ADDRESS

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"THE VALUE ADDED TAX, ITS IMPACT OF THE BAHAMAS: A CARIBBEAN PERSPECTIVE"

BY

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In my recent address, as part of the celebration of Bahamas' 40th Anniversary of its Independence, I called attention to the fact that the environment within which the development of Caribbean societies takes place has been subject to dramatic transformation.

I further stated that countries which failed or showed themselves as being too slow to adapt to their changed environment run the risk of falling behind in the race to development, and, at worst, of becoming failed societies.

This address today draws upon that perspective in offering an opinion on the likely impact of the introduction of a Value Added Tax on the Commonwealth of the Bahamas.

While the focus will be on issues related to the possible impact of a Value Added Tax, it would seem that justice can only be done to this subject if it is discussed within the context of a broader and interrelated set of issues.

That context was set out with wonderful clarity in an Article by A. Gabrielle Frasier at the 2001 Conference of the Caribbean Centre for Monetary Studies:

> ***"Can the Sir Stafford Sands Model of the Bahamian Economy Survive Today's Global Economy?"***

To be sure, the Global Economy within which Bahamas now has to operate is remarkably different from that which obtained when many of the structural and institutional characteristics which make up the Bahamian model were put in place in the late 1940s.

The Bahamas has now to find its way in a globalised economy which is governed, in large measure, by a body of international trade law which has been devised to give effect to a number of specific principles.

Among these is the principle that countries should as far as possible, reduce protection to domestic industries by reducing tariffs and removing other barriers to trade.

Another important principle is one that requires that tariffs and economic policies and regulations should be applied without discrimination among countries.

Of special interest to the Bahamas is the National Treatment rule in international trade law which prohibits the application of domestic taxes and regulations which discriminate between domestic and imported products and enterprise.

Such rules are now enforced and are enforceable by an international institution, the WTO, which has mechanisms for the settlement of disputes, and for the enforcement of penalties when countries are in breach of the rules.

Bahamas is the only country in the Western Hemisphere which is not a member of the WTO.

For a country whose economic activities and performance are influenced, to an extraordinary degree, by its participation in the global economic arena, it is inconceivable that the Bahamas will be able to indefinitely maintain this ***"odd man out"*** status where relating to a rules-based international economy is concerned.

The relevant issue therefore is not that as to whether Bahamas should become a member of the WTO. It is that as to how best the nation should prepare for and negotiate the terms of its participation in this critical institution, and how it should do so while giving equal priority to the other reforms that the forging of such a relationship with the global economy are sure to trigger.

The introduction and potential impact of a VAT in the Bahamas, have in, my judgement to be discussed in that broader context. It has to be viewed as an essential part of a broader suite of economic reforms which have to be implemented as a single, coherent undertaking.

In offering this broader framework, I do not seek to minimize the purely fiscal issues which have to addressed in the analysis of the proposal to introduce a Value Added Tax in the Bahamas.

In fact, the introduction of a Value Added Tax can be viewed as a necessary response to an evolving fiscal situation which derives from Bahamas' special domestic circumstances.

This country has a very narrow tax base that allows it to compete effectively with territories in its immediate neighbourhood, which are still colonies of

Britain, and which have economic structures similar to that of the Bahamas.

However, unlike them, the Bahamas is evolving a pattern of expenditure associated with its assumptions of all of the obligations of nationhood.

This is beginning to be reflected in the emergence of fiscal deficits, and the growth of the public debt. Although these at present are within international norms of acceptability, their projected trajectory is such that fiscal reform is required now to ensure that Bahamas does not eventually have to confront the kinds of fiscal challenges that are currently bedeviling so many of its neighbours in CARICOM.

This must constitute part of the rationale for fiscal reform, including a VAT in the Bahamas.

The introduction of a Value Added Tax in Bahamas, no matter how well intended or designed it is, will be sure to generate its own controversy largely because it will bring into the tax net activities that are not now such to indirect tax.

Indeed the 1774 statement of Edmund Burke continues to be true:

> ***"It is not given to men to tax and to please, no more than to love and to be wise."***

If I can however be allowed to draw from the Barbadian experience, I would judge that its successful introduction is not beyond the people of the Bahamas.

For a VAT was introduced in Barbados under more challenging circumstances that currently faces the Bahamas as you contemplate its introduction.

The VAT was introduced in 1997 at the same time as Barbados started to apply the programme of trade liberalization which had been agreed to when it acceded to membership of the WTO in 1994. Its introduction also coincided with the implementation of its obligations, as part of the CSME, to reduce its extra-regional tariffs from a high of 45% to 20%. It coincided with the OECD Harmful Tax Initiative threat to the functioning of our International Business and Financial Sector that helped to reduce the growth prospects of our economy.

Above all, the scale of fiscal adjustment that was intended to be accomplished by the move to a VAT by Barbados, far exceeded that now intended in the Bahamas. In Barbados, the VAT was used to replace 11 forms of indirect taxes, and 44 kinds of fees as a means of raising revenue.

Despite the challenges, the IMF’s publication, **“The Modern VAT”**, in evaluating the performance of the VAT in small countries, at page 168 cites Barbados as a success story.

On the face of it, the proposals set out in the Government of Bahamas’ White Paper ***“A VAT within a Reformed Tax System”,*** on balance suggests that this country is giving itself a reasonable change to successfully introduce a VAT.

Indeed the design features proposed for the VAT and the purposes it is intended to serve meet best standards and practices to be found in a VAT across the wide range of countries in which it is now the major form of taxation.

First, it is intended to be a broad based tax, levied at multiple stages of production, with the crucial essential feature that taxes on input will be credited against taxes on output.

It is in that capacity intended to be designed to ensure that the final base of the tax is consumption. In this regard deliberate provision is being made to shield exports and investments from the incidence of the VAT in a bid to use it, as elsewhere, as an instrument to promote greater efficiency and competitiveness in the domestic economy.

In conformity with best practice elsewhere, there is a clear commitment to use the invoice credit/method which should both help to discourage fraudulent reporting for tax purposes, and to more deeply embed proper accounting practices as a widespread feature of the Bahamian business community.

The concepts of exempt supplies and zero rating which are intended to be applied in the Bahamas are in keeping with the ordinary and widespread meaning of the terms as applied to the tax regime internationally. So too is the proposal to set a sales threshold to exclude much of the genuinely small businesses of Bahamas from the incidence of the tax.

Among its design features, there seems to be the intention to provide the VAT with a broad base, since there is intended provision for only a very narrow range of zero rated and exempt activities.

Another important proposed design feature is for a standard rate of 15%, and a lower rate of 10% for the Tourism Industry, with a view to making the tax easy to administer while at the same time benefitting the leading sector of the economy.

In addition, some of the purposes that clearly seem to have motivated the proposal to introduce the VAT, such as the prevention of cascading, which are given expression in the proposed design of the VAT, are to be found almost everywhere the VAT is applied.

In the case of Bahamas, there is a very special issue that has to be explicitly taken into account in the design of this VAT. Like the VAT elsewhere it has, for purposes of administration, to have a relatively simple structure, with only two rates, few exemptions and a relatively high threshold. It is intended to replace a tax regime characterized by very high rates of import duties. There is at the same time no intention to introduce taxes on income or corporation taxes as exists in other jurisdictions in the Caribbean.

The resulting new tax regime will therefore only succeed in generating an equivalent amount of revenue to that which it replaces if great care is first taken to accurately estimate, and then even greater discipline is exercised in maintaining the proposed broad base.

To be precise, the introduction of a VAT in the Bahamas will broaden the tax base especially by bringing a number of activities, particularly services into the tax net.

But in so far as income and profits will continue to be free of taxes, the overall tax base against which revenue is raised in the Bahamas will be smaller, in relative terms, that that of other CARICOM countries which have a VAT as well as taxes on income. The proposed rate of the VAT in the Bahamas will be the same as in most other Caribbean countries. With the proposed lowering of the rates of import duties, a VAT at the standard 15% rate will only serve its revenue generating objectives if discipline is exercised to maintain its base that it is given to begin with.

The size of the base will be such a critical determinant of the eventual impact of the VAT in the

Bahamas that two essential actions need to be carried out before the new tax is introduced.

The first relates to the need for the conduct of appropriate studies and simulations to gauge and to measure the proposed base, and to derive estimates of the likely impact of proposed design features of the new tax on prices, revenues and the productive sectors.

The Barbados experience emphasizes that this necessary research is a vital first step which must be mastered to ensure that the best decisions about the design features of the tax are made on the basis of the very best information.

Initially, decisions were intended to be made in Barbados regarding the VAT based on two reports of 1992 and 1993 which were basically baseline studies and which proposed a tax with single rate of 15% to replace the taxes to be abolished.

On coming to office in 1994, the administration I led decided to defer the date for the implementation of the VAT to enable a more intensive study to be undertaken to simulate the VAT empirically and scientifically, and to derive better estimates of its likely impact on the productive sectors, prices and on revenue.

The scope of the research that had to be undertaken in both the private and public sectors proved to be formidable. The research however yielded the empirical evidence which supported the structure and design of the VAT that was eventually introduced in 1997.

Secondly, the successful introduction and operation of a Value Added Tax require high levels of compliance. To deal with this, a very special challenge has to be recognized and mastered. The challenge is that the VAT is intended to simplify the tax system; but it is itself a complex tax to design and to administer.

To address this challenge, no effort should be spared to design and to have in place a fully competent VAT implementation unit before the VAT is introduced. In addition, the most comprehensive public relations outreach programme has to be undertaken to address the specific and legitimate concerns of the main target stakeholders and to solicit and secure their support for an initiative which carries its own intrinsic complications.

The drafting of the legislation for the VAT also has to draw from best practice. In particular, drafts have to make the subject of extensive discussion and refinement and the legitimate concerns of stakeholders have to be embraced and reflected in the Bill to be presented to Parliament to secure strong stakeholder sense of ownership of the new tax.

A systematic effort also has to be made to deal with the registration of those liable to pay the tax, and to iron out the transitional problems which are sure to arise as one tax regime is replaced by another. One major transitional issue is sure to concern the procedures that are put in to be in place to enable businesses to manage inventories as one tax regime is replaced by another.

The point in all of this is that no matter how sound may be the reasons for the introduction of a VAT, and no matter how perfect its features are in their conceptual design, the success of the new tax will depend on the strength and sensitivity surrounding the planning and administration of its introduction.

In the Bahamas, as elsewhere, where the introduction a VAT is accompanied by the abolition of a member of pre-existing taxes and the reduction of the rates of some that are allowed to remain in place, I cannot overemphasize how important it is to establish and prove the base of the tax before making adjustments.

A VAT on a large base that yields more revenue than required can always be adjusted and right-sized. But it is almost politically impossible to start with too narrow a base and to hope thereafter to expand it.

The case of Barbados and Belize is very instructive in this regard since the two countries introduced a VAT at virtually the same time.

The Government of Belize started with a tax with a base characterized by many exemptions. It could not meet the revenue or other requirements. The subsequent effort to attempt to broaden the base by reducing the number of exemptions brought the VAT into disrepute and led to its abolition.

In the case of Barbados, we started with as broad a base as possible and I gave the commitment to the public to review it after sufficient empirical evidence existed that the tax could get the job done in relation to the raising of revenue and its beneficial effects on the economy.

The VAT in Barbados was intended to yield the same revenue as the taxes it replaced. It yielded significantly more. Its yield and buoyancy having been established and verified, the fine tuning of the scope of its base was subsequently undertaken.

Policymakers in the Bahamas will have to contend with and to deal successfully with a number of other issues relating to the incidence and effects of a VAT.

First, a properly designed VAT is intended to be a tax on consumption, and to bring into the tax net a number of services which hitherto have not been liable to tax.

The case will be put that the relative burden will fall more heavily on the poor or those at the lower end of the income scale. The argument is therefore certain to be advanced that the tax is regressive in its effect and incidence, and that features should be built into its rate and base to offset any pain it inflicts on the disadvantaged and the genuinely poor.

Experience has shown that it is very difficult to address issues concerning the effects of the VAT on the poor by building special discriminatory features into the structure of the tax itself. It is better to collect the tax and distribute part of the proceeds through carefully targeted support programmes to the poor and the disadvantaged.

A number of special measures were used in Barbados to accomplish this end.

First, on the introduction of a VAT, a new Reverse Tax Credit was created. This new credit enabled persons below a specific income threshold to receive, on application, a tax refund even though they were not paying income tax. By this means, it was possible to refund part of the VAT to the poor.

Secondly, a new Poverty Eradication Fund was created and annually capitalized from the proceeds of the VAT to deal with poverty at the individual level. A new Social Enterprise Investment Fund was also established and capitalized to support the creation and operation of enterprises at the community level.

The opportunity was also grasped in Barbados, on the introduction of a VAT, to amend the income tax regime by increasing the threshold below which tax is payable, and by increasing the range of concessions and incentives to spur savings and investments by both the private sector and the individual tax payers.

Indeed, as a result of the buoyancy of the yield from the VAT, it was possible in Barbados to reduce the corporation tax from 40% to 25% and to introduce even lower tax rates on the small business sector.

The design and implementation of a VAT must also be undertaken in a manner that enable the leading sectors of the economy to lead and to ensure that the VAT helps to create conditions for the economy to grow.

In the case of Barbados, this was accomplished in part by applying a special concessionary rate of 7.5% to tourism and the hospitality industry, at a cost of $7 million to the Treasury.

The Offshore Financial and Business sectors were treated as the Export sectors they are, and were the beneficiaries of a zero-rating on their inputs under the Third Schedule of the Act. The domestic Financial Sector was accorded the status of an Exempt Supply, since, of course its output is savings and investment and the intention of a VAT is to tax consumption.

As said earlier, the purpose behind the introduction of a VAT is to evolve a tax regime which features a broader base with lower rates of taxes than that which it replaced.

The experience however is that such a worthwhile intention is frustrated by the practice of weakening the base of tax by the introduction of a number of exemptions over time.

I plead guilty in this respect. For having introduced the VAT and fine tuned its base to create conditions for fiscal sustainably and economic efficiency, I was subsequently persuaded to zero-rate the supply of computer hardware and software to support the country's move to a higher level of information technology sophistication.

The base of the VAT in Barbados has since then been further weakened by the introduction of a wider and wider range of zero-rated exemptions.

It is to be expected that in the Bahamas, there will be a similar clamour for any original base of the proposed VAT to be narrowed to support the perceived or expressed needs of sectors and groups.

As far as practicable, this should be resisted.

A related problem that must also be satisfactorily addressed with the introduction of a VAT is that of maintaining expenditure discipline.

Because of its very nature, the VAT tends to introduce a higher level of buoyancy to the tax system. The growth in revenues will tend to outstrip the growth of the GDP. There will be the appearance that the State is flush with cash, and that extraordinary expenditure claims on the Treasury can be made and sustained. Fiscal disorder can in consequence ensue, triggering in turn a need for adjustment to the VAT rate.

In many instances, in the Caribbean and elsewhere, where the original standard rate of the VAT has subsequently been increased, it has not been due to the revenue underperformance of the tax. It has been due to the lack or lost of expenditure discipline and control.

The recent experience regarding Barbados' fiscal affairs is a classic case in point.

It should also be borne in mind that the increase in the basic VAT rate to support the growth in expenditure can eventually prove to be counterproductive, for any tax that is set at too high a rate will suppress domestic demand and yield diminishing revenues.

In the final analysis, A Value Added Tax will only be successful in achieving the purposes of brining efficiency, simplicity and buoyancy to the tax regime, and helping to create the conditions for the sustained growth and development of the general economy if it is allowed to be vested with and retain the special characteristics it must have. These are a broad base, a relatively low standard rate, few exemptions, and a strong set of institutional arrangements to ensure high levels of compliance.

I said earlier that the outcome and effect of the introduction of a VAT in the Bahamas will be dependent not only on how the tax is designed, structured and implemented, but also on the terms and conditions attendant on the Bahamas accession to membership of the WTO.

The two matters ideally should be addressed as a single undertaking from a conceptual and planning perspective.

It is beyond the purview of the subject of this address for me to go into extensive discussion on matters relating to Bahamas’ accession to the WTO. I would cite the following as meriting priority attention.

First, accession to membership of the WTO will require that the Bahamas, in respect of the trade in goods, agree to a programme to reduce the existing level of tariffs and to dismantle the non-tariff barriers. Its market access commitments can and will bear upon the base of the VAT, and influence the extent of the revenue a VAT on services has to raise.

It has to be carefully negotiated, with appropriate transition arrangements agreed to in order to pre-exempt fiscal and economic dislocation.

The application of the principle of national treatment across the board to enterprises producing commodities is also a matter to which the Bahamas will have to pay close attention in relation to its negotiations under the GATT.

It is also, of course, well known that the GATT makes provision for an Agreement on Subsidies and Countervailing Duties.

This Agreement has special relevance for countries which have Special Economic Zones (SEZs), and has been the subject of a Special World Bank Policy Research Working Paper: ***“Implications of WTO Disciplines for Special Economic Zones in Developing Countries”*** by Creskoff and Walkenhorst.

Under this Agreement, direct subsidies that are contingent in law or in fact on the export performance of enterprises are prohibited.

However, the WTO Agreement on Subsidies and Countervailing Duties exclude from the definition of subsidies the core fiscal benefits provided by Special Economic Zones – exemptions from duties and taxes on goods exported from such zones.

The World Bank Study indicates that in addition to direct subsidies on export performance, there are a number of Government incentives related to the operation of SEZs which will be regarded as prohibited.

These include preferential transport and freight charges for export shipment, exemption or remission of indirect taxes on exports in excess of those on goods sold for domestic consumption, provision of export credit guarantees, and subsidies contingent on the use of domestic over imported goods, to name a few.

These matters should be the subject of close and careful attention in the Bahamas.

Barbados faces the challenge of having to make its concessions to international business operating in Barbados that are contingent on export performance WTO compatible by 2015. The Bahamas may wish to learn from this experience.

Happily for the Bahamas, there is no commensurate Agreement relating to subsidies under the General Treaty on Trade in Services of the WTO.

Equally, in negotiating a relationship with the WTO through the GATs, as a predominantly service producing economy the Bahamas, will find that it has more leeway than under the GATT because there is no requirement for across the board national treatment to be applied in relation to the trade in services.

Nonetheless, the GATTs make provision for the liberalization of the trade in services across 12 sectors, over 150 subsectors, and through 4 modes of services delivery.

The Bahamas will have to undertake careful research to negotiate the best terms of engagement across such a wide field of economic activity.

For, the terms of conditions under which Bahamas accede to the WTO by way of its GATTs commitment will bear very heavily on the future prospects of the Bahamian economy more than any other single undertaking.

In the final analysis, the ultimate effect of the introduction of a VAT and the accession of the Bahamas to membership of the WTO will be determined in large measure on whether a spirit of Governance can be brought to bear to develop a consensus on the critical aspect of the these two matters that can best promote the Bahamas' best interest.

The building of such a national consensus goes beyond the need for the adoption and support for sound technical positions, based on empirical findings. It requires that where common ground exists on the stated positions of otherwise contending parties, such common ground is recognised and held.

But above all, it requires recognition of the fact that if all agree that you cannot stand where you are, then all should simply have agree that you have to move.

This is the challenge facing all concerned in the Bahamas.

It is the common challenge from whose solution none should resile.

The decisions which have to be taken by the Government and people of the Bahamas in the near future will, in all probability, change the structure of the economy for ever.

It will be a great cause. But it is a cause which I am sure the Government and people of the Bahamas are more than capable of winning.

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