merits of imposing the above taxes, duties and levy given the relatively narrow tax bases, modest amounts of revenue collected and the inefficiencies and associated costs.

Exemptions further erode the consumption tax base, creating an unfair environment

Exemptions also further erode the consumption tax base as a variety of goods and purchasers are exempt from paying tax. Of particular concern are non-statutory (discretionary) exemptions as they are discriminatory, anti-competitive and inefficient. Exemptions lead to unfair outcomes as some receive exemptions, while those who do not face the full burden of tax. This creates an anti-competitive environment for business and causes an inefficient allocation of resources.

In 2016, around $120 million was the combined value of exemptions claimed for duty and goods tax on imports – meaning that $1 of tax was foregone via exemptions related to imported goods for every $7 dollars of total revenue collected in combined import duty and goods tax.

Given the high tax rates, narrowing of the tax base and the anti-competitive environment created by exemptions, there are strong incentives for small to medium size businesses to operate in the informal economy, to avoid paying the multiple taxes on their inputs and outputs.

Like all Pacific countries, Solomon Islands will also continue to face pressure internationally to reduce border/trade taxes, thus reducing the import duty base

Import Duty, while experiencing a slight drop off after 2013, has continued to represent around 8-9% of domestic sourced revenue since 2009 (around $215m in 2016). However,

there continues to be pressure to reduce border/trade taxes by virtue of Solomon Islands' trade negotiations and ratification of trade agreements[3]

The current tax system in inhibiting growth and development

Current consumption taxes are inefficient, anti-competitive and operate from a narrow tax base and as they are applied to most business inputs, they increase the cost of doing business in Solomon Islands and increase the costs borne by consumers.

The narrow tax base necessitates a high tax rate to collect a given amount of revenue for the Government. However, as the narrow base is fragile, this causes uncertainty for Government in terms of the sustainability of the current revenue base and uncertainty in terms of funding for Government expenditure over the medium-term.

Current consumption taxes constrain economic growth and limit development, particularly discouraging existing exports and the development of new export industries, as they compete with companies in other countries that effectively face no indirect tax on the production and export of their products. This impediment to exports is directly at odds with the focus of other Government policy to enhance the environment for business and create a conducive environment for exports.

Over the medium-term, Solomon Islands' economic success will depend critically on its ability to attract foreign investment and promote private sector activity. A transparent and clear regulatory environment that would reduce uncertainties to investors, as well as establish a level playing field for business has to be created. This means that the tax system should be moving towards a more efficient, fair, transparent and sustainable broader base.

[3] For example, the PacerPlus trade agreement requires the Solomon Islands to phase out most import duties for imports from other partners, i.e. Australia, New Zealand and most other Pacific countries except Fiji and PNG who already receive this through the MSG trade agreement.

Regional Country Comparison – a movement towards a value-added tax

Tax reform in the Pacific over the last decade has seen a switch from import trade taxes through the introduction of a value added tax (VAT)[4]. The switch away from trade taxes to a VAT mirrors a trend in developing countries worldwide, which seem to have largely come about as a result of trade liberalisation.

In the period from 2002 until 2015, Tonga, Niue, Tuvalu and most recently Kiribati (2013) joined Papua New Guinea, Fiji, Vanuatu, Samoa and the Cook Islands in implementing a VAT where tax is applied to the 'value added' in the production chain and is effectively paid by final consumers. Businesses receive input tax credits (ITC) for VAT paid on business inputs, while exports are generally zero-rated, with full ITCs and no VAT payable. This is in contrast to Solomon Islands, where exports can bear embedded Goods Tax, Import Duty and Sales Tax on their inputs. This makes exports less competitive on the international market.

The VAT registration thresholds vary from SBD$300,000 to $620,000 in comparable regional countries. This means that most small and medium size businesses do not need to register in the VAT system. As such, while VATs can be conceptually complex, simple versions can be implemented successfully in even the smallest economies, take Niue as an example.[5]

Table 1: Main indirect tax levied in comparable regional countries

Country	Main Tax	Introduced	Rate	Base	Threshold (SBD)
Fiji	VAT	1992	9%	Goods and services	380,000
PNG	VAT	1999	10%	Goods and services	620,000
Samoa	VAT	1994	15%	Goods and services	400,000
Tonga	VAT	2005	15%	Goods and services	350,000
Vanuatu	VAT	1998	12.5%	Goods and services	300,000

*** Fiji reduced their rate from 15% in 2016.*

Of the 6 countries that had VAT in 2008, 2 increased the VAT rate (though Fiji later decreased it) and 5 countries adjusted the VAT registration threshold. Overall, small island countries have been found to achieve good results from a VAT in terms of revenue and

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[4] Value added taxes are often called Goods and Services Tax (GST). In general the terms are interchangeable. For the sake a clarity this paper will use value added tax (VAT) except when referring to a particular tax which is identified in its home as a GST.

[5] PFTAC Report: Improving Revenue Collection and Capacity in Forum Island Countries (September, 2010)

administration, due to the relative importance of international trade to their economies. Under a VAT, the first (and often major) collection point for VAT is at the border as imports enter the country. The border is a convenient place to begin the withholding mechanism, and securing VAT collection on imports is considered a crucial part of ensuring effective collection of the tax throughout the chain of production and securing the success of the VAT overall.[6]

Reform Options: Improving the current regime to create a more efficient and fair system

There is a pressing need to reform consumption taxes. Improvements can be achieved by reforming the current system or by replacing the current system with a new efficient, fair, broad base and transparent alternative. Whatever option is pursued, reforms should seek 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.

1) Option 1: Making the current system work better

This paper has canvassed some of the problems of the current regime. Steps towards improving the current regime with a view to creating a more efficient, fair and sustainable revenue base, could include:

- Broadening the Sales Tax Base – Sales Tax is levied on a select amount of listed items. The list is clearly outdated, the transactions/services listed are narrowly defined and the rates (particularly the specific ($) rates) are overdue for a review. There is a clear need for rationalisation, simplification and broadening of the base. Broadening of the base could be accomplished by substituting the current narrow positive list to a negative list, whereby sales tax applies to everything sold by retailers except those things covered in the negative list.

- Broadening all consumption bases by restricting exemptions – A review of statutory exemptions and the discretionary exemption granting via the Exemption Committee could be initiated with a view to restricting the exemptions being provided and to enhance the transparency around who is receiving the exemption and why they are being granted.

- Abolishing inefficient taxes and levies that raise small amounts of revenue at large costs – Preliminary analysis suggests that some taxes are likely to be imposing significant costs (via direct costs of compliance and indirect costs by distorting activity) given the minimal amount of revenue being raised. This is particularly relevant for Stamp Duty and the Accommodation Levy.

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[6]Sapere Report: Evaluation of taxation reform in the Pacific (March, 2014)

- Moving the collection of Goods Tax to the border to improve compliance – Collections in recent years have created cause for concerns over the sustainability of Goods Tax collections. The fragility of the Goods Tax base is compounded by poor compliance with Goods Tax registration requirements, and the base is riddled with exemptions. Ineffective administration overall also compound compliance issues as both revenue authorities (IRD and CED) are collecting Goods Tax with minimal to no data exchange to support active compliance strategies.

  Given the concerning (up and down) performance of Goods Tax receipts in recent years, the merits of moving the taxing point of goods tax to the border could be further explored. A substantial proportion of goods tax would be collected on imports, given the high proportion of imports relative to the value-adding occurring within the country. Moving the taxing point to the border would be a shift away from the current system where Goods Tax registrants are allowed to quote their number and defer the payment of goods tax on imports from Customs to IRD, potentially making it harder to collect and raising compliance issues for IRD.

  Moving the taxing point for Goods Tax to the border could potentially have many ramifications which will need to be explored, including: how the value-added to goods internally within Solomon Islands will be taxed, and how the valuation at the border of all imports for wholesale will impact revenue collections (i.e. will valuation at the border result in a higher or lower valuation than the current mark-up (30%) when sold).

2) Option 2: Introducing a new, efficient, broad-based and fairer system to tax consumption

As has been the case around the world and with our closest neighbours in the region, vast improvement to the efficiency and equity of consumption taxes could be achieved through a movement to a value-added tax.

A value-added tax (VAT) is essentially a tax that is charged on a broad range of transactions (for most goods and services) with a tax deduction mechanism allowing businesses to offset VAT paid on inputs against VAT paid on outputs. It is a tax on final consumption by households that is collected by businesses in a staged payment process: each taxable business pays VAT to its providers (suppliers) on its inputs and receives VAT from its customers on its outputs. Because of the crediting/offsetting nature, tax paid by businesses along the value chain is not borne by them but ultimately on final consumers. VAT thus remains neutral for businesses.

The VAT could replace the current Goods Tax, Sales Tax, Accommodation Levy and Import Duty. The crediting mechanism would also remove the need to provide exemptions and

therefore reduce the distortions in the system, enhances transparency and improves competition and fairness. Also, compliance could be dramatically improved as the first (and major) collection point for a VAT is at the border as imports come into the country.

Crucial elements of a VAT, such as the base, rate and threshold, need to be determined after thorough analysis and would be initially developed in the context of a revenue neutral proposal. Any broadening of the consumption tax base will be good for efficiency, fairness and competition for business. PFTAC's review of Pacific Islands Forum countries has found that implementing a VAT requires sustained political and institutional commitment and has been generally most successful in the Pacific when implemented as part of a broader economic reform package.

What does a VAT potentially mean for business compliance costs?

All registered businesses will be required to keep records of their purchases and sales, to enable them to correctly remit VAT. However, the threshold for VAT registration will ensure that smaller businesses are not required to be registered for VAT and therefore do not do not charge VAT on their sales or remit VAT to the Inland Revenue Division. Businesses with large turnover of goods and/or services would however need to remit VAT and keep VAT records.

A large amount of VAT will be collected at the border as under a VAT most imports would be subject to VAT. There is no need for any mark-up nor deferral of VAT. This will substantially reduce administration costs, as imports currently need to be classified to determine what rates of Import Duty and Goods Tax apply, along with consideration of any potential concessions.

What does a VAT mean for Exporters?

Exporters that are VAT registered will be zero rated on their exports. This means they charge a zero rate of VAT on their exports, while receiving a full refund of the VAT paid on their inputs. This is the standard VAT approach to exports and will ensure Solomon Islands exporters are better able to compete internationally.