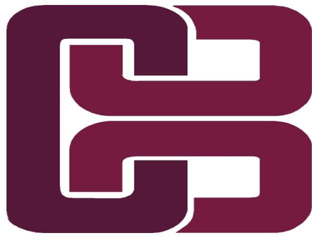

RESEARCH DEPARTMENT

FISCAL HARMONIZATION IN THE CARIBBEAN: A CASE STUDY OF THE VALUE ADDED TAX

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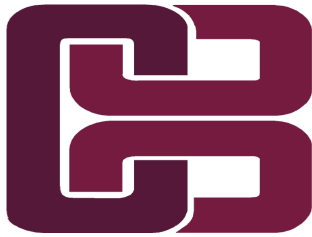

CENTRAL BANK OF
TRINIDAD & TOBAGO

Joseph Jason Cotton

Abstract

This paper examines the issue of fiscal harmonization within the Caribbean with emphasis on the Value Added Tax. It serves to accomplish three objectives; firstly, to examine some of the conceptual issues surrounding policy harmonization in a common market and the progress to date regarding initiatives towards fiscal harmonization in CARICOM. Secondly, it investigates the VAT experiences in three CARICOM member countries and finally, proceeds to explore the realities surrounding the harmonization of VAT within the Caribbean Single Market and Economy. Ultimately, this paper serves to be a catalyst for discussion and so continue the momentum towards the formation of a Single Economy within the Caribbean.

Introduction

One notable trend in the global economy within recent years has been the accelerated movement towards regional economic integration. The last decade has witnessed an unprecedented proliferation of regional arrangements. Between 1948 and 1994, 108 regional trade agreements were notified to the GATT or its successor, the WTO; 38 were in the five years ending 1994. Since creation of the WTO in 1995, at least 67 additional regional trade agreements have been reached, some pertaining to trade in services.

Amongst the attempts to establish free trade unions and common markets include: the Central American Common Market (CACM) in 1958; Latin American Free Trade Association (LAFTA) in 1961; Council of Arab Economic Unity (CAEU) in 1961; Central African Customs and Economic Union (UDEAC) in1964; Andean Sub regional Integration Agreement (ASIA) in1969; Caribbean Community (CARICOM) in 1973; Economic Community of West African States (ECOWAS) in1975 and Latin American Integration Association (LAIA) in 1980. However, the most advanced of these initiatives is the European Community (EC) established in 1975 and still in progress.

The economic case for regional integration is relatively straightforward and is premised on the fact that unrestricted trade allows countries to specialize in the production of goods and services that they can make most efficiently. Regional economic integration is therefore an attempt to achieve additional gains from the free flow of trade and investment beyond those attainable under international agreements such as GATT and WTO.

In this ever increasing globalizing world, Caribbean countries must pursue policies that enable us to benefit primarily from the expanding world market. Given the constraints of small size, significant degrees of openness and vulnerability to macroeconomic shocks we need to broaden our economic base through co-operation and pursue macroeconomic policies that reduce cost levels and increase efficiency. Whilst attempts have already been made in the form of the Caribbean Community (CARICOM), the Association of Caribbean States (ACS) and the Organization of Eastern Caribbean States (OECS), additional benefits can be achieved through closer co-operation.

The creation of the Caribbean Single Market and Economy (CSME) which emanated from the decision of the tenth meeting of the CARICOM Heads of Government in 1989 is an integral step in the effort to strengthen the Caribbean integration initiative. In effect the CSME is an attempt to create a larger, unified economic space within which productive efficiency and competitiveness could be achieved and regional growth accelerated, particularly through the expansion of exports to increasingly liberalized hemispheric and world markets.

This paper approaches the issue of Caribbean integration through an examination of fiscal harmonization and more specifically the Value Added Tax (VAT) as a means toward tax harmonization within the Caribbean community. It serves to accomplish three main objectives: firstly, to examine some of the conceptual issues surrounding policy harmonization in a common market and the progress to date regarding initiatives towards fiscal harmonization in CARICOM. Secondly, it investigates the VAT experiences in three CARICOM member countries and finally, proceeds to explore the issues surrounding the harmonization of VAT within the Caribbean Single Market and Economy.

SECTION I- CONCEPTUAL ISSUES

The concept of fiscal harmonization is a very broad one and the following section serves to provide a definition and highlight some of the key features so as to guide the rest of this research.

What is Fiscal Harmonization?

Fiscal harmonization may be viewed as the process of adjusting national fiscal systems to conform to a set of common economic aims. Fiscal harmonization can be either concerted or spontaneous and has two components: tax harmonization and public expenditure harmonization. Tax harmonization may be defined as the process of removing fiscal barriers and discrepancies between the tax systems of countries, states or provinces within a given area. Expenditure harmonization refers to joint-benefit public expenditure that yields

advantages of economies of scale to two or more member countries. Examples of such include the cost-sharing efforts of the University of the West Indies. The major challenge in expenditure harmonization is reconciling the distribution of costs with the benefits derived from the joint-benefit expenditure. Whilst in some cases the benefits may be measurable in others such as educational output, other services may be more difficult to assess. This paper will focus on tax harmonization and some of the conceptual issues identified in the available literature.

The Objective of Tax Harmonization

The objective of the harmonization of tax systems in common markets is to remove the inefficiencies associated with decentralized decision making. Amongst these inefficiencies are: double taxation of some forms of income and non-taxation of others, administrative costs are also likely to be excessive in an un-coordinated tax system, countries may also engage in beggar-thy-neighbour policies in order to attract economic activity from other states and states may also be induced by competitive pressures to implement tax measures which appear to be regressive from a national perspective. Ultimately a harmonized tax system should preserve the best features of tax decentralization and avoid its disadvantages. It should permit inter country diversity, reflect national preferences and minimize the net burden of benefits and costs of government intervention.

The Nature of Tax Harmonization

The concept can be classified according to several criteria: whether external or internal, the degree of harmonization and the component of taxation to be harmonized. External harmonization or "intra-jurisdictional" equity refers to the harmonization of taxation systems between countries and presupposes the process of establishing a wider regional economic grouping. Internal harmonization or "inter-jurisdictional" refers to the harmonization of taxation systems within countries with different levels of government and where fiscal functions are undertaken by lower level jurisdictions both on the expenditure and tax side, commonly referred to in the literature as fiscal federalism.

Levels of Tax Harmonization

There are also different levels of tax harmonization which relate directly to the varying stages of economic integration. The lowest level of economic integration is the free trade area. In a free trade area all barriers to the trade of goods and services among member countries are removed. In the theoretically ideal free trade area, no discriminatory tariffs, quotas, subsidies or administrative impediments are allowed to distort trade between member countries. Each country however is allowed to determine its own trade policies with regard to nonmembers. Within this arrangement countries are not under any obligation to harmonize taxes and as such we can have different taxes in different countries and the complete absence of any double taxation treaty and of any systematic administrative co-ordination between the tax authorities of the different countries over matters such as tax evasion. The customs union is one step along the road to full economic and political integration. A customs union eliminates trade barriers between member countries and adopts a common external trade policy which requires administrative machinery to oversee trade relations with non-members. This is the first movement away from "non-harmonization" since it involves a degree of tax administrative cooperation between tax authorities regarding tax affairs. The next step may be the negotiation of double taxation treaties so that the same income is not taxed twice by two or more different tax jurisdictions.

The common market is the next step towards full economic integration. Like the customs union there are no barriers to trade between member countries and a common external policy but have the additional feature of free movement of factors of production between member countries. An economic union entails even closer economic integration and cooperation than a common market. Like the common market, an economic union involves the free flow of products and factors of production between a member countries and the adoption of a common external trade policy. Unlike a common market, a full economic union also requires a common currency, harmonization of the member's tax rates and a common monetary and fiscal policy. The most extreme level of economic integration is the political union where the individual countries share a common government and the union is internationally treated as a single political entity. The literature describes two other levels of tax harmonisation to describe the levels of economic co-ordination in the economic union

and political union, they are complete harmonization and "nominal harmonization". Complete harmonization refers to the the standardization of taxes where each country has exactly the same tax system . "Nominal harmonization" is a slightly higher form of tax harmonization in that taxes not only have the same rate but are also levied on the same tax base or have the same administrative methods.

Theoretical Approaches to Tax Harmonization

The available literature identifies three approaches to tax harmonization: the equalization approach, the differentials or co-ordination approach and the competitive approach. The equalization approach seeks to achieve the highest degree of harmonization by the adoption of uniformity of the tax base and rates within an area. This approach seeks to achieve competition on equal terms and puts the interest of the area as a whole above that of individual member countries. The main advantage of this approach is the abolition of all market distortions and maximum efficiency in capital allocation. However, countries loose their sovereignty in economic policy making.

The differentials approach is premised on the fact that the tax system of each country functions as an instrument of economic policy and as such the different tax systems in the member states should be kept with the welfare of the union as the sum of the member's welfare. Inter-community effects of the different tax systems like cross-border taxation should be eliminated by co-ordination among the member states. The advantage is that tax policy is left to the member states rather than being imposed by the community. Further, the approach appreciates the different economic and social circumstances in each member state which justify different tax systems. The challenge to this approach is that the necessary co-ordination among member states in order to eliminate cross-border effects of different taxation systems may be much more difficult than harmonizing all the tax systems.

The competitive approach assumes that imposed tax harmonization is not necessary since under a single market competition among member states intended to attract capital will lead in the long term to an approximation of direct taxation. The limitations of this approach are:

the length of time it takes for taxes to be approximated, tax policy is not only determined by the attraction of investment capital but social policy and revenue generation. Finally, the competition approach presupposes absolute mobility of capital and zero transfer costs. This is only true for mere money investments like buying shares or giving credit all other assets face more or less immobility and subsequently a certain amount of transfer costs.

International Tax principles

Within open economies differences in taxation across countries may involve two international distortions. The first international distortion arises when a tax is levied by a country on all goods and services produced within its borders; this corresponds to the origin principle in international taxation. This principle states that commodities entering international trade are to be taxed at the rates prevailing in the country where they are produced, regardless of where they are consumed. This principle ensures neutrality if a uniform tax is imposed on goods produced in country, either for domestic consumption or exports. The destination principle implies that the international traded commodities are taxed at the rates in which final consumption takes place. This ensures that imports are taxed at the same rate as domestic substitute goods. The destination principle guarantees neutrality because different tax rates distort consumption.

Two other international tax principles are the residence principle and the source of income principle. The residence principle as applied to the individual income tax holds that all income earned by an individual, whether at home or abroad is taxable by his country of residence (and/or citizenship). The corresponding principle for corporation income tax is that of place of incorporation and/or management. The source of income rule says that income is taxable in the jurisdiction in which it originates.

Components of Tax Harmonization

Tax harmonization can occur on several components of taxation namely: an object of taxation, on the tax base, on the rules of tax payment and on the tax rate. Harmonization of an object of taxation would occur when member states all must tax a specified object of

taxation e.g. corporation tax. Harmonization of a base refers to the situation where regulation is laid down for principles and rules, which are applied to calculating the tax base. Harmonization of the rules of tax payment refers to regulations set for payment of a particular tax object; this is usually combined with harmonization of the tax base and rate. Harmonization of the tax rate can be conducted by fixing either a uniform, minimal or maximal rate at which the tax object is to be administered.

SECTION II-PROGRESS TOWARDS TAX HARMONIZATION IN CARICOM

Fiscal Policy Harmonization is one of the essential preconditions to CARICOM achieving its goal of becoming a single economy. Amongst, the others include: co-operation on sectoral policies, macroeconomic co-ordination, integration of capital markets and monetary co-operation. The EIPU reports that tax harmonization is a major requirement for the CSME to "operate smoothly" (CARICOM Secretariat 2002).[1]

The tax harmonization agenda emerged from what the Heads of Government of CARICOM described as "the emergence of tax competition" (CARICOM Secretariat 2002, p.8). Tax competition occurs as resource scarce countries compete to attract investment income from potential jurisdictions. It often results in the implementation of tax measures that are not in the host countries best interest and ultimately beggar-thy-neighbour policies. A harmonized tax system would remove this inefficiency from the taxation system by causing investors to choose criteria, other than differing tax structures to make investment decisions.

Technical work towards the achievement of fiscal policy harmonization is still in a preliminary stage; nevertheless several valuable lessons can be identified from the existing initiatives. The Council of Finance and Planning (COFAP) has established a working group on Fiscal Policy which is in the process of developing a framework and guidelines for tax harmonization in CARICOM.

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[1] Presentation by EIPU to the CARICOM Secretariat. "Exploring Caribbean Tax Structure and Harmonization Strategies", CARICOM Secretariat, Guyana, 2002.

Policy Harmonization Initiatives

Much of the progress that has been made towards fiscal policy harmonization has occurred in the area of initiatives to promote policy harmonization. Amongst these initiatives include: the ratification of the revised treaty of Chaguaramas which governs the fiscal policy harmonization process, the intra-CARICOM double taxation agreement and the agreement to the harmonization of corporate tax structures.

Revised treaty of Chaguaramas

In 1973 the Revised Treaty of Chaguaramas established the foundation of the integration process by the formation of CARICOM. This was originally designed to be a common market arrangement that removed barriers to trade in merchandise and set up a common external tariff. To further deepen the integration process, CARICOM Governments decided in 1989 to establish the CSME. This would create a single market in which all the factors of production would move freely and through legislation, executing instruments and institutions also create a single economy of harmonized economic and monetary policies.

The provisions for the CSME were inscribed in nine (9) protocols amending the Treaty of Chaguaramas. This was referred to as the revised treaty of Chaguaramas which was ratified in January 2006 and marked the implementation of the Single Market component of the CSME and provides in principle for most aspects of the Single Economy. The revised treaty contains provisions to facilitate the establishment of single economy through harmonization, co-ordination and convergence of macroeconomic policies in a number of areas including: capital market integration and development, investment and incentives, policy harmonization, fiscal policy harmonization, corporate tax harmonization and a monetary union.

One distinguishing feature of the Treaty of Chaguaramas that differentiates the integration approach of the CSME from that of the European Union is that the community's single

market and economy would operate “as a unit of sovereign states”, not as a single union like the EU. The approach of the EU as documented in the Single European Act (1986) was to create a single economy with the complete removal of physical, technical and fiscal barriers from market transactions. The Single European Act was incorporated into the Treaty of Rome to provide “an area without frontiers in which free movement of goods, persons, services and capital is ensured”. The revised treaty of Chaguaramas however seeks to achieve economic integration within a framework and under procedures where there is no commitment to any form of Caribbean union. The central issue that separates these two approaches to economic integration is that of national sovereignty.

Regional Investment Policy Framework

The ratification of the revised treaty of Chaguaramas provides the legal framework for all of the other policy harmonization initiatives, a key one of which is the Regional Investment Policy Framework. The harmonization of investment policy in the Caribbean is central to directing tax harmonization policies. The community investment policy will be guided by the following articles of the revised treaty of Chaguaramas:

Article 68- Community Investment Policy

COTED in collaboration with COFAP and COHSOD shall establish a community investment policy which shall include sound national macroeconomic policies, a harmonized system of investment incentives, stable industrials relations, appropriate financial institutions and arrangements, supportive legal and social infrastructure and modernization of the role of public authorities.

Article 69-Harmonization of Investment Incentives

The member states shall harmonize national incentives in the industrial, agricultural and service sectors. COFAP shall give due consideration to the peculiarities of the industries concerned without prejudice to the generality of the foregoing may provide for the following:

- National incentives to investment designed to promote sustainable export-led industrial and service-oriented development

- Investment facilitation through the removal of bureaucratic impediments; and
- Non-discrimination in the granting of incentives among Community nations

Articles 32-43 Regulatory Standstill and Relaxation of Existing Measures

Article 32	Prohibition of New Restrictions on the Right of Establishment
Article 33	Removal of Restrictions on the Right of Establishment
Article 36	Prohibition of New Restrictions on the Provision of Services
Article 38	Removal of Restrictions on Banking, Insurance and Other Financial Services
Article39	Prohibition of New Restrictions on Movement of Capital and Current Transactions
Article 40	Removal of Restrictions on Movement of Capital and Current Transactions
Article 41	Authorization to Facilitate Movement of Capital
Article 43	Restrictions to Safe-guard Balance-of-Payments

Other Supporting and Related Articles

Article 65	Environmental Protection
Article 66	Protection of Intellectual Property Rights
Article 168-186	Competition Policy and Consumer Protection
Articles187-224	Dispute Settlement

A special CARICOM appointed technical team is in the process of developing this regional investment policy framework which will include; a common investment policy framework which will include; a common investment code, a harmonized incentives regime, a streamlined approval process and the implementation of national investment policy reforms. In its completed form this framework will guide investment from both Intra-CARICOM and Extra-CARICOM sources.

The Intra-CARICOM Double Taxation Treaty

Another of the policy harmonization initiatives is the Intra-CARICOM Double Taxation Treaty. This is guided by Article 72 of the revised treaty of Chaguaramas which is stated as follows:

Article 72. The member states shall conclude among themselves on agreement for the avoidance of double taxation in order to facilitate the free movement of capital in the

community. The member states shall conclude their double taxation agreements with third states on the basis of mutually agreed principles which shall be determined by COFAP.

The Intra-CARICOM Double Taxation Agreement ("The Treaty") was ratified on 29 November 1994 and replaced the 1973 tax treaty ("the LDC/MDC Treaty") which was concluded between the more developed countries ("MDC") within CARICOM, i.e. Barbados, Guyana, Jamaica and Trinidad and Tobago and the less developed CARICOM countries ("LDC") being Antigua, Belize, Dominica, Grenada, Montserrat, St. Lucia, St. Vincent and St. Kitts and Nevis and Anguilla. The Treaty was intended to encourage and facilitate trade and investment between residents of all CARICOM member states who ratified the Agreement and sought to rectify its predecessor's limitations. In particular the treaty was designed not only to stimulate international trade and investment between the MDCs and LDCs but among the MDCs themselves. Additionally, it removed the barrier of the high effective rate of tax levied on income from one CARICOM territory by a resident of another.

An example of this situation is when a company in Trinidad and Tobago acquires a subsidiary company in Jamaica. Dividends received from the Jamaican subsidiary would have been subject to a 331/3% withholding tax in Jamaica. The dividends would also have been subject to tax in Trinidad and Tobago at the prevailing corporation tax rate with a credit for half of the Jamaican withholding tax. Assuming a Trinidad and Tobago corporation tax rate of 30%, the dividends would be subject to tax in Trinidad and Tobago of approximately 16.67%, giving rise to a combined effective tax rate of the dividend in Jamaica and Trinidad and Tobago of 46.67%. The effective rate would be even higher once account is taken of the tax on the profits of the Jamaican company out of which the dividend would have been paid.

The distinguishing features of the treaty is that it is a multilateral treaty, provides for income arising in one CARICOM territory by a resident of another to be taxed only in the source country and exempts dividends payable by a company resident in one CARICOM territory from taxation both in the country in which the income arises and in the country in which the

shareholder is resident. Therefore, dividends received by the Trinidad and Tobago company in respect of investment in its Jamaican subsidiary in the previous example would not be subject to any withholding tax in Jamaica and no tax in Trinidad and Tobago.

The treaty helped level the playing field so that investment decisions by investors within CARICOM are now based mainly on commercial grounds rather than on tax considerations and this encourages companies to cross-list shares on the stock exchanges in the region. The treaty is however not as generous in its treatment of income derived from trading activities carried on by a resident of one member state in another through a branch, where the country in which the branch is located levies a branch remittance tax on remittances or deemed remittances of profits to the head office. While the Treaty provides for the branch profits to be taxable only in the country in which the branch is located, it does not appear to restrict the rights of the source country to levy its branch remittance tax. The countries which currently levy a branch remittance tax, are Barbados (10%), Dominica (15%), Guyana (15%), St. Vincent (15%) and Trinidad and Tobago (10%). This means that profits derived from a branch operation established in a country, which levies a tax, is treated less favorably than dividends derived from a subsidiary in those countries.

The Harmonization of Corporate Tax Structures

A third policy harmonization initiative is the harmonization of corporate tax structures. The agreement resulted from the 1992 decision of the heads of Government to accelerate implementation of the CSME. This initiative is guided by article 40 of the original treaty which required that member states agree to study the possibility of approximating income tax systems and rates with respect to companies and individuals. The need to harmonize corporate tax structures was to encourage investment decision making to be based on efficiency criteria and not differences in tax rates among CARICOM countries which alter investment decision making.

Tax Harmonization Initiatives

Very little has been accomplished in terms of actual tax harmonization. Perhaps one of the few illustrations of tax harmonization can be seen in the introduction of the Common External Tariff (CET). The CET formed part of a larger trade reform programme during the period of structural adjustment of the 1990s and included the elimination of the import negative list, the phased reduction of the CET on imported goods, the removal of price controls, the removal of stamp duty on imported goods and the computerization of customs imports and exports procedures.

On the expenditure side, it would be noted that limited progress has also been achieved in terms of expenditure harmonization in joint benefit public expenditures. The two that can be identified are: the University of the West Indies and the Development of the Regional Development Fund.

One of the primary reasons for the delayed initiation of the Single Market and slow progress of the Single Economy is the concern by many nations of the potential loss of national sovereignty. Even the Regional Development Fund is being interpreted as an instance of shared sovereignty among CARICOM Government to allay some of the fears of the loss of sovereignty associated with the integration efforts.

Lessons from Existing Harmonization Initiatives

The following four lessons can be derived from the previous harmonization initiatives: Firstly, there is the need for mechanisms of enforcement for existing legislation to ensure their success. This is necessary since even though the legal framework existed and was revised to guide economic integration, progress has been slow. This raises another issue whereby the root of the problem may not be the legal framework but that the CSME commitments are based on higher levels of political commitment than previously exist.

Secondly, the harmonization of taxation cannot be conducted in isolation. To achieve community buy-in, the tax harmonization framework must be conducted in accordance with the overall development programme of countries and must reflect their priorities.

Thirdly, tax harmonization must go beyond just rationalizing tax systems but must seek to narrow the distortions that may impede free market access. Policy makers also need to recognize the delicate trade-off between national sovereignty and the development o CARICOM in regional harmonization. Finally, the CSME requires the establishment of new community institutions, these institutions should seek to address the removal of disincentives associated with integration whilst ensuring an equitable distribution of its benefits.

SECTION III - THE VAT EXPERIENCES IN TRINIDAD & TOBAGO, BARBADOS & JAMAICA

The rise of VAT has been an unparalleled tax phenomenon. It is no longer a tax associated with the European Community (EC) but has been adopted by several developing countries over the past 25 years. Today, over 135 countries around the world utilize VAT, with it contributing either the largest or second largest source of tax revenue (see table 1).[2]

[2] The International Tax Dialogue: VAT Conference hosted by IMF, OECD and the World Bank, March 15-16, 2005, Rome, Italy.

Table 1: The Spread of VAT

	Sub-Sharan Africa	Asia and the pacific	EU 15 plus Norway and Switzerland	Central Europe and FSU	North Africa & Middle East	Americas	Small Islands
Total 2/	33 (43)	18 (24)	17 (17)	27 (28)	9 (21)	23 (26)	9 (27)
1996-Present	18	7	0	6	2	1	3
1986-1995	13	9	5	21	5	6	6
1976-1985	1	2	0	0	2	6	0
1966-1975	0	0	11	0	0	10	0
Before 1965	1	0	1	0	0	0	0

Sources: International Bureau of Fiscal Documentation (IBFD, 2004); AND Corporate Taxes 2003-04, Worldwide Summaries (Pricewaterhouse Coopers)

1/ Regions defined as in Ebrill and others, 2001, except Serbia and Montenegro included in Central Europe.
2/ Figure in parenthesis is number of countries in the region.
3/ Island economies of under 1 million, plus San Marino.

During the 1980s and 1990s the majority of the region's economies embarked upon efforts to reform their tax and tariff policies and to modernize their administrative structures. These reforms were geared towards: revenue adequacy, neutrality in resource allocation, equitable distribution of the tax burden and streamlining of rules and procedures. Given the fact that revenue sustainability is perhaps one of the greatest challenges facing most Caribbean territories emphasis was placed on the efficiency of the new taxation system and there was a general move to increase reliance on indirect taxation as imposed to direct taxation. Within the reform efforts the VAT became the tax base of choice for the region's fiscal authorities. VAT was introduced to replace a number of different taxes which were seen as "nuisance taxes" that covered essentially the same base. Amongst the taxes that were replaced were: consumption tax, excise duties, package tax, hotel occupancy tax, etc. Replacing these taxes with a single tax measure would simplify the taxation system and essentially reduce compliance costs. This section takes a closer look at the VAT system and the experiences of three countries within the Caribbean namely: Trinidad and Tobago, Barbados and Jamaica with VAT.

An Overview of the VAT system

While there are many variations on the structure of the VAT and how it is implemented, there is wide agreement on two core issues: the first is that the final base of the tax is consumption and secondly, the invoice credit method is the most preferable.

In reality however, there are four possible ways to calculate value added, two from the additive side (wages and profits) and two from the subtractive side (output minus inputs). In both methods value added can be calculated both directly and indirectly, the indirect method is so called because value added itself is not calculated but only the tax liability on the components of value added. The following equation further explains these concepts:

Value added = wages + profits = output – input

Methods of calculating value added:

1. t (wages + profits) : the additive-direct or accounts method
2. t (wages) + t (profits): the additive-indirect method
3. t (output – input): the subtractive-direct (also an accounts method, sometimes called the business tax transfer)
4. t (output)- t (input): the subtractive-indirect (the invoice or credit method and the original EC model). This method requires the firm to calculate its tax liability on total sales and subtract the tax paid on goods purchased in the current period or in other cases, the tax paid on goods purchased in the previous period.

Most taxes are levied by first calculating the tax base (e.g. income, sales, wealth, property values, etc.) and then applying a tax rate to that value. However, with the VAT the most popular method in indirect, where a tax rate is applied to a component of value added (output and inputs) and the resultant tax liabilities are subtracted to get the final net tax payable.

Four reasons are advanced for the popularity the indirect method of VAT calculation[3], they include: the invoice method attaches the tax liability to the transaction, it creates a good audit trail, the accounts based methods (methods 1&2) need to identify profits and finally, it is the easiest method. The fact that the invoice method attaches the tax liability to each transaction makes it legally and technically superior to other forms. Additionally, these invoices create a good audit trail. Without the invoice two problems emerge; the first is ensuring that inputs are deducted only when tax is paid and when inputs exceed taxable sales. Thirdly, to utilize methods 1 and 2 profits would have to be identified. Company accounts do not usually divide sales by different product categories coinciding with different sales tax rates nor do they divide inputs by differential tax liabilities and as such the only VAT that can be levied on an additive basis would be a single rate VAT. Finally, the easiest way to calculate a VAT, Using the subtractive method, appears to be the calculation of the value added (output minus input) and then apply the tax rate to that figure. In practice firms do not find it convenient to calculate their value-added in this way month by month, as purchases, sales and inventories can fluctuate greatly. Calculating the direct value added is easiest through the trader's annual accounts and so in this method deriving a VAT (in addition to methods 1&2) is also an "accounts method". Thus to date method 4, the invoice or credit method is the only practical one. It is the method that allows the most up- to-date assessments since tax liability can be calculated weekly, monthly, quarterly or annually.

The VAT therefore is a tax on value added levied on all sales of commodities at every stage of production and distribution. Its primary advantage over other similar taxes e.g. retail sales tax is that VAT revenue is collected throughout the production process as opposed to the retail sales tax which is collected only at the point of sale to the final consumer. The "cascading" or "tax on tax" distortion that arises when taxes are charged on both an input into a process and the output of that same process is avoided as producers can reclaim the tax they are charged on their input. The mechanism of the VAT system also fosters greater transparency since all firms whose annual turnover exceeds a specified threshold must participate and not only those involved in making final sales to consumers. If the VAT

[3] Refer to Article if Fiscal Policy notes ("Why a Value Added Tax?")

functions as intended it will be equivalent to a sales tax on the final commodities, since the value of a final good will equal the sum of the values added at each stage of production.

The VAT is normally applied as a destination-based tax which means that it is imposed on imports and domestically-produced goods but not on exports. If the VAT is working properly exports receive rebates equal to the amount of VAT paid in the course of producing the item whilst imports are charged VAT at the same rate as domestically-produced goods.

In the calculation of VAT special provision needs to be made for the treatment of capital goods in either the output-input or accounting methodologies. If we utilize the output-input method purchases of long lasting inputs like capital would be deducted from sales for the particular period and may lead to significant negative value added in the succeeding months. Conversely, in the additive method profits are calculated after allowing for a portion of the cost of capital purchases (depreciation). In the output-input calculation of value added all goods purchased for business use are excluded from the tax base during the period in which they are purchased. The accounting variety of VAT also exempts all capital goods from the tax.

One simple illustration if the VAT is: suppose Firm A sells its output (assuming no material inputs) to Firm B for $110 (Price includes 10% VAT). Firm A can then remit $10 to the government in tax. Firm B then sells its output to final consumers for $440 (price includes VAT 10%). Firm B can remit $30 in tax, the output tax of $40 less a credit for the $10 of tax charged on its inputs. The Government therefore collects $40 in revenue. The economic effect would be the same as if the government charged a 10% sales tax on the final sale, nevertheless the advantage of the VAT system is that it protects against non-receipt of collections if Firm B somehow manages to avoid paying taxes. In this situation the government will still benefit from the receipt of $10 from firm A. If a retail sales tax was in place the government would receive no revenue in cases of tax avoidance or evasion.

At least four options are available in implementing a VAT system: implementation of the standard rate, a special rate, exemption of the service and zero rating of goods and services.

The standard rate is the highest rate whilst the special rate is slightly lower and applied to goods and services where it is believed that their viability would be impaired by application of a higher rate of taxation. The structure of VAT provides two mechanisms for excluding goods and services from the tax base: exemption and zero rating. The major distinction between both is that for zero-rated goods the seller receives a credit for taxes paid on inputs but in both cases the VAT does not apply to the sale of goods. All registered firms have to file a return either on a monthly or quarterly basis, these returns are then checked by the Board of Inland Revenue and fines are payable for late or falsified claims. The standard advice has been for a single-rate VAT, however, throughout the world countries have sought to design the VAT to suit the uniqueness of their domestic economies. . Table 2 provides information of the distribution of VAT around the world.

Table 2: Distribution of VAT rates[1]

One Rate	Two Rates	Three Rates	Four Rates	Five Rates	Six Rates
51	30	13	5	1	0

Sources: International Bureau of Fiscal Documentation (IBFD, 2004); AND Corporate Taxes 2003-04, Worldwide Summaries (Pricewaterhouse Coopers)

[1] Figure is percentage of all countries currently with a VAT with numbers of VAT rates shown.

The fundamental rationale for the implementation of VAT is dis-satisfaction with the existing tax system. This dissatisfaction may fall into any one of the following categories: the existing sales taxes are unsatisfactory, a customs union requires discriminatory border taxes to be abolished, a reduction in other taxation is sought or the evolution of the tax system has not kept pace with the development of the economy. The advantage of VAT is that it is a broad-based tax levied at multiple stages of production therefore revenue is secured by being collected throughout the production process (unlike a retail sales tax) but without distorting production decisions (as a turnover tax does). Additionally, it is argued that VAT can generate more revenue with less administrative costs than other broad based taxes and finally, it ensures neutrality in international trade by freeing exports of tax and treating imports and domestically produced goods the same. Perhaps the greatest disadvantage of VAT is the high administrative and compliance cost associated with setting up the system, especially for countries which did not previously have similar multi-stage

taxes existing before. Additionally, the regressive nature of VAT places additional burden on the poor in society.

Country Experiences with VAT (Trinidad and Tobago, Barbados and Jamaica)

Trinidad and Tobago

The VAT Act 1989 became operational on January 1, 1990 as part of a comprehensive tax reform process in Trinidad and Tobago. The tax is applied at the rate of 15 per cent and levied on domestic consumption and imports of goods and services.

VAT Performance

The available VAT data for Trinidad and Tobago for the period 1990-2005 reveals that collections from VAT gradually increased from $926.6 million to $3,218.5 million with little fluctuation (see table 4). VAT receipts, as a percentage of total tax revenue was relatively stable between 1990-2005, averaging around 19 per cent until 2003 when there was a slight decline in the VAT/ total tax revenue ratio to less than 15 per cent. Throughout the period 1990-2004 the VAT/GDP ratio has on average been 4.2 per cent. Within the local context, however, the VAT/GDP ratio may be misleading since domestic production includes the Petroleum Sector. As a result Non-oil GDP is a better indicator to measure the contribution of VAT to the domestic economy, the average VAT/ Non-oil GDP ratio for the period 1990-2005 is 6 per cent. The VAT/GDP ratio is low (4.2 per cent) when compared with other countries, e.g. Morocco (6.1% of GDP), Tunisia (6.7% of GDP) and is less than the average for middle-income countries (5.6% of GDP). Table 3 provides greater details of VAT/GDP ratios in selected countries.

Table 3: VAT/GDP ratios in selected countries

Country	Denmark	Hungary	West Bank and Gaza	Jordan	Tunisia	OECD average for 3 countries	Morocco	Middle-income countries average	Trinidad and Tobago
VAT/GDP	**9.7**	**9.4**	**9.1**	**7.2**	**6.7**	**6.2**	**6.1**	**5.6**	**6.0**

Source: IMF Working Paper (WP/02/67), and Ministry of Finance, Trinidad

VAT Efficiency

Given that the VAT was originally introduced as a mechanism to deepen the revenue base of the implementing country, the question of the efficiency of the system is always of utmost concern. The principal measure to gauge the efficiency of the VAT system is the C-efficiency ratio. This was introduced to replace the shortcomings of its predecessor the efficiency ratio that is simply the ratio of VAT revenue to GDP, divided by the standard VAT rate. The average efficiency ratio for VAT in Trinidad and Tobago since the implementation of the VAT is 28.2 per cent. Whilst this is very low it should be noted that VAT impacts principally on consumption and as such a more accurate measure of its effectiveness is consumption expenditure as a base rather than GDP. This is reflected in the C-efficiency ratio, which measures the ratio of VAT revenue to consumption divided by the standard tax rate.

Table 4: The VAT in Trinidad and Tobago 1990-2005

Year	Actual Net-VAT (TT$Mn)	Total Tax Revenue (TT$Mn)	GDP (TT$Mn)	Consumption Expenditure (TT$Mn)	VAT/Total Tax Revenue (%)	VAT/GDP (%)	Efficiency Ratio	C-Efficiency Ratio
1990	926.6	4,796.6	21,539.3	11,432.3	19.3%	4.3%	28.7%	54.0%
1991	1,054.4	5,697.3	22,558.6	13,363.5	18.5%	4.7%	31.2%	52.6%
1992	968.6	5,278.3	23,118.1	13,674.4	18.4%	4.2%	27.9%	47.2%
1993	1,163.1	5,698.0	24,986.9	15,490.9	20.4%	4.7%	31.0%	50.1%
1994	1,259.0	6,273.1	29,311.7	15,027.2	20.1%	4.3%	28.6%	55.9%
1995	1,344.8	7,198.8	31,697.0	15,478.7	18.7%	4.2%	28.3%	57.9%
1996	1,413.9	8,059.7	34,586.6	17,130.8	17.5%	4.1%	27.3%	55.0%
1997	1,623.9	7,659.3	35,870.8	20,701.7	21.2%	4.5%	30.2%	52.3%
1998	2,153.9	7,912.5	38,065.1	21,911.1	27.2%	5.7%	37.7%	65.5%
1999	1,637.5	8,241.4	42,889.1	25,105.1	19.9%	3.8%	25.5%	43.5%
2000	2,037.7	11,301.8	51,370.6	29,356.8	18.0%	4.0%	26.4%	46.3%
2001	2,178.7	11,326.3	55,007.2	30,856.1	19.2%	4.0%	26.4%	47.1%
2002	2,401.0	12,149.7	56,290.0	33,402.5	19.8%	4.3%	28.4%	47.9%
2003	2,272.2	15,641.7	67,301.6	34,592.0	14.5%	3.4%	22.5%	43.8%
2004	3,099.6	19,498.5	76,892.3	37,159.5	15.9%	4.0%	26.9%	55.6%
2005	3,218.5	28,085.7	90,454.6	n.a.	11.5%	3.6%	23.7%	n.a.
Average					**18.8%**	**4.2%**	**28.2%**	**51.6%**

Source: Central Bank of Trinidad and Tobago

It should be noted though then even utilizing the C-efficiency ratio the average efficiency for VAT is still only 51.6 per cent. This ratio is particularly low when compared to other small islands that are considered effective in raising revenue from VAT; they have efficiency ratios of 48 and C-efficiency ratios of 83, The EU received a C-efficiency ratio of 64 and Central Europe 62. In fact, C-efficiency ratios for small islands are strikingly high averaging 65 per cent, about the same as for the European Union countries (Ebrill, 2002). Table 5 provides greater detail about the effectiveness of VAT in selected regions of the world.

Table 5: The effectiveness of VAT in selected regions

Ratios	Sub-Saharan Africa	Asia and the Pacific	Americas	EU (plus Norway and Switzerland)	Central Europe and BRO[1]	North Africa and Middle East	Small Islands
Efficiency Ratios	27	35	37	38	36	37	48
C-efficiency ratios	38	58	57	64	62	57	83

Source: IMF Publication, The Allure of the Value-Added Tax

[1] Baltic States, Russia, and other countries of the former Soviet Union

Factors undermining the performance of VAT

The key question therefore, is what is contributing to the inadequate performance of the VAT system. Amongst the reasons include: adjustments to the VAT threshold, increasing exemptions and zero-ratings, provisions for input credits for capital purchases, the evolution and structure of consumption expenditure and the administration of the system.

Adjustment of the VAT threshold

The VAT threshold determines the size of the companies that are legally required to register for VAT. Companies that do not register cannot claim the VAT paid on purchases and cannot charge VAT on sales. If this threshold is set too low it places additional administrative pressures on the system and may lead to a weakness in the VAT system. The

failure or near- failure of the VAT systems in Ghana and Uganda was attributed to low registration levels. In Ghana the initial registration level was set at $20,000 when introduced in 1995 compared with $75,000 after its successful reintroduction in 1999. Uganda's VAT nearly failed when it was introduced in 1996, with a threshold level of $20,000, which was subsequently raised to $50,000. A rule of thumb is to set the threshold at the point where the collection costs saved are balanced against the revenues lost[4]. In reality, higher threshold levels tend to be more efficient since the value-added base is normally concentrated amongst a few firms. Whilst improvements have been made over the years the VAT threshold level in Trinidad and Tobago was initially set very low ($120,000) when introduced in 1990. This was further reduced to $100,000 in 1995. However, improvements have been made to the VAT threshold level as it was increased to $150,000 in 1996 and then $200,000 in 2000.

The evolution and structure of consumption expenditure

Another reason for the underperformance of VAT is the evolution and structure of consumption expenditure since the period of structural adjustment. In the late 1980s consumption expenditure comprised a high proportion of Gross Domestic Expenditure; this proportion averaged 75 per cent in the period 1987-1994. This was reduced to 68.8 per cent in the period 1995-1999 and now averages 63.4 per cent for the period 2000-2004. Since VAT is a consumption-based tax a reduction in consumption expenditure would lead to an undermining of the VAT revenue base.

Zero-rating and Exemptions

Additionally, the VAT base is also being eroded by an increase in exemptions and zero-rating of goods and services. It has been estimated that since 1990, approximately 56.2 per cent of consumption is presently VAT exempt (see appendix table 1).[5] The low C-efficiency ratio of VAT corresponds with tax elasticity estimates for the same period. After the period of tax reform indirect taxes received an elasticity coefficient of 0.83 indicating that it has not

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[4] IMF, The Allure of VAT

[5] Current Fiscal Problems and Related Issues Facing Caribbean States: The Outlook for Trinidad and Tobago, Penelope Forde

been effective as a source of revenue generation. [6] This result is further reinforced by another independent study by Ramsaran and Tang (2002) who estimated tax buoyancy coefficient for indirect taxes at 0.85 and VAT at 0.95 for the period 1990-2001.

One of the significant shortcomings of the VAT system in Trinidad is the zero-rating of natural gas and crude oil. Over the past five years the domestic energy industry has evolved from the predominance of oil to natural gas. This phenomenon has necessitated adjustments to be made to the oil and gas taxation regime which were announced in the 2006 budget. The energy sector contributed approximately 42.9 per cent of GDP in 2005 and whilst the effect of zero-rating gas was initially negligible since it was used by only a few industries, more industries are currently utilizing natural gas. These economic conditions require changes to be made in the VAT system to reflect the evolving dynamic of the economy. In 2005, exports from the petroleum, gas and petrochemical sectors represented approximately 85.9 per cent of total exports (US$ $8,834 Million) with petroleum exports contributing US$ 3,308 Million and gas and petrochemicals contributing US$ 2,632 Million and US$1,922 Million respectively.

Administration

The VAT is administratively demanding. The introduction of VAT has occasionally disrupted the functioning of an existing administration system because of inadequate preparations and/or ill-advised implementation decisions. A minimum planning period of three years was required before the implementing the VAT in the ECCU[7]. Experience shows that it takes 18-24 months to implement a VAT effectively.[8]

One of the biggest administrative burdens to the existing system is the current exemptions to oil companies. VAT refunds from these exemptions averaged 46 per cent of gross VAT collections between the years 2000-2004, from a low of 41 per cent to a high of 55 per cent. Sixty five per cent of the refund claims are from the petroleum sector for VAT paid on non-

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[6] Tax Reform and the Changing Direct/Indirect Tax Revenue Mix in the Caribbean, Dave Seerattan and Leslie Charles

[7] The Relevance of the VAT to ECCU Member Countries, Laurel Bain

[8] The Value Added Tax: Experiences and Issues, International tax Dialogue Conference, March15-16, 2005

oil purchases especially capital equipment for the development of oil fields and a large part of this production is for export. The auditing of the system is dominated by pre-refund verification as a result making the audit program inefficient. A well designed audit program is the key to reducing VAT fraud and evasion. The VAT was implemented very hastily in Trinidad and Tobago and much technical analysis did not go into the implementation of the system.

Barbados

The VAT system is not a new idea for Barbados and was first explored in 1978 but was officially implemented on January 1, 1997. There are two prevailing rates: a standard rate of 15 per cent for the general public on a wide range of goods and services and a concessionary rate of 7.5 per cent for the hotel industry. The VAT system also allows for the zero-rating and exemption of goods and services. The introduction of VAT accompanied the elimination of 11 different taxes including the stamp duty on imports, consumption taxes, entertainment tax, tax on overseas telephone calls and hotel and restaurant sales tax. The introduction of VAT was faced with much protest regarding the regressivity of the tax and caused significant amendments to be made to the VAT legislation.

VAT legislation

The intensive lobbying of interest groups in response to initial VAT proposals caused significant amendments to be made before the VAT was introduced in January 1997. The lobbying surrounded the following issues: the regressivity of the tax and impact on lower-income grouping, repercussions on the hotel industry and the impact on businesses in general.

Prior to 1997, amendments were made to the zero-rating, VAT deposits by promoters of public entertainment and input tax recovery. Electricity and Telecommunications services, commercial rent, travel tickets and accounting and legal services were all zero-rated to diplomatic missions and the international financial sector. Additionally, promoters of public entertainment were required to deposit 5 per cent of the value of tickets printed as compared

to the previous rate of 15 per cent. Thirdly, an allowance was introduced for input taxes on goods and services used in the construction, alteration or renovation of a building. Finally, the list of zero-rated supplies was extended to include; the supply of sugar to the Barbados Agricultural Management Company Limited, the supply of international cruises, the payment known as service charge payable to hotels, guest houses and restaurants and the supply of meals, drinks and snacks to students and staff of an approved educational institution (other than a tertiary institution).

Further amendments were made to the VAT legislation on 29 September, 1997, nine (9) months after the VAT was implemented. Perhaps the most significant of which was the zero-rating of selected basic food items (refer to appendix table 2). Additionally, hotel rooms provided on a complimentary basis to travel agents, tour operators and all educational, scientific, cultural or literary materials recorded on electronic or printed media will be zero-rated. Another significant change is that persons in the process of establishing a business can now register for VAT before making a taxable supply. The de minimis rule was extended beyond financial services to all types of exempt supplies. This rule states that if the exempt supply represents less than two (2) per cent of the value of total supplies made during the taxable period the registrant would be deemed to have no exempt supplies. Goods sent on sale or return, consignment or similar terms will no longer be deemed supplies and will not be subject to VAT.

Efforts are being made to improve the efficiency of the system, in the budget speech of 1st January, 2005 the government announced the introduction of a web-based system that will enable taxpayers to file and pay taxes electronically and permit the Inland Revenue Department to act as a collection agency for other government tax agencies. Secondly, interest imposed on the reassessment of output tax will be computed from the date of reassessment and not the date of filing.

VAT performance and efficiency

The receipts from VAT climbed steadily since its introduction from BDS$ 74.9 million in fiscal 1997 to BDS $598.2 million in fiscal 2005 (see table?.?). VAT is a major contributor to the revenue stream of Barbados, contributing on average 29.7 per cent of Central Government's Revenues and 9.5 per cent of GDP. This compares positively with Trinidad where VAT contributed on average 18.8 per cent of total tax revenue and an average of 4.2 per cent of GDP. Whilst, little information was available on the efficiency ratios of the Barbadian VAT system, the IMF estimates the C-efficiency ratio to be 1.01. This is extremely high as compared to Trinidad 0.51 and even the average for small islands 0.83.

Table 6: VAT in Barbados

Year	VAT (BDS $000s)	Total Tax Revenue (BD $000s)	GDP (BDS$ Mı	Consumptior Expenditure (BDS $Mn)	VAT/Total Tax Revenu	VAT/GDI
1996/97	74,906.0	1,231,064.0	4,390.9	2,764.1	6.1%	1.7%
1997/98	451,932.0	1,458,277.0	4,740.7	2,983.4	31.0%	9.5%
1998/99	455,095.0	1,545,029.0	4,955.6	3,241.2	29.5%	9.2%
1999/00	461,383.0	1,604,063.0	5,117.7	3,422.8	28.8%	9.0%
2000/01	491,621.0	1,716,119.0	5,108.4	3,316.2	28.6%	9.6%
2001/02	498,633.0	1,723,605.0	4,952.2	3,173.2	28.9%	10.1%
2002/03	494,620.0	1,715,538.0	5,389.7	3,547.2	28.8%	9.2%
2003/04	572,213.0	1,866,645.0	5,625.0	4,009.0	30.7%	10.2%
2004/05	598,201.0	1,901,843.0	n.a.	n.a.	31.5%	n.a.
Average					**29.72%**	**9.5%**

Source: Central Bank of Barbados

VAT concerns

The concerns surrounding the VAT system in Barbados are similar to that of Trinidad and include: the processing of tax refunds in a more timely manner, on-going public education and training of personnel, registrants keeping proper records and books of account and issuance of proper tax invoices in a timely manner. One of the major issues surrounding the implementation of VAT in Barbados is the impact it has on the tourism industry. A study

done by the Central Bank of Barbados noted that on average the VAT has been passed on to the tourist in the form of higher hotel room rates (Griffith 2000).[9]

Jamaica

Similar to Trinidad and Tobago and Barbados, Jamaica also underwent a significant tax reform program where several indirect taxes were replaced by two new levies, the General Consumption Tax (GCT) and the Special Consumption Tax (SCT). Both were introduced on October 22nd, 1991 and are governed under the General Consumption Tax Act (GCTA). The GCT is a normal VAT and is charged on all taxable supplies (sales) of goods and services by registered taxpayers in the course of taxable activity, the importation of goods and services into Jamaica and the sale of motor vehicles by non-registered payers. A "registered taxpayer" is any person who makes a supply of goods and services in Jamaica in the course of a taxable activity where the gross value of such supplies averages less than J$12,000 per month.

Under the GCTA, the importation and manufacture of certain prescribed products (e.g. petroleum products, alcoholic beverages and spirits, tobacco products) are subject to a special consumption tax (SCT) at varying ad valorem rates. The SCT is levied on the same value-added base as the GCT. In the budget speech of April 14th, 2005, the GCT chargeable on the supply of goods and services was increased to 16.5 per cent (from 15 per cent), the 20 per cent GCT rate of telephone services remain unchanged, GCT on building materials was also increased from 12.5 per cent to 16.5 per cent.

VAT performance and efficiency

The GCT and SCT are important sources of revenue to Jamaica and contribute a combined 37.4 per cent of total revenue (GCT 27.7% alone) and 11.2 per cent of GDP (GCT 8.3% alone) in fiscal year 2003/04.[10] Given the importance of GCT to the contribution to indirect

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[9] The Impact of VAT on Tourism in Barbados, Central Bank of Barbados Working Papers, Jennifer Griffith, 2000, pp. 197-209.

[10] Taxing Consumption in Jamaica, Kelly Edmiston and Richard Bird, April, 2006

taxes, the following discussion will focus heavily on its performance and efficiency since implementation (see table 7 below).

Table 7: Jamaica: Productivity and Efficiency of the GCT over Time

Fiscal Year	GCT as % Total Taxes	GCT as % GDP	VAT Productivity	VAT Efficiency
1991/92	11.9	2.7	0.27	0.51
1992/93	21.4	4.9	0.49	0.80
1993/94	28.0	7.2	0.57	0.86
1994/95	28.6	7.2	0.58	0.85
1995/96	31.4	8.4	0.56	0.80
1996/97	30.6	7.5	0.50	0.71
1997/98	30.2	7.3	0.49	0.71
1998/99	29.2	7.4	0.50	0.74
1999/00	26.8	7.2	0.48	0.72
2000/01	25.7	7.1	0.47	0.68
2001/02	25.7	6.7	0.44	0.64
2002/03	27.3	7.4	0.49	0.71
2003/04	27.7	8.3	0.55	0.80
Average	**26.5**	**6.9**	**0.49**	**0.73**

Source: Edmiston and Bird (2004)

One of the key issues surrounding the performance and efficiency of the VAT system is exemption and zero-rating. Few goods but a wide variety of services were initially exempt from the GCT prior to 2005. However, the budget speech of April 14, 2005 announced that all zero-rated items with the exception of exports and items from diplomats, international organizations and the government be transferred to the list of exempt items. This change would aid significantly in the administrative process of the system since exempt items make no allowances for input tax credits. The potential revenue lost through exemptions was approximately J$18.6 billion or about 44 per cent of estimated GCT collections in fiscal 2003/04 (Edmiston and Bird, 2006). The potential gain from eliminating all zero-rating other than that of exports was estimated at J$12.4 billion for 2004/05, or 29 per cent of the estimated yield of the GCT for that year.

Comparing the VAT systems (Trinidad and Tobago, Barbados and Jamaica)

The VAT systems in Trinidad, Barbados and Jamaica as shown in table 8 reveals that they are fairly convergent and as such our emphasis must be beyond harmonization to rationalization so as not to restrict market access. There is already agreement between the three systems that the nature of the tax is a consumption type and its base is all domestic goods and services except financial services and exports. The major issues surround: the number and levels of rates and agreement on the list of exemptions and zero-ratings and administration of the VAT in different countries. Though the standard advice suggests one rate at 15 per cent, the only VAT system in the Caribbean that complies with this is Trinidad and Tobago whilst Barbados and Jamaica have more than one rate.

Additionally, there is some harmonization of exemptions of zero-ratings for selected goods and services including: basic food, medicine and medical equipment, taxi services, agricultural inputs and equipment. These however reflect the economic variations in their respective countries and rules concerning the standardization of these exemptions and zero-ratings must be developed.

Table 8: VAT/GCT in Barbados, Jamaica and Trinidad and Tobago

Country	Tax Base	Rate	Exemptions*	Zero-ratings
Barbados	The VAT was introduced on January 1, 1997 and is imposed on the value or mark-up added to imports and other g&s supplied by one business to another or to final consumers.	The VAT is levied at the rate of 15% on all g&s except those zero-rated and exempt and at 7.5% on hotel accomodation.	The supply of financial services, passenger transport & provision of education instruction by approved educational institutions.	Includes a list of basic foods, educational literature, exports, inputs for agriculture and supplies to foreign sales corporations, international business companies, exempt insurance companies and offshore banking companies.
Jamaica	The GCTwas introduced on 22 Oct.,1991 and is imposed on g&s supplied in or imported into Jamaica. Taxable activity includes activity carried on in the form of business, associations or clubs. Special rates for motor vehicles and hotels.	The GCT is charged on all taxable g&s at the rate of 16.5% with effect from 14 April, 2005. There are special rates for motor vehicles,tourism-related businesses and "prescribed goods". GCT on building materails including:cement, blocks, steel bars etc. will be taxed at 16.5% effective 14 April, 2005 (previously 12.5%). Telephone services including telephone cars will be taxed at 20%. The GCT rate applicable to tourist services increased to 50% of the standard rate (i.e 8.25%) effective 14 April, 2005.	Exempt goods include: tickets for inter'n. travel,cement and related products, basic commodities and essential products(agric. equip.,& supplies, medical, dental & veterinary instruments & supplies). Exempt services include: construction operations, transportation of goods and passengers within Jamaica excluding the tourist sector, rental of residential accommodation and hotels (over 30 days), repairs to agricultural equipment, aircraft and vessels used in inter'n. transportation and supplies of water and electricity.	Zero rated items limited to exports and items for diplomats, international organizations and the government, effective 14 April, 2005. The supply of funeral related services up to JMD $100,000 and certain agricultural inputs including cereals, animals feeds, machetes, planting material and herbicides will be zero-rated, effective 1st July, 2006.
Trinidad	The VAT was introduced on January 1, 1990 and is levied on consumer expenditure on imported goods and on commercial supply within T&T of g&s and prescribed services by a registered person.	VAT is levied at the rate of 15%.	The following items are exempt: buses an taxi services, medical, dental, hospital, optical and paramedic services. Training and education, real estate brokerage, rental of residential property, public postal services, betting, gambling and lotteries and financial services.	The zero-rated items include: various goods, agricultural and medicine.Water, exports, natural gas, crude oil, international freight, books and hotel accommodation.

Source: Central Bank of Trinidad and Tobago

A comparison of the available performance and efficiency data for the three countries (table 9) suggests that the VAT system in Barbados and Jamaica are performing very well according to the standard for small islands as well as for larger countries and country groups like the EU and the Americas. Barbados had a C-efficiency ratio of 101.1 per cent. Whilst Jamaica had efficiency and C-efficiency ratios of 55 per cent and 80 per cent respectively. These compare positively with the efficiency and C-efficiency ratios for small islands (48% and 83% respectively), the EU (38% and 64% respectively) and the Americas (37% and 57% respectively). The VAT in Trinidad and Tobago on the other hand has not been performing as well with efficiency and C-efficiency ratios of 28.2 per cent and 51.6 per cent respectively.

Table 9: A Comparison of the VAT/GCT in selected Caribbean countries

	VAT/GCT as a % Tax Revenue	VAT/GCT as % GDP	Efficiency Ratio	C-Efficiency
Jamaica	27.7%	8.3%	0.55	0.80
Trinidad	18.8%	4.2%	0.28	0.51
Barbados	30.7%	9.8%	n.a.	1.01
Small Islands	n.a.	n.a.	0.48	0.83
EU	n.a.	n.a.	0.38	0.64
Americas	n.a.	n.a.	0.37	0.57

Source: The Modern VAT, Central Bank of Trinidad and Tobago and Taxing Consumption in Jamaica, IMF

However, caution needs to be exercised when comparing efficiency estimates since they could be biased either upward or downward due to differences in administrative procedures and differentiated rates. Limitations on input credits enable a larger amount of the intermediate as well as final consumption of goods and services to be taxed and therefore artificially boost VAT receipts. One illustration of this is Jamaica where input credits for cars and entertainment are limited and capital expenditure is claimable over a two-year tax period. Additionally, the efficiency ratio may be higher due to differentiated rates. In Jamaica in 2002, 9.8 per cent of total GCT liabilities were attributed to goods and services taxed at above standard rates (mainly vehicles) and only 2.6 per cent at below standard rates.

[11] Vehicles are subject to an average GCT rate of over 55 per cent in Jamaica as compared to 16.5 per cent on goods and services. Additionally, vehicles account for approximately 5.5 per cent of imports and 21.5 per cent of tariff revenue in Jamaica.

SECTION IV: ISSUES SURROUNDING VAT HARMONIZATION IN THE CARIBBEAN

The VAT has cemented its place as a viable means of revenue generation both internationally and within the Caribbean. Whilst, the system has its inherent weaknesses it is also filled with promise and as such must be considered as one of the critical elements in the tax harmonization framework. To effectively integrate the VAT systems of CARICOM member countries the following issues would have to be addressed: the approach to harmonization, the objective of harmonization, the choice of harmonization, exemptions and zero-rating, the administration of the system and the cost of harmonization.

The approach to VAT Harmonization

One of the challenges to the VAT harmonization process in the Caribbean is the existing structure of the markets in the respective countries under consideration. Though the countries form the same region, the markets are largely imperfect and are at varying stages of economic development. This poses obstacles to the achievement of a harmonized tax rate in the divergent markets of the Caribbean. The approach to tax harmonization therefore may have to follow the differentials methodology, whereby, the VAT systems need not have equal rates but rather member countries are allowed to pursue different tax systems with the welfare of the union as the sum of the member's welfare. The obvious limitation of this approach would be the co-ordination necessary to ensure the elimination of the cross-border effect of different tax systems. Additionally, in achieving the best arrangement for the community as a whole, some countries may benefit more than others. The disparity in the nature of the markets within CARICOM may also necessitate that the harmonization process

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[11] Is VAT the best way to impose a GCT in Developing Countries by Richard M. Bird and Pierre-Pascol Gendron

be two-tiered, separated into the larger and more developed countries for example: Trinidad and Tobago, Barbados and Jamaica and the smaller countries including the OECS. The VAT is already operational in Trinidad and Tobago, Barbados, Jamaica and Dominica and Guyana is scheduled to be implementing the VAT at the beginning of 2007. Studies within the OECS have already proposed the implementation of VAT which a few of the territories have already accepted and are committed to doing.[12]

The objective of VAT Harmonization

The harmonization of the VAT as outlined in the differentials approach seeks to arrive at an arrangement that allows the improved collective welfare of the participating countries, with emphasis being placed on revenue stability, efficiency and equity. When the VAT was originally introduced it was primarily a mechanism to foster greater robustness in revenue but demonstrated noticeable weaknesses in the area of efficiency and income distribution. One of the major limitations of the VAT in the area of equity relates to the inherent regressive nature of the tax. Attempts have been made to curb this through exemptions and zero-rating. Nevertheless, the lack of clear guidelines to steer this process resulted in abuse in several cases.

Additionally, the issue of equity also filters into the distribution of the tax among countries; tax revenue should accrue to the country that provides the service connected with the economic activity. Secondly, any attempt to harmonize VAT should consider the efficiency of the system. Efficiency has several components, which includes the ability of the tax to generate revenue but also concerns the movement towards a uniform effective tax regime. An effective tax regime need not necessarily entail unifying tax rates but will consider the specifics of the local economy and the countries performance in administering taxes. One area of further research is the development of a taxonomy within which countries can be placed. This taxonomy would consider critical factors which define the VAT design for a

[12] The IMF through Caribbean Regional Technical Assistance Centre (CARTAC) prepared tax studies for the OECS and recommended the implementation of VAT. Peters and Bristol (2006).

country and develop a list of five or six VAT structures that can be proposed to countries with similar characteristics.[13]

Bird (2005) also proposed a decision-tree approach to VAT where the implications of different decisions such as zero-rating are factored into the varying design aspects of VAT so as to try and assess the “rightness” of particular decisions according to the characteristics of the environment within which VAT functions. Part of the reason for some of the problems associated with VAT is the reality of political interference in the taxation system. The VAT has in some instances been misused to pursue social and other agendas to the detriment of revenue. Finally, it must be understood that social and economic inequality considers the overall impact of the budgetary system on efficiency and equity rather than solely VAT or any other tax. Therefore, the inadequacy of the VAT to achieve efficiency should not be an indictment if the total tax system and policy measures accomplish all three of the tax objectives.

The choice of taxation principle

Within open-economies inter-country differences in commodity taxation produces two international distortions in the taxation system referred to as the destination principle and the origin principle. The destination principle taxes internationally traded commodities at the rates in which final consumption taxes place (the destination). In a VAT designed to tax domestic consumption only, exports are zero-rated, meaning they leave the country free of any domestic VAT. The destination principle is the international norm for indirect taxes with the total tax paid on a good being determined by the rate levied in the jurisdiction of its final sale and revenue accruing to that jurisdiction. Conversely, there is the origin principle where the tax is paid at the rate of, and to, the country or countries in which the item is produced.

Exemptions and Zero-rating

One of the greatest challenges to the harmonization of VAT would be the regularization of exemptions and zero-rating so as to maintain equity and efficiency both within and between

[13] Refer to Value Added Tax in Developing Countries: Lessons and Questions, 2005.

countries. The expansion in zero-rating and exemptions is a global phenomenon and the Caribbean is no different. One possible solution to this problem is the development of formal rules to guide exemptions and zero-ratings. Whilst this study did not unearth any such research, the following points highlight some general rules utilized within VAT systems and the experience of South Africa in dealing with exemptions and zero-rating.

Some of the general rules include:

- Zero-rating should be applied to basic necessities where the objective is to relieve low-income individuals of the tax burden
- Exemptions can be applied to services where the determination of the taxable base and/or compliance is difficult e.g. financial services
- Preferences should be designed so as to target the objective with the least damage to the tax structure
- Standard advice is for a short-list of exemptions limited to basic health, education, basic food and financial services since their consequences are complex and generally adverse.

In dealing with the issue of the regressivity of VAT in South Africa a decision was taken that the sale of basic foodstuff should be either zero-rated or exempt from VAT. The major challenge in this was to ensure that the foodstuff identified were those primarily consumed by the poor. The recommendation to solve this problem was the ranking of certain commodities on the basis of "a weighted equity ratio". This refers to the ratio between the percentage of lowest income budget spent on a specific commodity and the percentage of highest income budget spent on the same commodity. Secondly, the South African VAT review committee proposed that public transport be VAT exempt primarily because low-income consumers utilize it. Finally, a blank exemption or zero-rating of medical services may not be efficient if the poor have access to preferential treatment in provincial hospitals and clinics which are already exempt from VAT.

The administration and legislation of VAT

Even if success were achieved in harmonizing VAT rates differences in administration of the respective VAT systems and differing or weak enforcement of the rule of law would undermine its efficiency. CARICOM countries could benefit from the economies of scale associated with synchronized administrative procedures. Most of the Caribbean islands already utilize the ASYCUDA system for customs administration and several of the OECS countries have adopted standard information technology systems for their tax administration (SIGTAS). Nevertheless, administrative systems seem to be more divergent in the area of extensions in exemptions and zero-ratings, which place additional burdens on the tax system.

Additionally, one of the major reasons for administrative weaknesses is inadequate preparation before the implementation of VAT. This accurately describes the case of Trinidad and Tobago whilst both Jamaica and Barbados are less affected. The administration of VAT concerns several issues including: where VAT administration would be placed within the larger tax administration process, self-assessment procedures, auditing and refunds.

Whilst it is largely agreed that the customs authority is responsible for the collection of VAT the issue of VAT administration is vague. Three options are available for the administering of VAT: the first is that it be handled by the department responsible for domestic tax operations, the second is the creation of a separate VAT department and the third is to give the customs authority the responsibility to administer VAT. Irrespective of the organization chosen to administer the VAT there must be close co-ordination between the income tax administration and customs authority to ensure the proper functioning of the system. The international standard is that VAT is administered by the domestic tax administration although illustrations of administering the VAT in separate divisions exist in Albania, Australia, Bulgaria and Sri Lanka as was popular during the early years of VAT.

The education of those taxpayers who fall within the VAT threshold is also important to the process of tax administration. This is so because modern tax systems are premised on the principle of "voluntary compliance" where by taxpayers are expected to calculate their liability and submit their returns and payments to the tax administration. This allows the tax authority the flexibility to concentrate their effort on the minority who choose to occupy the outskirts of the tax perimeter. Nevertheless, if taxpayers have difficulty in calculating their taxable liability and returns have several mistakes much of the manpower and hours within the tax administration centre would be spent on routine rather than strategic tasks. Additionally, it has been argued that regular contact between tax payers and tax officials poses a grater possibility of corruption taking place. Some of the approaches geared towards increasing VAT collections in administratively weak areas include the implementation of VAT withholding schemes and increasing the VAT threshold so as to regulate the number and size of registered taxpayers.

Another weakness in the administrative process of the VAT within developing countries is the auditing function. In many instances within the Caribbean this has been reduced merely to pre-refund checks and lax auditing systems are some time characterized by complex procedures such as increased filing requirements and numerous cross-checking of audits. Strengthening the audit procedure is a key challenge and critical to ensuring the minimizing of fraud and evasion.

Finally, the mechanism for refunds whilst simple in theory can be problematic for the administration process in practice. The difficulties of the refunding mechanism relate to: the opportunities for fraud, corruption in tax officials and the delaying of refunds during times of budgetary constraint. The enticement to fraudulent procedures may especially be applicable to exporters and business with large investment purchases whereby input taxes paid are buffered so as to increase the value of total refunds. Related to this is the opportunity of tax officials to engage in these types of activities. Finally, the government may also contribute to the problem by failure to or delays in making legitimate refunds to business due to constraints in their budgets.

The cost of harmonization

Amidst all of the benefits of tax harmonization its costs may exceed its benefits if the overall harmonization framework is inefficient. Choosing the "right" system is all the more difficult since it is not easy to measure the excess burden of taxation (Tanzi and Bovenberg, 1990). This is particularly so if the integrating countries are at different levels of economic development and is further complicated by the fact that efficiency would differ according to country, public expenditure needs and instruments to finance them.

Conclusion and Policy Recommendations

Whilst the VAT has its limitation one cannot deny that it has the potential to play a key role in the diversification of the taxation regimes within Caribbean countries. To effectively harmonize the VAT however, much work still needs to be done. Amongst some of the policy recommendations that may facilitate the expediting of this work are:

- The development of a formal research agenda to address some of the issues related to agreement on rates, exemptions and zero-rating and the administration of the system. This agenda should include research on the development of formal rules to guide the process of exemptions and zero-rating.

- Secondly, the development of a taxonomy of tax structures within which countries with similar characteristics can be placed. This taxonomy would consider critical factors which define the VAT design for a country and develop a list of five or six VAT structures that can be proposed to countries with similar characteristics.

- There should be a closer examination of the decision tree approach to VAT as recommended by Bird (2005) so that the implications of different decisions like zero-rating could be evaluated in a more objective way. Part of the reason for some of the problems associated with VAT is the reality of political interference in the taxation system.

- To help in dealing with the regressive nature of VAT, "a weighted equity ratio" can be developed as utilized in South Africa to determine which basic foodstuff should be either zero-rated or exempt from VAT. This ratio seeks to rank certain commodities based on the percentage of lowest income budget spent on a specific commodity and the percentage of highest income budget spent on the same commodity.

- Finally, to propel the movement towards tax harmonization the following three elements must be in place: political will, the need for mechanisms of enforcement and the review of agreements and instruments to ensure their success. The overall development program of the respective CARICOM countries should be the platform for the harmonization of the taxation system.

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APPENDIX

Appendix Table 1: Changes to the VAT system in Trinidad and Tobago

Year	Zero-rating	Exemptions	VAT Threshold	Other
1990	VAT introduced in T&T.Zero rating was limited to:Unprocessed food and a few basic processed foods, such as flour, bread, milk and margarine.Prescription medicine. Live animals, livestock feed, seed, fertilizer and farm machinery. Water sold through pipes. Exports and certain export-related activities. Natural gas and crude oil and Veterinary and pest control services.	Exempt Services . Medical, dental, hospital and other health-related services. Most education. Rental of residential property. Betting, gambling and lotteries, Bus and taxi service and postal service. Real estate brokerage, insurance, banking and stock brokerage.	VAT threshold set at $120,000.	
1992	VAT will no longer be charged on books, selected over the counter drugs and testing kits used for the diagnosis of diabetes.			
1994		The new financial tax was designed to bring into the tax net some of the services which were excluded from the VAT system. It has the effect of exempting from VAT those services performed by licensed-financial institutions which are subject to the Financial Services Tax.		The 1994 Finance Act Amended Section 18 (1) due to the introduction of a Road Improvement Tax on 5%on all motor fuel. Intro. of a Financial Services tax (15%) which is to be paid for the supply of specified financial services in a manner similar to the way VAT (which is not imposed on financial services) is imposed.
1995		Removal of VAT from Hotel rooms and introduction of a room tax of 10% of the value of the accommodation. The supply of services for yachts and pleasure craft owned by non-residents and hotel room services (to be replaced by a room tax) would be zero-rated.	VAT threshold decreased from $120,000 to $100,000.	
1996	Extension of zero-rating provisions for certain basic foodstuffs.		VAT threshold increased to $150,000	
1998			VAT threshold increased to$200,000.	

Appendix Table 1 continued : Changes to the VAT system in Trinidad and Tobago

Year	Zero-rating	Exemptions	VAT Threshold	Other
2002	Zero rated: Extended to include only those services which are physically performed outside Trinidad and Tobago.			The date of VAT payment changed from the 25th to the 20th of each month.
2003		Customs and duty and VAT on medication are abolished.		
2005	Zero rated list extended: To include brown sugar, cocoa powder, coffee, mauby and orange juice.			The Board of Inland Revenue may use a taxpayer's VAT refund to offset any other outstanding tax liability of the taxpayer with effect from 1 January 2004.
2006		The VAT and customs duties abolished on educational materials, geometry sets, notebooks,puzzles,magazines,uncoated paper and paperboard for writing, printing or other graphic exposed in rectangular sheets.		
2007		Removal of VAT on telecommunication equipment acquired for internet and broadband services and the purchase of all computer peripherals such as cables, speakers, mouse pads and anti-glare screens.		

Source: Budget speeches, Trinidad and Tobago various years

Appendix Table 2: Changes to the VAT system in Barbados

Year	Zero-rating	Exemptions	VAT Threshold	Other
1997	**Amendments made to the VAT legislation due to intensive lobbying before 1 January 1997**.Zero-rating of certain supplies to the Diplomatic and International Financial Sectors including: electricity services, telecommunication services, commercial rent, trav			VAT introduced Jan.1 1997replacing 11 indirect taxes. Three rates 15%;7.5% and 0%.
1998	**The following has been added to the list of zero-rated supplies** set out in the first schedule of the VAT Act:Barbados Agricultural Management Company Limited, the supply of international cruises, the payment known as service charge payable to hotels, gues	**Amendments as identified in the budget speech of 29, September, 1997.** Effective 1 Oct. 1997 eould be the zero-rating of certain basic food items: fresh milk, condensed milk, evaporated milk, fresh fruit, fresh fish, fresh vegetables, ground provisions, ca		The next budget sppech was delivered on 29 September ,2007after studying the nine (9) month impact of the VAT. Further changes were made:
Source: International VAT Monitor, various years				

Appendix Table 3 :Changes to the VAT system in Jamaica

Year	Zero-rating	Exemptions	VAT Threshold	Other
1996		The increase in rate to be offset by exempting basic foods, medicines and toilet goods from the tax.The tax rate for cement will remain at 12.5%.		Increase in the GCT rate from 12.5% to 15%.
1998			The threshold for personal income tax is to be raised with effect from January 1999, from JMD 80,496 to JMD 100,464 per annum.	
2004		Effective from 1 June 2004, solar water heaters manufactured in CARICOM countries will be exempt from GCT and customs duties, whilst those manufactuted outside the CARICOM region will be exempt from GCT but subject to the CARICOM External tariff. Also from 1 June, 2004, GCT on health insurance premiums will be abolished.		Budget presented on 15 April, 2004.
2005		Zero-rated items with the exception of exports and items for diplomats, international organizations and the government will be transferred to the list of exempt items. The GCT rate applicable to tourist services will be increased to 50% of the standard rate (i.e. 8.25%) and will automatically be adjusted to changes of the standard rate.		Budget on April 14, 2005. Standard GCT increased from 15% to16.5%. The 20% GCT on telephone services remains unchanged. GCT on building materials will be increased from 12.5% to the new rate of 16.5%.
2006	Budget presented on 27 April 2006. The supply of funeral related services up to JMD 100,000 and certain agricultural inputs, including cereals, animals feeds, machetes,planting materials and herbicides will be zero-rated for the purposes of the general consumption tax with effect from 1 July, 2006.			

Source: International VAT Monitor, various years