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FISCAL POLICY AND TAX REFORM IN THE CARIBBEAN

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FISCAL POLICY AND TAX REFORM IN THE CARIBBEAN

I. Introduction

Economic growth of Caribbean Community (CARICOM) economies has exhibited a gradual decline over the last two decades. Whilst average per capita GDP growth accelerated during the second half of the 1980s and the second half of the 1990s, it decelerated in the first half of the 1990s and the first four years of the new millennium; consequently, the overall average per capita growth rate of GDP for the period 1980-2004 was only equivalent to 2.0 per cent (see Table 1). This weak growth performance has been accompanied by an increase in debt stocks in member States over the last two decades of the twentieth century (see Table 2) to such levels, that 14 of the 15 Caribbean countries currently find themselves ranked within the world's 30 most highly indebted emerging market economies. The combination of weak economic performance coupled with increasing debts is a cause for concern.

Identifying the causes of low growth significantly increased debt is an important step to tackling the problem. Fiscal policy plays a crucial role in this discussion as rising fiscal deficits in the region during recent years have been key in contributing to the emergence of unsustainable debt levels in the region. However, whilst fiscal policy – the extent to which revenue is spent as well as the efficiency of policy makers to raise revenue from economic activity – defines the evolution of debt, fiscal policy has a particularly important role in small economies where lack of economies of scale and a narrow resource base place a pivotal function on fiscal policy role in providing economic impetus.

One of the factors leading to the decline in the fiscal outcome is increasing expenditure that has not sufficiently been matched by increasing revenue; in fact, overall, revenue has remained relatively constant over the years. However, as the tax burden in the CARICOM region is already quite high, increasing it is not necessarily a preferred policy option. Rather, tax reform must be viewed as a way to spread the tax burden more equitably across the population and as a means for making revenue generation more efficient whilst simultaneously fostering economic growth. As such, the aim of this study is not to identify new means of increasing the tax burden on individuals but rather to identify how revenue generation and collection can be improved upon. Key to doing so will be to identify how fiscal policy has evolved over recent years. Identifying recent fiscal performance in the CARICOM region, in particular identifying the principal sources of tax revenue in the various countries, will be crucial in analyzing the potential for tax reform in general, and what steps need to be taken in particular.

The importance of tax reform is even more pressing given the impact that trade liberalization will have on fiscal coffers in the region: in line with a reduction of trade barriers, countries will see an erosion of their tax bases. This will in particular affect developing small-island economies as these have a more pronounced dependency on trade taxation. Whilst the transition from trade taxation will prove to be a challenge, the prospect of increased trade liberalization should act as an impetus for immediate fiscal reform, in order to create an economic environment that can readily absorb the impact of more open markets.

Section II of this paper compares differences in expenditure and revenue performance between the Caribbean and Latin America. Highlighting differences and similarities between small and large developing economies is an important step to knowing whether in fact there are common or diverging trends in their fiscal policy: differences in fiscal indicators may indicate that policy advice valid for one group of developing countries may well not be so for another. This section essentially provides the justification for the remaining study. Section III consequently analyzes fiscal policy in the CARICOM region, presenting a taxonomy of sources of revenue as well as objectives and challenges to fiscal policy in CARICOM member States. Section IV presents details on tax reforms envisaged, recommended or actually implemented in the Organisation of Eastern Caribbean States (OECS), Barbados, Jamaica and Trinidad and Tobago.

Table 1 - Growth rates

Period	Average growth rate (in %)
1980-1985	0.9
1985-1990	4.1
1990-1995	1.5
1995-2000	2.5
2000-2004	1.2
1980-2004	**2.0**

Table 2 - Public and publicly guaranteed (PPG) debt (% GDP)

Country	1980	2004
Barbados	11.4%	27.5%*
Belize	24.1%	84.6%
Grenada	18.9%	79.6%
Guyana	104.5%	145.1%
Jamaica	53.4%	64.4%
St. Kitts and Nevis	15.1%[a]	79.0%
St. Lucia	10.2%[b]	35.2%
St. Vincent and the Grenadines	17.1%	55.4%
Trinidad and Tobago	11.4%	11.3%
**: 2003, a: 1984, b: 1981*		

SECTION II
FISCAL POLICY – THE CASE FOR SMALL ECONOMIES

A. The role of fiscal policy

The theory of public finance, in particular the scope for government to correct market failures, provide public goods and intervene to restore efficiency, is well-documented. To achieve its goals, fiscal policy has two principal tools through which it can influence markets and the level of aggregate demand to attain its objectives: extraction of revenue and disbursement of expenditure.

Application of these tools has however proven to be significantly more complex than may be obvious at first. Thus, one of the most important aspects of revenue generation is necessarily linked to equity, as tax systems should be equitable at least in horizontal terms: that people with similar income and welfare characteristics should be treated similarly by the system is a generally accepted principle.[1] A further dimension related to equity is whether taxes should primarily be based on direct taxation, on indirect taxation or on a combination of both. Thus, income-based (i.e. direct) taxation is in general believed to be more progressive in nature than consumption-based (i.e. indirect) systems as lower-income groups spend a relatively larger proportion of their income on consumption and hence have a proportionally heavier tax burden with indirect taxes. However, it has consequently been argued that the disincentives to work and invest, resulting from income-based systems, may counteract positive equity effects; furthermore, progressive tax systems implicitly foster capital flight and hence have a curtailing effect on savings relative to indirect tax systems. The choice therefore of whether taxation should principally be direct or indirect is therefore also less obvious than appears.

Whilst these issues have been at the heart of public economics, the analysis of fiscal policy in developing countries is a relatively recent field and is being driven by the recognition that challenges to developing countries may well differ from challenges to developed economies. For one, the former are, by definition, at a stage that governments in the latter found themselves several decades ago; thus, policy proposals put forward today for developed economies are unlikely to be suitable to developing countries, just as they are likely to have been unsuitable to these developed economies 30 to 50 years ago. Furthermore, concerns of economic efficiency as well as social issues relating to poverty, human resources and unemployment are significantly more pressing in developing economies than in the developed world. This provides the rationale for a fiscal policy in the former that necessarily differs from that of the latter and hence forms the foundation for increased interest in this area. In fact, whilst it has been previously argued that 'growth must be the overriding objective' in developing economies (Tanzi (1991)) as only developed economies could afford to be more concerned with stabilization and equity, it is now recognized that the quality of growth matters as a country's development objective will necessarily include reducing inequalities prevalent in society.

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[1] The philosophy of vertical equity, referring to the fact that people who are not in equal positions should perhaps not be treated equally, is not only less accepted in theory, but even more so in practice. Whilst progressive tax systems, i.e. where wealthier individuals face a higher tax burden, are considered to be vertically equitable, the abundance of regressive taxes points to the difficulty of tax administration finding the balance on a vertical scale.

B. Small vs. larger developing economies

The presentation of idiosyncrasies particular to fiscal policy in developing economies in general is outside the scope of this study.[2] This subsection, however, analyzes a selection of small and large developing economies to see whether common or diverging trends in their fiscal policy can be identified. The relevance of doing so as well as making explicit reference to fiscal policy in Small Island Developing States (SIDS) is particularly important to underline the additional challenge fiscal policy faces in SIDS vis-à-vis larger, non-island developing economies.

Small economies are particularly constrained by their narrow resource base as their smallness limits the extent to which production structures can diversify. At the same time the high degree of openness that is characteristic of small economies – especially of those in the Caribbean – implies that economic performance is constrained by the performance of their balance of payments as this determines the availability of foreign exchange, which is ultimately required to finance production structures and imports required for export production.[3] Furthermore, the vulnerability to external events has an impact on fiscal policy particularly in small economies, which is especially pronounced in the Caribbean where the frequent occurrence of natural disasters has a significant destructive impact on economies in the region (see Table 3) and hence is particularly disruptive to the ability of fiscal policy in achieving development goals.

Table 3 - Destructive impact of natural disaster in region

Disaster	Country	Damages (% GDP)
Gilbert (1988)	Jamaica	65%
Hugo (1989)	Montserrat	200%
Debbie (1994)	St. Lucia	18%
Luis & Marilyn (1995)	Antigua	65%
Michelle (2001)	Jamaica	1%
Keith (2000)	Belize	46%
Ivan (2004)	Jamaica	8%
	Cayman Islands	183%
	Grenada	212%
Source: ECLAC from various sources		

This subsection compares expenditure and revenue indicators of Central America, South America and Caribbean countries, classifying countries into four different groupings, based on economic size: large countries, countries with a population of more than 10 million; medium-sized countries with a population between one and 10 million; small economies with a population of less than one million; and finally CARICOM member States.[4,5] Table 4 gives the members of each group.

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[2] Rather, reference is made to Howard (2001).

[3] The import-content of exports is generally higher in small economies than in larger economies.

[4] Montserrat was excluded from the latter on the basis of non-availability of data, as was Haiti.

The data shows that CARICOM member States are on average wealthier than economies in the other groupings. Furthermore, smaller economies have significantly larger revenue-to-GDP and expenditure-to-GDP ratios, in fact, average government expenditure and revenue in CARICOM is twice the size of that registered in large economies (see Table 5).

Higher revenue collection could be argued to be the result of a narrower base, both in terms of country size as well as economic activity, and hence not necessarily a surprising result. Higher expenditure in smaller economies is a result that could suggest higher leakages, or less efficient expenditure. It could also however be a signal of the need for more government interaction with the economy in response to the narrower economic base and the resulting need for government to provide more economic impetus than is the case in larger economies.

Table 4 - Members of groupings, and population size

Group 1:>10 million		**Group 3:< 1 million**	
Brazil	Venezuela, RB	Guyana	St. Vincent and the Grenadines
Mexico	Chile	Suriname	Grenada
Colombia	Ecuador	Belize	Antigua and Barbuda
Argentina	Guatemala	Barbados	Dominica
Peru	Cuba	St. Lucia	St. Kitts and Nevis
Group 2:1-10 million		**Group 4:CARICOM**	
Bolivia	Nicaragua	Jamaica	Barbados
Dominican Republic	Costa Rica	Trinidad and Tobago	St. Lucia
Haiti	Uruguay	Guyana	St. Vincent and the Grenadines
Honduras	Panama	Suriname	Grenada
El Salvador	Jamaica	Bahamas, The	Antigua and Barbuda
Paraguay	Trinidad and Tobago	Belize	Dominica
			St. Kitts and Nevis

Table 5 – General indicators, Latin America and the Caribbean

Indicator	**>10 million**	**1-10 million**	**< 1 million**	**CARICOM**
Population, total	46,027,400	5,315,769	230,097	5,000,000
GDP per capita (constant 2000 US$)	3,716	2,760	4,754	5,615
Tax revenue (% of GDP) [a]	12.1	12.9	30.8	24.0
Expense (% of GDP) [a]	15.4	20.2	38.5	31.5
Cash surplus/deficit (% of GDP) [a]	-3.1	-2.7	-0.6	-2.7
Central government debt, total (% of GDP) [a]	18.8	55.5	11.3	59.1

[a]: data average for period 2000-2004

[5] In fact, the CARICOM group identical to the group of *small economies* with the addition of Jamaica and Trinidad and Tobago. Also, note that the nomenclature ‘large’, ‘medium-sized’ and ‘small’ is not the standard nomenclature used in relation to the country size.

1. Expenditure

Most expenditure items differ significantly in magnitude in CARICOM States relative to larger economies in Latin America and the Caribbean (see Table 6). At 40 per cent of overall expenditure, compensation of employees is twice as high as in large economies; in fact, the correlation of size of government wage bill and country smallness points to economies of scale of government in country size.

A similar observation can be made regarding expenditure on goods and services: this expenditure is two-thirds higher in CARICOM relative to large countries, and still 25 per cent larger than medium-sized economies. Government is thus a significant contributor to the economy, much more than in larger countries.

Turning to what can be termed 'social expenditure', health expenditure, measured as a proportion of GDP, in CARICOM member States is relatively similar to that in non-CARICOM countries. In fact, total health expenditure is slightly lower in CARICOM relative to larger economies. This suggests that smallness here acts in a beneficial way as targeting health services is more efficient, leading to lower expenditure. Furthermore, public expenditure on health is more significant in CARICOM countries, as well as more important to overall expenditure. This is however due to an overall policy approach where greater emphasis lies on the public provision of goods and social services.

Expenditure on education is higher across all levels in CARICOM, particularly at the tertiary level, where cost is more than eight times that of primary education (measured as a proportion of per capita GDP), compared to an average of three times the cost in other countries. One of the reasons for such high costs may be that enrolment in higher education is relatively low in the Caribbean, compared to international standards, which limits the potential of member States to benefit from economies of scale in the provision of higher education. Although close to universal (net) primary enrolment has been achieved, several countries in the region do not provide free secondary education and net enrolment drops to 70 per cent at this level. Due to the high variability in participation rates at upper secondary school levels, less than 30 per cent of the total labour force possesses sufficient secondary level qualifications to enter into tertiary education or other positions requiring secondary level qualifications (World Bank, 2000). Moreover, enrolment at the tertiary level in OECS member States is a mere 2 per cent, compared to 32 per cent for Europe and Central Asia and 58 per cent for high income countries. Finally, debt servicing consumes a substantial proportion of government expenditure. There is however no clear pattern across the various economies vis-à-vis debt burdens, suggesting that debt is not necessarily linked to size.

Table 6 - Expenditure data, Latin America and the Caribbean, data average for period 2000-2004

Indicator	>10 million	1-10 million	< 1 million	CARICOM
Compensation of employees (% of expense)	20.79	35.67	42.99	39.57
Goods and services expense (% of expense)	10.99	14.56	16.22	18.29
Health expenditure, private (% of GDP)	2.82	3.78	1.96	2.18
Health expenditure, public (% of GDP)	3.50	3.54	3.83	3.55
Health expenditure, total (% of GDP)	6.32	7.31	5.79	5.74
Expenditure per student, primary (% of GDP per capita)	13.09	12.35	18.83	18.08
Expenditure per student, secondary (% of GDP per capita)	15.35	13.53	20.57	20.63
Expenditure per student, tertiary (% of GDP per capita)	39.69	43.95	207.47	151.15
Interest payments (% of expense)	16.50	15.07	13.84	21.56
Source: World Bank Development Indicators (2006)				

2. Revenue

Revenue in CARICOM member States is also significantly larger than that raised in other developing economies in the region (Table 7). The ratio of revenue to GDP is approximately twice the amount raised in large economies and roughly 70 per cent larger than that of medium-sized economies.

Although the proportion of revenue resulting from taxation of income, profits and capital gains is relatively similar between large economies and CARICOM, there is a notable difference in how taxes are levied on goods and services versus taxation of trade (including revenue from customs and other import duties), with the latter being significantly more important than the former in smaller economies. This is a clear indication that taxing trade, particularly imports, in small economies, especially island economies, is significantly easier than in larger economies. In contrast to this, revenue from the taxation of exports is significantly less in the Caribbean vis-à-vis larger developing economies, amounting only to a quarter of revenue in terms of GDP. This may, though, be due to specific policy choices made in smaller countries in that export-promotion strategies exempt many export goods from taxation (or at least reduce taxation on exports). It may also be due to the low local input content in manufactured exports: taxing exports would reduce the competitiveness of exports significantly as a large proportion of inputs were already taxed upon importation.

Table 7 - Revenue data, Latin America and the Caribbean, data average for period 2000-2004

Indicator	>10 million	1-10 million	< 1 million	CARICOM
Revenue, excluding grants (% of GDP)	15.99	18.55	43.08	31.23
Taxes on income, profits & capital gains (% of revenue)	23.42	16.20	22.52	25.02
Taxes on income, profits & capital gains (% of total taxes)	31.58	25.55	31.74	34.35
Taxes on goods and services (% of revenue)	43.08	33.66	21.92	20.42
Taxes on international trade (% of revenue)	7.45	9.67	21.96	27.22
Customs and other import duties (% of tax revenue)	8.85	13.82	29.90	29.70
Taxes on exports (% of tax revenue)	5.39	0.10	1.25	1.35
Other taxes (% of revenue)	4.67	4.11	3.32	8.89

The above-mentioned differences in fiscal indicators suggest that the role and importance of government differs in smaller and larger economies and that policy advice that is valid for one group of developing countries may well not be so for another. As such, it is important to understand how fiscal policy functions in the region and what challenges policy makers face in dealing with specific recommendations.

The remainder of this study will focus on fiscal performance and on the revenue dimension in CARICOM member States. Highlighting differences between these permits the identification of best practices vis-à-vis revenue generation and creates useful policy-advice for member States contemplating reform, as tax collection must be improved whilst the tax burden and tax benefits are spread more equitably across the population.

SECTION III
FISCAL POLICY IN CARICOM

Overall, fiscal performance can be captured by the fiscal balance, measuring the difference between current revenue and current expenditure and thus giving an indication of the government's ability to finance its 'day-to-day' business: current revenue captures revenue arising from taxation (such as taxes on income, property, goods and services and trade) as well as non-tax revenue, whilst current expenditure reflects items relating to payment of government staff, goods and services as well as servicing debt obligations.[6]

The average fiscal balance for CARICOM as a whole registered an average surplus equivalent to 2.6 per cent of GDP in 1995. This balance turned negative in 2000 and has registered a deficit since (see **Error! Reference source not found.**).[7] This deterioration is mainly due to the fact that revenue increases were unable to match increased expenditure: whilst tax revenue (as a proportion to GDP) increased on average by 1.5 per cent of GDP between 1995 and 2004, current expenditure increased by 3.5 per cent of GDP.

Although an average deficit of 0.2 per cent of GDP (2004) is marginal, more nuanced observations for the CARICOM region arise when economies are classified into different sub-categories. Thus, figures show that whilst there is no clear trend that distinguishes smaller economies (the OECS member States) from larger economies (the Bahamas, Barbados, Jamaica, Guyana and Trinidad and Tobago), fiscal performance in service-based economies (referring to smaller economies as well as the Bahamas and Barbados), was stronger than in resource-based economies (Guyana, Jamaica and Trinidad and Tobago) in recent years (see **Error! Reference source not found.**), calling for a more detailed comparison of revenue collection systems and practices within the region.

A. Sources of revenue

The most important sources of revenue are generally taxation of goods and services, income taxation, international trade taxes and property taxation. International trade taxes are currently the most important source of revenue for the smaller and the service-based economies, providing more than half of their overall tax revenue, whilst larger economies derive slightly less than a quarter from this source and resource economies less than a sixth. Instead, the main source of revenue for all categories of countries is from taxation of income, followed by goods and services, which account for approximately a half and a third of revenue, respectively. Property taxation is relatively minor in all groupings, yet provides up to 4 per cent of revenue (Table 8).

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[6] The fiscal balance therefore neither includes capital expenditure nor capital revenue as these items are not counted as part of day-to-day operations of the government, but rather as investment items as they comprise expenditure on goods and services with a lifespan of more than one year and which are intended for productive use; these are included in the overall fiscal balance.

[7] These figures exclude Montserrat, which has had a current account deficit in excess of 35 per cent of GDP since 1997.

Table 8 - Sources of revenue, average 1995-2004, as % of total tax revenue

	Income & Profits		Property		Internal. Trade & Trans.		Dom. Goods & Services	
Type of Economy	**1994**	**2004**	**1994**	**2004**	**1994**	**2004**	**1994**	**2004**
Smaller	25.6	23.5	1.9	2.6	56.5	54.5	16.0	19.5
Larger	47.0	47.0	2.0	3.4	37.6	24.7	29.3	34.2
Resource.	47.0	51.0	1.5	0.0	17.9	14.6	33.8	33.1
Service-based	25.6	25.2	2.10	3.5	59.4	50.8	16.6	23.6

Box 1: Sources of revenue

In principle, there are three main sources of taxation: taxation of capital, including physical capital and financial capital, taxation of labour and consumption taxation. Before presenting the extent to which these taxes form the basis for revenue in the CARICOM region, an understanding of the economic effects the various types of taxation will have on the economy – in particular an understanding of the various channels through which taxation will affect economic performance – is required to be able to analyze tax regimes in the region and pass judgment on their efficacy and appropriateness.

Taxes affect economic performance through several channels. One important channel is through distortions that labour and capital taxation have on factor markets, and hence on the intensity of use of these inputs in production: taxation will affect supply and demand for factors by affecting their price.[1]

Wage taxation creates a wedge between gross and net pay. As a consequence, the quantity of labour employed will vary: in flexible labour markets since wage increases generally fall on workers, who may react to lower net wages by reducing labour supply.[1] In inflexible labour markets, higher wage taxes may lead to higher wage demands, implying that taxes are generally borne by employers; these consequently reduce their demand for labour. In either case, consequent to higher taxation is a reduction in output/production due to a reduction in the quantity of labour used in production. Wage taxation can have an indirect effect on the *quality* of labour, in particular if income tax schemes are progressive: by placing proportionally higher wage taxes on high earners, the incentive to invest in human capital decreases.[1]

Taxing capital on the other hand leads to a higher cost of capital, which in turn will decrease the capital intensity of production as firms substitute labour for capital. Capital taxation, however, also lowers savings and investment, which will have a negative impact on growth. On the one hand, it has a long-term effect on physical investment: in particular, there is a significant effect on foreign direct investment as multinational firms can reallocate investment to lower-tax jurisdictions, and, as the incentive to invest abroad increases for residents, this may result in an overall decline in savings. On the other hand, taxing capital will change an individual's saving decisions: whilst a lower post-tax return may lead to increased private savings ('income effect'), the higher discount rate will lead to decreased savings ('substitution effect', replacing future consumption by current consumption). Whilst a priori the overall effect is ambiguous, empirical results suggest that the substitution effect dominates, resulting in an overall decrease in savings as a result of higher capital income taxation, thus confirming the point made above that direct (progressive) taxation may well act as a disincentive to save and lead to capital flight.

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[1]: This is a relevant issue particularly in CARICOM where increasing education levels are important (ECLAC, 2005). In fact, all of the above-mentioned factors vis-à-vis wage taxation are of relevance to CARICOM as unemployment, standing in double digits in several countries, is already considered one of the most important economic challenges for member States.

One can, however, note that over the decade spanning 1994 to 2004 there has been a shift from the taxation of international trade and transactions towards the taxation of goods and services in larger and smaller economies, which is a significantly more pronounced shift in the former than in the latter. Furthermore, whilst taxation on income and profits has become important in resource-based economies, service-based economies have seen a trend towards increasing taxation of goods and services.

Box 2: Tax buoyancy

Tax buoyancy captures the overall responsiveness of taxes to overall income and hence measures to what extent tax policy is able to increase revenue yield; in doing so it does not however assume that the tax law is constant (and hence differs from a tax elasticity). Thus, a low coefficient is indicative of an unsuccessful tax policy in terms of increasing revenue (whilst it may also suggest low tax elasticity).

Formally tax buoyancy stems from the relationship that tax revenue and GDP are related, specifically, that the relationship follows the form

$$T=\alpha Y^{\beta},$$

where T represents total tax revenue collected and Y represents GDP (both measured in nominal local currency terms). Thus, the following equation was estimated for those countries with available data covering the period 1992-2004:

$$log(T)=\alpha+\beta*log(Y),$$

Results show that the buoyancy coefficient is below, yet close to unity only in the Bahamas, Belize and Trinidad and Tobago; in all other cases the coefficient is higher than unity; all coefficients are highly significant and robust (see table below). A coefficient that is higher than unity implies that in times of recession the fiscal balance is likely to worsen proportionally more as reductions in domestic production will result in more-than-equi-proportional decreases in revenue, yet also implies that tax revenue increases faster than growth in GDP.

Country	α	β	R^2	Country	α	β	R^2
Antigua and Barbuda	-2.393	1.046	0.934	Jamaica	-3.412	1.112	0.980
t-statistics	*-2.000*	*12.499*		*t-statistics*	*-3.705*	*23.358*	
Bahamas	-1.279	0.968	0.916	St. Kitts	-8.431	1.506	0.953
t-statistics	*-0.806*	*9.320*		*t-statistics*	*-5.882*	*14.192*	
Barbados	-6.232	1.329	0.976	St. Lucia	-6.382	1.341	0.961
t-statistics	*-5.112*	*16.748*		*t-statistics*	*-4.916*	*14.821*	
Belize	-1.506	0.984	0.809	St. Vincent	-5.136	1.272	0.980
t-statistics	*-0.625*	*5.815*		*t-statistics*	*-6.278*	*21.250*	
Dominica	-4.508	1.230	0.862	Suriname	-3.238	1.133	0.982
t-statistics	*-2.273*	*8.302*		*t-statistics*	*-3.982*	*19.326*	
Grenada	-3.991	1.184	0.987	Trinidad and Tobago	-1.121	0.977	0.968
t-statistics	*-5.963*	*24.403*		*t-statistics*	*-1.128*	*17.269*	

1. Taxation of income and profits

The extent to which taxation of income and profits (of individuals and companies) is levied in the CARICOM region varies considerably. In terms of income taxation, there are countries at one end of the spectrum, such as Antigua and Barbuda, the Bahamas, the Cayman Islands, St. Kitts and Nevis and the Turks and Caicos Islands, that do not levy any taxes on income (other than national insurance contributions, as in the case of the Bahamas, the Turks and Caicos Islands and St. Kitts and Nevis). At the other end of the spectrum are countries that levy

taxes on income of all residents, whilst between the two poles variations are found that classify income tax liability either according to residence status (e.g. domiciled, or non-domiciled, as in Anguilla, Barbados and the British Virgin Islands), source of income (whether domestic origin or abroad) or in fact on whether the individual is a wage-earner or not. Furthermore, taxes that are administered may be applied at flat rates (as in Belize, Grenada and Jamaica), or are applied at rates according to income brackets; amongst these, the highest marginal tax rate of 55 per cent is levied in Antigua and Barbuda. There are moreover wide variations regarding, for example, the degree of exemptions and threshold income levels across countries.[8] In terms of corporate and capital taxes the situation is similar: whilst tax rates differ, with corporate taxes ranging up to 45 per cent in Guyana, there is a wide degree of variation in statutes, exemptions and deductions, which makes a generic overall assessment of corporate and capital taxes difficult.

Overall, approximately a third of tax revenue is generated by corporate and individual taxation, which is on average equally derived from taxes on companies and individuals.[9] However, there are significant discrepancies within the region. Whilst Trinidad and Tobago receives almost two thirds of its tax revenue through taxes on income and profits, Antigua and Barbuda earns less than a sixth from this source (see Table 9). Antigua and Barbuda only decided to re-introduce the personal income tax in April 2005 and as a result and all revenue from this source has reflected taxation of companies. In Belize, Grenada, St. Kitts and Nevis as well as Trinidad and Tobago companies contribute a larger proportion of tax revenue than individuals; the counterpart of course being that in the other countries personal income taxes are more important, particularly in Dominica and Montserrat – two small economies heavily dependent on services.

Interestingly, although Trinidad and Tobago, Jamaica and Barbados are generally considered to have the most diversified economies, with relatively vibrant production-based economies, the importance of taxes levied on companies and businesses is only reflected in the revenue data for Trinidad and Tobago, where more than 37 per cent of revenue is from taxes on this source, whereas in Jamaica and Barbados these taxes show 'below-average' performance. In particular, with only 6.9 per cent of revenue from the taxation of income and profits of firms, Jamaica needs to strengthen this revenue dimension.

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[8] For a detailed overview of exact tax rates and specificities of tax systems in the region, see Bain and dos Santos (2004).

[9] The figures quoted here relate to the average of the last five observation points available (generally covering 2000-2004); this data covered the following countries: Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Jamaica, Montserrat, St. Kitts and Nevis, Saint Lucia, St. Vincent and the Grenadines, Suriname and Trinidad and Tobago.

Table 9 - Tax revenue from income and profits - origin, average of latest 5 observations

Total tax revenue from income & profits		Personal Income	Company & Business
Antigua and Barbuda	14.0%		14.0%
Barbados a/	36.2%	19.0%	14.6%
Belize a/	34.3%	8.9%	22.5%
Dominica	23.5%	15.9%	6.3%
Grenada	18.0%	3.3%	14.0%
Jamaica	40.0%	22.6%	6.9%
Montserrat	44.6%	35.3%	7.6%
St. Kitts and Nevis	29.0%	9.9%[a]	18.5%
St. Lucia	28.0%	10.8%	12.6%
St. Vincent and the Grenadines	31.2%	13.9%	15.4%
Suriname	45.2%	21.6%	23.6%
Trinidad and Tobago	63.2%	20.1%	37.2%
Average	**33.9%**	**16.5%**	**16.1%**
... w/o Trinidad & Tobago	31.3%	16.1%	14.2%
[a]: social security levy			

2. Taxation of goods and services

At an average of close to 27 per cent (2004) of overall tax revenue, revenue from goods and services represents a sizeable proportion of overall tax revenue and has increased significantly from the average of 19.7 per cent a decade earlier.

(a) Value-added taxation

One of the factors contributing to the relative importance of revenue resulting from the taxation of goods and services in larger economies is the fact that three of the larger economies in CARICOM, namely, Barbados, Jamaica and Trinidad and Tobago, have introduced a value-added tax.

Value-added taxes have been introduced in several developing countries, in particular to bolster declining revenues in view of increased trade liberalization. In fact, economic theory has shown that a consumption tax such as a value-added tax is in fact superior to a system with non-zero tariffs in that it is possible to increase revenue and consumer welfare by replacing tariffs by consumption taxes.[10] The reason this is the case is that tariffs lead to distortions of factor use in production as domestic prices are no longer equal to international prices. Thus, replacing tariffs by consumption-based taxes can lead to more efficient production and in particular a wider tax base as consumption taxes can be levied on all goods consumed whereas tariffs only apply to imports; hence the latter will raise less revenue than the former at equal rates.

[10] Keen and Ligthart (2002) show that any tariff cut that increases production efficiency combined with a consumption tax that leaves consumer prices unchanged will result in both higher welfare and higher revenue.

Although this argument is relevant to all economies, the potential for small economies to benefit from value-added taxes is not as large as for larger economies owing to the fact that the ratio of consumption to imports is likely to be higher in larger economies as their productive capacity is greater and hence consumption of own production is more important. Therefore, benefits of a value-added tax will be higher due to the larger tax base.[11] Nevertheless, the introduction of value-added taxation gained momentum in the 1990s in the Caribbean region: following the introduction of a value-added tax in Grenada in 1986, value-added taxes were introduced in Trinidad and Tobago in 1990, in Jamaica in 1991, in Belize in 1996 and in Barbados in 1997 and in Dominica in 2006.

Experience with value-added taxes has been mixed in the region. In fact, Grenada (1995) and Belize (1999) have joined the ranks of only three other countries (Malta (1997), Vietnam (in the 1970s) and Ghana (removed two months after introduction in 1995)) to have removed a value-added tax. In Grenada design and administration weaknesses brought about the downfall of the value-added tax: as many domestic goods and services were zero-rated, the value-added tax was essentially unable to significantly broaden the tax base. In addition, a low threshold led to a large number of businesses being liable for value-added tax. This in itself posed significant challenges for the authorities to administer the tax efficiently; the situation was aggravated by a significant number of tax refund requests. However, Grenada has announced plans to re-introduce the VAT in 2008, St. Vincent and the Grenadines plans to do so for 2007 and Antigua and Barbuda in 2006. In Belize the value-added tax was largely abolished for political reasons, as doing so formed part of the elected party's political manifesto. However, although the tax was abolished, it was replaced with an 8 per cent sales tax, which in turn was subject to a wider overhaul in 2005 when a 'General Sales Tax' of 10 per cent was introduced.

Despite the failure of value-added taxation to gain a permanent foothold in Grenada and Belize at the time, the experience in Barbados, Jamaica and Trinidad and Tobago with value-added taxation has been successful in the sense that c-efficiency ratios for Barbados, Jamaica and Trinidad and Tobago show that whilst VAT revenue in consumption exceeded 100 per cent c-efficiency ratio in Barbados, it reached 48 per cent in Trinidad and 66 per cent in Jamaica (see Table 10).

Table 10 - Co-efficiency ratios of value-added taxation, in %

	Average, 1996-2001	**Latest year**
Barbados	86.8	101.2[a]
Trinidad	51.9	48.2[b]
Jamaica	65.3	66.1[c]
[a]:2001, [b]:2004, [c]:2002		

[11] In fact, Howard (1991) notes that there is little merit for a VAT in economies that are characterized by either few intersectoral linkages, as is the case in many highly service-oriented economies where the level of imports in consumption is high, and/or the existence of a significant informal economy; rather, in such an environment either a retail sales tax or a consumption tax on imports may equally well fulfil the task of raising the required revenue, whilst posing a lower administrative burden.

Box 3: Efficiency ratios of value-added taxation

To measure the effectiveness of VAT, two measures are can be drawn upon: the efficiency ratio and the c-efficiency ratio: whilst the former measures the ratio of VAT revenue to GDP, the latter measures the ratio of VAT revenue to consumption (both ratios are consequently divided by the standard VAT rate). For one, using GDP may result not yield satisfactory results owing to measurement errors in GDP which can contaminate results. In addition, one can argue that using consumption as the relevant VAT base is more relevant, as the value-added tax is largely a consumption based tax. Thus, the c-efficiency ratio measures by how much VAT revenue in consumption will increase owing to a 1 point increase in the standard value-added tax rate.

In Barbados, the value-added tax was introduced to simplify the tax system as well as to increase its efficiency and equity. A value-added tax thus was introduced which replaced 11 other taxes.[12] Whilst the standard rate of 15 per cent is applied, there is a reduced rate of 7.5 per cent which is applied to holiday and vacation accommodation as well as an exempt rate (zero-rated rate) which is applied to the export sector as well as to staple food items, financial services, real estate, transportation, medical and dental services.

Revenue generated by the value-added tax in Barbados has been significant. Following its seventh year in operation, the tax raises the equivalent of two thirds of total taxes on goods and services. At B$598.1 million revenue, it contributes approximately a third to overall tax revenue of B$1.8 billion and is equivalent to almost 10 per cent of GDP.[13]

In Trinidad and Tobago the VAT system has also proved to be successful. Whilst it, too, is levied at 15 per cent and replaced a purchase tax as well as other indirect taxes, there are however a substantial number of items and services exempt from the tax, such as various food items (unprocessed food and basic processed foods), inputs to agriculture (e.g. seed, fertilizer, livestock and farm machinery), export-related activities, medical and health-related services, rental of residential property, transportation services, insurance, banking and stock brokerage etc.) and the natural gas and oil sector. In fact, considerable preference creep, referring to the phenomenon that the number of exempt and zero-rated services and items is increasing, has been observed in Trinidad and Tobago over the years. The VAT revenue forgone is rather significant, with estimates pointing to approximately 25 per cent of current VAT yields.

Nevertheless, revenue from VAT has also been significant, amounting to two thirds of total revenue from goods and services and yielding approximately 16.2 per cent of total tax revenue. On average the net-VAT to non-oil GDP ratio was approximately 6.0 per cent between

[12] These were the consumption tax, a luxury tax on goods (surcharge), stamp duties on imports, an entertainment tax, a hotel and restaurant sales tax, a service tax on pleasure cruises, a tax on quarriable minerals, a travel ticket tax, an airline business tax, a tax on overseas telephone calls and a surcharge on rental income. In fact, many of these taxes amounted to less than B$5 million revenue per annum, respectively.

[13] Latest figure for 2002 yields 9.5 per cent of GDP.

1990 and 2001.[14] A cause for concern however in Trinidad and Tobago is that VAT refunds are considerable by international standards, reaching approximately 30-45 per cent of tax collection. This is related to the large number of zero-rated items, as sellers of such goods will always be in credit positions with the government due to the fact that they claim the VAT paid on their inputs and have collected VAT at zero per cent on their sales. It is however also related to VAT refunds to the oil industry on capital equipment purchased, as their products are largely exported (these refunds account for more than half of all refunds). In addition, the large number of small taxpayers that have registered, despite being under the income threshold, remains a burden on the tax administration.

As part of its consumption tax reform, Jamaica introduced a general consumption tax (GST) and a special consumption tax (SCT), which together replaced eight other taxes. The GST is equivalent to a VAT and is levied in general at 15 per cent. However not only do zero-rated items exist (such as various food items, medical services, utilities and public works, financial services), moreover, due to special GST rates levied on, for example, motor vehicles, the tax structure is extremely complex, with rates reaching 100 per cent. It contributes approximately 27.9 per cent of revenue to governments' revenue coffers and is equivalent to 7.5 per cent of GDP (2004 figures).

Whilst a high c-efficiency ratio in Barbados could suggest the existence of a uniform value-added rate that is applied to all consumption, again this is not the case. Overall, significant exemptions exist across the board in all three countries; in Jamaica the tax is applied at a number of rates. This thus limits the use of such ratio in the region to a certain degree.

Other consumption taxes, not value-added taxes, exist in other countries in the region, notably in members of the OECS. These report the consumption tax revenue under trade taxes, although it is levied internally on domestic transactions as opposed to international trade per se.

3. International trade taxes

As noted above, revenue derived from international trade is the most important source of revenue for smaller and service-based economies and accounts for more than half of their overall tax revenue. In fact, for the CARICOM region as a whole, the contribution of revenue from international trade represented approximately 41 per cent of total revenue (2004), a slightly lower percentage than the 45.1 per cent registered in 1995.

Examination of revenue from international trade reveals that this consists of several different components, including import duties, consumption taxes, service charges, and export and stamp taxes (Table 11). This breakdown reveals that despite the variety, most of the tax regimes include both import duties and consumption taxes and more importantly that revenue levied by the consumption tax is more significant than that levied as import duties.

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[14] Taking the non-oil to GDP ratio is a more relevant measure than the VAT-GDP ratio (which averaged 4.4 per cent for the above-mentioned period) not only as the oil sector is exempt from the value-added tax, but also to ease comparability of the productive capacity of economies excluding any comparative advantage due to the existing natural resources.

Whilst Barbados's economy is heavily reliant on goods (light industry), services, particularly tourism and the financial/ business services, form the backbone of the economy. As a result, international trade taxes only amount to about one fifth of the contribution to tax revenue that taxation of services has registered over the past decade. Furthermore, the overall increase in its contribution of trade has been approximately 2 percentage points in this period while that of goods and services has been approximately 7 percentage points. Further trade liberalization is expected to impact the 10.5 per cent of trade revenue earned from import duties but the revenue from goods and services can also be affected as the competition provided by new imports (at lower duties) can also lead to a decline in the revenue generated from domestic goods and services.

For the resource-based economies like Jamaica and Trinidad and Tobago, taxation of income and profits is a greater contributor to tax revenue from international trade. However, analogous to the situation for resource-based Caribbean economies, Jamaica's tax base is relatively evenly distributed with income/profits, goods/services, and international trade taxes accounting for an average of 39.5 per cent, 31.9 per cent, and 28.3 per cent, respectively. Jamaica's relatively diversified portfolio, earning significant revenue from the three major sources, places it in a more advantageous position regarding potential future trade liberalization that will affect the 11.4 per cent of international trade revenue earned on import duties.

Whilst import duties in Trinidad and Tobago increased from 5.7 per cent in 1993 to 6.5 per cent of trade revenue in 2004, simultaneously the overall contribution of international trade taxes declined steadily from 11.3 to 6.8 per cent over the past decade. This could in large part be due to the expansion of the energy sector and its accompanying increases in income and profits than an actual decline in international trade.

In fact, import duties only exceed a sixth of total tax revenue in Antigua and Barbuda (though overall dependency on international trade averages almost 65 per cent), this ultimately has consequences for the impact of trade liberalization in that reduction of duty lines should only affect this proportion of tax revenue, leaving untouched the revenue generated in the form of consumption duties on imports. In contrast, other economies, like the OECS, and the Bahamas whose import tax accounts for 80 per cent of their international trade tax revenue and nearly half of total tax revenue are still very dependent on international trade revenues and will feel a greater impact of trade liberalization. Recommendations for harmonization of their revenue authorities, monitoring, and administrative bodies have been made, yet there is significant disparity among the member States on what reforms will be contemplated.

Taxation on international trade must be revamped both in terms of the tax base and most importantly in the effectiveness of collection. There have been no clear trends across the region in terms of international trade taxes, size and resource base, perhaps the largest determinants of policy with global market fluctuations and general fiscal outlook also playing a part.

Table 11 - Revenue from international trade, 2004

Country	Presentation format	Import tax dependency (%of total tax revenue)
Antigua and Barbuda	**Taxes on Inter. Trade & Trans.**	**64.1%**
	Import Duty	14.2%
	Consumption Tax	23.4%
	Foreign Currency Levy	2.5%
Bahamas	**Taxes on Inter. Trade & Trans.**	**61.5%**
	Import tax	48.8%
	Stamp tax from imports	10.6%
	Export tax	2.0%
	Stamp tax from exports	0.0%
Barbados	**Import Duties**	**10.5%**
Belize	**Taxes on Inter. Trade & Trans.**	**43.1%**
Dominica	**Taxes on Inter. Trade & Trans.**	**51.4%**
	Consumption Tax (Imports)	27.2%
	Import Duties	12.2%
	Service Charge (Imports)	5.7%
Grenada	**Taxes on Inter. Trade & Trans.**	**60.2%**
	Import Duty	14.4%
	Value Added Tax (incl. Gen. Cons.)	33.3%
	Customs Service Charge	10.6%
Guyana	**Taxes on Inter. Trade & Trans.**	**10.0%**
Montserrat[a]	**Taxes on Inter. Trade & Trans.**	**38.2%**
	Import Duty	5.0%
	Consumption Tax	12.7%
	Customs Service Charge	12.3%
St. Kitts and Nevis	**Taxes on Inter. Trade & Trans.**	**49.8%**
	Consumption Tax	24.4%
	Import Duties	14.4%
	Customs Service Charge	12.2%
St. Lucia	**Taxes on Inter. Trade & Trans.**	**56.8%**
	Consumption Tax (Imports)	23.6%
	Import Duty	14.7%
	Service Charge	8.9%
SVAG	**Taxes on Inter. Trade & Trans.**	**50.9%**
	Import Duty	11.3%
	Consumption Tax	29.9%
	Customs Service Charge	7.6%
Trinidad and Tobago	**Taxes on International Trade**	**6.8%**
	Import Duties	6.5%
[a]: *data for 2001*		

4. Property taxation

Whilst taxing an asset such as land has clear benefits as it is an inherently fixed asset in limited supply, implementation of property taxation is far from straightforward as authorities need to decide on the relevant tax base and on who it will apply to. Property taxation may in

principle be levied on the rental value of the property, on its actual market value, on its improved value or on the land area, each of which faces its own difficulties. In consequence, while basing property taxes on the rental value may lead to understating rental income, the market value of a plot is not easily determined and requires costly revaluation at regular intervals. When the tax liability is contingent on market value, long lags between consecutive revaluations can result in substantial increases in tax liabilities, especially in economies where demand is strengthened by investors from abroad. This has not contributed to the overall willingness to pay property taxes. Finally, basing the tax on land value may lead to a division of ownership among family members to reduce the tax. Similarly, basing the tax on land area may in fact be regressive if a uniform tax rate is imposed; furthermore, although this kind of tax is relatively easy to administer, it generates little revenue.

In addition to what the tax shall be based upon, the taxpayer base can differ. In fact, several islands levy higher rates of taxes upon non residents/non citizens, arguing that these benefit from the infrastructure yet are not subject to income tax.

All of these factors contribute to the difficulty in comparing revenue from property taxation amongst countries. Nevertheless, as shown in Table 12, property taxation can generate significant revenues. On the whole, the average contribution of property taxation is relatively small in the region, accounting for less than 2.5 per cent of overall revenue on average. However, although its contribution is less than 1 per cent in Trinidad and Tobago, Jamaica, Belize and Saint Lucia, the experience of the Bahamas, Barbados and Grenada show that revenues from property taxes can contribute significantly to revenue.

Table 12 - Property Tax as a percentage of revenue

Country	2000	2001	2002	2003	2004	2005
Antigua/Barbuda	1.66	1.85	2.21	2.93	2.34	2.95
Bahamas	3.72	3.89	4.30	4.55	5.06	6.66
Barbados	6.47	5.97	6.36	5.91	6.03	6.23
Belize	0.71	0.82	0.77	0.65	0.91	..
Dominica	1.37	1.47	1.60	1.06	2.28	2.63
Grenada	3.58	3.90	6.86	5.70	5.87	..
Montserrat	3.14	0.45	2.94	1.88	3.21	2.98
St. Kitts and Nevis	2.03	1.86	2.07	2.26	2.17	2.22
Saint Lucia	0.42	0.33	1.70	1.00	0.77	0.55
St. Vincent	1.06	1.52	0.96	1.05	0.92	..
Trinidad and Tobago	0.69	0.55	0.88	0.57	0.53	..

Property taxation in the CARICOM region has been plagued with several problems. For one, the collection rate has been rather weak in most countries, as will be shown in the case of Jamaica and Barbados. Collection is furthermore hampered by the fact that rather than imposing fines, tax write-offs increase the willingness to evade property taxation.

B. Objectives of, and challenges to, fiscal policy in CARICOM

It has been argued the goal of fiscal policy is to create an environment that stimulates the private sector to act as the principal engine of growth. Doing so ultimately implies that policy makers need to find the right balance between generating the level of revenue required to finance a socially acceptable minimum level of public services, whilst at the same time limiting the extent of taxes on the private sector as a whole to enhance its capacity to invest in productive assets.

Whilst this claim may hold for larger economies, its validity for small economies, such as those constituting CARICOM, must be called into doubt as lack of economies of scale and the small market size characteristic of these economies are likely to limit the effect that increased domestic demand will have on output. Rather than resulting in increased investment activity, expansionary domestic demand policies are more likely to create higher demand for consumption goods, leading to increased imports and consequently a reduction in foreign exchange reserves. This is undesirable in a balance-of-payments-constrained environment.[15]

The scope for fiscal policy to provide the impetus for growth in small economies is therefore broader than in large economies, as there is a role for public sector investment to act as a substitute for the lack of private impetus. This role is not only confined to providing the infrastructure needed for an export industry, but extends to the government acting as economic agent in markets by taking on the role of an innovator to substitute for the lack of research and development facilities that would otherwise be provided by transnational corporations, and as an initiator in creating linkages between domestic and international agents.

There is therefore ample scope for fiscal policy as a microeconomic tool alongside the traditional use as a macroeconomic instrument, where the latter refers to the use to control e.g. inflation, to expand employment, to provide an impetus to output growth; and the former referring to its effect on developing certain sectors of the economy by providing incentives or disincentives to certain aspects of production and hence encourage (or discourage) certain economic activities.[16]

In response to the need to diversify economies, the overall extent to which fiscal policy has been used as a microeconomic tool to stimulate demand in certain economic areas and strengthen individual sectors of the economy is significant. Accordingly, numerous fiscal incentives were put in place after independence, especially during the 1970s and 1980s, as part of the region's strategy of 'industrialization by invitation' à la Prebisch to attract foreign investment, promote exports and act as an engine for diversification. In fact, the Treaty establishing the Caribbean Community (1973) explicitly has an Agreement for the

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[15] In fact, this is supported by the fact that private investment in the region has been on a general downward trend since the beginning 1990s, whilst foreign direct investment has seen significant increases, see Roache (2006).

[16] The use of fiscal policy to both satisfy macroeconomic as well as microeconomic objectives may lead to policy inconsistency as indeed the needs of the two may conflict. This is particularly relevant in a region where the availability of monetary policy as an independent tool for economic management is lacking in many member States as the majority of these operate on fixed exchange rates – either fixed *de jure,* or in fact *de facto* fixed – where monetary policy is used as a device to stabilize exchange rate pressures and volatility and hence of little use for other economic management.

Harmonization of Fiscal Incentives in which fiscal policy is viewed as a tool for microeconomic objectives and which stipulates limitations on the extent to which incentives can be granted to limit competition amongst members for foreign investment whilst simultaneously granting the less developed members greater flexibility. Further to this agreement, most individual countries introduced further domestic tax incentives taking their own national development objectives into account.

Under the provision of the Harmonization of Fiscal Incentives Act, 1973 (see Table 13); profit holidays for up to 15 years were granted to less developed countries of CARICOM. Clearly these incentives were designed to stimulate domestic production and attract investment similarly, as shown in the lower half of Table 13; export promotion was particularly encouraged, with higher tax relief going to those firms with higher export profits. Likewise, substantial fiscal incentives exist in the OECS, tax holidays up to 25 years for offshore banking are granted, many inputs to production and the construction of buildings and/or plants are duty exempt and special treatment of dividends and depreciation are made (**Error! Reference source not found.**).

Whether or not these incentive schemes have been successful and have resulted in higher levels of foreign investment than would otherwise have been the case is a counter-factual exercise. Research on the OECS however suggests that revenue losses have been substantial as these incentives have narrowed the region's tax base. Thus, Chai and Goyal (2005) have found that forgone tax revenues range between 10 and 16 per cent of GDP in several countries. Bain and Laurel (1995) found that tax concessions resulted in revenue losses between 36.4 per cent in St. Vincent and the Grenadines to 24 per cent of GDP in Anguilla. Sosa (2006) estimated that the use of tax holidays granted for 'approved' cases in the OECS has resulted in significant capital subsidies for those companies granted the concession.

Furthermore, the effectiveness of incentive schemes in attracting investment and hence widening the resource base as well as increasing a country's export base is not obvious in view of the recent downward trend in economic performance, the lack of diversification in the region, the worsening fiscal stance and the region's need to meet its high expenditure.[17]

However, rather than dismiss the general principle of such incentives, there is a need to revisit the implementation and the framework of these; whilst the underlying principle of incentives to act as a catalyst for economic development still stands, their design leaves room for improvement. For one, enforcement and monitoring of the use of incentives is weak.[18] Furthermore, granting tax holidays per se which do not differentiate between the size of investment and hence imply that the resulting value of the incentive differs from investment to investment, is not effective; rather, the current incentives should gradually be replaced by a combination of tax allowances and investment credits to be charged against taxable profits,

[17] CARICOM economies' export market share in most major markets decreased over the period 1985 and 2002, with its contribution to total global imports decreasing 44 per cent to 0.15 per cent of global imports (see ECLAC, 2003), suggesting that incentives have at least not been able to maintain competitiveness as indicated by constant market shares in the global economy.

[18] It has been pointed out that investors often fail to submit documentation that allows monitoring the use of their entitlements, which may lead to an abuse of the system (ECCB 2005).

alongside a value-added system with the appropriate design features that rebate VAT paid on capital goods.[19]

Table 13 - Fiscal incentives of CARICOM member States, Harmonization of Fiscal Incentives Act, 1973

Profit Holiday	Duration (number of years)		
	MDCs	Barbados	LDCs
When 100% of sales are exported extraregionally.	10	10	15
When the local value added exceeds 50% of total sales.	9	1	15
When the local value added is comprised within a range of 25%-49%.	7	8	12
When the local value added is comprised within a range of 10%-24%.	5	6	10
When the industry is highly capital intensive:	10	10	15
LDCs when the initial investment > EC$25 million			
MDCs when the initial investment > EC$50 million			
Tariff exemptions	For the duration of the above tax holidays, inputs, machinery and spare parts can be imported duty free as can all materials and equipment for new factories.		
Export allowance for extra-regional exports after expiration of tax holiday			
When exports profits > 61% of the total.	Tax relief of 50% up to 5 years		
When export profits are comprised between 41% and 61% of the total.	Tax relief of 45% up to 5 years		
When export profits are comprised between 21% and 41% of the total.	Tax relief of 35% up to 5 years		
When export profits are comprised between 10% and 21% of the total.			
Dividend payments	During the validity of the above tax holiday dividends paid to shareholders are tax exempt.		
Depreciation allowance	After the tax holiday expires, a deduction of up to 20% on any capital expenditure incurred.		

Source: McIntyre, 1995 and World Bank, 1990

The following section will present some of the recent and current tax reform efforts being made in Barbados, Jamaica, the OECS and Trinidad and Tobago, focusing however only on 'significant' changes either to major taxes, or to changes in the system as a whole. Analysis of the reform steps and their underlying motivation should lead to drawing conclusions as to what direction fiscal policy is taking in the region and should point to some 'best practices' for other countries to emulate.

[19] In fact, evidence has shown that current incentive schemes that attract foreign direct investment have not been able to foster domestic investment as the two have not been found to be complementary and as the latter is more sensitive to the cost of capital (Roache, 2006), suggesting that policy measures required to unleash domestic investment should rather be targeted at increasing access to capital by reducing its cost.

SECTION IV
TAX REFORM

Tax systems cannot be static entities. As economies change over time, new markets emerge, new dynamics take place and shifts in relative importance between sectors and factors of production may occur. The need for tax reform therefore becomes a reality to adapt to such a changing environment. Nevertheless, reforming tax systems necessitates a clear identification of why reform is needed. Reform might either be necessary due to a change in the above-mentioned economic fundamentals, rendering the current taxation regulation insufficient or misaligned to the current functioning of the economy; it may also be due to realized inadequacies of the current system or to shifts in political focus.

Tax reform can take two forms. It can either follow a 'big bang' approach, which is characterized by a fundamental, profound change in the tax system, or it can take place following a gradual reform process. Whilst the former may have more tangible immediate results, the latter is easier to implement both from a political point of view as from an institutional point of view.

As noted above, revenue generation is crucial in the region considering government's pivotal role in functioning as a principal economic agent and hence acting as an incubator of growth. Revenue generated in the region already represents a sizeable proportion of GDP. The driving motivation of tax reform should therefore not be to primarily increase revenue by raising taxes, but rather to increase the efficiency of revenue generation. Raising taxes is more likely to lead to negative spillovers and have a negative impact on the region's attractiveness for (foreign) investment as well as lead to more incentives to evade taxes. Making revenue generation more efficient and widening the tax base will make taxation more equitable and could in theory lead to decreases in tax rates.

Overall, throughout the region a shift in the philosophy of taxation has taken place since independence from what can be labeled 'optimal tax policy' to a more supply-side oriented policy, i.e. from an understanding that tax policy should be based on minimizing the excess burden when collecting a required amount of collected tax revenue, to the use of tax policy as a tool for development by creating an environment conducive to attracting investment. The underlying realization being that rather than use the tax system for redistribution and equity, it is recognized that the tax system should be efficient and simple and that ultimately public expenditure can more readily be adapted to target equity.[20] In this view, supply-side policy recognizes the negative impact, high income-tax rates on economic growth and seeks to move to a more neutral system characterized by a larger emphasis on consumption taxes.

As will be seen below, changes in tax legislation has largely proceeded along these lines in Barbados, the OECS (specifically, the Eastern Caribbean Currency Union (ECCU)), Jamaica and Trinidad and Tobago. However, the extent to which this has happened, has differed.

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[20] One of the drawbacks of optimal tax theory is however that from an efficiency point of view, goods with inelastic demand should be highly taxed, whilst e.g. the marginal tax rates on the bottom and the top of the income scales should be zero; these two results however can rightfully be criticized as inegalitarian (see e.g. Alleyne and Howard (2004) and Howard (1991), chapter 9 for a more detailed discussion of the two theories).

A. Barbados

Tax reform in Barbados was particularly pronounced at end-1980s and the 1990s. In line with the above-mentioned shift to supply-side oriented taxation, income-taxes were reduced significantly in 1986; whilst the highest marginal tax rate was reduced (from 60 per cent to 50 per cent), the number of tax bands was reduced from six to five and a tax-exempt income threshold of B$15,000 (only for residents) was introduced to ensure that households with low incomes were affected as little as possible by the reform. Following these large cuts in income taxes in 1986, the tax scheme was further simplified in 1992. Alongside the elimination of most itemized allowances and deductions, a maximum limit was introduced for the total amount of claims allowed. Furthermore, the multi-tiered system was replaced by a two-tiered tax system with a rate of 25 per cent levied on incomes above B$13,000 (note, the income threshold had been reduced) and 40 per cent levied on taxable incomes of more than B$37,000 per annum. The income threshold has since been raised, in 1998 it stood at B$15,000 and reached B$22,500 in 2006. Simultaneously, the basic income tax rate has been reduced to 20 per cent (2004) whilst the top marginal income tax was reduced to 35 per cent in 2006.

Overall, income tax reforms have simplified the tax code; whilst the introduction of a two-tiered income tax has made the system more transparent, the removal of numerous itemized deductions, etc., has made it more difficult for individuals to minimize their tax bills. It has also increased the efficiency of the inland revenue department by reducing substantially the need to pore over large amounts of documentation submitted in support of claims.

The government is also reducing corporation tax. Whilst the tax rate on profits was 40 per cent prior to 2002, it was reduced to 37.5 per cent and 25 per cent in 2006. However, due to many incentives which take the form of tax holidays, investment allowances and, in particular, tax credits relating to earnings of foreign exchange, hence granting foreign firms significant concessions, the result is a significantly lower effective corporate tax rate. Thus, Alleyne and Howard (2004) estimate the effective corporate tax rate in 2002 was approximately 25 per cent for companies benefiting from incentives, compared to the nominal 37.5 per cent applicable.

Property taxation has long been a contentious issue in Barbados. Usually this tax is collected annually and is based on the market value of the property, as assessed usually in three-year intervals. Collection of this tax has not always been timely; in fact, in 1998 arrears still relating to the period 1972 and 1981 were written off. One of the issues leading to the general unwillingness to pay this tax is related to the fact that property prices are burgeoning – often as a (direct or indirect) consequence of the vibrant tourism sector, resulting in relatively high tax liabilities. To counteract these dynamics, tax rates were decreased and an exemption threshold was introduced in 1998 on properties with an improved value of B$125,000 or less, which essentially removed half of all properties from the tax role. This notwithstanding, the contribution of property taxation to overall revenue in Barbados is the highest in the CARICOM region. However, the most recent valuation resulted in significant average increases in property

values (between 25 and 30 per cent on average); this has led to a reduction in the rate of tax for properties valued between B$350,000 and B$850,000 from 0.65 per cent to 0.45 per cent.[21]

Overall, in recent years, the tax scheme in Barbados has been simplified, whilst the tax base has been broadened. Whilst the introduction of a value-added tax in 1997 contributed significantly to the simplification by eliminating 11 other taxes (see footnote 12), changes in the personal income tax have resulted in lower tax rates and fewer brackets. Although the contribution of personal income taxation relative to overall tax revenue has declined over the last decade slightly (from 19.75 per cent in the fiscal year 1995/1996 to 16.72 per cent in 2004/2005), this decrease was more than offset by the increases in corporate taxation (12.34 per cent and 15.82 per cent in 1995/1996 and 2004/2005, respectively). Nevertheless, despite the changes, more fundamental measures are required, in particular, the income tax act may need to be revised to reflect the current economic framework of the country and to close loopholes leading to tax evasion and avoidance. Furthermore, a review of the incentives given to corporations may be required, to analyze the costs and benefits of preferential treatment granted. This has been recognized by the authorities, who announced in the most recent budget that a committee will be instituted to do precisely so.[22]

B. Jamaica

In 1986 the income-tax system in Jamaica was comprehensively reformed. Following recognition that the tax system exhibited horizontal inequities and high marginal tax rates which acted as a disincentive to investment and work, and ultimately to a dampening of growth, the multi-tiered income-tax scheme was replaced by a system with one flat rate (33 1/3 per cent) on income above a certain threshold (J$8,580) whilst simultaneously various tax credits were removed (see Bahl 1989 for more details).

These wide-ranging measures were the last that were introduced in a comprehensive manner for nearly 20 years, during which tax 'reform' essentially consisted of introducing individual tax measures on an ad hoc basis, with little consideration given to the overall consistency of these. The issue of tax reform has however received renewed impetus in Jamaica, owing to the realization that the existing scheme no longer met the demands of the current economic environment and that reform was urgently needed to address the significant fiscal imbalance, which is reflected in a debt-to-GDP ratio of 133 per cent (2005), making Jamaica one of the most indebted countries in the world.

Recognizing that the current tax legislation was insufficient to meet the current economic environment, a series of studies was commissioned to provide relevant technical analysis upon which a Tax Policy Review Committee could present its recommendations to the government.[23] Based on these studies, the committee recommended that the government follow a 'big bang' approach and introduce a number of significant changes in a one-off manner. The government has however opted for a more gradual approach and will be implementing the reforms over a

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[21] See Government of Barbados (2006).
[22] Idem.
[23] In this view, the Andrew Young School of Policy Studies at Georgia State University (USA) was engaged and provided 10 detailed studies on various aspects of the Jamaica tax system.

period of several years; in this view, it introduced the first of a series of tax reform measures in 2005.

The main conclusion of the Tax Policy Review Committee was that high taxes on labour income were one of the principal factors contributing to the country's lack of competitiveness and that a move away from taxing labour was advisable, thus a principal recommendation was to address the general consumption tax (GCT). In particular, the committee urged a reduction in the number of exemptions as well as the elimination of non-export zero-rated allowances. These recommendations were largely followed: whilst many zero-rated goods and services were shifted to exempt status, the GCT was increased to 16.5 per cent (higher than the 16 per cent recommended) whilst the exempt threshold was increased from J$300,000 to J$1 million.[24]

In line with the recommendation to reduce the burden on labour, the government has also increased the individual income tax threshold from J$120,432 to J$275,184. However, rather than increasing the threshold in one go, the threshold will be increased over a period of 18 months in three individuals steps. This increase is expected to reduce the tax burden on labor and will remove approximately 98,000 taxpayers from the income tax role, which will lessen the administrative burden further.

In line with the shift to capital taxation, several changes were introduced relating to the corporate income tax regime. Notably, the number of asset types eligible for capital allowances was reduced to five, in line with recommendations to harmonize tax receivers within the Caribbean Single Market and Economy (CSME), whilst the number of years to carry losses forward was reduced to five. Furthermore, to reduce some of the inequities arising from the tax incentive regime in Jamaica, and the resulting favourable treatment of the tourism sector, the government increased the GCT applicable to the tourism sector to 8.25 per cent (thus, the sector benefits from a 50 per cent lower rate than the rest of the economy); it also reduced and eliminated several deductions and credits that were applicable to this sector. Overall, there is a need to revisit the country's tax incentive regime in a more holistic manner to understand what the costs in terms of lost revenue are, relative to the benefits of having these measures in place.

Several recommendations regarding the transfer tax and stamp duty were put forward, such as the elimination of the latter and the removal of the former from transfers of securities and from capital distributions, as well as a reduction of the former on real estate transfers and transfers of estates at death. These were mainly made to address the fact that the current system was hindering the development of a smoothly functioning market and was inhibiting markets for non-public sector debt and equity instruments.

However, only the taxation of transfer payable on estates at death has so far been addressed by the government: the introduction of a threshold of $100,000 as well as a uniform tax of 7.5 per cent for transfers above the threshold have simplified this tax significantly compared to the four-tiered system with a threshold of $10,000 and a top marginal tax of 15 per cent above $110,000 that had existed previously. Similar simplifications also were introduced

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[24] The status of exempt versus zero-rated is relevant as whilst GCT input tax credit can be claimed for the latter, it cannot be claimed against the former.

vis-à-vis property taxation where a ½ per cent on properties valued above $300,000 has been introduced and a flat-tax of $600 is applied to properties below the threshold.

Whilst tax reform in Jamaica has only just begun, the government looks well-poised to tackle the issue as a wealth of analytical and empirical studies on the economy are available.[25] Ultimately, it is up to the authorities now to implement the appropriate measures.

C. The Eastern Caribbean Currency Union (ECCU)

The ECCU is a rather unique construct in the sense that whilst all its member States (other than the British Virgin Islands) share a common currency, the Eastern Caribbean dollar, fiscal policy is essentially undertaken under the prerogative of the individual countries.[26]

The Monetary Council of the ECCB, comprising the finance ministers of its member countries, has adopted a set of fiscal benchmarks aimed at supporting the quasi-currency board arrangement by creating a stable macroeconomic environment. These fiscal benchmarks are similar to the benchmarks incorporated within the Maastricht Treaty of the European Union which defined eligibility for the introduction of the Euro, and relate to national debt and the fiscal deficit. In particular, they stipulate that by 2007: (i) a surplus equivalent to of 4-6 per cent of GDP must be registered on the government's current balance; (ii) the overall government budget deficit of individual countries should not exceed 3 per cent of GDP; (iii) total outstanding central government debt must not exceed 60 per cent of GDP; and (iv) that debt service payments not exceed 15 per cent of current revenue. However, these benchmarks have yet to be incorporated into the national budget and laws of the ECCU members. In fact, no member State complies with the entire set of benchmarks to date; moreover, several countries do not meet any of the four benchmarks.

Symptomatic of the failure to meet the benchmarks is the fact that not only is there a lack of fiscal coordination amongst members, who adjust their fiscal policy according to own needs, but that changes to fiscal policy in individual member States seem to have been implemented rather haphazardly, as witnessed by a number of changes to tax legislation over the last years, with a lack of clear overall reform framework.

One of the challenges of the members of the OECS and consequently of the ECCU is the reliance on a narrow resource base which is, in addition, to a large degree focused on the provision of services, in particular on tourism. As outlined above, the main source for revenue is therefore on trade taxes, which in most cases accounts for more than half of all revenue, due largely to consumption taxes and import duties. In fact, this high reliance on trade taxation had contributed to the unwillingness of member States to meet deadlines that had been set regarding the implementation of the CARICOM Common External Tariff (CET), resulting from the fear of

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[25] This is referring to the studies commissioned by the reform committee.

[26] Therefore, the ECCU is a subset of the OECS. The common currency maintained by the Eastern Caribbean Central Bank, ECCB, was established in 1983. This institution is responsible for maintaining the peg of the Eastern Caribbean dollar, which has been pegged through a quasi-currency board arrangement to the US dollar at a rate of EC$2.70 to US$1 since 1976 (before the establishment of the ECCB, this peg was maintained by the Eastern Caribbean Currency Authority).

loss or revenue on the one hand, but also from the skepticism of the overall possible gains that may arise from the trade liberalization.

However, it must be pointed out that concerted tax reform has been on the economic agenda for some time. Thus, following a fiscal reform report of 1998, more recent efforts are taking place amongst members of the ECCU as member States are contemplating reform recommendations put forward in 2004 by a reform commission (ECCB, 2004). Whilst the commission recognizes the need to improve upon administrative practices, it notes that one of the obstacles to development is the complicated nature of tax systems, a consequence of which is significant non-compliance and widespread evasion, as well as the fact that the already narrow tax base is eroded even further by the granting of numerous concessions. In this view, the overarching goal of tax reform within member States should be focused on creating a simple system which is not difficult to administer and that encourages growth whilst simultaneously minimizing exceptions and thus creating a broad tax base.

Thus, principal components of the suggested tax reform relate to the need to revisit tax concessions and to strengthen monitoring of these as well as to shift from tax holidays to tax allowances and/or tax credits, which will create a link between the benefit of the incentive and the overall investment. Furthermore, it calls for the elimination of 'nuisance taxes' and for broadening the tax base. A significant step in view of the latter would be the creation of a simplified three-tiered personal income tax system with an upper marginal tax rate of 30 per cent and generous thresholds that would contribute towards equity.[27] This should be complemented by a two-tiered corporate income tax with the same upper marginal tax rate and no thresholds, which also has a special regime for small incorporated businesses and companies listed on the Eastern Caribbean Stock Exchange, granting them reduced upper marginal tax rate of 25 per cent.

Whilst the report points out that revenue generated from property taxation can be strengthened and that in fact average revenue from property taxation could be doubled (see Table 14), it realizes that property valuations, which are to take place in regular intervals, may have to be phased in to 'avoid undue hardship on tax payers'.

Table 14 - Tax ranges, ECCU

Type of Tax	Existing range*	Average*	Proposed range*
Personal income tax	0.9 - 4.7	3.5	3.0 - 4.0
Corporate income	2.7 - 5.2	4.0	4.0 - 5.0
Property	0.1 - 1.1	0.5	1.0 - 2.0
Trade and Excise	6.0 - 14.4	7.6	3.0 - 5.0
Transactions tax	9.1 - 14.5	11.5	9.0 - 14.0
Total	18.8 - 39.9	27.1	20.0 - 30.0
Non-tax revenue	2.0 - 7.5	4.0	3.0 - 5.0

*: as per cent of GDP, *Source: ECCB (2004)*

[27] The threshold is suggested to be at least equal to 125 per cent of per capita GDP in the respective member countries.

To reduce the reliance on revenue from trade taxes, it is also suggested that import duties be phased out and that instead a value-added tax be introduced to replace all indirect taxes. Whilst value-added taxation should not be considered as the panacea for fiscal problems in member States, in particular as the success of such a tax may be limited by the lack of intersectoral linkages (see footnote 11), a VAT bears the potential of ultimately simplifying the current systems which have proven to be rather complex.

(a) Implementation of the reforms

Some progress has been made regarding implementation of reform recommendations. Thus, following the recommendation to introduce a value added tax, Antigua and Barbuda intends to implement one at 15 per cent in 2006, whilst Dominica introduced one at 16 per cent in 2006, St. Vincent and the Grenadines has one planned for 2007 and Grenada for 2008.

Likewise, in terms of personal income taxation, whilst Antigua and Barbuda introduced a personal income tax in 2005, Grenada introduced a levy on personal income in 2006; Montserrat is contemplating a change in the threshold and in the rates and Saint Lucia and Dominica are contemplating changes in the threshold. Although Anguilla and St. Kitts and Nevis are to date not considering a personal income tax, Anguilla will introduce a social services levy, which already exists and will in fact be increased in St. Kitts and Nevis.

In view of reform of the corporate income tax, only St. Kitts and Nevis and Antigua and Barbuda are currently considering the recommendation for the special regime for small-incorporated businesses; both have reduced the highest corporate income tax to from 35 to 30 per cent in 2005. In Antigua and Barbuda this follows a reduction from 40 per cent to 35 per cent in 2002. However, reform of the property tax has made more progress, Anguilla has decided to increase the frequency of property valuation which currently takes place every 10 years; both Anguilla and Antigua and Barbuda are carrying out property valuation exercises in 2006. Furthermore, valuations in Grenada, Montserrat, St. Kitts and Nevis, Saint Lucia and St. Vincent and the Grenadines will be based on the market value, as opposed to the rental value as is currently the case.

Despite efforts made in individual member States, more needs to be done. Considering that in a region as vulnerable to natural disasters as the OECS, governments should be operating on a fiscal surplus, which would give them added flexibility in terms of expenditure when disaster strikes, rather than running deficits as was the case in six of the groupings members, bringing the average deficit in 2005 close to 2.2 per cent of GDP. Furthermore, given the fact that the ECCU members share a common currency, more efforts should be made to achieve fiscal harmonization among member States; closer fiscal coordination of tax reform would simplify and facilitate transactions among countries and would create synergies among the tax administrations.

D. Trinidad and Tobago

From a fiscal point of view, tax reform in Trinidad and Tobago is not as pressing an issue as in other countries owing to the fact that it is a country rich in natural resources. Thus, revenue

inflows from the energy sector, which include oil, natural gas and oil and gas-based petrochemical production and accounts for more than 40 per cent of GDP, have increased to such a degree that whilst the oil sector contributed 30 per cent of all tax revenue in 1995, by 2005 that contribution had increased to 49 per cent.[28] Consequently, the country has enjoyed a healthy primary balance over recent years, with surpluses exceeding 5 per cent of GDP.

However, due to the risks of relying heavily on revenue generated from a resource that has a high underlying price volatility, tax reform is needed not only to address weaknesses in the tax system and make revenue collection more efficient, but also with a view to ensuring that the reliance on the energy sector as a main contributor to government coffers is reduced through production diversification in the economy.

As outlined above, experience with the valued-added tax, which was introduced in Trinidad and Tobago in 1990 following a wide-ranging income-tax reform, has largely been successful. More recently, the Government has embarked on a tax reform process, which is currently underway. A tax commission has been formed and proposals have been submitted. In fact, in 2006 significant changes were introduced to the personal income tax and the corporate tax.

Changes to the income tax system consisted largely of simplification, as the two-tiered system with rates of 25 per cent and 35 per cent, respectively, was replaced by a system with one flat tax of 25 per cent. In addition, several allowances, notably the mortgage, child and tertiary education allowance, were abolished as these were deemed not only to increase the burden of tax administration, but their overall value was unclear and they were not necessarily progressive. However, abolishment of these allowances is partly compensated by the fact that the income tax threshold was increased from TT$25,000 to TT$60,000, or approximately 95 per cent of the country's per capita GDP, a move which bring benefits to all tax payers and is estimated to remove 300,000 taxpayers from the income tax net. In fact, whilst the previous threshold was considered relatively low compared to other countries in the region, the present threshold is rather generous. Overall, it is expected that these changes may increase compliance.

The contribution of non-oil corporate taxes to overall revenue is relatively low in Trinidad and Tobago, standing at 5.8 per cent of non-oil GDP in 2005 (compared to 16.5 per cent and 15.8 per cent in Saint Lucia and Barbados, respectively). This has been suggested to be due to the existing wide range of special tax incentives and tax holidays. In this view, several tax holidays were removed in 2006, other than tax holidays on tourism-related projects that fell under the Tourism Development Act. Tax exemptions for new investments in approved activities that fell under the corporation tax act and the fiscal incentive act were removed, as was the tax holiday for free zones and exemptions on tax earned on loans to new investments in tourism, housing, small business and agriculture. The removal of these, and other, exemptions was however cushioned by a reduction in the corporation tax rate to 25 per cent from formerly 30 per cent.[29] Furthermore, to encourage small business development, profits of 'approved small

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[28] Trinidad and Tobago is the most important supplier of methanol on a global scale and ranks fifth in terms of LNG exports; overall production of crude oil in 2006 stands at 144,442 barrels/day.

[29] However, the corporation tax rate on petrochemical companies remains at 35 per cent, whilst that on energy companies remains at 50 per cent.

companies' and 'approved activity companies' are exempt from taxation for the first five years. Alongside these two corporation tax rates, there are two further rates which are applicable to petrochemical companies, which pay a 35 per cent corporate tax, and energy (oil and gas) companies, which pay a 50 per cent corporate tax, making the corporate tax system in Trinidad and Tobago essentially a four-tiered system.

Several countries that have substantial non-renewable resources have created particular funds to capture windfall gains arising from increases in international prices in their abundant resource, with a view to investing these funds in productive assets and hence securing benefits of the non-renewable resources to future generations.[30] Along these lines, the authorities in Trinidad and Tobago created such a fund in 2000: the 'revenue stabilization' fund and have proposed the establishment of a Heritage Fund in 2006/2007. Whilst the former fund has accumulated resources, there has however not been a formal mechanism to invest these resources productively; consequently, they are currently held in an account at the Central Bank. The government has however recently announced the reform of this fund; a framework will be created that allows use of the funds to meet shortfalls in revenue owing to price fluctuation of the underlying asset, as well as to invest a proportion of the fund in productive assets so that future generations could share the wealth of the country's current non-renewable stock of natural resources, i.e. be creating an intergenerational link. The precise details are however yet to be worked out.

Whilst the introduction of a single income tax rate combined with a generous threshold for exemption is rather unique in the region, this creates an environment where authorities must carefully ensure that expenditure is particularly appropriately targeted towards the needy.

Although the fiscal situation of Trinidad and Tobago is considered healthy from an overall perspective, activity in terms of tax reform has increased as authorities have recognized that there is urgent need to strengthen revenue from the non-oil sector. Whilst the economy is less reliant on the energy sector in general, and the oil sector in particular, than in the 1970s and 1980s (see box 4), this sector generates significant revenues to the extent that although the overall fiscal surplus was equivalent to 5.4 per cent of GDP in 2005, discounting revenue resulting from the oil sector would have resulted in an overall deficit of 11.4 per cent of GDP. This highlights the fact that increasing revenue generation from other sources is imperative. It also emphasizes that expenditure must be tightened, in particular if Trinidad and Tobago wishes to avoid repetition of the profound recession witnessed in the 1980s following the oil bust, during which income per capita declined by a third.[31]

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[30] Countries that have implemented these funds are Norway with its State Petroleum Fund (created in 1995), Chile with its copper stablisation fund (created in 1987) and Kuwait, Oman and other oil-producing countries.

[31] Following a substantial increase in GDP per capita during the 1970s, the economy contracted at an average 4.5% per annum during 1983 and 1989, negating previous gains in per capita income, which subsequently declined 33% during this period alone, falling in 1989 to a lower level than in 1976.

Box 4 - The Resource "Curse"

Trinidad and Tobago would probably have been better off today had it not been "blessed" by an episode of oil windfalls. Two decades after the beginning of the oil boom, not only have per capita incomes in Trinidad and Tobago fallen back to pre-1973 levels, but the oil boom has also left a legacy of structural rigidities that have undermined the growth and development of the economy. Such a legacy of a boom based on mineral resources is not unique to Trinidad and Tobago. Mineral rich countries, on average, experienced lower rates of growth during the past two decades than less well-endowed countries due to the way mineral revenues are absorbed and transmitted to the rest of the economy. Mineral-based industries, and especially oil, are highly capital intensive and have few direct linkages to the rest of the economy, except through a fiscal link. Hence, mineral-based wealth tends to lead to an over extension of the public sector, a crowding out of the private sector and to a reduction of the competitive pressures on economic management and domestic industry. The competitiveness of the non-mineral sector is usually further eroded by the real appreciation of the exchange rate brought about by the mineral-export boom.

Thus, in Trinidad and Tobago the non-oil tradable sector was virtually decimated. By 1982, oil revenues accounted for more than 90 per cent of total exports and the resultant real appreciation of the exchange rate eliminated other exports. The production structure became inefficient and non-competitive as production subsidies, import barriers and labor market regulations were put in place to protect floundering domestic enterprises. The public sector expanded as oil revenues, which accounted for more than 50 per cent of Government revenues, enabled it to branch into commercial activities, crowding out the private sector. Public expenditures also became skewed toward current expenditures while public employment and transfer payments expanded to alleviate the continued high rates of unemployment caused by the decline of the traditional sectors and the capital intensive nature of the oil sector. Oil revenues did enable a temporary increase in living standards for many population groups. But this was accomplished by poorly designed government programs. When oil revenues declined, a sustainable base for income growth had not been established for these groups, creating a mismatch between their raised expectations and the feasibility of maintaining their high living standards.

Source: World Bank, 1995

SECTION V

Conclusions

Caricom governments are already under increased fiscal pressure owing to significant debt burdens, their sizeable wage bills, as well as significant social challenges such as high and persistent unemployment, HIV/AIDS, ageing and rising crime, all representing urgent issues that need to be tackled by policy makers. In view of this, governments will find it challenging to compensate for the reduced revenue flows that will result from trade liberalization in reaction to increased globalization, in particular as fiscal balances have already deteriorated significantly over the recent years and have turned negative in many member States, signaling expenditure needs beyond the financing possibility of economies.

One conclusion readily drawn is that governments in the region would need to move towards leaner structures both by reducing expenditures and making them more efficient. Furthermore, the efficiency, and sources of revenue collection need to be revisited. Streamlining taxes by making tax systems less complex as well as reducing tax exemptions will improve efficiency and increase revenue; by putting a greater emphasis on income and consumption taxation in general, and on value-added taxation in particular, tax regimes will be able to operate on a wider basis, leading to further revenue strengthening.

In an environment where growth is essential and where factors of production are mobile – particularly in view of the CSME, which will lead to an increase in the mobility of skilled labour – implementing changes to tax regimes will necessitate policy coordination amongst member States to avoid relocation of production facilities among them and elsewhere.

Implementing tax reform is a challenging exercise. For one, constituencies do not appreciate increasing tax burdens. It is clear that the choice of taxes and tax bases is not always one based upon economic arguments, but is frequently an outcome of a process that reflects resource constraints, and in particular political preferences. This is especially true in economies with small populations. This notwithstanding, governments in CARICOM have recognized the need to reform their tax systems and several have embarked on concerted tax reform efforts by establishing reform committees charged with putting forward recommendations. One can observe a general tendency in the region where tax systems are being simplified, 'nuisance taxes' are being abolished and tax rates are being lowered. These measures all follow the philosophy that simpler schemes are less costly to administer and create fewer incentives to evade taxation.

Two issues are however essential to the success of tax reform efforts as both are eroding the tax base that countries operate upon: incentive regimes and an increasing informal economy. The fact that the informal sector is not only significant in many countries, but is moreover increasing in size creates a formidable challenge as this sector is, by definition, able to evade direct taxation. This can have a substantial effect on revenue, as has been put forward by Faal (2003), who estimated that the informal economy in Guyana, at approximately 47 per cent of official GDP, cost the country at least 7 per cent of GDP for the period 1970-2000 in terms of lost tax revenue.

Furthermore, reform will depend on whether authorities are able and willing to revisit the incentive regimes that exist in the respective countries, in particular given the fact that whilst incentive regimes in the region, i.e. granting preferential tax treatment to certain sectors are widespread, the true value of these is not apparent. In fact, Lim (1983) concludes from a cross-sectional study on developing countries, including Barbados, Jamaica and Trinidad and Tobago, that foreign investment is explained by natural resources and economic development rather than by tax factors, pointing to the fact that the generous tax incentives may in fact be misguided. There is a clear lack of comprehensive studies analyzing the actual costs and benefits of the various fiscal incentives and tax concessions operational in the region. This situation needs to be remedied and should in fact form the backbone of any serious tax reform: governments should analyze whether incentives granted have been successful in attracting economic activity or whether these have led to an erosion of tax revenue.

Finally, one must point out that tax reform is only one part of the equation for reducing fiscal pressure and decreasing debt. Economic prosperity can only truly be achieved if governments also tackle the other part of that equation, namely, public expenditure.

Table 15 – Tax provisions and fiscal incentives in the ECCU

	Antigua and Barbuda	Dominica	Grenada	St. Kitts and Nevis	Saint Lucia	St. Vincent and the Grenadines
CIT 1 rate	40%	30%	30%	37%	33.33%	40% (35% for hotels)
Personal income rate	on interest: no tax on dividends: no tax capital gains: no tax	on interest: no tax on dividends: 15% capital gains: no tax	on interest: no tax on dividends: 15% capital gains: no tax	on interest: no tax on dividends: no tax capital gains: no tax	on interest: 30% on dividends: 30% capital gains: no tax	on interest: no tax on dividends: no tax capital gains: no tax
Nonresident withholding taxes	on interest: 20% on dividends: 20%	on interest: no tax on dividends: 15%	on interest: no tax on dividends: no tax	on interest: no tax on dividends: 10%	on interest: no tax on dividends: 25%	on interest: 20% on dividends: 20%
Depreciation Schedule	Declining balance	Straight line	Straight line	Declining balance with initial allowance of 20%	Declining balance with initial allowance of 20%	Declining balance with initial allowance of 10% (buildings), 20% (equipment
Loss carry-forward period	Maximum 6 years (cannot reduce taxable income by more than 50% in any one year)	Maximum 5 years,	Maximum 5 years (cannot reduce taxable income by more than 50% in any one year)	Maximum 5 years (cannot reduce taxable income by more than 50% in any one year)	Maximum 6 years (cannot reduce taxable income by more than 50% in any one year)	Maximum 5 years (cannot reduce taxable income by more than 50% in any one year)
Tax holidays	5 (hotels) and 10–15 (manufacturing) years, exemption from CIT, duties and VAT on imports of plant, equipment and inputs for "approved" cases	Up to 20 (hotels) and 10– 15 (manuf.) years, ex1emption from CIT, duties and VAT on imports of plant, equipment and inputs for "approved" cases. No dividend taxes during the tax holiday	Up to 10 (hotels) and 10–15 (manufacturing) years, exemption from CIT, duties and VAT on imports of plant, equipment and inputs for "approved" cases. No dividend taxes during the tax holiday	5–10 (hotels) and 10–15 (manufacturing) years, exemption from CIT, duties and VAT on imports of plant, equipment and inputs for "approved" cases	Up to 15 (hotels) and 10–15 (manufacturing) years, exemption from CIT, duties and VAT on imports of plant, equipment and inputs for "approved" cases	Up to 15 (hotels) and 10–15 (manufacturing) years, exemption from CIT, duties and VAT on imports of plant, equipment and inputs for "approved" cases
Other incentives	No taxes for offshore banking and insurance Incentives for Export Processing Zones Tax holiday of 15 years for enclave enterprises.	No taxes for offshore banking and insurance Tax holiday of 15 years for enclave enterprises	Projects with exports over 60% are given additional tax holidays No taxes for offshore banking and insurance Tax holiday of 15 years for enclave enterprises	No taxes for offshore banking and insurance Tax holiday of 15 years for enclave enterprises	No taxes for offshore banking and insurance Tax holiday of 15 years for enclave enterprises	Tax holiday of 25 years for offshore banking and insurance Tax holiday of 15 years for enclave enterprises

Source: SOSA (2006)

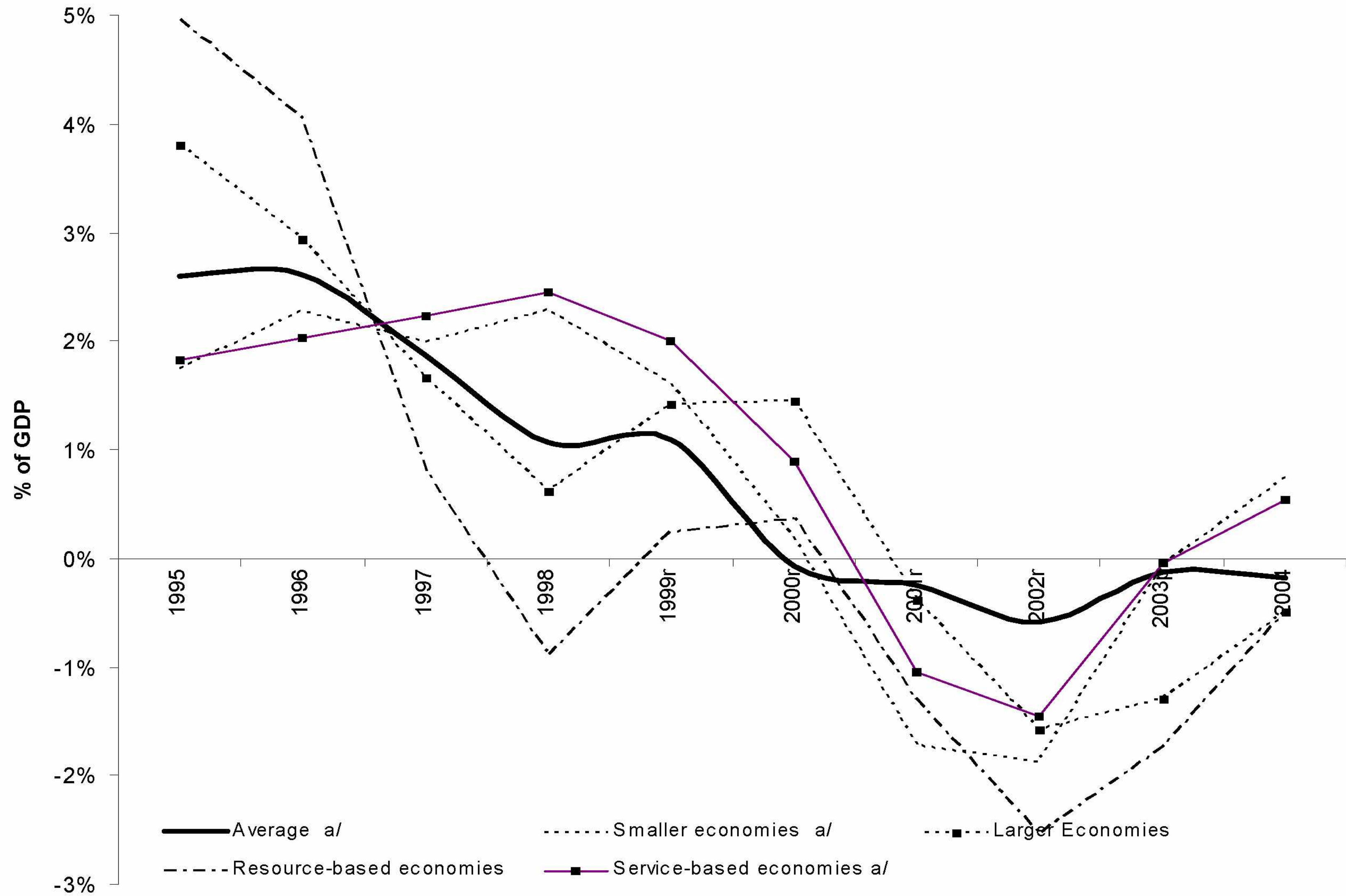
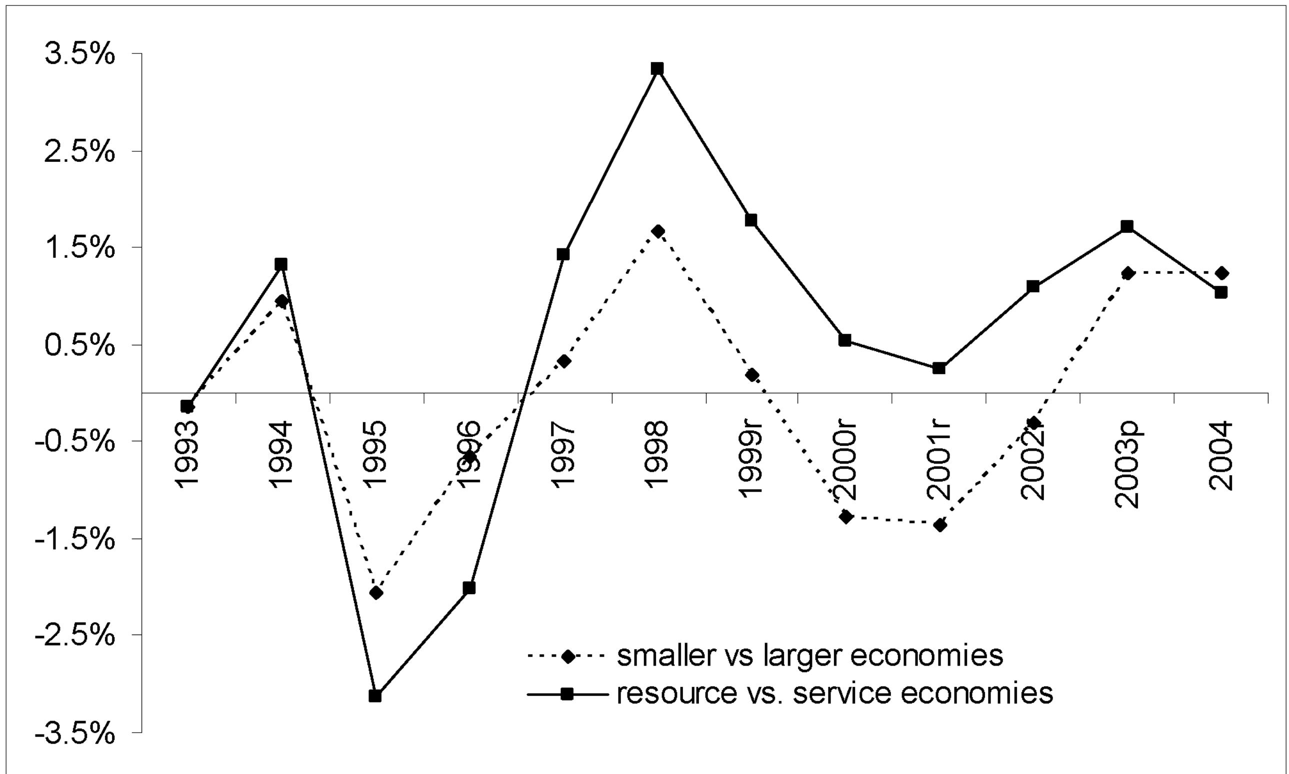


Figure 1 – Primary Fiscal Balance
% of GDP
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
1995
1996
1997
1998
1999r
2000r
2001r
2002r
2003p
2004
Average a/
Smaller economies a/
Larger Economies
Resource-based economies
Service-based economies a/

Figure 2 – Fiscal performance – differences in outcomes



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