TAX REFORM FOR GROWTH

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This brief highlights the most pressing tax reform measures that would benefit the Jamaican economy. The list is informed by the findings and recommendations of three thorough reviews of Jamaica's tax system: "The Final Report of the Tax Policy Review Committee to the Government of Jamaica" (2005) commonly referred to as "the Matalon Report", "Tax Reform and Economic Development: The Jamaican Case" (2007) by Bahl and Wallace, and "A Blueprint for Taxation Reform in Jamaica" (2009) by the National Planning Summit Tax Reform Committee, referred to in this brief as "the Blueprint." While it is now generally accepted that an overhaul of Jamaica's tax system is overdue, maximizing the effectiveness of the reform process requires a clear sense of priority. It is hoped that this brief will help to provide that clarity.

INTRODUCTION

Taxes are the price that, collectively, citizens pay for the activities of their governments.[1] The most significant variable in determining the level of taxation in a given economy is the level of public spending. Even if a government opts to finance its spending through borrowing, it will eventually be forced to repay that debt through taxes. It follows that there are two questions which must arise if, as in Jamaica's case, a country is not generating sufficient revenues to meet public expenditure needs. The first question is – "Is government spending too high?" If government spending is deemed to be wasteful or excessive, then the first step towards ensuring that public revenues become sufficient to meet public expenditure needs should be to reduce government spending.[2]

The second question that must arise if a country is not generating sufficient revenues to meet its public expenditure needs is – "Is the particular design of the tax system impeding its ability to generate revenue?" If the answer to this question is yes, then a determination must be made as to what kind of changes are in order; is it necessary and sufficient to alter the tax rate, or should revenues be increased by making changes to the overall structure of the system (i.e. changes to the body of laws and regulations that determine: the total tax burden, who will be taxed, and how such persons/entities will be taxed)? It is widely accepted that what is needed in Jamaica is the latter, changes to the overall structure of the system, commonly referred to as *tax reform*.

Aside from revenue generation, there are a number of other considerations when measuring the efficacy of a tax system and proposed reform measures. Namely:

- Efficiency – technically speaking, this is the inverse of the cost of collection (including difficulty) per dollar of taxation. Put more simply, the less costly it is to collect taxes, the more efficient a tax system is.
- Fairness (horizontal equity and vertical equity) – The extent to which citizens' share of the tax burden is deemed to be socially appropriate to their economic circumstances. Horizontal equity ensures that individuals in similar economic

[1] Tanzi (2007).

[2] The public sector restructuring exercise currently being pursued is a crucial step towards reducing the level of government spending in Jamaica.

circumstances face similar tax obligations. Vertical equity ensures that those with higher incomes pay an appropriately larger proportion of their income in taxes i.e. bear a greater share of the tax burden.[3]

- Integrity – the extent to which opportunities for evasion are minimized.
- Growth effects – the extent to which the tax structure facilitates the attainment of progressively higher standards of living.

These factors are so important to the performance of a tax system in the long run that it is often recommended that tax reform be constrained to be revenue neutral,[4] so as not to risk failure in respect of making other improvements. But, in the present fiscal context, increasing revenue is a necessary objective. The reforms highlighted in this brief, and the specific actions under each, aim to improve the efficacy of Jamaica's tax system while enhancing revenue and minimizing the burden on taxpayers.

[3] Vertical equity brings into focus the Government's responsibility to protect the basic welfare of its citizens, even through supplementary measures such as social protection programmes, if necessary.

[4] When tax reform is "revenue neutral" the reform measures are designed to leave the overall revenue position of the government unaffected in the short run.

1. Simplify The System of Compliance

Next to crime and theft, inefficient government bureaucracy is ranked as the most problematic factor for doing business in Jamaica, according to the Global Competitiveness Report 2010-11.[5] The Blueprint (2009) similarly acknowledged the general sentiment among business owners that the level of effort required to maintain tax compliance represents a costly distraction from the pursuit of the core activities of businesses. Complications include, inter alia, multiple registration, payment and filing requirements, challenging tax filing deadlines and cumbersome tax clearance procedures. Not surprisingly, Jamaica was ranked in the bottom ten of the 183 countries assessed for ease of tax compliance in Paying Taxes 2011;[6] a position which has not changed in the six years that the study has been conducted. The aspect of the system that has been most detrimental to Jamaica's standing is the required number of tax payments per year.

Basic Steps towards a Simpler System

The following are a few basic steps that may be taken to simplify the system of compliance:

- Extend the period of validity of the Tax Compliance Certificate (TCC) for taxpayers with a history of compliance. (As a meaningful policy shift, greater emphasis ought to be placed on rewarding compliance.)
- Design and implement a Unified Tax Return (UTR) to facilitate monthly filing and payments with respect to GCT, payroll and withholding tax data.
- Permit groups of companies to elect to form GCT Groups for the purpose of filing a single consolidated GCT return, ignoring intra-group activity. (In Barbados, this is achieved through the issuance of the same registration number to parent companies and their subsidiaries.)
- Permit bi-monthly filing for small taxpayers.

Conclusion

Taking the aforementioned steps towards simplifying the system of compliance would have a positive effect on efficiency and economic growth, since it would result in lower tax administrative costs and less distraction from core business activities. By making it easier for taxpayers to become and remain compliant, the reform would also improve fairness within the system.

[5] See World Economic Forum (2011).

[6] See PriceWaterhouseCoopers and the World Bank Group (2011).

2. Decrease Reliance on Direct Taxes

In May 2010, KPMG predicted an intensification of the global shift, which began before the recession, away from direct taxes and towards indirect or value-added taxes (VATs).[7] Two of the primary reasons for the growing trend are:

Revenue Stability: Indirect taxes are charged on consumption. Consumption provides a more stable tax base than income, because it is less volatile and less mobile than profits or labour.

Simpler Administration and Increased Compliance: Indirect taxes are harder to evade because they are generally payable as transactions occur. VATs are also likely to be more cost effective to administer than individual or corporate taxes. These characteristics are particularly advantageous to developing countries, where administrative systems are not very well-developed, have few resources, and are open to corruption.

In light of these considerations, Jamaica also stands to benefit from shifting its reliance away from direct taxes and towards indirect taxes. The challenge is to do so in a way that does not leave disadvantaged citizens worse off.

Making the Shift

Both the Matalon Report (2005) and the Blueprint (2009) recommended an immediate reduction in the corporate income tax (CIT) rate to 25% in the short run, to bring it in line with the personal income tax (PIT) rate.[8] There were, however, significant differences between the reports in their approach to increasing the reliance on indirect taxes. The Matalon Report (2005) recommended an increase in the GCT rate from 15% to 16%, in the context of a simultaneous reduction in other taxes and an adequate expansion of the social safety net. But increasing the government's reliance on indirect taxes does not require a higher tax *rate*, if it is feasible to tap into the alternative of broadening the tax *base* to the full extent necessary. Hence, supported by the fact that the prevailing GCT rate is above the regional average for VAT rates,[9] the Blueprint (2009) recommended that the rate be restored to 15% and that the number of zero-ratings and exemptions be drastically reduced thereby increasing the tax base.[10]

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[7] See KPMG International Cooperative (2010)

[8] The Blueprint (2009) also recommended that the CIT rate be reduced further over the longer term (matched by an elimination of investment incentives), and that the scope for further reduction in the PIT rate also be explored.

[9] The GCT rate in 2009 was 16.5% and the rate was increased to 17.5% in early 2010.

[10] The key difference between zero-ratings and exemptions is that suppliers of goods or services that are *zero-rated* are required to file GCT returns and, as a result, GCT borne on their inputs are fully recoverable, whereas for goods and services that are *exempt*, GCT returns are not applicable and so the GCT borne on their inputs is irrecoverable.

However, the Blueprint's comparison of VATs across the region did not speak explicitly to differences in the tax base to which these taxes were being applied, or to the implications of these differences. With the current fiscal position of the Government of Jamaica being weaker than most of its regional counterparts, it is likely that either the tax rate in Jamaica would need to be higher than the regional average, or the tax base wider, or both. Now, to the extent that there may be strong justifications for having some limits on the expansion of Jamaica's indirect tax base (especially, if the social safety net is not adequate[11]), a strong argument may be presented in favour of maintaining a higher than average VAT rate on a restricted base.

Ensuring the adequacy of social protection programmes is a *precondition* for pursuing an extensive expansion of the indirect tax base and, as noted in Appendix I, protecting citizens living beneath the poverty line is a minimal requirement. From a social and political perspective, broader coverage of lower income groups may be crucial for successful implementation.

Considering the points above and noting, in particular, that no significant actions have yet been since the time of the reports to shift reliance *away* from direct taxes, the following actions are recommended as the next steps in making the shift away from direct taxes towards indirect taxes:

- Reduce the CIT rate from 33 $^{1}/_{3}$% to 25%. The expected revenue impact is -0.7% of GDP.[12]
- Double the income tax threshold. The expected revenue impact is -0.5% of GDP.[13]
- Eliminate zero-ratings on supplies to the government. The net revenue impact would likely be negligible. However, by reducing opportunities for misreporting, this expansion in the indirect tax base would raise revenue by more than expenditure while improving fairness and integrity.

Conclusion

While actions have been taken in recent years to increase reliance on indirect taxes, this has not been accompanied by a decreased reliance on direct taxes, which would serve as a stimulus for economic growth. The actions recommended above therefore focus primarily on decreasing reliance on direct taxes.

[11] See Appendix I.

[12] This estimate was calculated directly from the simulation results presented in the Ministry of Finance Green Paper on Tax Reform released in May 2011.

[13] This estimate was extrapolated from the simulation results presented in the Ministry of Finance Green Paper on Tax Reform released in May 2011. The results actually implied that the loss would be somewhat lower.

3. Eliminate Tax Concessions

The issue of excessive tax expenditures is one which has been historically ignored despite its significance.[14] Based on the estimates provided by Bahl and Wallace (2007), the total value of tax expenditures in Jamaica could be as much as 60% of total tax revenue. Six categories of tax expenditures were identified:

1. Individual Income Tax: the income tax threshold, allowances and gratuity exclusion.[15]
2. HEART: gratuity exclusion and the non-taxation of government entities.
3. Education Tax: exemption of NIS contributions, superannuations and gratuities.
4. GCT: exemptions, zero-ratings for non-exports and lower rates for tourism.[16]
5. Property Tax: relief and derating.
6. Tax incentives: CIT tax holidays, Duty/GCT/Stamp Tax Relief, Waivers of Penalty/Interest/Surcharges, PIT Tax Holidays, and special treatment via the Hotel Incentives, Resort and Cottage Act.

By far, GCT and tax incentives are the largest sources of tax expenditures, amounting to about 6 percent and 4 percent of GDP, respectively.

The Special Problem of Tax Incentives

As Bahl and Wallace (2007) emphasized, we should resist the temptation to interpret tax expenditures as necessarily being "giveaways." In some cases, they are used to achieve distributional objectives or to garner other important social benefits. In the absence of adequate alternatives, it is not hard to defend these kinds of tax expenditures despite the fact that they are not expected to generate economic growth. However, tax incentives fall outside of this category.

In Jamaica, tax incentives are usually defended based on the *assumption* that they provide stimulus for economic activity. The Blueprint (2009) highlighted the fact that very little analysis is actually done in terms of evaluating their overall economic impact. Of special cause for concern are waivers granted at the discretion of the Minister of Finance (generally falling under the categories of Duty/GCT/Stamp Tax Relief and Waivers of Penalty/Interest/Surcharges). Bahl and Wallace (2007) noted that the Jamaican tax system has moved away from a rules-based approach toward one that is characterized by numerous special treatments. This environment compromises fairness and integrity, which encourages a culture of non-compliance. Some taxpayers will aim to "get away" with as much as they can by soliciting discretion. Those who cannot access special treatment will also be less likely to comply, partly because of the sense of

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[14] There is wide variation across countries in the definition of the term "tax expenditures." We invoke a definition similar to the one offered by Brown (2004) for Australia, as it succinctly describes the character of the systemic problem in Jamaica: tax expenditures are concessions designed to provide a benefit for a specific activity or class of taxpayers that forego revenue.

[15] Bahl and Wallace (2007) include dividends of listed companies. However, since companies already pay income tax on profits, the taxation of dividends would be, in effect, double taxation.

[16] Bahl and Wallace (2007) regard the zero-rating of exports as a norm for taxation across jurisdictions internationally and, on that basis, excluded this item from their estimate.

unfairness but also, in the case of business, because complying will diminish their capacity to compete with those who are accessing special treatment

Estimates of the revenue cost associated with the various categories of tax incentives are presented in Tables 1. A partial breakdown for the largest category of tax incentives, Duty/GCT/Stamp Tax Relief, is presented in Table 2.

Table 1: Revenue Cost of Exceptions to Standard Taxation[17]

	Revenue Lost (% of GDP)
Corporate Income Tax Holidays	0.33
Duty/GCT/Stamp Relief	3.26
Waiver of penalty, interest and surcharge	0.08
Hotel Incentives and Resort & Cottage Act	0.25
Personal Income Tax Holidays	0.01
TOTAL	**3.91**

Table 2: Revenue Cost: Disaggregation of Duty/GCT/Stamp Relief[18]

	Revenue Lost (% of GDP)
Raw materials for use in Manufacturing	1.22
Bauxite and Alumina Industry	0.91
Motor Vehicles for Particular Categories of Persons	0.36
Warehousing – Duty Free Shops	0.32
Modernisation Program	0.14
Hotel Incentives	0.09
Other Categories	0.23
TOTAL	**3.26**

The biggest problem with the use of tax incentives is that the revenue losses associated with concessions necessitate elevated tax rates which affect economic activity across the breadth of the Jamaican economy. The fundamental point that must be appreciated is that <u>while it may provide an incentive for the targeted recipient, *whenever* a tax concession is made it is simultaneously providing a disincentive for the rest of the economy</u>. Bahl and Wallace (2007) argued that Jamaica's paradox of high investment and low productivity might be attributed, at least in part, to having an incentive programme that channels investment to less productive sectors. Similarly, Rider (2004) concluded that

[17] Derived from absolute estimates by Rider (2004), also presented in Bahl and Wallace (2007). Describing the values relative to GDP compensates for the subsequent impact of inflation and fluctuations in output.

[18] Derived from absolute estimates provided by Rider (2004). Describing the values relative to GDP compensates for the subsequent impact of inflation and fluctuations in output.

instead of seeking the highest rate of return, it may be that investment decisions are being led by tax considerations.

Initiating the Process of Rationalization

The following actions are recommended as specific steps towards eliminating the inefficient and ineffective use of tax expenditures:

- Eliminate discretionary waivers. The expected revenue gain from duty/GCT/stamp relief and waivers of penalty, interest and surcharge alone is 2 percent of GDP.[19]
- Prepare and present a tax expenditure budget as part of the budgetary process. (Tax expenditures must be subjected to the same scrutiny as the direct spending side of the budget if their total cost or efficiency is to be captured.[20])

Conclusion

Eliminating the inefficient and ineffective use of tax expenditures should be the first priority of tax reform in Jamaica. By facilitating lower tax rates, this action would stimulate economic activity across the breadth of the Jamaican economy. Fairness and integrity would also be improved since these factors tend to be compromised when some taxpayers receive special treatment. The very first step to rationalizing tax expenditures should be to eliminate discretionary waivers. This would raise revenue by more than 2 percent of GDP. The additional gain expected from eliminating other tax incentives is 1.9 percent of GDP.[21]

[19] According to Rider (2004), approximately 60 percent of Duty/GCT/Stamp Tax Relief is remissions by the Minister.

[20] See Brixi, Vandeluc and Swift (2004).

[21] This revenue gain could be augmented if preferential treatments, such as the remaining differential between the GCT for tourism and the general GCT, were eliminated

CONCLUSION

As noted in the introduction, maximizing the effectiveness of the tax reform process requires a clear sense of priority. The reform measures that Jamaica would most benefit from are to:

- Simplify the system of compliance.
- Decrease reliance on direct taxes.
- Eliminate the inefficient and ineffective use of tax expenditures/concessions.

Given the potential for positive growth effects under that particular reform, eliminating the inefficient and ineffective use of tax expenditures should be the first priority for tax reform in Jamaica and, among the categories of tax expenditures, tax incentives should be the first target. The expected revenue gain from the elimination of tax incentives is 3.9 percent of GDP. With total tax revenue hovering around 26 percent of GDP, this represents a potential revenue increase of 15 percent. The elimination of tax incentives is therefore a *significant* means of affording lower tax rates. The eliminate discretionary waivers alone would raise revenue by 2 % of GDP, allowing for a reduction of the corporate income tax rate from 33 $^{1}/_{3}$ to 25 percent and a doubling of the income tax threshold. Further rationalization would be facilitated by including a tax expenditure budget in the budgetary process.

The other actions prescribed in this brief are straightforward steps to simplifying a system which has, for six consecutive years, ranked Jamaica in the bottom ten of 183 countries assessed for ease of tax compliance, especially on account of the number of tax payments required per year.

In aggregate, the actions recommended would improve all five criteria for determining the efficacy of the tax system (efficiency, fairness, integrity, growth effects and revenue generation) but, most importantly, would encourage economic growth. A summary of all nine recommendations and their original source is presented in Appendix II.

APPENDICES

I. TAX REFORM AND SOCIAL PROTECTION

One of the government's core responsibilities is to safeguard the social welfare of citizens. Therefore, the issue of social protection must be contended with during the reform process. Widening the indirect tax base would increase the tax burden on lower income groups, because most of their income goes towards consumption. A precondition to widening the indirect tax base should therefore be to ensure that adequate social protection is given via direct spending.

In terms of what constitutes an adequate social protection, coverage of citizens falling beneath the poverty line is the minimum requirement. But, from a social and political perspective, broader coverage of lower income households may be crucial to ensure the long term success of the tax reform effort. Under their alternative proposals for comprehensive reform, Bahl and Wallace (2007) estimated the amount required for a social fund as being the amount of increased tax liability borne by the bottom 40 percent of the population.

Using the restriction of the indirect tax base as a means of protecting low income groups from taxation means the shielding of the rich from taxation as well, to the extent that the rich consume the goods being excluded. This is the central rationale behind emphasizing a direct spending approach to social protection (e.g. PATH). If social protection were pursued entirely through direct spending, then much revenue could be saved by targeting citizens who actually need relief. At the same time, some of the net saving arising from removing the shield from the rich could be put towards the expansion of social protection programmes. Hence, more social protection can be afforded by using the direct spending approach than by restricting the indirect tax base.

Existing Programme Capacity

The primary social safety net programme, both in terms of number of clients and budgetary allocation, is the Programme of Advancement through Health and Education (PATH). PATH is a conditional cash transfer programme which began in 2001. It was designed for the purpose of rationalizing the operations of three income support programmes – the Food Stamps Programme, the Poor Relief Programme and the Public Assistance Programme. PATH has proven to be more successful in combating poverty than its predecessors and it has also been far more effective at identifying the poor than the remaining social programmes over which it dominates.[22]

Following the world food crisis (in late 2007) and the subsequent global recession, the target number of beneficiaries was increased from 267,000 to 360,000 in April 2008. However, based on a poverty estimate in 2009 of 16.5 percent, and indications from public agencies that the poverty level has since risen, the number of Jamaicans currently living in poverty is over 440,000. The existing programme capacity is therefore inadequate to assist all poor citizens.

[22] See Levy and Ohls (2007).

Identification of Intended Beneficiaries

PATH has been more effective in identifying intended beneficiaries than its predecessors. Still, much consideration is being given to how to improve the identification process which is based on a proxy means test.[23] One deficiency is that the process tends to produce a bias against selecting urban citizens. In an attempt to compensate for this deficiency, the cut off score for urban areas was increased in 2008. The system also tends to exclude persons who may be genuinely in need of assistance due to unemployment as they may find it difficult to pass the proxy means test given their past accumulation of physical assets. This weakness is likely to become of greater significance should tax reform lead to structural improvements in the economy, which would be accompanied by temporary increases in unemployment.

II. List of Specific Recommendations and Sources

Action	Source
1. Extend the period of validity of the Tax Compliance Certificate (TCC) for taxpayers with a history of compliance.	The Blueprint
2. Design and implement a Unified Tax Return (UTR).	The Blueprint
3. Permit groups of companies to elect to form GCT Groups for the purpose of filing a single consolidated GCT return.	The Blueprint
4. Permit bi-monthly filing for small taxpayers.	The Blueprint
5. Double the income tax threshold.	CaPRI
6. Reduce the Corporate Income Tax rate from 33 $^1/_3$ % to 25%.	The Matalon Report
7. Eliminate zero-ratings on supplies to the Government.	The Blueprint
8. Prepare and present a tax expenditure budget as part of the budgetary process.	The Matalon Report
9. Eliminate discretionary waivers.	The Matalon Report

[23] The proxy means test is used in order to circumvent the challenge of persons falsely reporting income.

III. Comment on the Green Paper on Tax Reform

Maximizing the effectiveness of tax reform efforts requires clear priorities. Given the persistent stagnation of the economy and the negative implications of such an environment for sustainable revenue generation, the number one objective of tax reform in Jamaica should be to stimulate economic activity in order to achieve economic growth. Having examined the findings and recommendations of the most recent comprehensive reviews of the Jamaican tax system,[24] CaPRI has concluded that the top three priorities for growth-focused tax reform in Jamaica should be (i) to simplify the tax system (ii) to decrease reliance on direct taxes, and (iii) to eliminate the inefficient and ineffective use of tax concessions.

The Green Paper is consistent with (i) and (ii), namely, simplifying the tax system and decreasing reliance on direct taxes. Notwithstanding that broad consistency, some straightforward steps to achieving the first priority, simplifying the tax system, have been overlooked, such as,

- Extend the period of validity of Tax Compliance Certificates for taxpayers with a history of compliance (which would also be a part of a meaningful policy shift towards rewarding compliance), and
- Permit groups of companies to form GCT Groups that file a single consolidated return. Since GCT applies only to value added, this entails no loss of revenue for the government

In respect of decreasing the present reliance on direct taxes (i.e., income taxes), the Green Paper does suggest a reduction in income tax rates and a raising of the personal income tax threshold. However, the proposal in the Green Paper to also reduce the rate of GCT implies that a further reduction in reliance on the income tax could be effected by foregoing the GCT reduction. This would effect a stronger shift from easily-evaded income tax to the harder-to-evade GCT.

A weakness of the reform programme outlined in the Green Paper is the failure to articulate a more measurable commitment to the reduction of tax waivers and tax incentives. The proposals stop short of accepting the IDB proposal to get rid of discretionary waivers, and instead states an intention to "significantly reduce" them. This cannot be reconciled with CaPRI's conclusion that eliminating the inefficient use of tax concessions should be the *first* priority of growth-focused tax reform. It is of fundamental importance that policymakers accept that whenever concessions are used to provide an incentive for targeted recipients, they are simultaneously providing a disincentive for the rest of the economy by necessitating higher overall tax rates and by encouraging the exploitation of the tax code in making investment decisions.

To illustrate the quantitative importance of making progress on tax concessions, note that the potential revenue gain from eliminating all tax concessions is estimated to be 3.9 percent of GDP, an amount that would boost revenue by some 15 percent. The elimination of <u>discretionary</u>, but not statutory, waivers

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[24] "The Final Report of the Tax Policy Review Committee to the Government of Jamaica" (2005) commonly referred to as "the Matalon Report", "Tax Reform and Economic Development: The Jamaican Case" (2007) by Bahl and Wallace, and "A Blueprint for Taxation Reform in Jamaica" (2009) by the National Planning Summit Tax Reform Committee, referred to in this brief as "the Blueprint."

alone would raise revenue by 2 percent of GDP, which would be sufficient revenue to afford both a reduction of the corporate income tax rate from 33 1/3 to 25 percent and a doubling of the income tax threshold.

The elimination of discretionary waivers is also of paramount importance given that it is a necessary step to restoring fairness and integrity to Jamaica's tax system. As long as discretion is permitted in the application of taxes, taxpayers who are in equivalent circumstances won't all be treated in the same way and some taxpayers will aim to "get away" with as much as they can by soliciting discretion. Furthermore, those who are not benefitting from the discretion will be less inclined to comply, not only because of the sense of unfairness but also, in the case of businesses, because complying will diminish their capacity to compete with others who are benefitting from the discretion. From every angle, discretion encourages a culture of non-compliance.

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