TAX REFORM IN THE CARIBBEAN

edited by

KARL THEODORE

Tax reform has become a buzz word in recent years. Many industrial and developing countries have implemented tax reform and many others are contemplating it. At a seminar held at UWI, St. Augustine, in 1987 university academics and regional and international tax experts debated the question of tax reform in the Caribbean. The experience of Barbados, Trinidad and Tobago, Jamaica, Grenada and Dominica was discussed, as well as plans for regional fiscal harmonization with regard to CARICOM. All this and more can be found in this instructive new volume from ISER Books.

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The Technical and Economic Issues in Tax Reform

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The question of fiscal reform has been in the forefront of public policy in the Caribbean for the past few years. The papers presented at the UWI St. Augustine seminar in December 1987 sought not only to reflect this public concern but also to point Caribbean policy-makers in new directions. By design the seminar brought together University academics as well as regional and international practitioners. In spite of the diversity of origin of the presenters and the independence of the individual presentations it was clear that most participants shared similar concerns.

It is fair to say that traditionally economists have put more weight on equity as opposed to efficiency in making recommendations for tax reform. In recent times, however, we have been observing a steady shift in the opposite direction, and this, on a worldwide basis. There can be little doubt that tax reform proposals in the Caribbean have reflected this new trend. In fact, the proposals and modifications we have seen so far have all presumed that the need for reform was a foregone conclusion. When International Monetary Fund specialist, Ved Gandhi, opened with his discussion on the type of circumstances that warranted tax reform and the kinds of limitations that tax reform exercises are all subject to, he was very much on target. What is more, it seemed that he had touched on most of the major issues that would come up later in the discussions. To begin with, the central issue of direct versus indirect taxation, that is, the overall structure of the tax system, was put into pragmatic perspective. For although textbooks have traditionally lauded direct taxation for its equity potential, Gandhi was emphatic that in the real world the situation is complicated by the unwillingness or the

inability of tax administrations to do what would be necessary to make the direct taxes really progressive. In this situation the theoretical regressiveness of indirect taxes is usually overshadowed by the practical need to put in place a system of buoyant revenue generation for the government. However, even if there is a practical case for a shift towards indirect taxation in the Caribbean, we should not fool ourselves into believing that "tax reform is a magic wand which, by itself, will have a significant and positive effect on the rate of economic growth by causing a massive transformation of the economy".

The proper role of tax reform in economic transformation was addressed in the second major paper by Clarence Ellis of the Eastern Caribbean Central Bank (ECCB). Eschewing what he calls the "wealth of detail on the design of taxes for a tax reform programme" which characterizes most discussions on tax reform, Ellis sought to clarify the "messy social parameters in which reform will take place". In this context the very first question that needed to be posed was whether all the potential sources of government revenues were being properly tapped. Focusing on the Agricultural Sector as being a key sector in the transformation effort, it was evident that the revenue contribution of the region's Agricultural Sector was way below what was warranted. It simply cannot make sense to be targeting this sector as the engine of growth and then take steps to ensure that little or no revenues come from that source. If tax reforms did not address the need to derive more revenues from one of the largest sectors in the economy, then the entire development effort was being jeopardized. Ellis saw the attempt to exempt Agriculture from taxation as being a short sighted policy which was a source of distortion for the remainder of the development effort. A major requirement, as far as Ellis is concerned, is the need to harmonize the tax system with the overall development programme. Referring to the need to link tertiary education with productive activity in Agriculture and other sectors Ellis reminds us that "the task of fiscal policy may not be so much that of raising additional taxation .... as one of restructuring the expenditure programmes". This reminder also serves to emphasize the *political* framework within which tax reform is carried out. No proper evaluation of tax system can therefore ignore the impact of the political system on the operation of the tax system.

In a similar vein DeLisle Worrell of the Barbados Central Bank argued that one of the objectives of tax reform in the Caribbean should be to enhance macroeconomic control. If we operate small open economies then our tax systems need to be constrained by the need to keep our exports competitive as well as by the need to maintain foreign exchange balance. While it is understood that tax reform should itself take place within an overall policy framework geared to avoiding balance of payments crises, Worrell was emphatic that we should not underestimate the contribution that the fiscal system makes towards an appropriate overall policy design. The relevant question was whether those engaged in tax reform exercises were aware of their role in this regard.

Terrence Farrell of the Trinidad and Tobago Central Bank was not satisfied that the mechanics of tax reform reflected the kinds of concerns raised by Ellis and Worrell. In his review of the Trinidad experience it seemed to him that apart from an overriding concern for ensuring that government revenues did not decline what seemed to matter most was the need to arrive at a package of measures which had the broadest possible consensus. What this invariably meant was that reforms were never very sweeping and were almost always never fundamental. In fact, although Tax Reform Committees were established from time to time, perhaps the most significant reforms were those that were part of the ordinary budget process.

Some of the case studies presented expanded on the issues raised in Farrell's paper. The Jamaican study by Omri Evans was carefully articulated. Evans was convinced that the Jamaican reforms had merit in respect of the simplicity and the equity improvements they incorporated. The question that was raised was whether enough consideration was given to the matter of implementation. In Evans' words, the Jamaican "implementation strategy seems irrational": it was a question of doing the right thing in the wrong way. The effectiveness of the Jamaican reforms is therefore questionable. It may well be that after all is said and done, the Jamaican system as it applied to businesses might not be really different from what existed before.

Michael Howard's study of Income Tax reform in Barbados was also conscious of the implementation problem. In fact, the Barbados experience

is demonstrative of the previously mentioned tendency towards gradualism that has chracterized Caribbean fiscal reform. For while there was a concern for growing budget deficits there was never any effort to go beyond the modifications in rates and coverage which Barbadians had become accustomed to. In fact, the most dramatic reforms in Barbados were in 1986 and 1987 when, as part of the in vogue supply-side thinking, huge tax cuts were followed by expenditure cuts and eventually by increases in consumption taxes. On the basis of what evidence was available, Howard stated that the tax-cut policy did not appear to accomplish any of its stated macro-economic goals.

The two countries that seemed to present a different picture were Grenada and Dominica. In the case of Grenada, the study by Karl Theodore seemed to make two points. First, although the contingency of the post-invasion situation may have provided a catalyst for tax reform, the objective economic conditions seemed to point to the need for some reform. Second, the decision to abolish the income tax and to replace it by a VAT, though in principle one that might have merit, turned out to be wrong because of the special circumstances prevailing in Grenada. pragmatism seemed to suggest that there was a good case for gradualism in the Grenada context. For one thing, the domestic infrastructure, both physical and administrative, seemed inadequate. Sweeping changes are likely to work best where the tax administrative system is itself properly organized.

Hodge Oliver's study of the Dominica reforms also pointed to a more sweeping approach. The overriding concern was to get the growth rate to be as high as 15 per cent. By a combination of measures, which included major changes in the direct and indirect tax regimes, the Dominica system clearly intended to break new ground in the region. However, although the end result was supposed to be somewhat dramatic, Oliver was conscious of the need for an implementation that was "incremental or marginalist".

Clearly the question of implementation had emerged as a major theme of the discussions. In this context the paper by Rose Byam became very relevant. For although Byam focused on the administrative and legal aspects of the Trinidad and Tobago system, her remarks were clearly relevant to the region as a whole. Given the resource limitations as well as

the low budget priority of most of the revenue collection agencies in the region, the whole question of tax reform for economic purposes seems somewhat premature. At the very least, the message of Byam's paper was that we can attempt to put new wine in old bottles if we want, but then we cannot turn around and blame the tax administrators for the failure of any new system that is introduced.

The case studies were all subject to limitation in that no particular effort was made to "plan for reforms that relate to the successful operation of CARICOM or more specifically to foster regional fiscal harmonization". This was the motivation for the CARICOM Secretariat paper presented by Stanley Lalta. There was a clear need to recognize the trade-off between national sovereignty and the development of CARICOM. Lalta was confident that the drafters of the various articles governing CARICOM had the foresight required to face up to this trade-off. Yet in many ways the whole question of fiscal harmonization is treated by Caribbean tax reformers as an idea whose time has not yet come.

It was clear that the UWI St. Augustine seminar on the Technical and Economic Issues had not delivered a package of answers which Caribbean tax reformers could now use to create optimal tax systems in the region. What the seminar certainly did was to provide a timely reminder that there are no short cuts, no simple answers where tax reform is concerned. What was also clear is that there is a great need for more attention to be placed on the better administrative and information systems if some of the more important aspects of tax reform — income redistribution in particular — are to be approached rationally. As a contribution to better performance on the tax reform front perhaps the dominant message of the papers presented can be summarized in the Latin expression —*festina lente,* hasten slowly. For although we needed to move urgently it remains important to be ready and willing to learn from our mistakes. Is this not the essence of the scientific method?

Tax Reform: Some Considerations and Limits (Lessons from Experiences of Developing Countries)

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Introduction

Tax reform has become a buzz word in recent years. Quite a few industrial and developing countries have already implemented tax reform (for example, the United States, Australia, the United Kingdom, Denmark, New Zealand, Hungary, Portugal, Argentina, Mexico, Jamaica, Indonesia, Bolivia, the Philippines, India, Grenada, Mauritius, Senegal, Mali) or have it under serious consideration (for example, Canada, France, Japan, Sweden, Norway, Germany, Italy, Ireland, Ghana, Thailand), making many others wonder if they are lagging behind. In a relatively interdependent world, with large capital and commodity flows, the authorities of many developing countries seem worried that their countries may "lose out" if they do not follow the examples of others and work toward some kind of international tax policy convergence or, at least, coordination. In addition, they have the feeling that a reformed tax system can perhaps contribute to economic growth, but some officials may not be aware of what such tax reform might involve or what benefits might possibly accrue from it.

In this paper, I attempt to answer three questions which might help the concerned policy-makers of developing countries:

a. Who needs tax reform?
b. What does tax reform involve?
c. What limits the benefits of tax reform?

My answers are admittedly brief and not exhaustive. Even in respect of tax reform, very many issues relating to customs reform and their coordination with the reform of domestic indirect taxes as well as the reform of property, wealth, and inheritance taxes, all of which are extremely important, are not covered in the paper.

Who Needs Tax Reform?

Countries whose tax systems exhibit one or more of the following characteristics need to consider seriously comprehensive tax reform:

- The tax system attempts to achieve such a large number of objectives — macroeconomic, microeconomic, international, political, social, institutional — that it achieves none effectively.
- The tax system contains all the major taxes — incomes, consumption, and wealth — but their bases have been seriously eroded over time with the provision of tailor-made reliefs to selected categories of tax payers or special interest groups.
- Individual taxes contain an extremely large number of tax rates, raised or modified in an *ad hoc* manner, in support of one specific objective or another, a number of times in history, resulting in (a) unequal tax treatment of tax payers in essentially similar situations, or (b) anomalous tax treatment of sectors of the economy producing essentially similar goods.
- The tax system is perceived by the authorities and tax payers alike to be serving the redistributive objectives; however, for one reason or another, in reality this may not be so.
- The tax system embodies highly differential taxation of rewards of different factors of production (labour versus capital, financial capital versus physical capital) and investments (productive versus speculative as well as nonproductive, manufacturing versus agricultural, debt versus equity) through comprehensive income taxes but which, in effect, have become schedular income and differentiated corporate taxes as a result of various tax provisions and tailor-made tax incentive packages.

- The tax system gives "signals" to economic agents which are quite contrary to those given by other economic policies of the government or which run counter to the stated economic goals of the authorities.

- The tax system is so much out of line with that of other countries, which trade with it or compete with it and which supply capital to it and to its competitors, that it has actually become a serious disincentive to the country's exports or has actually started to either discourage direct foreign investment into the country or encourage capital flight out of the country.

- The tax structure has not been revised over time to account for the changing structure of the economy or the changing characteristics of the tax paying population.

- The tax system contains multiple taxes piled up on top of each other on the same base and/or contains a large number of what might be termed nuisance and relatively minor taxes, absorbing a significant amount of scarce tax administrative capacity.

- The tax laws have become highly complex or their rules so vague over time as not to encourage maximum compliance even on the part of honest tax payers. Alternatively, their provisions may have remained unchanged over time despite rapid inflation and other elements of emerging economic reality.

- Even if the authorities in a country run through the above-described sort of list and identify that the country needs tax reform, there may still be no agreement on the sort of tax reform that the country might need. This is because tax reform often means different things to different people.

- To policy-makers, responsible for formulating budgets, tax reform may mean tax measures which aim at raising revenue (to meet budget deficits now) with least tax payers' resistance, or improving the elasticity of the tax system (to contain budget deficits over the medium term). In some cases, ministers of finance may want to use tax reform to achieve one or more elements of their political agenda.

- To officials, responsible for administering taxes, tax reform may mean measures which aim at simplifying taxes, improving tax compliance, and reducing tax evasion. (Lawyers, on the other hand, may want the tax codes to remain complex and vague.)

- To most individual tax payers, tax reform may mean measures which aim at reducing "his own" tax burden and increasing "someone else's" tax burden.

- To many sociologists, tax reform may mean measures which aim at strengthening the equity and fairness of the tax system ("socking it to the rich", if necessary) or ensuring the rights of the tax payers vis-à-vis those of the tax authorities as well as minimizing the compliance costs to the tax payers. (Accountants too would like to see tax provisions conform to the normal accounting concepts and procedures to minimize tax compliance costs.)

- To industrialists and owners of enterprises, tax reform may mean measures which aim at providing generous tax reliefs and tax incentives, preferably without any undue requirements.

- To most economists, tax reform often means measures which aim at improving the efficiency of resource allocation and encouraging labour productivity, capital formation, and technological change. It may also mean measures which minimize the "unintended" economic effects of tax laws and their provisions as well as improve the horizontal equity of the tax system, at the very least.

Obviously, the nature and scope of tax reform would depend very much upon whose objectives and vision finally guide the process of tax reform. Given the great diversity of views, someone will have to sift them through critically and, given inherent conflicts among some of them, establish clear-cut priorities among them before the task of reforming a given tax system can be taken in hand.

What Does Tax Reform Involve?

To begin with, comprehensive and fundamental tax reform would involve political courage. Beneficiaries of the prevailing tax system could well see a loss of their income as well as property and asset value as a result of the reform while others may see a gain in their income and/or wealth. And it is highly probable that the politicians will have to face the substantial anger of the potential losers (current beneficiaries) while the potential gainers

(others) may show little gratitude. This, perhaps more than anything else, explains the political lethargy towards a fundamental shake-up of the tax system in many developing as well as industrial countries.

Once this political lethargy has been overcome, and a "green signal" has been given for a comprehensive review of the tax system (usually in the form of establishment of a tax commission or committee), policy advisers have to wrestle with quite a few important but intricate issues. Based on the tax reform work in many industrial and developing countries as well as modern developments in the theory of taxation, it appears that at least five major issues would need to be tackled head on in one way or another.

Should the tax system be moved more towards an income-based tax system or a consumption-based tax system? If the latter, should the taxation of consumption take the form of an indirect tax (a broad-based sales tax or a value-added tax (VAT) or a direct tax (an income tax with exemptions for savings or a personal expenditure tax)?

Should the country have tax systems of the type Korea and Japan have, which contain high tax rates accompanied by liberal tax incentives and exemptions, or of the type Jamaica and Indonesia now have, which have low tax rates levied on broad bases?

Should the tax system aim at uniformity in the taxation of income, consumption, and sectors, in order to ensure horizontal equity, or wide differentiation in the rates of taxation, in order to generate the "correct" economic response from each and every one or to ensure vertical equity?

How much equity and redistribution should *reasonably* be expected of the tax system?

Is there much scope for improving the revenue elasticity of the tax system of developing countries in the short run?

Income-based Versus Consumption-based Tax System

Until recent years, a tax system based on income was considered superior to that based on consumption. The former could be related to the personal ability of a tax payer to pay (capital incomes were taxed much like labour incomes) and, as consumption as well as savings were equal partners in the

tax base, it was believed to be nondistorting between consumption today vis-à-vis savings today for consumption tomorrow. An income-based tax system was, thus, considered superior to a consumption-based tax system on both equity and efficiency grounds.

Not so, say the modern theorists now. Taxation of accrued income, including unrealized income, which truly represents the personal ability of a tax payer to pay, is simply not feasible — those incomes which cannot be easily taxed on administrative and other grounds enjoy automatic tax exemption. Furthermore, under income tax, work gets taxed while leisure remains untaxed. (Leisure goes untaxed under consumption tax too.) Finally, the distinction between income and capital is not easy to make or to administer. As a result, much of the superiority of income taxation in terms of equity and efficiency is said to be completely lost.

Modern theorists have, therefore, made a strong case *against* an income-based tax system and *in favour* of a consumption-based tax system. They accuse an income-based tax system of being "wrong" for the growth and development of the economy in two ways. First, supply of labour (including labour productivity) is not completely inelastic to after-tax wages. Therefore, an income tax affects the availability of labour and its productivity, or quality of its performance. Second, aggregate supply of savings as well as and the allocation of savings between uses is elastic to after-tax interest and other forms of rewards to capital. Therefore, an income tax reduces the incentives to save and affects its uses. In fact, existing income taxes everywhere have been found to contain such complex interactions between personal and corporate taxes that they create a diversity of effective tax rates on different forms of savings and capital incomes and result in mostly "unintended" and undesirable effects on the allocation of savings between different uses.

The case against an income-based tax system, thus, hinges on the empirical values of the price elasticities of factor supplies. If the price elasticity of factor supplies (labour as well as savings) were zero (or negligible), income tax would be harmless (or, at least, not so harmful) to growth and development. However, empirical evidence gathered so far suggests that they certainly are not zero and that while the elasticity may be

small in the case of labour, it certainly is not so small in the case of savings. The fact that savings are taxed twice under income tax (first when income itself is taxed and then when the returns on savings are taxed) and the interest elasticity of savings is not so small, gives the modern theorists a powerful case for a consumption-based tax system, based solely on efficiency considerations, especially in situations where savings are valued, as they are in most developing countries.

A consumption-based tax system can, of course, be brought into existence in one of three ways. First, through a complete exemption of savings as well as capital incomes from the base of personal income tax as well as full deductibility of capital expenditures from the corporation income tax, or second, through a replacement of personal and corporate income taxes by a broad-based sales tax or VAT, or third, through a replacement of personal income tax by a personal expenditure tax and corporate income tax by a cash flow tax (a few recent tax reform reports have shown that personal expenditure tax and cash flow tax are not as administratively difficult, as was once believed). The advantage of the first is that it utilizes an existing tax and its administrative structure but its disadvantage is that the complete exemption of savings and capital incomes from taxation will be politically unacceptable. The advantage of the second is that, being a tax on goods and services, it will be collected through traders and enterprises but its disadvantage is that the tax will not take the personal characteristics of the tax payer into account and will thus in all likelihood be regressive. The advantage of the third is that, personal expenditure tax being a personal tax, progressivity can be readily introduced, if so desired, but its disadvantages are the serious transitional problems it will pose and the large amount of financial data and record keeping that will be expected of all tax payers.

Many tax reform efforts in recent years have, therefore, attempted to steer a "middle course" by substituting consumption-based taxes for income-based taxes, at the margin, through a reduction of income tax rates and an increase of value added or sales tax rates.

Liberal Tax Incentives Versus Broad-based Taxes

Existing tax systems rely on nominally high marginal income tax rates (they are justified on vertical equity grounds) and liberal tax incentives to selected tax payers or industries (they are justified on grounds of encouraging a certain behaviour on the part of tax payers or certain sectors of the economy which are considered desirable by the policy-makers).

Lately, this kind of tax system has come under serious attack. High nominal income tax rates are believed to cause disproportionately large economic disincentives and high tax evasion while liberal tax incentives are believed to be "hidden" subsidies to certain tax payers, creating horizontal inequities and giving discretionary powers to bureaucrats and politicians, which can easily be misused and abused — all this in the hope of encouraging certain behaviour or activities which are believed either to rarely materialize or to materialize at "excessive" economic costs to the consumer and to the economy. These beliefs have encouraged a visible trend in many countries towards a gradual reduction of nominal tax rates and an elimination of all tax incentives and reliefs or, at least, a thorough rationalization of the structure of tax incentives.

Many modern theorists do not consider this to be a desirable trend. Broad-based taxes are looked down upon by them, because they believe that such taxes do not distinguish between individual elements of the tax base even though they react very differently to a given tax rate. (Savings, for example, are believed to react to income taxes very differently from labour supply and labour supply by wives is believed to be substantially more elastic than by husbands.) These modern theorists would, thus, like to see decisions regarding what should or should not be taxed, and at what rates, be guided by strict efficiency considerations and, as far as possible, made strictly on the basis of the price elasticities of supply and of demand.

However, as the price elasticities of supply and of demand of various factors of production, or of various goods and services, are rarely known, the views of these modern theorists have not yet taken hold anywhere. As a consequence, most tax reform efforts have continued to be in the direction of making taxes broad-based and lowering the rates of taxes, in ways which are consistent with the review needs of the government and the perceived horizontal equity of such a system.

Uniform Versus Differential Tax Rates

Differentiation in tax rates has traditionally been considered desirable in the belief that different tax payers needed to be taxed differently on grounds of vertical equity or for some other reason. The levy of higher rates of excises on luxury goods than on essential goods is an obvious example of the former while the levy of higher import duties on final goods than on raw materials or intermediates is an example of the latter (viz., to encourage domestic processing). In relation to income, too, argument was often made, on vertical equity grounds, for differential taxation of different kinds of incomes or different levels of incomes. For purposes of this paper, the relevant rates, of course, are the effective tax rates (after various tax rules have been taken into account) rather than the legislated nominal tax rates.

However, recent developments in the theory of taxation have shown that differentiation in tax rates, based on considerations of vertical equity, can be counterproductive from an efficiency point of view. If efficiency of resource allocation *alone* is to be the guiding force behind tax reform, the theory suggests that tax rates which are levied on different goods and services should be inversely related to the price elasticity of demand. Goods and services with higher price elasticity of demand (for instance, luxuries and goods with substitutes) should be taxed at lower rates and those with lower price elasticity of demand (for example, necessities, habit-forming goods, and goods without substitutes) should be taxed at higher rates. This suggests that the prevailing structure of excise duty rates in many developing countries may be fair but not necessarily efficient.

Similar arguments have also been presented against the imposition of general commodity taxes (namely, VAT or retail sales taxes) at a uniform rate. The levy of a uniform rate of sales tax or VAT was traditionally recommended in the belief that it will leave prices unchanged and will not interfere in consumer choices between products. Modern tax theory, however, has shown this belief to be incorrect and holding good only under exceptional conditions (when labour supply is totally inelastic or when all commodities have exactly the same price elasticity). Thus, the levy of a uniform rate of sales tax or VAT on all goods and services is shown by the modern theorist to be inefficient. It will be much better instead to have a

structure of highly differential excises, where tax rates for each commodity are guided by the inverse (price) elasticity rule.

In relation to income tax, some modern tax theorists have argued in favour of the levy of uniform rather than differential rates. The principle of differential taxation, according to them, is flawed. All income earners respond to nominal income tax rates to one degree or another — earners of some forms of income do more so than others. Given this fact, the extreme amongst the modern theorists argue that if the market-determined decisions of income earners are to be kept totally unaffected, taxes should be completely unrelated to earnings and all tax payers should preferably be taxed equally through a poll tax or a lump sum tax. But if income tax must be retained, some other modern theorists argue, the efficiency objective will be best served when the marginal income tax rate is invariant to the level of income to be subjected to taxation, i.e., the nominal average income tax rate be uniform, after allowing for personal exemption.

It is, thus, obvious that arguments in favour of differential commodity taxes and uniform income taxes are essentially based on the overriding considerations of efficiency and the theory that market-determined decisions are optimal and should be disturbed the least while arguments in favour of uniform commodity taxes and differential income taxes are offered in support of competing objectives, such as vertical equity, ease of tax administration, or political acceptability. (It would be very hard to persuade the public to support a system of differentiated tax rates based on differential elasticities.)

The case for or against uniform tax rates is, thus, not clear cut. In fact, the relative importance attached to efficiency and equity objectives can yield highly contrary conclusions.

Redistributive Role of the Tax System

It is well known that commodity taxes can never be a vehicle of *major* redistribution. General sales taxes or VAT, for example, are known to be regressive with respect to income insofar as savings and housing expenditures, which form an increasing share of incomes as incomes rise, are excluded from the tax base. Some of this regressivity is, of course, reduced

by exempting unprocessed food from the tax base as well as including selected services in the tax base. In addition, by having higher than basic tax rates apply to income-elastic goods and services, but, leaving aside the administrative complications these adjustments create, they frequently do not turn these taxes into major vehicles of redistribution.

Excise duties on liquor and tobacco products, too, are regressive, as poorer people spend a much larger proportion of their incomes on these commodities than the rich do. Some of the regressivity of these excises is, of course, compensated by the levy of excises on petroleum products, motor vehicles, and other selected luxury goods and services but, once again, these do not turn excise duties into a major tool of redistribution. Taxes on international trade, both import and export duties, also frequently have a regressive impact, to the extent they fall on small farmers involved in the production of exports.

It is only direct taxes (progressive income tax, land tax, property tax, progressive gifts and inheritance taxes, capital gains, and other capital transfer taxes) which often are believed by one and all to be vehicles of major income and wealth redistribution. However, some facts in relation to developing countries need to be taken into consideration.

Do income and corporate taxes reduce income inequalities? One may be tempted to believe so by looking at the nominal progressivity of these taxes but when all the statutory exemptions and exclusions from income tax and prescribed reliefs from corporation tax are taken into account, along with the evasion of both these taxes, it is only the naive who will believe that the nominal progressivity of these taxes reflects their effective progressivity.

Do land and property taxes reduce income inequality? Land tax and property tax are generally proportional with respect to values, and may be progressive with respect to income as the size of real estate rises with income, but when one considers how under assessed the land and property values always are, one cannot have much faith in the redistributive powers of these taxes either.

Do other direct taxes reduce wealth inequality? Gifts and inheritance taxes as well as other capital transfer taxes, though generally progressive in

terms of tax rates, are frequently avoided, if not evaded, so much so that their impact on equity often tends to be negligible.

It is, therefore, best to recognize the limited role that even direct taxes can ultimately play in achieving *major* redistribution. Recognizing this, most recent tax reform reports have, therefore, built their recommendations around the premise that a broad-based income tax coupled with reasonably (but not excessively) progressive tax rates and a high basic exemption level, but which is effectively administered, can perhaps be as equitable as a prevailing narrow-based income tax, which nominally has highly progressive nominal tax rates but which are often evaded or avoided. Similarly, the premise has been that a corporation tax which is partially, if not fully, integrated with the individual income tax, and which partially, if not totally, eliminates generous tax breaks and loopholes, will be as equitable as the prevailing corporation tax. Finally, the premise is that land and property taxes, based on correct valuations of land and properties, to begin with, and frequent adjustment of these valuations, to reflect rising inflation and speculative gains, will certainly be far more equitable than the prevailing taxes.

Whether or not many of these premises are valid in the particular circumstances of individual countries will need to be reviewed; however, there is no denying the fact that tax systems of developing countries generally cannot be (given the relative unimportance of direct taxes), and perhaps should not be, an instrument of major redistribution (especially if the efficiency objective is at all considered important). It will be preferable to use other policy instruments, (public expenditures, land reforms) which are far more direct and effective in this regard.

Revenue Elasticity of the Tax System

Most taxes which dominate the revenue structures of developing countries tend to be inelastic. For example, revenue from import duties is often inelastic because of large exemptions of raw material, intermediate and capital goods imports of most industries (on the ground that they are "infant"), which tend to grow over time with political pressures and with the widening of the industrial base; of large exemptions of all imports of

government departments and parastatal bodies (on the ground that their activities are in the "public interest"), which also tend to grow; and of a changing composition of imports over time, from heavily taxed final consumer goods to lower taxed intermediate and capital goods. Revenue from export duties, of course, grows in line not with GDP but fluctuates with world demand and the volatility of the world prices of the country's exports. Revenues from excise duties also tend to be inelastic, especially in inflationary times, because excise duties are often specific rather than *ad valorem* and are not frequently adjusted. Finally, revenue from corporation tax often turns out inelastic because "new" and large enterprises in the manufacturing sector enjoy long periods of tax holidays and other incentives while most enterprises in the public sector are completely exempt from tax.

Sales Tax and Personal Income Tax

Revenues from sales taxes and VAT can theoretically be relatively elastic, given that their bases are often comprehensive and that luxury goods and income elastic services are often included in the tax base. However, this elasticity is seriously eroded in many developing countries where a large number of enterprises enjoy exemptions from the levy of sales taxes on their imports and sometimes even on their domestic production, simply because they are designated as "infant" and "priority" or are located in some backward region of the country.

Similarly, revenues from personal income tax can also be relatively elastic in theory, given the progressivity of tax rates and the absence of inflation adjustment of the tax base. However, this elasticity is also severely reduced in many developing countries, where income tax administration is weak or where penalties for income tax evasion are negligible or ineffective.

Whether or not the overall revenue elasticity of the tax systems of developing countries can be greatly enhanced in the short run is debatable. But there is no denying the fact that, unless tax reform efforts in developing countries are directed specifically at this objective, the authorities will need to undertake "painful" discretionary tax measures every year simply to "stand still", that is, to maintain their tax to GDP ratio. The potential for

financing growth in the share of development expenditures in GDP from out of the government's current budget savings will, under such circumstances, be limited.

So far, I have reviewed only five major issues relating to tax reform. Others have not even been mentioned. The nature and complexity of the debates involved in the subject of tax reform are obvious. Also obvious is the fact that receiving a "green signal" from the politicians is only a first step and no more. Tax reform is, and will continue to be, an extremely complex subject, requiring a "satisfactory" resolution of a number of conflicts, including those among objectives and interest groups, and what a "satisfactory" consensus may be in the context of one country may not necessarily be so in the context of another country.

What Limits the Benefits of Tax Reform?

Even after a thorough and comprehensive review of the tax system has been carried out and a "satisfactory" package of reform proposals to support the "agreed" objectives of tax reform arrived at, one still has to recognize the possibility that the reformed tax system may not exactly live up to one's expectations. At least four factors can limit the benefits of tax reform efforts.

First, the government may be going through a period of budgetary crunch and cannot afford to forego any revenue in the short run. Under such conditions a fundamental reform of the tax system, some elements of which are likely to involve an immediate revenue loss, may have to wait. Depending upon what those elements are and how serious their revenue losses are, tax reform discussions may well turn out to be theoretical under current conditions. Consider the following scenario. In the interest of export promotion, the reform proposal may well be to reduce the general levels of import duties. Both these proposals would involve revenue losses and it might well be that they cannot be completely offset by the revenue gains of other proposals, even if one could hope that, in the long run, increased growth from the more efficient industrial base would boost revenues. The current budgetary situation would, thus, become a binding constraint on the capacity of the country to carry out a comprehensive tax reform unless the

country can find alternative short-term sources of financing the budget or can reduce the size of the budget.

Second, other economic policies of the government may interact with the tax system in ways that can limit the scope and efficiency of tax reform in developing countries. For example, massive quantitative restrictions, which exist in practically all developing countries, can limit the scope and erode the efficiency of tariff reform. Overvalued exchange rates, which are also prevalent in many developing countries, also have a similar effect. In addition, they may distort the reform of export duties. Administered interest rates are commonplace in most developing countries and, as long as they continue, the clamour for liberal tax incentives for savings as compensation will also continue, and this may limit the scope for income tax reform. Distorted wages and incomes policies too are commonplace and frequently have to be compensated for by generous income tax reliefs and deductions. Incentives and reliefs will continue to be sought for wages and dividends whenever they are constrained. Any one of the distortions described above, all relating to nontax economic policies, can hold the process of comprehensive and efficient tax reform hostage. In many developing countries, there are always political and social reasons for interest rates not to be raised beyond their administered levels, for exchange rates not to be reduced from their overvalued levels, for wages and incomes to remain distorted, or for monetary policy to remain expansionary. Given such realities of life, one must acknowledge the obstacles that exist in instituting comprehensive tax reform and making tax policy an instrument of economic efficiency.

Third, limited administrative capacity and various other factors peculiar to the circumstances of developing countries can easily limit the scope of tax reform. In dualistic economies, where subsistence agriculture and small-scale enterprises are far more dominant than monetized sectors, it will obviously be difficult to apply many of the principles of tax reform. Furthermore, limited administrative capacity and education levels of tax payers and tax officials alike can make sophisticated taxes such as a comprehensive income tax or a cash flow corporation tax, or a wealth tax, a VAT, or even a capital gains tax "off limits" for many developing countries. Finally, in elitist "close-knit" societies of the kind many developing countries have, it may be difficult to collect taxes effectively or give "bite" to tax

laws in the form of penalties and prosecutions in cases of non-compliance. All these suggest that comprehensive tax reform may remain mainly on the statute books or remain limited in scope unless supported by reform of the tax administration, creation of conditions for the effective implementation of tax laws, and the education of tax payers.

Finally, it is well known that taxes affect economic prices (income taxes reduce factor rewards, commodity taxes raise commodity prices while trade taxes affect the prices of tradables) and, through them, influence the market-clearing quantities. Depending upon differences in the price elasticities of demand and supply, taxes can have significant impact on the efficiency with which resources of an economy would be utilized at present or enhanced for the future. And as the growth rate of an economy is dependent upon the generation of savings and investment, as well as the efficiency with which given resources are utilized, one can easily be *lured* into believing that tax reform is a necessary ingredient of a successful strategy of economic development. It will, however, be a mistake to believe that tax reform is a magic wand which, by itself, will have a significant and positive effect on the rate of economic growth by causing a massive transformation of the economy.

Tax reform may well be a necessary condition but is certainly not a sufficient condition for the realization of a spurt in the growth rate. This follows from the fact that higher levels of work effort, savings, and investment are necessary but not sufficient conditions of achieving rapid economic development. There are many more variables that affect the growth rate of an economy than getting economic prices right or even correcting all the tax-generated distortions of these prices, through an appropriate tax reform.

Conclusion

I have taken a long tour just to derive a rather simple message: all of us must certainly recognize the need for tax reform when we see it, and do our best to define priorities for reform and to tackle the complex issues involved while advising on it, but, in the final analysis, we must remain humble in our expectations regarding its immediate benefits to the economy.

Tax Reform and Economic Transformation in CARICOM

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There is a tendency in discussions on tax reform and transformation to focus on means and not on ends. Thus, there is a wealth of detail on the designs of taxes for a tax reform programme but no similar concentration on the outlines of the transformation task. Even within the context of means, the discussion tends to be sanitised of the messy social parameters in which reform will take place and to concentrate on normative and/or definitive solutions.

Definitiveness is not my objective in this paper but rather, at first, a probing of the transformation concept. The next section focuses on some general concerns of the political conditions in which reform programmes are being pursued. The third section outlines a statistical framework for identifying the effects of a reform programme. Finally, the economic analytical features of the reform are given brief analysis.

The Transformation Task

The fundamental difficulty facing tax reform in the CARICOM countries is that the strategy for growth rests heavily on the development of the agricultural sector for which taxation policies (given the region's plantation heritage) remain exceedingly rudimentary and undeveloped. Although the development strategy in CARICOM has shifted its emphasis to tourism, a similar deficiency is apparent. If, therefore, the sectors that underpin the growth strategy cannot adequately contribute to the finance of expansion, then transformation that is consistent with independence will be severely handicapped.

Where a contribution to the growth process is to be made from internal sources, it is usual to expect that surpluses of existing sectoral activity (for example agriculture) can finance a deficit sector (for example, manufacturing) which is increasing investment for growth. Where such cross-sectoral financing cannot be effected by monetary and financial instruments, the solution usually requires reliance on fiscal measures or on "intra-sectoral" financial arrangements, including self financing by dynamic enterprises. If, however, fiscal measures are equally impotent, and dynamic enterprises cannot directly mobilise such surpluses as exist, then a case can be made out for state intervention in the production process or an abandonment of any pretence at major domestic entrepreneurship in the growth process. Growth may occur but with an accumulation of external savings by the domestic economy at the same time as valiant efforts have been made, and are being made, to attract foreign investors to provide the finance for growth, expanding the monetary base and increasing inflation.

While these comments are both elementary and elemental to political economic considerations affecting growth, a defeatist attitude prevails in respect of better tax designs for agriculture and tourism. Usually tax reform models seem more appropriate to the functioning of manufacturing enterprises when, for a number of reasons, domestic manufacturing may require tax incentives and do not represent appropriate sources for surplus extraction by taxation. In 1984, at the Fifth Meeting of the Conference of the Heads of Government of the Caribbean Community in Nassau, The Bahamas, the Caribbean Development Bank presented a formidable document on *Measures for Structural Adjustment in the Member States of the Caribbean Community.* The document stresses the difference between economic stabilisation, structural adjustment and structural transformation. The salient features of the respective definitions are:

> *Economic stabilisation* ... involves taking ... short-term measures mainly of a demand management type (and often deflationary) to cope with balance of payments problems.
>
> *Structural adjustment* is meant to have its effect in the medium term and aims at putting the economy on an efficient growth path with a current account balance of payments deficit

> reduced to sustainable levels ... As compared with economic stabilisation, structural adjustment gives more emphasis to the growth in supply and production (as against the demand) side, even though initially the demand management aspect may be prominent.
>
> *Structural transformation* ... involves more than economic growth and a sustainable balance of payments deficit on current account. It includes structural changes in the composition of output and in foreign trade; diversification of production and exports; development of greater linkages between economic sectors; a permanent rise in the ratio of total investment to Gross Domestic Product and in the locally financed part of such investment in both the public and private sectors; and technological changes in all sectors of the economy.

There is no doubt that this definition of transformation gives rise to a massive research agenda (even if the growth strategy is restricted primarily to agriculture and tourism) in order to establish the phasing between stabilisation, adjustment and transformation and to associate these management approaches with regionally oriented, outer-regionally oriented and import substitution growth strategies. To some extent, headway with these complexities requires step-by-step examination of industry and sectoral possibilities. This approach was attempted in the CDB document even to the point of developing "Action Programmes in Critical Sectors". Yet even before the ink was dry on the document at that very Nassau meeting, tariff changes were negotiated as a short-term measure to stimulate trade without much reference to dimensions of phasing and growth strategies. Since then, progress on the Action Programmes has not been reviewed at the level of the CARICOM summit and subsequent meetings have been engrossed with issues of more immediate topicality.

In order to indicate why definitiveness is not easily established, it is necessary to be reminded of the relative pricing assumptions of goods and services in the aggregation of incomes to arrive at the total national product and in the projection of that aggregation into the future. Despite the fact that the poor are expected to be better off, both absolutely and relatively, in the

future, the measure of growth is not free of income distributional considerations because the index of growth could be greater if the later output is weighted more heavily with goods, such as necessities, that form the greater part of the budget of those with lower incomes.

This is an important dimension that can hinder or facilitate the transformation process by the emphasis that is given to the production of necessities and, by inference, to the growth of lower incomes. This was given consideration in a formal model by Kalecki who proposed that the development process should be guided by an increase in the saving rate achieved by restraint on the prices of necessities and by taxation policies that do not increase taxes on lower-income groups and on necessities. The saving rate would in those circumstances be increased by reducing the proportion of non-essentials in total consumption while demand will expand most rapidly by growth of lower incomes. Development along these lines will be non-inflationary if production can expand in relation to demand. In addition, such development will be less lop-sided than where growth is associated with the production of "luxuries" and where the expansion process requires growth of higher incomes to provide the increases in demand for greater production of luxury items.

It is true that an open economy removes some of the Kalecki constraints by permitting the importation of necessities at low prices and simultaneously promoting the production, say, of luxuries like tourist facilities, that can provide foreign exchange to pay for the necessities that are to be imported. Yet the overriding principles in the Kalecki model seem important as we attempt to integrate the CARICOM economies and thereby reduce openness. The progressive establishment of the customs union could then be associated with the production of necessities cheapened by linkages within the economic community (as identified in the CDB definition of economic transformation).

That these considerations are of great importance is attested by the demise of intra-CARICOM trade over the last decade and by the failure to restore growth of such intra-CARICOM trade by the mere reduction of tariff barriers even though *total* trade has grown with the production recovery of most of the economies. It should be remembered that in

response to the need to reduce demand (stabilisation), the first casualties of restraint were non-essentials which formed a considerable proportion of intra-CARICOM trade. By the same token, it is unrealistic to expect restoration of those trade levels unless a greater emphasis is placed on the production of "necessities" for the CARICOM market.

Hence, structural adjustment, but more so structural transformation, is required if regional trade is to be restored now that the economies face world demand conditions that are different from those that prevailed in the 1960s and early 1970s. In this regard, it is useful to note that necessities include a broad range of food items (raw and processed), household utensils, tools and a wide array of inputs into the production of necessities for the regional markets and of exports, including tourism and other services, for the extra-regional markets.

This [Kalecki] approach brings us next to the supposed dichotomy between import substitution and export promotion strategies of development. In this regard, Pedro Malan observes: "I have always been uncomfortable with simple dichotomic views which try to reduce a rather complex set of issues to 'two schools of thought' or, in this case, into a conflict between import substitution diehards and export promotion triumphalists." (Malan in Corbo, Goldstein and Khan (1987), p. 344).

Nowhere is there a greater need to avoid this dichotomy than in the OECS countries (Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines). In an examination of very crude data on sectoral flows of foreign exchange, it has become apparent that apart from remittances of nationals now living abroad, only two sectors — traditional agriculture and tourism — were direct "net earners" of foreign exchange. Manufacturing (apart from its activity in one island) reflected its import substitution bias and showed up as a substantial net user of foreign exchange. This does not necessarily mean that manufacturing activity is inefficient since only a comparison of prices of imports and import substitutes can establish the efficiency of import substitution production.

This caveat notwithstanding, the crude foreign exchange data suggest that the net outflows of the "deficit" sectors are so large that growth of the

net foreign exchange earners would have to expand at unrealistically high rates to outstrip moderate rates of increase of the net users of foreign exchange. If, therefore, viability of the economy rests on the maintenance of a current account gap that can be later financed by borrowing more substantially on commercial terms, it will be necessary to shift new business into *production which can be related at one and the same time to both substitution imports and expanding exports.* This is, of course, consistent with the Kalecki approach identified above and could be combined as already noted with the integration effort. The production possibilities of this approach are so many that it is amazing that development strategies in CARICOM seem often bereft of specific investment ideas.

The interesting feature of production that addresses import substitution and export promotion simultaneously is that it reduces the need to drive a wedge between the effective exchange rate for the country's exports (EER_x) and the effective exchange rate for the country's imports (EER_m). Bhagwati formalises the distinction as follows:

> Many trade economists identify the outward oriented, EP strategy as one that broadly ensures that EER_x (the effective exchange rate for the country's exports) ≅ EER_m, and is therefore synonymous with "neutrality" of relative incentives for home and export sales. On the other hand, a significant excess of EER_x over EEM_m may [be] ... described ... as [an] ultra-EP strategy (Bhagwati in Corbo, Goldstein and Khan (1987), p. 259).

Largely, the wedge is operationalised by differentiating between the returns to labour in export activity and in import substitution activity. If preoccupation with operationalising that wedge can be avoided, it permits concentration on institutional and human capital developments that will contribute lastingly to the depreciation of the overall effective exchange rate. Several possibilities exist and only a few examples will be mentioned here. Among the most striking is the opportunity that is being missed to develop CARDI (Caribbean Agricultural Research and Development Institute) and CARDATS (Caribbean Agricultural and Rural Development Advisory and Training Services) and the Faculty of Agriculture at U.W.I. (St. Augustine campus) into areas of research excellence like IRRI (Inter-

national Rice Research Institute) and ICMWI (International Centre for Maize and Wheat Improvement). In such arrangements, it would be useful to combine advances in plant genetics and related disciplines with the economic relations of maximising profits and with the political economic considerations of modes of production, types of farm enterprises and relations of these to social strata in the society. More remunerative farming to which these arrangements will give rise will reduce post-harvest losses and the abandonment of farming by young people. The average age of farmers in some islands is over 50 and *transformation and taxation prospects are not possible* with such evident decline especially when, as we said at the outset, the strategy for transformation will rest substantially on the agricultural sector.

A similar example is the potential for symbiotic relationship between the Faculty of Engineering at U.W.I., St. Augustine and the assembly of motor cars and the manufacture of steel in Trinidad. The prospects for parts manufacture for exports and for regional use ought to be considerable once the appropriate technologies can be absorbed with assistance from the University. These examples could be extended to the existence of large gaps in education facilities related to forestry, to mining, to chemical engineering (the manufacture of plastics), to marine engineering and to marine biology. Arnold McIntyre puts it in the following terms:

> It is important for small developing countries to focus their attention on their university programmes and those of their technical institutes. The aim should be to orientate the content of the programmes to the needs of the local scientific research institutes and private companies. This implies that the professors themselves be adequately trained which means that they must develop *an orientation to industry-related rather than solely purely theoretical research.* Such a shift in the focus of higher education will require some measure of government support. (McIntyre 1987).

Obviously, it requires more than government support. If limitations on institutional development (such as merging CARDI and CARDATS without an associated merger with U.W.I.) provide any pointers, it requires, first, grasp of what is involved, second, commitment to the implementation

of a science and technology policy and, third, professorial concurrence and enthusiasm.

Some of the proposals have high costs though those may be less than the opportunity costs of losing young people who are not excited by the intellectual prospects of the science and technology environment in CARICOM and who migrate to where they find such stimulation.

Finally, transformation is a process requiring transformation of the perceptions of the managing elite. Where societies are as small as ours and where, for historical reasons, such a high proportion of our trained manpower is locked into the public sector, it follows that the quickest way to benefit from the use of that manpower is to engage the public sector *intelligently* in the transformation task. In fact, this turns out to be one of the major lessons to be learned from a study of the success stories of the Pacific Rim countries. In many ways, this is the theme of a paper by Jeffrey Sachs who stresses the role of intelligent dirigisme in Japan, Taiwan and South Korea. Professor Sachs makes the following points:

> The East Asian experience suggests that export promotion policies can be pursued (and maybe are best pursued) by a dirigiste government, and even in the presence of tight import controls and tight regulations in the capital markets.... The Asian experience, does suggest ... that successful development might be helped as much *by raising the quality of public sector management* as by privatising public enterprises or liberalising markets. (Sach in Corbo, Goldstein and Khan 1987).

In an analysis of *Policy Aspects of Outward-Oriented growth in East Asia,* his inductive approach and an understanding humility are sobering: "I begin with this example [of Japan] to urge on the reader a humble and *inductive* state of mind regarding growth-oriented adjustment. The Policies of 'outward orientation' in Japan, and in the East Asia generally, have not been modelled on a free market approach as is frequently asserted" (Sachs, ibid). He continues to list, however, aspects of dirigisme that stress the importance of matching authority with equivalent responsibility.

(i) Government budgets were maintained near balance, often with large surpluses on the current account of the budget. Tight

budgets had the salutary effect of low and stable rates of inflation.

(ii) Low rates of inflation meant, among other things, that nominal rates of exchange could be maintained at fairly stable levels without jeopardising export profitability.

(iii) Current account surpluses meant that governments could contribute to the capital accumulation process.

(iv) Tight budgets provided governments with resources for subsidies and fiscal incentives to promote particular sectors of the economy or to offset reductions in general export profitability that might have arisen from an over-valuation of the nominal exchange rate. (Sachs, ibid, pp. 296-7).

There were in addition other important lessons to be drawn:

(i) Stabilisation should precede any dramatic shift to liberalisation.

(ii) Export orientation can be pursued without an across-the-board liberalisation and can be favoured by an activist government.

(iii) Relatively equal income distributions in East Asia freed the hand of governments to focus on issues of efficiency. (Sachs, ibid, pp. 322-3)

As one commentator put it: *Improving our analysis of these issues is the next major item of business.* (Karaosmonoglu, ibid, p. 336).

To summarise: the transformation task should specify options with greater specificity, putting emphasis on the production of necessities and on commodities that can expand exports and substitute imports at one and the same time. This permits attention to institutional and human capital development as long-term measures to adjustment of the real exchange rate. A regional dimension needs to be given simultaneous attention as country specific programmes are considered. Country specific initiatives which treat regional factors as parameters will find variations in trade and prices and capital and even manpower flows that cannot be ignored. It will therefore be in the interest of each country to ensure that a transformation programme at regional level is given consideration. Perhaps an activation

of the "Action Programmes in Critical Sectors" of the Caribbean Development Bank Structural Adjustment document may be a useful start.

One useful action programme would be to aim for current budget surpluses, both for stabilisation and for capital accumulation reasons. Another would be to co-ordinate regional efforts in raising the quality of development administration. A third would be to initiate action that will increase the compatibility between education programmes and the production systems. Each of these action programmes is simple in concept but will be very difficult in execution. The task of effecting change at these levels is the practical one of communicating workable ideas to politicians, technicians, entrepreneurs and trade union leaders to modernise the respective areas in which operation with increasing synchronisation is necessary. That requires an increasing cognisance of the impact of social and political spheres on the pace and direction of transformation.

The Political Parameters

Professor Buchanan began his Nobel lecture with the following quote: "The science of public finance should always keep ... political conditions clearly in mind. Instead of expecting guidance from a doctrine of taxation that is based on the political philosophy of bygone ages, it should instead endeavour to unlock the mysteries of the spirit of progress and development" (Wicksell, as quoted by Buchanan, 1987).

For Caribbean (and perhaps for all Third World) countries, it is appropriate that the economic analysis of government received Nobel Laureate recognition since, in these parts, major besetting difficulties are those of the role and the place of the state. The Wicksellian approach (when applied to the Caribbean, where proximity and familiarity result in the major discontent of what we see close up as governmental action) suggests choice between the construction of models of taxation as if government behaviour is ideal (often a fictional Westminster ideal) and prescription of political change to achieve reform. The latter leads to an indeterminate agenda from which the former is not entirely free once the proposals shift to take greater account of reality. And it should be noted that shifts are not only intra-territorial, they are also inter-territorial, given the pluralism that

prevails in CARICOM. Thus, the agenda for this seminar is immense if it hopes to produce action-oriented proposals.

An obvious solution for local reformers is to be steeped in the expertise of taxation so that details of alternative models can be drawn on for particular situations as they arise. For West Indians, this requires a degree of specialisation that may not be easily achievable, given the demands that are likely to be placed on available expertise, or given that experts may find satisfaction in pursuing broader interests. Possibly, the task of designing taxes for transformation may benefit from reliance on the instincts of the generalist rather than on the expertise of the specialist. Of course, teams of generalists and experts can work together on design as in the 1987 tax reform programme of the United States (see McLure and Zodrow, 1987). In the Caribbean, we solve the problem by bringing in specialists to work along with local generalists. This has not always worked well for the reason that expatriate specialists require time to be more familiar with political and social realities of the tax environment.

These points are noted by way of a reminder of the presentation in the previous section in which transformation was not stripped of ethical values. In fact, transformation was premised on development based on improving the distribution of income and improving the supply of necessities. The transformation process ought not to be conceived as an act of benevolence for the amelioration of poverty but should associate the removal of poverty with progressive improvements in the standard of workmanship to compete with any anywhere in the world. This has been the message of the productivity "revolution" in the Pacific Rim and that should be our message.

The question is "How"? The interventionist role of the state requires not only efficiency of the technician — a very necessary condition as was noted earlier. It is also necessary that rulers be fair. In the Buchanan approach, based on the individualist ethic, emphasis is given to the rules of the political game to keep the individual's preferences at the fore. Buchanan advised as follows: "The political economist who operates from within the Wicksellian research programme ... who seeks to offer normative advice must, of necessity, concentrate on the process or structure within which political decisions are observed to be made" (Buchanan, ibid).

Earlier he advanced an observation from which we can all learn: "Economists should cease proffering policy advice as if they were employed by a benevolent despot, and they should look to the structure within which political decisions are made" (Buchanan, ibid).

In respect of tax reform in CARICOM countries the institutional structure is woefully inadequate. A mixture of Dutch and French and English Common Laws complicates the process by which information is obtained and does not ensure easy compliance with the requests for information. The rights to withhold information seem greater than the rights to demand it. If hotels are to be taxed or even monitored, the systems of information gathering seem almost impotent in the face of non-compliance. These rules that give rise to data deficiency are even greater in relation to the holding of land, a political hot potato that draws alliances from opposed ends of the social spectrum.

The neglect to address these problems seems almost conspiratorial though one cannot be sure who are the conspirators. For many years now, a major project to streamline the company laws of CARICOM countries has been under way but progress seems slow. The original agenda under which the company law revision was conceived may well be irrelevant to today's needs and may need to be revised. The new agenda should not only require appropriate disclosure by those companies which are privately owned but should embrace all enterprises, financial and non-financial, that are publicly owned.

That, however, is not the end of the story. The Wicksellian approach assumes a settled state in which, as Buchanan put it, "politics is a structure of complex exchange among individuals, a structure within which persons seek to secure collectively their own privately defined objectives that cannot be efficiently secured through simple market exchanges" (Buchanan, ibid).

In the transformation approach that was earlier advanced, Wicksellian concepts are shunned and transformation is associated with production biased towards the needs of the lower income groups. This is clearly not a settled issue. The reality is that there are fragmentations and groupings in CARICOM societies that do not justify seeing politics either in the Buchanan

(Wicksellian) mould or in terms of a transformation process biased in the Kaleckian manner. In this regard, Dudley Seers points to a cultural dimension that inhibits the development of nationalism:

> The strength of national culture in former colonies depends on the length and nature of colonial rule. A long occupation ... not merely removed the opportunity of learning from political experience, it deeply penetrated the colony with the custom and attitudes of the dominant power.
>
> A younger generation educated [either overseas or with foreign syllabuses] is likely to be quite alienated and even to lose the possibility of communication with their compatriots, especially in rural areas. (Seers 1987, pP. 74, 71)

The difficulty which we must face is one of new alliances in the societies, of bonds that have been severed (particularly in the tourist economies), and of new cohesions that are being formed. In the face of the need to resolve some of the emergent contradictions, Alain de Janvry, for example, sees little hope of what he calls "reformism" in Latin America because "appealing to the 'political will' of the elites as a pre-requisite for policy implementation is idealistic and utopian" (de Janvry 1981).

There are two critical problems here. The first relates to the need for a countervailing force to restrain arbitrary use of the power of the state. That requires not only clearer rules of the game (as in Buchanan). It needs a commitment by all to emancipate those most disadvantaged by the legacy of history. The second is inter-generational. If the education process is to be emancipatory in its effect on all groups, it must allow for changes in the social hierarchy. Witness the upheavals in evidence in South Korea.

An enlightened way to avoid such later disruption is to have elites base their concept of the new society on benevolence that is not despotic (see Buchanan). An alternative is to permit migration — "exit" as Hirschman calls it - since "voice" or protest is not permissible. The latter solution is not transformational. Yet it may turn out to be the path that we will choose in the hope that the passage of time and the requisite amount of restraint will maintain an easy enough calm for elites. It seems obvious when faced with the alternatives which choice is sensible. If, indeed, we do have a say about

the future, why should we not try to maximise our welfare and the welfare of our children?

The Statistical Framework

A damning criticism of some of the tax reform measures that have already been undertaken is their scant regard for data on income distribution. There haVE never been good income distribution data in the Caricom countries and the situation has become worse.

In a more general context, the following criticism by Dudley Seers is eloquent:

> In any case, there are virtually no statistics anywhere on most of the aspects of life that really matter — the average distance people have to carry water and food, — the numbers without shoes; the extent of overcrowding, the prevalence of violence, how many are unable to multiply one number by another, or summarise their own country's history ....
>
> This lack of information on poverty is — like the meagre data on distribution — scarcely surprising. Those who hold power rarely have much interest in such matters, still less in attention being drawn to them. (Seers 1983, p. 6.)

In another reference to the paucity of useful statistics, Seers' comments are, in places, bitter:

> [Now] the task [to collect statistics on the scope of poverty] would be too great; it would have to be collected by those in official statistical offices. But these are not merely protected by their residence and lifestyle from contact with social reality; they also enjoy tenure ... [International agencies] could be playing a vital role in encouraging the translation of changing perceptions of national problems into new data collections. But their technical assistance experts tend to emphasize established international standards rather than emerging national priorities, and their own statistical offices press for information needed for their international tables, whether or not these are useful locally ....

> There are time lags in data production, on top of those in changing perceptions. It takes years to plan and implement the collection of new types of data, and to prepare them for publication. (ibid, pp. 132-3)

The truth of the matter is that data are often prepared for international agencies and not for domestic use. In effect, were it not for the requests from the international agencies, data may never have been available. It is obviously better to have some data better than none at all.

Dudley Seers is, however, correct on a number of points. The first is that data are needed for economic management. Transformation of the Asian variety, we have seen, did not occur without intervention. If anything, the data requirements for the present are greater than twenty years ago. Yet one does not get the impression that the macro-economic aggregates are monitored periodically, for example, each quarter, i.e. the balance of production and expenditure and the counterpart balances of saving and investment, the balance of payments and its relation to real sector balances as well as to the financial balances of the monetary and fiscal sectors. As earlier indicated, stabilisation logically precedes transformation. If the economy is not monitored for stabilisation, monitoring for adjustment and for transformation is not likely to be meaningful.

The information relating to the macro-economic balances should be published with interpretations to the private sector businesses and to the trade unions. The actual performances should be compared with the targets so that the agencies outside the governments can comment on the accuracy of the data and can appreciate the reasons for measures being taken to achieve the targets.

The additional point that Seers made in respect of the length of time to set up data collection systems is one that any transformation programme must take seriously. Also, as perceptions of data needs change, different data may be required. In our circumstances, with outdated company laws, changing perceptions will be realised in new data with a very considerable lag.

In addition to data requirements on macro-economic balances are those related to sectoral real and financial flows which can give rise to overseas borrowing in situations where there are unutilized domestic

surpluses. Flow of funds data can identify cyclical fluctuations in sectoral surpluses and deficits and indicate whether monetary or fiscal policy will be appropriate to even out sectoral imbalances.

The table (on page 42) gives an example of excess overseas borrowing when it may have been more appropriate to increase government borrowing internally, identifying potential investments at the same time. The arrangements also make it possible to answer the question raised at the beginning on the viability of the transformation programme in so far as it must rely on finance from dominant sectors such as agriculture, tourism and mining.

The effort to gather these data will take time and careful planning and can be accelerated with help from the international agencies. The furtherance of a programme along these lines will benefit also from a greater use of macro-economic data by the authorities in their routine management of the economies.

Can Tax Reform Aid Transformation?

In the smaller economies of the Eastern Caribbean, whether tax reform will make a significant contribution to the transformation process or not will depend on the ability to mobilise higher taxes from agriculture and from tourism. If the assessment is correct that the manufacturing sector consists mainly of import substituting activities, then in terms of the flow-of-funds matrix set out in the previous section, taxation design in respect of the manufacturing sector should be aimed at removing any surpluses (or rents) that have accrued as a result of protection since further investments seeking similar rents may cause a waste of potential entrepreneurship and thereby limit further growth of exports. (See Reynolds, "Integrating Financial Planning with Macroeconomic Planning for Efficient Foreign Debt Management".)

The larger economies of Jamaica, Trinidad and Tobago and Guyana depend to a greater extent on mining activities, in addition to agriculture and tourism, and require emphases in taxation related to the depletable nature of their resources. There are prospects for joint products (gas and oil, bauxite and kaolin) and for linkages of industry with mining that may require special considerations in tax design. These differences may be sufficiently

FLOW OF FUNDS MATRIX

	AGRICULTURAL SECTOR		HOTEL SECTOR		GOVERNMENT SECTOR		REST OF WORLD		ALL SECTORS	
	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources
Savings		30						-10		20
Investment	5		10		5				20	
Borrowing		5		10		15				30
Lending	30				10		-10		30	

Adapted from Clark W. Reynolds, ''Integrating Financial Planning with Macroeconomic Planning for Efficient Foreign Debt Management''

substantial to warrant some modification also to the concept of a common external tariff.

The varying degrees of stability in the CARICOM economies also require differences in emphasis to be given to stabilisation, adjustment and transformation. In Guyana, the major concern is that of stabilisation — hence structural adjustment and transformation emphases may well be inappropriate. Jamaica and Trinidad and Tobago are in the process of adjusting from high growth rates in earlier years to lower but sustainable rates of growth. The OECS economies and Barbados have achieved considerable stability and require investments that can maintain growth and aid transformation.

In the context of the bewildering diversity of CARICOM tax systems, the principles outlined in a USAID Tax Reform Study for Dominica present reformers with an excellent guide. In general, the study noted:

1. Income taxes have less adverse economic effects than taxes on production or on inputs to the production of income. **Consumption taxes and taxes on wealth** have even less adverse effects than income taxes. (My emphasis.)
2. An incremental approach to tax reform is sounder and more equitable than wholesale tax reform unless the Government can afford to lose large amounts of revenue.
3. The identification of desirable reforms that cost revenue should be accompanied by the identification of potential sources of income of new or increased revenue, since it is not clear that the Government's fiscal situation will permit a large net loss of income.
4. A system with a small number of broad taxes is better in terms of equity, economic efficiency and administrative cost than a system with a large number of small taxes with different rates and bases.
5. Administrative feasibility sometimes dictates settling for "second best" solutions.

The aim of tax reform in the contexts earlier outlined should be to develop a tax base that permits governments to be largely discretionary in

the use of border taxes. The latter should be instruments that have as their purpose the achievement of desirable levels of protection or the encouragement of import competition. As we adjust these excellent criteria to encourage the efficient production of necessities, we should continue to consider tax and tariff reform as parts of a single overall fiscal system. As I.M.D. Little puts it in a related context: "Investment planning criteria and the analysis of comparative advantage, originally two separate specialisations in economics, have come together" (Little 1982, p. 138). But they tend not to come together in many partial proposals for tax reform as, for example, in the CAIC document (CAIC, 1985) or even in CARICOM reform efforts. the practical difficulty is that step-by-step reform is the only feasible way to proceed. That approach, however, should not lose sight of the overall perspective.

In order to be funded with the resources to provide incentives to carefully targeted activities, a few wide-ranging reform measures are proposed.

1. The first is to eliminate all exemptions from border taxes as well as from direct and excise taxes. This will raise both revenues and expenditures of the Budget but it would have the effect of making hidden costs transparent. The expectation is that transparency will lead to greater efficiency, and therefore to an increase in net revenue. This approach corresponds with the fourth of the guiding principles noted above.

2. The second approach is to associate the elimination of exemptions with low tariff levels, without surcharges and stamp duties. Real exchange rate biases will be minimal if tariff levels are kept low.

3. The third approach is to impose low levels of personal and corporate income taxes over judgmentally determined threshold levels. This will broaden the tax base for some countries and is an efficient means of raising revenue.

4. The fourth approach would be to institute or to strengthen wealth and land taxes on values in excess of judgmentally determined threshold values. This would help to strengthen revenues and

thereby contribute to the human resource and institutional developmental goals that have been earlier outlined. The present under-funded school and hospital programmes sit uncomfortably beside the burgeoning growth of wealthy homes.

5. Broad-based sales or value added taxes should be instituted thereby transferring the burden of taxation from inputs of production to domestic transactions primarily on consumption.

These approaches derive from the guiding principles set out in the Dominica study and incorporate initiatives on tariff reform by the World Bank. They represent a massive effort which should be appraised by quantitative simulations before implementation. If adopted regionally they can constitute the greatest contribution to regional integration.

Conclusions

The concern in this paper is with transformation in a regional context. This concern derives from the state of disillusionment with which some view the future of CARICOM and from the fragmentary approaches that seem to be replacing earlier strategies. The need exists for continued debate on regional development with social justice as the first section stresses. This is not only possible. It can also be efficient.

It is in this context that tax reform should be viewed. The attempt in the last section to suggest definitive proposals should not be perceived without reference to intra- and inter-territorial political differences. It has become clearer that transformation is a process and that the function at this seminar is to stimulate debate on goals and on the process. It is hoped that some balance in respect of both has been achieved.

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Tax Policy for Small Open Developing Economies

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This paper discusses the impact of personal income taxes, corporation taxes, import duties and other indirect taxes on the economic performance of small open developing economies. There is a growing consensus among decision-makers that economic policies should be designed to promote long-term expansion as well as stability in the short run. Accordingly, for each of the taxes considered, both the impact on output, prices and the balance of payments in the short run, and long-term growth implications are examined. The study searches out combinations of tax policies which provide the highest potential growth with reasonable stability in the year-to-year movements of the main economic aggregates. The first part of the paper, comprising sections one to three, describes features of the economies which affect the outcome of the policies. It discusses how exports limit sustainable growth, the determinants of investment and saving and the relationship between taxation, the financing of government's deficit and economic performance. The second part of the study consists of four sections, each dealing with a specific tax, one section which looks at tax combinations and a section dealing with repercussions from the economic responses to the policy (the 'second round' effects).

Growth Potential Depends on Tradables

Potential growth in the economies we are concerned with is governed by the expansion of the tradable goods sector rather than by factor availability or absorptive capacity. Capital is internationally mobile, and the small economy has access to as much as it needs, provided profitable opportunities exist and artificial barriers such as troublesome exchange controls are eliminated. There is invariably a surplus of unskilled labour: the unem-

ployed, those employed in make-work jobs and those who are discouraged from entering the labour force by lack of opportunity. Lack of skills may be a restriction on their employment, but only where widespread illiteracy leaves a population which may not readily be trained. Many developing countries have a surplus of skilled labour as a result of government provisions for education over many years.

Growth may effectively be limited by lack of physical infrastructure, poor organisation, weak institutions, inadequate information, social tensions and political unrest. Absence of agricultural feeder roads, insufficient port capacity, bad roads and poor telecommunications are commonly recognised as inhibiting investment. However, they are more easily overcome than deficiencies of organisation and knowledge, which have been less closely scrutinised. Perhaps the most stifling factors in the quest for economic growth are the failure to attain political consensus and to identify a social contract which commands acceptance, implicity or explicity.

These circumstances define what can be termed — appropriating familiar terminology — a warranted growth rate for the country. Growth may be sustained at this rate provided that the non-tradable sector (a net user of foreign exchange) does not expand too quickly in relation to the growth of the tradable sector (which is the net source of foreign exchange). If the output of non-tradables increases too rapidly, a chronic excess demand for foreign exchange emerges. The exchange rate will depreciate until the relative price of tradables increases sufficiently or real national income declines sufficiently to eliminate the excess demand.

If relative price effects were sufficiently strong to ensure a declining ratio of tradables to non-tradables in consumption, it might be desirable to accelerate the growth of non-tradables. That would generate the required change in relative prices and promote optimum growth. However, the rates of tradables in the expenditure of small economies must increase as national welfare improves, because small size limits the range and variety of domestic production. An important aspect of improved material well-being is a more varied menu of consumption choices, which, for the small economy, means importation. The relative price effects have little power to divert expenditures from tradable goods if real spending power increases. Invariably

it is the income effect of devaluation which restores the balance of tradables and non-tradables in consumption and eliminates the excess demand for foreign exchange. The devaluation reduces the real value of national income and the command over all goods and services, tradable and non-tradable. In this case the attempt to accelerate the growth of non-tradables fails, and output in both sectors contracts.

Whether the growth rate for tradables must be greater than that for non-tradables depends on the ratio of tradables to total output and on the import requirements of consumers and of producers of tradables and non-tradables. Moreover, these ratios should change over time, in the direction of increased demand for tradables, so the relative growth of non-tradables may have to fall as the economy grows.

The maximum sustained rate of growth, given political, social and institutional arrangements, depends critically on the capacity of the tradable sector. If the supply of tradables cannot be increased sufficiently to accommodate the demand for foreign exchange stimulated by growth of non-tradables, the output of non-tradables will slow down, by design or involuntarily, by relative price changes or by income loss.[1] If the production of tradables is buoyant it is conceivable that growth may fall short of what is possible because there has been insufficient capacity creation in non-tradables. However, this is a tractable problem, which may be eliminated by such devices as emergency housing and road building programmes.

Investment in tradable capacity may be especially sensitive to the supply of foreign exchange, to purchase fuels, raw materials and technology. An imbalance of growth towards non-tradables may be doubly dangerous: it threatens adjustments that may cause recession and it may disturb the supply of foreign exchange for the ongoing production of tradables, unless prompt exchange rate correctives are applied. Hence we give central importance to investment in tradable sector capacity in the analysis of the effects of taxation on long-term growth potential.

Savings and the Determinants of Investment

In the economies with which we are concerned the factors which determine the intended level of investment are independent of the rate of domestic

saving. If tax measures are to influence the growth of capacity they must affect the return on investment directly. Measures to enhance the savings rate may affect the balance of payments, but investment will not increase.

The investment rate depends on projections of the relative profitability of local and foreign investment, the acquisition of new technology, the development of public utilities and infrastructure, and a number of social, political, and geographical factors. The anticipated profitability of domestic investment, relative to investment in a competing location may be written as

$$RPR^* = PR^* - PRF^* - ER^*$$

where asterisks denote expected rates. If competitive conditions prevailed the profit rate PR would be the same everywhere, except for exchange rate uncertainty, but the world is not like that. We expect a positive relationship between expected profit and investment, a condition that reflects the reality of ongoing disequilibrium, in a classical sense. In theory wealth holders may choose from a long menu of alternative assets, real and financial; in practice the investor who is considering setting up a local plant has already determined on real capital formation and has usually fixed on an area of activity. His concern is to locate his plant so as to secure the highest exported return, allowing for exchange risk. He is attracted to the local economy if the domestic return exceeds the foreign return PRF, after discounting for expected changes in the exchange rate ER.[2]

Technology is usually embedded in equipment. For small countries noticeable technological changes happen discretely, when new products and new processes are introduced. Examples include the development of jet transportation and its effects on tourism, the spread of microelectronics fabrication and the introduction of new agronomic techniques. Innovations such as these rapidly transform profitability relationships, which may then stabilise for a while until there is a new technological disturbance. Technological changes may be treated as displacement factors which may be allowed for in order to expose an underlying relationship between investment and profitability. The development of public utilities and infrastructure has similar effects and may be accounted for in the same fashion.

The remaining considerations cannot make for any significant change in investment over time because they are 'permanent' characteristics of the economy — its geographical location, the affinity between its culture and the investor's own, and its social and political history. Except for geography all these factors may change over time, and surveys find them to be among the compelling factors in the international flow of capital. However, changes take so long to become embedded that these influences must be taken for granted for the purposes of our analysis.

In assessing tax policy for promoting investment we shall therefore be concerned with effects on the rate of return. Tax changes may also affect intended investment if they induce exchange rate changes, though this would not usually be a deliberate effect. The impact on the rate of return will depend on the firm's ability to shift taxes, which is examined fully in a later section.

Investment is not at all influenced by domestic saving, which is determined by the level of real income, the expected exchange rate, the expected level of inflation, the interest on bank deposits at home and abroad and, where inflation is very high, the real rate of interest on financial assets. The desired level of saving is determined by real income, but if the exchange rate is expected to depreciate, some saving may be held in foreign assets. Exchange controls have proven useless in containing this tendency.

If inflation is expected to accelerate consumption purchases may be advanced, and saving may decline. The proportion of saving which is held as domestic financial assets may not be large, because most bank deposits are on-lent for consumption purposes, and do not represent saving. Bank deposits may be shifted abroad if foreign interest earnings exceed domestic deposit rates by enough to cover the cost and nuisance of transferring funds; this is a loss of domestic saving only to the extent that banks cut lending for investment to make the transfer possible. The elasticity of substitution between real and financial assets is not great because of vastly differing degrees of liquidity, possibilities of capital gain or loss, costs of maintaining values, and diverse factors affecting expectations on real and financial markets. It will require a rather large discrepancy between interest and expected inflation to affect a shift from consumption to saving.

If domestic saving is not forthcoming in quantity sufficient to satisfy intended investment induced by expected relative profits, foreigners will come in to take advantage of the domestic opportunity. There is not much point to increasing savings per se. Unless the savings-promoting policies also generate additional investment the additional saving will all be lent abroad.

Tax relief on interest income may raise the savings ratio by making savings attractive relative to inflation or foreign exchange hedges. However, this has the result only of an induced outflow of finance, and will not affect investment and growth. Tax policies that influence the growth rate are those that increase the net return to investment, and they may include concessions on mortgage servicing and on direct investment.

Tax Changes and Government Finance

If there is a change in tax policy with no change in government spending or other sources of government revenue the fiscal deficit is affected. It is necessary to explore the consequences of the changed deficit alongside the tax measures which occasion it. When tax receipts are increased government may reduce its borrowings from the banking system, repay the non-bank public or repay foreign loans.

If government repays commercial banks they may be expected to adjust loan and deposit rates in order to maintain levels of profitability. Deposit rates may fall somewhat, but they cannot be reduced substantially below comparable rates abroad, without provoking a switch to foreign deposit holding. That is one possible reaction, although too low a deposit rate risks an ongoing drain of funds from the domestic economy which would eventually exceed the surplus deposits created by government debt repayment. Some differential between domestic rates and comparable foreign rates is to be expected because of transactions costs and exchange rate expectations; banks may exploit this margin to shave something from deposit rates. The legacy for altering deposit rates is insufficient to induce any switch between bank deposits and other financial assets available to the public.

Banks may either lower or raise loan interest rates, depending on their perception of the interest elasticity of loan demand. If the elasticity is sufficiently high to secure additional loan volume sufficient to replace credit to government loan rates will fall. However, it is equally possible that loan rates will rise, so banks compensate for the lower volume of loans by increasing the net return on each unit.

Table 1 presents evidence drawn from several studies on the interest elasticity of loans and deposits in three Caribbean countries. With the generally low elasticities recorded, a tax increase is likely to provoke an increase in loan rates and a decline in deposit rates. The loan rate increase may not affect the volume of loans very much and it should not make much difference to the level of economic activity, so long as the change does not push the rate far out of the range of recent experience. If it does, interest costs may inflate the prices of non-tradables and depress the supply of tradables. The falling deposit rate should not affect the level of deposits unless it goes below comparable foreign rates, after the cost and risk of foreign financial transfers are allowed for. If the rate does go too low there will be a drain on foreign exchange and an equivalent fall in deposits.

So long as banks are able to accommodate without drastically changing interest rates the system may absorb new finance from the proceeds of taxation without any detectable effects on the real economy. Significant changes in the ratio of taxation to GDP may provoke interest movements that do have real effects, however. The effects may include a deterioration in the capital account of the balance of payments as low deposit rates act as an incentive to hold foreign assets and domestic inflation and contraction of tradables as finance costs rise. Conversely, a very large tax cut may serve to induce the repatriation of financial assets, to the extent that banks seek to finance the increased fiscal deficit. However, the effects may not be symmetrical for increasing and decreasing deficits. If the deficit rises the differential between loan and deposit rates may not narrow if banks are fully loaned up to begin with. The rising government borrowing requirement will tend to lift loan interest rates in this case. Only where lending to government offers an opportunity to employ idle funds may the general level of loan rates be depressed. A modest tax cut may be innocuous, but if the impact on the fiscal deficit is large, the inflation and output consequences are much the

TABLE 1. INTEREST ELASTICITIES OF MONEY AND CREDIT

Study	Variable Explained	Interest Rate Variable	Coefficient and t-statistics	Indicators of Education Performance
Holder & Worrell [1985]	Ln TML (B'dos)	$D(r_d - r_f)$	-0.05 (-0.46)	R^2 = 0.56, DW = 1.29, SEE = 0.96, F(3,17) = 7.33
"	Ln TML (Jamaica)	"	-0.04 (-0.36)	R^2 = 0.62, DW = 1.91, SE = 0.91, F(3, 17) = 9.38
"	Ln TML (Trinidad)	"	0.79 (7.29)	R^2 = 0.93, DW = 2.02, SEE = 0.58 F(3,16) = 67.9
Bourne [1974]	SD	RTSD	-0.1911*	R_2 = 0.9994, SEE = 0.9127, F = 628.1, Rho = -0.4924, DW = 1.86
Worrell [1985]	LnCR (B'dos)	Lnr_l	0.22 (0.60)	R^2 = 0.99, DW = 1.63, SEE = 0.12, F(2,18) = 6414, Rho = 0.81
"	LnCR (Jamaica)	"	1.69 (1.56)	R^2 = 0.99, DW = 2.02, n = 22, Rho = 1.15
"	LnCR (Trinidad)	"	2.31 (2.26)	R^2 = 0.97, DW = 1.63, SEE = 0.21, F(2,17) = 282.5, Rho = 0.1
"	LnDP (B'dos)	$LnD(r_d/r_f)$	-0.24 (0.90)	R^2 = 0.75, DW = 2.16, SEE 0.62, F(2,18), 27.09, Rho = 0.41
Worrell [1985]	LNΔDP (Jamaica)	$Ln\ D(r_d/n_f)$	-0.09 (0.20)	R^2 = 0.62, DW = 2.04, n = 22,; SEE = 1.50
"	LnΔDP (Trinidad)	"	-0.29 (-1.17)	R^2 = 0.76, DW = 2.04, SEE = 0.93, F(2,18) = 28.65
Worrell & Prescod [1983]	TML	r_d-r_f	-5.20 (-4.79)	R^2 = 0.9351, DW = 2.42, Rho = 0.66 (1963-80)

"	TML	"	-0.52 (-1.59)	R^2 = 0.3870, DW = 2.06, Rho = 0.39 (1963-80)
"	SD	"	0.61 (1.59)	R^2 = 0.6767, DW = 1.3 (1960-80)
"	TD	"	-0.64	R^2 = 0.5082, DW 1.98 (1960-80)
"	Cr (agr)	r_l-P	-0.13 (-0.49)	R^2 = 0.03
"	Cr (mfg)	"	-0.18 (-1.48)	R^2 = 0.85
"	Cr (Constr.)	"	0.02 (0.15)	R^2 = 0.12, DW = 2.23
"	Cr (distribution)	"	0.09 (0.38)	R^2 = 0.26, DW 1.60
Saunders & Worrell [1978]	Loans	r_l	-9.00 (-1.19)	R^2 = 0.9624, DW = 1.73, n = 17
Worrell [1985]	LnDP	Ln_d/r_f	0.01 (0.05)	R^2 = 0.9417, SEE = 0.2399, DW = 0.4, F = 178.66 (1961-85)
"	LnCr	Lnr_l	0.42 (0.94)	R^2 = 0.9425, SEE = 0.2575, DW = 0.51, F = 181.36 (1961-83)

Note: *Long-term elasticity *Sources:* Bourne (1974), Holder and Worrell (1985) pp. 411-28, Saunders and Worrell (1978), Worrell (1985a, b), Worrell and Prescod (1983).

Symbols: Cr = Credit; D = A dummy variable; DP = Deposits (total); r_d = Deposit interest rate; r_f = Foreign interest rate; r_l Loan interest rate; RTSD = Interest rate on time and savings deposits; SD = Savings deposits; TD = Time deposits; TML = Total monetary liabilities.

same as for an increase in taxation, if the fiscal deficit is accommodated by the banking system in either case.

The proceeds of increased taxation may be used to repay government bonds, bills or other obligations held by the non-bank public. If the change is sufficiently large the unwanted liquidity may serve to depress time deposit rates and returns on private securities. There may be an outflow of funds and finance costs for producers may moderate. However, there may be some inflationary tendency, if the demand for real estate is stimulated by the excess liquidity, for example. Where a large tax reduction is financed by borrowing from the public there may be a tendency to draw funds from abroad and some inflation in the costs of finance.

The tax adjustment may be financed directly by overseas borrowing or repayment, provided that there are sufficient foreign exchange reserves, that the country's credit rating is satisfactory or that government is satisfied that any induced changes in the exchange rate are desirable.

None of the effects on real output, prices or the balance of payments will appear for modest changes in tax rates of the kind that are a feature of most budgets. How large a shift in the tax system would be needed to provoke these changes can only be gauged on a country by country basis. However, we are on reasonably firm ground if we assume that there will be no real economy effects from the financing of tax rate changes unless the overall tax/GDP ratio shifts by several percentage points.

The Personal Income Tax

For each of the taxes examined we look separately at changes in the rate of tax and in the tax structure. The rate may be measured by the ratio of the tax to its base, and a change in rate occurs when that ratio changes as a result of policy without affecting the relative burden of the tax on any segment of the population. The structure of the tax refers to the provisions which determine its incidence on each category of income earner, and it is determined by the marginal rates and their cut-in points, the levels of exemptions and the criteria for exemption. The distinction is for convenience of exposition; tax measures usually involve changes in rate and structure. For each tax we discuss how changes in rate and structure may be used for economic

stabilisation — that is, to alter income, the balance of payments outcome and prices in the short run of one year or thereabouts — and to influence the growth of output in the long run of five years or more. It is useful to distinguish two categories of activity, following the familiar Solow-Swan dichotomy: production of tradable goods, including all items which may be exported or substituted for imports, and the production of all other (non-tradable) goods. We assume that factor markets are similar in both kinds of activity, but differences in product markets will make for different outcomes of the same tax measure in the two cases.[3]

An increase in the rate of personal income tax may serve to arrest a deteriorating balance of payments and slow down inflation, but it may also depress production in the short run. The tax increase reduces real disposable income and cuts the demand for imports and for locally produced goods. As the demand for non-tradables contracts, production falls and prices level off. Tradables have a ready market overseas, so their sales are not affected. If anything, exports should increase as local demand for exportables falls, but this is not likely to be of significance in small economies. The balance of payments improves because of the drop in imports of consumer goods and of imports for the non-tradable sector. There will be some accretion of foreign exchange reserves; even if the exchange rate is flexible, the magnitude of reserve gain from tax rate adjustment is unlikely to provoke an exchange rate appreciation in small developing economies. The reserves gain will be associated with increases in monetary liabilities, which may cause adjustment of bank loan and deposit rates, but they are unlikely to be of a magnitude to affect prices, output or capital movements.

A reduction in the tax rate may have symmetrical effects on the economy in the short run if the exchange rate if fixed and foreign exchange reserves are ample. However, if the exchange rate is flexible there is the risk of serious inflation. Exchange rate influences are symmetrical in small economies: quite small impulses may depress the rate, but only major improvements such as the discovery of a valuable natural resource will cause it to appreciate. The danger of inflation is even greater where there is a nominally fixed exchange rate inadequately protected by foreign reserves. As reserves are depleted speculative demand for foreign exchange grows, and heavy devaluation ensues, either officially or by diversion of

foreign exchange to unofficial markets. Excessive devaluation may wipe out the gains in output expected from the tax cut, because local producers are unable to cope with the rapid changes in costs.

Changes in the personal tax rate will have little impact on the economy's long-term prospects. They do not directly affect the rate of return on investment in the tradable sector which is the crucial factor for the economy's overall capacity for growth. The impact on disposable incomes may affect the profitability of producing non-tradables in the short run, but output will presumably be adjusted to restore desired profit levels. The profitability of producing tradables rises if a tax cut causes the exchange rate to depreciate, but that outcome may be secured by devaluation with no tax cut.

Changes in the structure of the personal income tax would not normally be intended to stabilise the economy. They may in fact have such effects if the propensities to spend on tradables and home goods are markedly different for individuals at different income levels, for earned income and property income, or for capital gains and other income. However, information of the kind needed to guide policies to exploit these differences is seldom so reliable as to make structural tax adjustment a useful stabilisation policy, except in cases of severe disequilibria.

Changes in the personal income tax structure are more properly designed to accelerate growth in the long term. The desired adjustments are those which improve the net yield on fixed investment relative to the yield on foreign and financial assets. They include tax credits on earnings retained by the firm for investment, tax credits for corporation tax payments, allowances on service payments for mortgages and tax sparing on income used for direct investment. Concessions on savings instruments — tax free interest earnings, tax credits for purchase of savings bonds — have no inherent effect on growth.

If policy-makers wish to adjust personal income taxes so as to stabilise the economy and enhance the prospects for long-term growth it seems their best policy is an increase in the overall tax rate with concessions which will increase the net return on investment directly.

There may be a modification of this recommendation where taxation represses the supply of skills. Much recent popular attention has focused on the impact of tax changes on the supply of labour (including female participation in the labour force), but the marginal unskilled worker pays no tax and in most developing countries there is a pool of unemployed labour ready to replace him at some reservation wage. The impact of taxation can therefore only be on the level of skills. If highly skilled workers are heavily taxed they may emigrate. Many of those whose capabilities are in greater demand may divert their attention from other production to the tax evasion industry. Furthermore, talent may be deflected to the underground economy, which is less efficient than the formal economy in producing on a scale that can make noticeable impact on economic growth. It is much less likely that the tax system will dissuade people from investing in improving their skills. There is nothing to the popular argument that taxation causes workers to malinger and produce less with the same labour input. Aggregate labour productivity is a function of management and technology, not at all of workers' motivation. (Some would argue that worker motivation varies with the quality of management.)

Adverse effects of taxation on the supply of skills may arise where the domestic tax rate is inordinately high relative to rates in the centres of migration, once discounts are made for the costs of relocation, which are monetary, social, psychological and political, and may include climate and the home environment. Also, the levels of government service available to potential migrants must appear roughly comparable at home and abroad. If the security of person and property, health care, education and assistance to dependents are not at comparable levels, sufficient discount must be allowed against the less burdensome tax regime before there is a sufficient incentive to migrate.

The tax system reduces the supply of skills where there is lack of consensus on the distribution of the burden of paying for public services, or when governments fail to respect that consensus. Loss of skills also occurs where the society cannot find a generally acceptable compromise on the proper scope for provision of public goods, or where government ignores the preferred compromise.

In circumstances where social consensus has been obtained one may excite long-run growth by removing the perceived inequities in the tax system. It may be necessary to restructure the personal income tax to redistribute the burden, to alter tax rates overall or to change the level and scope of government expenditure.

The Corporation Tax

The effect of changes in the rate of corporation tax will vary from sector to sector, depending on the elasticity of demand for the product, the elasticity of factor substitution and the returns to scale in the industry. In the non-tradable sector, where the elasticity of demand is relatively low, tax changes may be passed on to customers to some extent. Tax increases may lead to some inflation, a reduction in output and, where there are elements of monopoly, a squeezing of profit margins. In the tradable sector elasticities of demand are high, and the tax must be added to the producer's cost. Output may have to be reduced substantially in order to restore an acceptable rate of profit.

In industries where the elasticity of substitution is low it will not be possible to sustain output by switching from capital, now relatively more expensive because of the additional tax, to labour. The price increase or quantity reduction, or the loss of profit will therefore be more severe for firms in this situation than for those which can avail themselves of greater factor substitution. Similarly, if the returns to scale diminish perceptibly, it may be possible to effect adjustment of prices, output and profit with an adjustment in the neighbourhood of the pre-tax level of operation. However, if there is not much change in the returns as output increases or decreases, the adjustment must be substantial.

Table 2 summarises the probable outcomes for an increase in the rate of corporation tax. In general it will be inflationary because of its effects on the supply price of non-tradables, it will weaken the balance of payments because of its effect on the supply price of tradables and it will depress output on both accounts. In the long run growth potential will be impaired if tradables are less profitable to produce. But tradable profits may not fall much because there is less scope for 'excess' profits in the tradable sector

TABLE 2. IMPACT OF INCREASED CORPORATION TAX

Elasticity of Demand	Elasticity of Substitution	Returns to Scale	Short Run			Long Run
			Q	B	D	PR
High (Tradables)	High	Rapidly	-	-	-	-
	Low	"	—	—		—
	High	Slowly	-	-		-
	Low	"	—	—		—
Low (Non-tradables)	High	Rapidly	-	+		-
	Low	"	-	+		-
	High	Slowly	-	+		-
	Low	"	-	++		-

Key Q Change in output
B Change in balance of payments
P Change in prices
\- Small to moderate decline
— Moderate to large decline
\+ Small to moderate increase
++ Moderate to large increase

(which might be used to cushion taxation) though in the real world we should not assume that firms operate only at 'normal' profit, even in the tradable sector. The magnitude of all effects depends on elasticities of substitution and the returns to scale.

A reduction in the corporate tax rate might enhance growth potential, strengthen the balance of payments, dampen inflation and stimulate output in the short run, but only if the elasticities of substitution and scale factors are favourable. The profitability of investment in tradables is enhanced if

the elasticity of substitution is low in that sector, so that a fall in tax liability provides a significant increment to the rate of return, an improvement which is not available by switching to more labour intensive processes. If returns to scale are diminishing slowly in the tradable sector there may be considerable gain in output in response to tax concessions before unit costs increase sufficiently to wipe out the additional profit. This combination of circumstances is the most propitious in its implications for growth. In general, we should issue a caution about all the expected reactions; for most actual circumstances they may be quite weak.

Changes in the structure of corporation tax which discriminate in favour of the tradable sector should strengthen the balance of payments and increase output by allowing more competitive pricing in the supply of tradables. They might also encourage higher investment in the tradable sector, to the extent that it can take advantage of market imperfections to enhance its profitability. Corporate tax credits for export performance are an example of changes which might be justified on these grounds.

Corporation tax revisions that reward investment should also be growth promoting because of the impetus they give to the tradable sector. Accelerated depreciation allowances, investment tax credits and changes in the rules of accounting to permit higher claims against investment should all serve to enhance the economy's potential.

Corporate tax reform for economic stabilisation and growth requires prior information on the elasticity of substitution and the returns to scale, particularly in the tradable goods sector, to determine whether a reduction of the corporate rate will have measurable effects. If the tradable sector meets the criteria for significant impact, a reduction of the corporate tax rate is indicated. In addition, the tax structure might be biased so as to give higher returns for investment in tradables and for the re-investment of earnings.

Import Duties

Increases in the rate of import duty have relative price effects that depress imports and substitute demand for domestic output. They thereby boost output and strengthen the balance of payments. Absolute price effects are

diminished because most developing countries make intermediate and capital goods exempt from duty. Inflation varies with the proportion of consumer imports, the elasticity of substitution between consumer imports and domestic final goods (which determines to what extent the duties will reduce the propensity to import final goods), and the pricing policies of firms which distribute imports. Provided imported inputs remain tax exempt import duties have no effect on the profitability of exports. They may make a contribution to the capacity for growth by their effect on the profitability of import substitutes. Increases in the import duty may therefore be a useful component of economic stabilisation packages; their long-run effects may not be very powerful because of the limited potential for import substitution in small economies, but they are in the right direction.

The arguments for long-term growth point in the direction of full exemption for imported inputs. The case for uniform import duties on all items rests on the assumption that long-term discrepancies in the rates of profit on tradables, non-tradables and investment abroad cannot persist. If that were so import duties would not matter because production would always adjust to the level required to restore the common rate of profit. In practice rates of profit differ, and may be enhanced by reducing the cost of imported inputs by eliminating taxation on them.

The input tariff is never imposed at a single rate for all items. The structure is frequently changed as rates are altered for one class of goods and not another. To maximise the extent of import substitution one might tax more heavily those items where the elasticity of substitution between home goods and imports is very high. But this strategy is limited by the potential loss in government revenue, which may be significant.

Other Indirect Taxes

Changes in the rates of sales taxes, value added taxes, excises and stamp duties have relative price effects because of the varying price elasticities of demand for the products to which they apply. They also increase costs of inputs and final goods, adding to the rate of inflation. Disposable income may decline as a result of general inflation because we have stipulated that government will not spend the additional revenue, and the reaction of the

banking system to reduced government borrowing does not raise incomes in the private sector. Higher indirect taxes should arrest the growth of demand and cut imports, but at the expense of inflation. Moreover, their impact on long-run growth is negative, to the extent that taxes raise the costs of inputs.

However, indirect taxation offers the possibility of selecting the items on which additional imposts are to be laid. The choice can be made so as to minimise the adverse growth and inflation outcomes. To reduce the threat of inflation the tax increases should rest heavily on items where price elasticities are quite high, so that the impact falls mainly on output. To lessen the danger of loss of investment taxes on intermediate goods should be replaced by taxes on final goods whenever possible. In general, indirect taxes are useful mainly for economic stabilisation, and they should concentrate mainly on final goods, with reduction or elimination of excises and stamp duties which fall indiscriminately on intermediate and final goods.

Tax Changes for Growth and Stabilisation

The foregoing discussion offers no clues about the kind of tax package that would encourage rapid growth without precipitating an external payments crisis. Quantitative exercises would have to be undertaken to establish the probable magnitude of the responses to tax changes in the long run and in the short. As far as possible complementarity of effects could be exploited. In this section we sketch the contours of a desirable tax package, without attempting quantification. The effects on the distribution of income have been left out of the picture; in practice it would be necessary to analyse the income distribution effects of whatever policy emerges from a study of this kind, and make adjustment if the alterations were deemed socially unacceptable.

In order to promote economic growth the structure of the personal income tax should be adequate to allow sizeable exemption for direct investment by the tax payer. The authorities may need to change the personal tax ratio, if there is strong public sentiment that government services are woefully out of line with the tax burden, or if there is glaring discrepancy between the domestic taxation/services compromise and that

in countries to which skilled workers may migrate. If there is threat of external payments disequilibrium, an increase in personal income tax rates may be useful, and it would also help to dampen any inflationary pressure. However, real output might be expected to fall in the near term.

A reduced rate of corporation tax should serve as a stimulus to investment and growth, particularly where the possibilities for factor substitution in the tradable sector are low. Investors in tradables, which are crucial for potential growth in the long term, capture most of the gains from tax relief in this circumstance. Corporation tax concessions based on export performance and on firms' propensity to invest would also enhance the prospects for growth. Reduction in the corporate tax may strengthen the balance of payments in time as exports grow, and it may help in the fight against inflation, but it is not a powerful weapon for stabilisation.

Higher import duties, with exemption for producers' goods, should spearhead the measures for short-term economic adjustment. They have no lasting effect on growth potential, and they should result in an improved balance of external payments with some increase in the production of import substitutes. Inflationary effects will be softened by exempting producers' goods and by structuring the duties to fall most heavily on items where the relative price elasticity for imports and local goods is high.

Increases in sales taxes and other indirect taxes on final consumption goods may be used to cut back demand which threatens the balance of payments, though at the expense of some inflation and possible loss of output. The increases are less inflationary if they are arranged to fall most heavily on items with a high elasticity of demand. Excises and stamp duties have a significant impact on producers' costs and therefore on profitability and long-term prospects, so indirect taxes should be adjusted to reduce the burden in these directions.

The preferred tax combination for stabilisation and growth, assuming there is no other fiscal change, would include personal tax exemption for investment, mortgages, purchase of shares and dividends, but no change in the rate of tax. If the overall revenue requirements permitted, corporation tax rates might be reduced, and provisions for relief based on investment and export performance reinforced. The rates of import duty and of sales taxes might be increased, but excises and stamp duties should be eased. We

do not stipulate whether the overall effect should be to increase or reduce tax revenue. That question may only be answered by addressing simultaneously government spending, revenue and financing. An assessment of the direction and magnitude of the overall tax change would have to be made before deciding on the issues discussed in this paper, which have to do with the allocation of any additional tax burden. That initial target for revenue would have to be revised after assessing the impact of taxes by means of the disaggregated analysis which the present study provides.

Second Round Effects

The analysis so far has concentrated on the direct impact of tax measures on the economy, to the neglect of further repercussions that the initial responses might themselves instigate. We now explore these possible reactions — the wage-price spiral, the implications of demand expansion or contraction and the monetary effects of balance of payments changes.

Any tax measure which generates inflation risks setting off a delayed wage reaction which can fuel inflation in an upward spiral of prices and wages. Increases in indirect taxation included in the suggested package for controlling an excess demand of foreign exchange carry the danger of initiating an exponential increase in prices. It could frustrate the policy-makers' intentions by driving up costs, eroding the competitiveness of exports and import substitutes and diverting demand from increasingly expensive non-tradables. The balance of payments weakens and profit rates are compressed, worsening the investment outlook. This danger highlights an important advantage of taxation over other policies of balance of payments adjustment such as exchange rate adjustment, interest rate changes and credit policy. By selecting a judicious mix of tax policies one may target the balance of payments directly, skirting possible inflation by discriminating among individual tax rates. Taxes may be set to target final goods rather than producers' goods and elasticities of demand can be exploited to reduce real purchases rather than to drive up prices.

Where threat of a wage-price spiral emerges it might be thought that concessions on the personal income tax could be used to discourage aggressive pursuit of nominal wage increases. In practice such a trade-off

is normally beyond reach. It demands a much more sophisticated understanding of the tax system than is typically the case. More fundamentally, the switch of tax relief for wage increases, even if it has identical impact on real disposable income in the aggregate, will cause some households to gain at the expense of others. The potential losers will remain adamant about their wage increase.

The crucial variables in determining the strength of the wage-price spiral are the magnitude and duration of the initial inflationary shock, the extent of formal indexing and the extent of unemployment. Large price increases which are sustained by widespread systems of formal indexing or a succession of policies which generate inflation year after year ensure the persistence of inflation expectations and bring up a virulent cost reaction. However, very high levels of unemployment eventually break the spiral.

The strength of expected cost reaction will colour the choice of tax policy. In economies which are inflation-prone especial care should be taken to avoid taxes which have a strong price impact. Such taxes might be helpful to policy-makers in low-inflation countries, which may tolerate the costs of some rise in prices.

Tax increases designed to dampen spending tend to depress income, or at least to slow down the rate of expansion. The loss of income further reduces spending and helps to correct balance of payments disequilibria. However, this is the kind of adjustment countries are most anxious to avoid, because of the trade-off between growth (in the short term and perhaps also in the long) and stabilisation. The use of expenditure switching tax measures such as import duties could theoretically correct the external payments and stimulate the growth of output, but that requires very high values of the elasticity of substitution between imports and domestic output, of the ratio of non-tradables to output and of the marginal propensity to import.

Improvements in the balance of payments lead to a build-up of foreign exchange reserves and a corresponding rise in domestic deposits and currency. The reaction for changes of the magnitude that can result from tax policy should not generate any real sector response. However, if the balance of payments worsens and the currency is allowed to depreciate (or the authorities do not have the foreign exchange with which to support the

exchange rate) inflation will result and the spectre of the wage-price spiral re-emerges. Such an outcome inevitably destroys the credibility of the tax strategy which provoked it.

Summary

Because fiscal policies have such powerful macroeconomic effects in small open economies, it is vital that they be framed so as to promote the transformation developing economies need for growth, as well as to ensure tolerable price, output and balance of payments outcomes in the short run. This paper examined how tax policy may be used creatively to this end. The variety of available taxes, each with a different impact, provides an opportunity to custom design the tax package in light of each economy's problems and circumstances. Our survey of the effects of the personal income tax, the corporation tax, import duties and sales taxes provides the basis for putting together a package that offers the best growth rate that is compatible with the objective of stabilisation. The package will be tailored to the country's circumstances and its elements will vary according to the virulence of domestic inflation, the existence of excess demand or supply of foreign exchange, the extent of spare capacity in the tradable sector and the existing propensity to invest. The tax arrangements would have to be fitted into an overall programme which included policies for government spending, government finance, financial adjustment and the exchange rate, all evaluated on similar criteria of short- and long-term effects.

NOTES

[1]The notion of the balance of payments constraint, dismissed by neo-classical economists, has recently re-emerged as a major issue for the UK (Williamson [1984]) and for developing countries (Thirlwall and Hussein [1982], Helleiner [1986]).

[2]This assumes that domestic currency is the investor's currency of reference. If it were not we would have $RPRN^* = PR^* - PRF^* + ERN^* - ERF^*$ where ERN and ERF are competitive exchange rates in terms of the currency of reference.

[3]The model we have in mind is described in Holder and Worrell [1985].

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APPENDIX

A Model of Output, Prices and the Balance of Payments

The model which informs our discussion of the short-term repercussions of tax changes may be represented by a system of seven equations to determine output, prices and the balance of payments.

Output

Output is decided on the markets for tradables and non-tradables. The demand for tradables is infinite and output depends on the costs of supply:

$$q_t = q_t, s, c) \qquad \text{(A1)}$$

is the equation of the supply curve where the symbols are:

q_t = output of tradables

P_t = exogenous price of tradables

s = unit labour cost

c = user cost of capital

Suppliers of non-tradables aim to provide a quantity sufficient to make up some of the discrepancy between expected demand and the amount reaching the market in the previous period.

$$q_n = q_n\,(y, P_t/P_n, q_n\,(-1)) \qquad \text{(A2)}$$

q_n = output of non-tradables

y = real disposable income

P_n = price of non-tradables

They supply this amount at a price given by their supply curve:

$$P_n = P_n\,(q_n, s, c) \qquad \text{(A3)}$$

These three equations together determine total output and the price of non-tradables.

Prices

Consumer prices move with changes in the prices of tradable goods and with the inflation of non-tradable prices, which include the distribution costs of bringing tradable goods to retail markets:

$$P_c = P_c(P_t, P_n) \qquad \text{(A4)}$$

The Balance of Payments

The demand for real imports (m) is similar to the demand for non-tradables:

$$m = m(y, P_t/P_n) \qquad \text{(A5)}$$

The simplest way to represent external balance is to constrain the change in foreign exchange reserves to zero. The reserves change is the difference between exports and net capital inflows, and imports:

$$o = P_t\, x\,(q_t, P_t, P_n) - P_t m + K \qquad \text{(A6)}$$

x = real export

K = net capital inflow

The first term on the right hand side gives exports as a function of the output of tradables, simplified by neglecting domestic consumption of tradables which is typically small for small open developing economies. It is derived from the identity for value added in the tradable sector:

$$P_t x = P_t q_t + P_t m_t\,(q_t) + P_n\, i(q_t) \qquad \text{(A7)}$$

m_t = imported inputs for tradable sector

i = domestic inputs for tradable sector

The Effects of Taxation

The effects of taxation may be traced through from the variable which registers their initial impact. The personal income tax reduces disposable income and thereby inhibits the demand for non-tradables and imports. Corporation taxes increase the user cost of capital and raise the supply prices of both categories of goods. Depending on the basis for tax exemption the personal income tax may also affect the user cost of capital; a formula combining all the tax effects appears in Chirinko and Eisner [1983, p. 141]. Import duties alter the relative price terms and the mix of imports and non-tradables in consumption. They will also affect exports. Sales taxes also affect relative prices because of the differing elasticities of demand for the products on which they are applied.

The Political Economy of Tax Reform in Trinidad and Tobago

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Since Independence in 1962, Trinidad and Tobago has witnessed three formal attempts to review and reform the tax system.Tthe first was the Report of the Tripartite Committee to Review the Fiscal Policy of Trinidad and Tobago, 1967 (the Alleyne Committee). The second was the Report of Fiscal Review Committee, 1981 (the Bruce Committee), and the third was the Report of Fiscal Review Committee, 1986 (the Barsotti Committee). The Tax Performance Committee (the Ferguson Committee) has been established to continuously monitor and review the operations of the tax system.

In addition to these special committees, there have been other reports which have dealt with specific aspects of tax policy, viz.

(i) Trinidad and Tobago: Sales Tax and other Options of Indirect Tax Reform (IMF Fiscal Affairs Department). Ved Gandhi and others (1983);

(ii) Kong Committee on Land and Building Taxes (1980).

Also noteworthy are certain budget statements which effected substantial changes in the tax system, as well as the Report on Government Expenditures (Bobb Committee).

This paper seeks to review and assess these reform attempts by (i) examining their impetuses and objectives, (ii) examining their methods and approaches and (iii) assessing their results and achievements. In doing this, I seek to place emphasis on the contexts within which each reform exercise was undertaken and who the major players and interests were, since these factors were likely to bear on, if not determine, the observed outcomes. By

taking this approach, we are of the view that it is likely to complement other approaches which attempt to concretise abstract notions of equity, efficiency, stabilisation, etc.

ORIGINS AND DEVELOPMENT OF THE TAX SYSTEM

From Surpluses to Deficits, 1951-1967

The tax structure in Trinidad and Tobago has been different from that of most other developing counties in the relative importance of direct taxation compared with indirect taxation. In the 1950s, direct taxes accounted for over 50 per cent of total recurrent revenue while indirect taxation accounted for 37.0 per cent over the 1951-56 period and 35.3 per cent over the 1958-62 period. Non-tax revenue averaged 11.0 per cent over the 1951-56 period. (The discussion here draws extensively on Bobb, 1969 for the period 1951-68. See also Farrell, 1975.)

The dominance of direct taxation is explained by the importance of the petroleum sector and its taxation as a source of government revenue. Indeed, oil revenues accounted for two-thirds of direct taxes and one-third of total recurrent revenue over the 1951-56 period. Import duties accounted for two-thirds of total indirect taxes. Thus, as Bobb noted: "... the tax system was heavily imbalanced in the sense that a very high proportion of revenue derived from a limited number of sources" (p. 60).

Up to 1956, the fiscal authorities seemed to be acutely aware of the imbalance in the structure of government revenues and, apparently, also took the view that taxation was as high as it should be, lest the tax regime prove to be a disincentive to investment. Fiscal policy thus tended to focus mainly on expenditure control so as to achieve a current budget surplus, taking tax and non-tax revenues as given. After 1956, and particularly after independence in 1962, this approach to fiscal policy changed and, as a consequence, there was a concomitant change in tax policy.

The nationalist government which came to power in 1956 determined that government should play a rather more active role in the development process than hitherto. The role of government was still to provide the infrastructure to facilitate the growth of economic activity led by the private sector. However, the new political directorate was to be more dynamic and

aggressive in the pursuit of its objectives. Inevitably, this meant a higher level and a faster rate of growth of expenditures. As a result, the recurrent surpluses declined and the surplus balances were soon exhausted (Bobb 1969, pp. 71-75). (See also Robinson (1967).)

Government expenditure expanded even more quickly after independence, partly because the government now had responsibility for defence and foreign affairs, but also because a newly independent people were more expectant and hence more demanding. At the same time, the rate of economic growth was slowing due to a decline in the petroleum sector, and unemployment had begun to rise, putting pressure on the social welfare system.

The fiscal response to this was to attempt to effect a shift toward indirect taxation and to undertake a number of institutional reforms. The 1962 budget sought to increase revenue by introducing purchase taxes and increasing tariffs. As a result of these initiatives, the share of indirect taxes in total recurrent revenue increased from 35.3 per cent in the 1958-62 period to 38.4 per cent in the 1963-67 period, while the share of direct taxes fell from 54.5 per cent to 51.7 per cent over the same periods.

Direct taxation was also increased. Rates of tax on personal incomes were raised, the company tax was increased from 40 per cent to 42.5 per cent and the initial (investment) allowance was reduced from 40 per cent to 20 per cent.

Institutional changes over the 1962-66 period included (i) the broadening of the system of current payment of tax to include companies and the self-employed (1963); (ii) the strengthening of tax administration with the introduction of training for staff of the Inland Revenue Department, and (iii) the Finance Act, 1966 which provided for:

(1) the separation of the personal income tax from the taxation of companies and the provision of a dividend income allowance for residents;

(2) the imposition of a 30 per cent statutory rate of withholding on distributions and certain other payments to non-residents subject to the variation of this rate through Double Taxation Treaties;

(3) the removal of the favourable treatment which used to be accorded to income earned abroad by a resident so long as it was retained abroad;

(4) the limiting of tax concessions in respect of insurance premiums to policies written in Trinidad and Tobago currency;

(5) the removal of tax liability from distributions out of tax-exempt profits made by a company to its shareholders and received from a pioneer company;

(6) the removal of the provision requiring pioneer companies to distribute their tax-exempt profits within two years of the expiration of the pioneer period;

(7) an export allowance to companies for increased exports;

(8) administrative provisions designed to strengthen the Inland Revenue Department and for the functioning of an Appeal Board;

(9) a charge to tax on capital gains accruing on disposal of an asset within one year of acquisition. Certain gains, principally from securities, were exempted from this provision.

In addition the establishment of the Central Bank and the passing of the Insurance Act, 1966 laid the basis for the development of a capital market and therefore the long-term financing of government budgetary deficits (Robinson 1967).

Despite these changes to the tax regime, the ratio of tax revenue to GDP averaged 15.2 per cent in the period 1958-67 compared with 15.7 per cent in the 1951-56 period. The buoyancy coefficients with respect to total tax revenues computed by Bobb for the period 1951-67 and 1958-67 were less than unity (0.94 and 0.96, respectively), while the buoyancy coefficients for oil revenues were even lower (0.85 and 0.70, for 1952-67 and 1958-67, respectively). On the basis of a comparison with several countries which shared certain of Trinidad and Tobago's characteristics, Bobb concluded that Trinidad and Tobago's tax effort was low relative to its taxable capacity (Bobb 1969, pp. 88-100). A similar analysis was reported in the 1968 Budget Speech (E.E. Williams, Minister of Finance) which came to the same conclusion.

The reasons for Trinidad and Tobago's low tax effort seemed to be due mainly to its inelastic tax bases. For example, personal income taxes yielded a small proportion of revenues because of widespread avoidance and evasion. In 1958, the Pay As You Earn (PAYE) system was introduced to reduce tax evasion among wage and salary earners in large enterprises. The personal income tax structure in the 1950s and 1960s appeared, prima facie, strongly progressive to the point of being punitive. The highest marginal rate in the 1958 and 1964 structures was a staggering 90 per cent (Table 1). However, effective tax rates were lower than elsewhere for most income-earners. Bobb reports that:

> On the average, between 1964 and 1966, approximately 97 per cent of *chargeable* incomes assessed to tax were less than or equal to TT$8,600 (a single individual claiming only a personal allowance of TT$1,000 has a chargeable income of TT$8,600 when his gross income ... is TT$9,600). Yet an individual earning TT$9,600 per annum and claiming only the minimum allowance pays tax at a lower effective rate in Trinidad than an income earner at the same *absolute* level of income in the United Kingdom in 1965/66 (p. 157).

Indeed, effective rates were lower in Trinidad and Tobago than in Barbados and Guyana up to income levels of $48,000 and higher.

Non-oil corporate taxes were also inelastic because of the several fiscal incentives granted — tax holidays, duty-free concessions, accelerated depreciation — under the various incentives legislation. Oil taxes were also arguably lower than they should have been. Oil companies had been granted a submarine-well allowance to develop offshore fields. In addition, there was the problem of determining the chargeable income of the companies in an industry where arms-length transactions were not the norm at the time and the tax authorities may themselves not have been fully up to the task of properly assessing the tax liability of the oil companies.

The Fiscal Review Committee, 1967

In April 1967, the Prime Minister appointed a committee to review the fiscal policy of Trinidad and Tobago. The terms of reference of that committee are set out in Appendix 1. The committee was charged with designing a growth-

TABLE 1. MARGINAL AND EFFECTIVE RATES OF TAX, 1958, 1964, and 1968

	1958		1964		1968	
Income TT$	Marginal %	Effective %	Marginal %	Effective %	Marginal %	Effective %
1,200	—	—	5	0.8	—	—
2,200	6	2.7	8	3.0	8	2.8
3,200	8	4.4	13	4.9	13	4.6
4,200	12	6.2	20	7.1	20	6.8
5,200	18	8.5	28	9.9	25	9.8
6,200	25	12.8	32	12.9	25	12.2
7,200	28	14.8	35	16.6	30	14.8
8,200	30	16.8	40	19.0	30	16.6
11,200	40	21.0	45	24.7	40	22.9
15,200	45	28.8	50	30.1	45	28.5
19,200	50	33.0	60	34.5	50	32.3
23,200	60	38.4	70	39.1	50	35.6
29,200	70	44.9	80	49.0	60	40.0
61,200	80	63.3	90	65.3	50	50.0
70,000	90	66.7	90	68.3	50	50.0

Source: Bobb (1969) p. 156, Table V.7

[1]The data refer to an individual claiming only the personal allowance. The personal allowance was reduced from $1,200 to $1,000 in 1963. The column 'Income' refers to income before the deduction of the personal allowance.

oriented fiscal policy while ensuring that government revenues were forthcoming to meet "necessary developmental efforts and recurrent expenditures". The committee interpreted its terms of reference to mean that they were to suggest "modifications to the existing fiscal system which would influence a much greater volume of investment decisions in favour of (Trinidad and Tobago) and which, in turn, would result in greater Government revenues needed for the development programme." (para 2, p. 4).

The committee appeared to be influenced by research which had just been published, which cast doubt on the efficacy of fiscal incentives. However, it was equally conscious that Trinidad and Tobago was competing with other developing countries for foreign capital and resources and, as such, also had to compete in the arena of incentives. Their recommendations in this area, therefore, retained incentives but advocated less generous provisions, although a wider range of activities could qualify. Emphasis was also given to avoiding the discouragement of foreign investment and it was recommended that the withholding tax on dividends and other distributions be lowered from 30 per cent to 15 per cent for parent/subsidiary companies, and from 30 per cent to 25 per cent for other companies.

The committee also recommended that the personal income tax rate structure be lowered so that the highest marginal rate would be 70 per cent, subject to a maximum average rate of 50 per cent. In its only concession to considerations of vertical equity, the committee recommended a system of rebates for incomes of less than $4,000 and tax exemption for incomes of less than $250. The committee also recommended that the corporation tax rate be increased from 44 per cent to 45 per cent.

The committee also seemed to place emphasis on resource allocation, seeking to use the system of indirect taxation not only to increase revenue but also to discourage certain kinds of consumption, especially luxuries and imported goods. Accordingly, it recommended that the list of items on which purchase tax was levied should be extended to include non-essential consumer durables even when assembled and produced locally, while a special system of sales or purchase taxes should be applied to a wide class of goods. The net effect of the committee's proposals therefore would be to shift the tax structure more toward indirect taxation. This approach pre-

sages the current conventional wisdom in tax reform. The committee's recommendations were accepted, and several were implemented in the 1968 Budget.

The revenue performance of government improved over the 1969-73 period compared with the 1958-67 period. The ratio of revenue to GDP averaged 19.3 per cent compared with 16.9 per cent over the 1958-67 period. However, government expenditure continued to grow rapidly, rising at 14.8 per cent per annum over the 1969-73 period, compared with annual revenue growth of 11.9 per cent. As a consequence, there were recurrent account deficits in 1971 and 1972 (Farrell 1975, p. 134).

The increase in oil prices in 1973-74 led to a dramatic improvement in government finances. The recurrent surplus rose from just $23 million in 1973 to $627 million in 1974, while the revenue/GDP ratio rose to 31.4 per cent. The revenue/GDP ratio averaged 33 per cent over the 1974-80 period. The share of oil revenues in total current revenues averaged 64 per cent, ranging from 59 per cent to 70 per cent. Government expenditure began to increase rapidly and the government also made a number of concessions in respect of personal income taxes and indirect taxes in various budgets over the 1974-80 period.

Indeed, the changes made in the tax system between 1973 and 1978 were more far-reaching than at any other time. Between 1973 and 1975, the system of tax rebates was extended so that by 1975 incomes below $2,000 received a 100 per cent rebate and incomes between $3,000 and $4,000 a 20 per cent rebate. In 1977, the rate/bracket structure was modified, with marginal rates generally lowered, except for the lowest and highest income groups. Allowances in respect of personal income tax were increased in 1975 and again in 1978. Excise duties on gasoline and gas and diesel oil were lowered in 1974. Purchase taxes on certain consumer durables — stoves, refrigerators, freezers — were effectively lowered in 1974 and 1975, while purchase tax rates were actually lowered in 1976 and 1977 on certain foodstuffs and consumer durables, by 5 per cent in 1976 and 10 per cent in 1977 (see Bobb (1969) for Report on Government Expenditure, pp. 40-45).

It is important to note, at this juncture, that there were strong concerns about the sustainability of government revenues and therefore about the

sustainability of its high expenditure programme over the second half of the 1970s. These concerns were expressed most strongly in the Report on Government Expenditure (Bobb Report), which urged that there should be restraint on expenditure, particularly welfare expenditure. The second oil shock of 1979-80, however, served to convince the sceptics that the government's revenue position was durable and therefore its expenditure programme could be sustained.

The Fiscal Review Committee, 1981

The terms of reference of the 1981 (Bruce) Committee were quite wide. They were:

(i) to review the fiscal policy of the Government of the Republic of Trinidad and Tobago;

(ii) to appraise existing fiscal policies in the light of submissions made by:

- (a) The National Advisory Council of Trinidad and Tobago;
- (b) The Trinidad and Tobago Chamber of Industry and Commerce;
- (c) Trade Unions; and
- (d) Small Business Operations.

The Committee drew on the principles of fiscal policy articulated by the 1967 (Alleyne) Committee. The committee was, however, mindful of the then prevailing economic circumstances and had to take cognizance of the views of the trade union movement and the business community, which pointed to the effects of inflation on personal income taxes where tax brackets were not adjusted regularly or otherwise indexed (bracket creep) and the 'disincentive effect' on saving, investment and labour productivity of high marginal tax rates. The committee recommended that the personal income tax brackets be widened and the tax rates reduced, with a highest marginal rate of 60 per cent, subject to a maximum average rate of 50 per cent. In addition, several allowances — housekeeper, pensioner's and spouse — were increased. It was also recommended that the level of chargeable income to which the unemployment levy is applied be raised to $35,000.

In respect of corporation taxes, the committee declared against a reduction in corporate tax from the 45 per cent level, plus 5 per cent unemployment levy, but recommended (i) increases in the investment allowance, (ii) the deductibility of 25 per cent of export promotion expenses and (iii) the deductibility of 50 per cent of expenditure on training.

The committee made no substantive recommendations on indirect taxes and indeed hinted that purchase taxes should be reduced or removed on locally produced consumer durables. Concessionary recommendations were made in respect of housing, education and savings (increased dividend income allowance).

The overall thrust of the recommendations of the Bruce Committee was to reduce the tax burden. It seemed to have been influenced by (i) an inflationary environment, (ii) buoyant oil revenues and a bullish outlook for oil prices, and (iii) the representations of the trade union movement and the public at large, which favoured lower taxes.

Several of the recommendations of the Bruce Committee were adopted. However, events overtook the report in that oil prices began to fall in real and then in nominal terms and the economy went into a period of severe decline from which it is yet to emerge. Oil revenues fell from $4,253 million or 62.3 per cent of total current revenue to $2,472 million or 38.6 per cent in 1985, and $1,686 million or 32.4 per cent in 1986. The revenue/GDP ratio peaked at 39.7 per cent in 1981 and thereafter fell steadily to reach 31.7 per cent in 1985 and 29 per cent in 1986. Large deficits emerged amounting to 13.8 per cent of GDP in 1982, and falling to 7.2 per cent of GDP in 1985, and 6.7 per cent in 1986. In these circumstances, notwithstanding the persistence of double-digit inflation up to 1984, it would have been imprudent to contemplate major reduction in taxation along the lines of the recommendations of the Bruce Committee.

The Fiscal Review Committee, 1986

The 1986 (Barsotti) Committee had even worse luck than the Bruce Committee. Appointed in December 1985, oil prices, and with them government revenues, collapsed before its eyes. This development, perhaps more than any other, coloured its thinking and outlook on the tax reform exercise.

Its terms of reference were somewhat curious in that it spoke of reviewing 'incidence'. The terms stated that it was:

(i) to review the incidence of taxation in Trinidad and Tobago, both direct and indirect, and to make recommendations;

(ii) in the context of the new rates of lands and buildings taxes, and mindful of the contribution to the national economy, to recommend the preferred method of taxation of large plantations in productive forestry or agricultural use;

(iii) with respect only to higher education being pursued abroad and to the $3,800 higher deduction from income for income tax purposes, to recommend a modification to the quantum.

However, the committee interpreted its brief much more broadly and set about to review fiscal policy as a whole and included in its report some comments on government expenditure which were absent from the Bruce Committee Report. Specifically, the Barsotti Committee suggested that government had over-reached itself in pursuing its developmental and welfare support roles and that it should cut recurrent expenditure significantly.

Like previous fiscal review committees, the Barsotti Committee was persuaded that the tax brackets should be widened and marginal tax rates be reduced, and suggested a maximum marginal rate of 50 per cent. This position was taken in light of bracket creep and the fact that the process of tax reform world-wide was moving toward lower rates of personal income taxes, with less steeply progressive rate structures and broadly-based consumption taxes or value added taxes. In respect of corporation taxes, the committee recommended (i) a structure of scale rates ranging from 25 per cent for profits of less than $50,000 to 45 per cent for profit levels in excess of $100,000; (ii) abolition of the loss carry forward limitation, and (iii) allowing groups of companies to consolidate the results of subsidiaries. In respect of indirect taxes, it recommended the introduction of a value-added tax on goods and services. It also recommended the introduction of a contributory unemployment insurance scheme, which had also been advocated by the Bruce Committee.

The Barsotti Committee took a tougher line on tax expenditures, however. It suggested the rationalization of allowances and recommended limitation on mortgage interest deductibility, abolition of the leave passage allowance, abolition of the medical expenses allowance, limitations on deeds of covenants to charitable bodies and a global ceiling on the various savings incentives allowances (pension contributions, insurance premiums, unit trust purchases, credit union shareholding, etc.). At the same time, it recommended a higher education allowance in respect of overseas students, a new trade union membership allowance and an increase in the dependent relative allowance which would apply to handicapped persons.

The Barsotti Committee Report was never formally adopted. Its recommendations were reviewed by a government team and the new government, which came to power in December 1986, adopted some of the recommendations in the 1987 Budget, but subsequently appointed a new tax performance committee whose work is ongoing.

TAX REFORM ISSUES IN TRINIDAD AND TOBAGO

Tax reforms generally involve consideration of one or more of the following six fundamental issues: (i) equity, vertical and horizontal; (ii) economic efficiency and the allocation of resources; (iii) neutrality; (iv) stabilisation; (v) simplification, compliance, collection and other tax administration questions; and (vi) revenue maintenance and maximisation.

Not all of these issues have figured in each of the tax reform exercises undertaken in Trinidad and Tobago. The one aspect which has featured continuously from the 1950s to the 1980s has been the tension between the provision of incentives to various activities (resource allocation) and revenue maintenance. As Euric Bobb has put it: "In a country where the Government is seriously committed to an active role in the development process we may expect changes in tax policy aimed at countering the erosion of the tax base" (Bobb 1969, p. 3). These two issues — resource allocation by means of fiscal incentives and revenue maintenance — have featured in all the reform exercises.

Equity was not a major issue in the 1967 Alleyne Committee exercise. There was a concession to vertical equity considerations by introducing tax

exemptions and rebates at the lower end of the income scale which endured through all the subsequent reform efforts. There was also an important, though latent issue of horizontal equity. The PAYE system drew the employed into the tax net in a way which made evasion impossible. However, the self-employed were less easily corralled and the low yields on personal income taxes in the 1960s and early 1970s reflected the difficulty of pulling these individuals into the tax net on a consistent basis. It meant that there was considerable horizontal inequity which was exacerbated during the inflationary 1974-84 period, and in respect of which only limited progress has been made. The Barsotti Committee also noted that the plethora of allowances could be taken advantage of only by the relatively well-to-do in the society, and thus contributed to inequity.

Neutrality, the extent to which the tax system influences intertemporal consumption and savings, has been an important issue in all the reform efforts. The Alleyne and Bruce Committees sought to increase the incentives to save by introducing or increasing savings incentives allowances. The Barsotti Committee took a somewhat different approach and proposed a global limitation on savings incentives for revenue maintenance reasons, while proposing the introduction of a value added tax so as to curtail consumption, or expenditure generally.

Stabilisation has never really figured as an important element of tax policy in Trinidad and Tobago. Although direct taxation has loomed large in total revenues, because of the dominance of oil tax revenues which derive from an enclave sector, it is really only non-oil direct and indirect taxes which affect disposable incomes and expenditures. In any event, the fiscal authorities have never sought to use the tax system as a countercyclical policy instrument, probably because it is understood that the cycles in Trinidad and Tobago are exogenously generated and are not amenable to classical countercyclical policy.

The tax administration issue has featured in all of the reform efforts. However, despite calls for rationalisation and simplification, the tax system has grown more complicated and unwieldy, mainly because of ad hoc changes occurring in the context of annual budgets and the failure of the reform exercises to get to grips with the problem of simplification. One has

the paradox of the Barsotti Committee calling for the rationalisation of allowances, while seeking to add a new allowance and increasing others. Each review committee has also called for improvements in tax administration which it is believed will increase the yield of tax revenues from a given tax base. It would be true to say that administration has improved, particularly in respect of oil taxation and personal income taxes, although the kinds of allowances and deductions (e.g. repairs to owner-occupied property) make administration burdensome and difficult for both the Inland Revenue and the tax payers.

In respect of resource allocation, tax policy has sought to influence the allocation of savings and investment by the provision of tax concessions, import duty concessions, and investment allowances. The reform exercises wrestled with the question of whether these tax expenditures were at all efficacious in increasing the flow of investment and/or directing it to desired areas of activity. Nonetheless, they have been loath to abolish these incentives altogether on the ground that if other countries offer them, then so must Trinidad and Tobago lest at the margin it loses investment to other countries. Tax policy has been much more aggressive and pro-active in respect of incentives to savings and investment than it has been in respect of the taxation of goods and services. Indeed, there has been a curious reluctance to use the tax system to penalise heavily luxury consumption or the consumption of undesirable goods and services. To illustrate, for a long time, gasoline prices in Trinidad and Tobago were actually subsidised on the ground that transportation costs needed to be kept down.

The revenue maintenance/maximisation issue was most prominent in the work of the Alleyne Committee and indeed only thinly veiled in its terms of reference. The Bruce Committee operated in what it thought was a situation of budget surpluses for the foreseeable future and therefore revenue maintenance was not a major concern. The Barsotti Committee was torn between the need to maintain or increase revenues, given the collapse of oil prices, and the evidence that persuaded it that the incidence of taxation was too burdensome and was proving to be a disincentive. The tax reforms of the 1962-66 and 1967-73 periods were expressly concerned with raising revenue, while those undertaken in the 1974-80 period were not at all concerned, and delivered tax concessions.

Apart from these six issues, there is a seventh major issue peculiar to Trinidad and Tobago and other mineral-based economies and that is the sustainability of government revenues. In the early 1950s the colonial government was apparently very sensitive to this problem and its fiscal policy emphasised expenditure control and the accumulation of large current surpluses. The self-government administration and the independent government of Trinidad and Tobago opted for high expenditures, which brought the issue of sustainability of revenues sharply into focus. The strategy adopted between 1962 and 1973 was to attempt to effect a shift toward indirect taxation such that the tax base would be broadened and would be less susceptible to sharp short-term fluctuations. The exception was the institution of the Unemployment Levy in 1970, in the context of widespread social unrest born of high levels of unemployment.

The approach to indirect taxation was, however, neither comprehensive nor consistent. The Alleyne Committee had suggested the move to a general sales tax. It was not until 1983 that an IMF team was invited to study the question and make recommendations for the introduction of a general sales tax. The Barsotti Committee recommendation for a VAT must also be seen as raising this issue, which again became sharply focused with the dramatic collapse of oil revenues.

Finally, we notice that the taxation of petroleum has not been treated by any of the review committees. Petroleum taxation has been regarded as a special, complex topic and has always been dealt with using special teams. This approach is an acknowledgment of a reality. Yet it is inappropriate to treat the oil and non-oil tax regimes as if they are separate and distinct. They interact at several levels. Higher oil revenues mean higher government spending and therefore the incidence of non-oil taxes will be modified by the resulting changes in the incidence of benefits. Lower oil revenues usually lead to an increase in non-oil taxation in order to maintain total revenues. These interactions cannot be ignored or assumed away if correct tax policy is to be formulated.

MECHANISMS FOR TAX REVIEW AN REFORM

Our review of the development of the tax system and tax policy in Trinidad and Tobago has indicated that essentially two mechanisms have been used

for tax reform, viz. (i) the annual budget exercise, and (ii) specially appointed committees. Although the discussion in the first section was framed around the three specially appointed committees, it is clear that the annual budgetary exercises have been just as significant as, if not more so than, the committees in reforming the tax system.

Why were committees appointed to do what could be and was done by the ministry of finance? The first reason, which is perfectly valid, is that ad hoc changes to the tax system are inevitable and it is therefore appropriate at periodic intervals to step back and review the system as a whole since time and the accretion of changes to the system may have effects which are unintended or undesirable. The second reason is that by bringing other interests — labour and business — into the reform exercise, it is theoretically possible to win support or acquiescence in the measures which emerge. Unilateral action by a finance ministry will not usually attract immediate support. A third reason is political. At difficult times, when hard decisions are required, politicians find it congenial to appoint a committee either to buy time, defuse an issue, or come up with potentially consensus-building solutions which turn down the political heat.

All of these reasons can be adduced in the Trinidad and Tobago experience. Between 1962 and 1966, the government introduced major institutional and other changes which fundamentally altered the rules of the game. The architect of these was Mr. A.N.R. Robinson, the Minister of Finance, who, on the evidence of his pronouncements, believed strongly in fiscal discipline. His Finance Bill of 1965 created a furore and was attacked by the business community. The Act which was passed in 1966 was modified but, for its time, was still strong in its provisions, as was the 1966 Insurance Act. It is probably because of the reaction to 'unilateral' tax reform that the then prime minister elected to establish a tripartite committee under Doddridge Alleyne to review fiscal policy. The composition of the committee is indicated in Table 2.

It is also probable that Mr. Robinson's insistence on fiscal discipline was seen to fly in the face of the imperative of funding a large development programme and implementing it as quickly as possible. The inclusion of William Demas and Frank Barsotti as the government representatives was probably to ensure that the 'developmentalist' perspective would be aired,

TABLE 2. MEMBERSHIP OF FISCAL REVIEW COMMITTEES

	1967	1981	1986
CHAIRMAN	Doddridge Alleyne	Victor Bruce	Frank Barsotti
LABOUR	W.W. Sutton M.P. Adams James Manswell	Flavius Nurse Nathaniel Crichlow Vernon Glean	Flavius Nurse Nathaniel Crichlow Cecil Paul
BUSINESS	Max Marshall John De Lima K. Narinesingh	T.A. Gatcliffe C.A. Jacelon Ainsley Mark	T.A. Gatcliffe Joy Caesar Peter Ganteaume Ainsley Mark
GOVERNMENT	William Demas Frank Barsotti	Frank Barsotti T.A. Harewood	
OTHER	Alfredo Bermudez	Jerry Hospedales	Frank Rampersad Joseph Pounder Terrence Farrell Louise Horne Karl Theodore
SECRETARY	Phillip G. Rochford	Lennox Archer	Valance Patino

and strongly. Both men are structuralist in their approach to economics generally. The report clearly reflected the influence of the thinking of Demas.

The Alleyne Committee was a truly tripartite committee. The Bruce Committee was less so in that it included two central bank officials — Victor Bruce himself and Jerry Hospedales — who could not necessarily be presumed to articulate the government's position, but rather the macro-economic implications of the measures. The Barsotti Committee was even representative of other interests, to the point that the government interest

was diluted. Joseph Pounder was a retired commissioner of the Board of Inland Revenue, Frank Rampersad was a former permanent secretary in the Ministry of Finance but substantively the head of a para-statal organisation. The Central Bank was again represented. The Committee also included, for the first time, an academic in Karl Theodore. Only the chairman, Frank Barsotti, could have been explicitly identified with the government, and even he was at the time on leave from his post of permanent secretary in the Finance Ministry.

While the 'tripartite' formula has its strong points, it also has important weaknesses. First, while the committee members purport to 'represent' their sectional interests, they may not have a mandate to do so from those very interests. Second, the committee is structured to reach consensus by compromise, and representatives may be reluctant to adopt compromises which appear to betray their sectional interests. Third, the committee is really not a technical committee of fiscal experts. Indeed, reviewing the combined membership of all three committees, only one member — Karl Theodore — may be said to qualify as a fiscal specialist. True, there was accounting expertise and a range of experiences as economists, tax administrator, businessmen and union leaders. But tax policy is an especially complex area, requiring these specialisations *as well as* fiscal economists and lawyers.

The latter weakness of the committee approach was probably not of great concern to the political directorate who, in any event, reserved the right to review the report and select from it whatever suited them. The Barsotti Committee Report was subjected to review by a team of public servants before the process was aborted. There is therefore a divorce between the committee and its report and the implementation of the recommendations of the report, with the politicians and, I daresay, the senior technocrats having complete control over the implementation phase.

It is also instructive to note that the committees were given very little time to do their work, a fact which reinforces the view that the work of the committees is seen to be more as establishing a basis for consensus on tax policy outside the framework of parliamentary or national politics. The Alleyne Committee reported in about seven months, and noted that

"pressures of time and the clear need for the Committee to report promptly on its overall findings and to make recommendations for corrective action aimed at early stimulation of the economy has precluded the possibility of full examination and comment on all aspects of the terms of reference noted above" (p. 4). The Bruce Committee received its terms of reference about three months after the intention to form the committee was announced and reported in six months. The Barsotti Committee was initially given three months in which to report. It eventually submitted its report in mid-1986 after parts of its drafts had appeared in the press. It too noted the lack of time for adequate study of the issues and its recommendations included a long list of matters to be studied before recommendations could be made.

Of the three committees, the Alleyne Committee seemed to have had the greatest influence on actual policy. The Bruce and Barsotti Committees were largely overtaken by events, the one economic and the other, political.

This record brings into question the whole approach to tax reform in Trinidad and Tobago. The contraction of the economy has muted demands for reform of personal income taxes, and government's revenue has probably made it extremely reluctant to entertain discretionary reductions in revenue over and above endogenous declines. However, the structure of taxes remains unbalanced and there is a need for a thorough rethinking and reform. It remains to be seen if the new administration and its new committee will deliver the goods.

APPENDIX 1

The Tripartite Committee was appointed by the Government in April, 1967, with the following terms of reference:

"To review the fiscal policy of Trinidad and Tobago including incentives, and to make recommendations designed to stimulate and encourage the permanent overall growth of the economy, bearing in mind the need to maintain optimum government revenues for the purpose of meeting necessary developmental effort and recurrent expenditures with special reference to:-

(1) The dependence of the economy on petroleum and sugar;

(2) Increased investment and productivity in agriculture;

(3) The exploration of new petroleum resources;

(4) The enlargement of employment opportunities and the encouragement of labour-intensive methods of production;

(5) The growth, development and retention of professional and marginal skills;

(6) The maximum production of local foodstuffs and raw materials and their utilization in manufacturing and processing;

(7) The attraction of increased investment from abroad;

(8) The mobilization of local savings for investment in productive enterprise locally;

(9) The increase of exports of existing industries, and the encouragement of new industries with export potential;

(10) The achievement of the greatest possible reinvestment of profits in productive enterprises;

(11) The stimulation of hotel development;

(12) Research into and development of available local raw materials."

"The Committee should also bear in mind the possibilities of any regional economic groupings, trade relations with Latin America and the Caribbean area and the question of Trinidad and Tobago's interest in Commonwealth preferences."

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The VAT System in Trinidad and Tobago: The Prospects for Success

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There are at least three distinct issues which have to be considered in any evaluation of a new tax system for an economy like Trinidad and Tobago: the development context, the rationale for the change, and the implementation aspects of the change. This paper is divided into three sections, each dealing with the issues mentioned and will then end with a concluding statement.

SECTION I: THE DEVELOPMENT CONTEXT

I begin with the proposition that there are two salient features of the development context in Trinidad and Tobago. The first is the *revealed fragility* of the socioeconomic system in the face of sporadic external income flows, and the second is the *continued intractability* of the basic problem of unemployment. What are the relevant facts? It is customary to make reference to the smallness and the openness of the Trinidad and Tobago economy, with the implicit suggestion that these properties make it specially vulnerable to changes taking place in the international economy.[1] These changes may include sudden export commodity price changes or institutional developments in the international capital markets.[2] With reference to small, open economies Harberger [8] has argued that not only do they face upward rising supply curves of funds like everyone else but "they also face supply curves that shift around a great deal, largely at the whim of the international banking community".[3] There is no question that whatever the changes, economies like those in the Caribbean usually have

to make involuntary adjustments which invariably involve economic contraction and social hardship.

In this kind of context it would be reasonable to expect that the role of the tax system, and of fiscal policy generally, would be to perform two kinds of functions:

1) to generate public revenues in such a way that the perceived vulnerability of the economy would be reduced — which generally would mean a reduction in net outflows as well as a stabilization of public expenditure, and
2) to generate public revenues in a manner that is so transparently equitable that the compliance cost incurred is itself minimized — which would generally mean that notions of simplicity of tax administration have to be seen in a comprehensive context.

In this kind of economic development context it is reasonable to expect that every effort would be made to ensure that a VAT system, if introduced, will enhance the transformation objectives normally taken as given, i.e. equity, efficiency, and the creation of opportunities for making sustainable economic progress. To put the matter differently, the proponents of any new VAT system have a responsibility to properly address issues that go beyond the revenue potential of the system. In this connection DeLisle Worrell has argued that because of the wide-ranging significance of fiscal policy, tax systems have to be designed "so as to promote the transformation developing economies need for growth, as well as to ensure tolerable price, output and balance of payments outcomes in the short run".[4] It can be argued that a VAT system can permanently change the way in which most economic agents make their decisions. Yet it remains true that the issues of the kind mentioned which had been raised by Harberger [8] and by Worrell [13] seem to have played no part whatsoever in the considerations explored by those designing the new system in Trinidad and Tobago. The position, it would seem, is that studies of the kind that ought to be done were not done by the contracted experts.[5]

Remarks of a similar nature can be made in respect of the second major feature of our development context: the continued intractability of unemployment. My concern here is twofold: the efficiency and the equity

aspects of major tax changes. I am first concerned with the fact that in spite of several efforts to deal with the unemployment problem in a systematic way, there is very little that can be claimed as success in this area.[6] While no one can expect fiscal policy by itself to get rid of the unemployment problem in a country like Trinidad and Tobago, it is important that if the existing tax regime has not made a positive contribution, then the expected contribution of the proposed system must be more than a vague hope.

The second concern is more related to the social effects of prolonged high unemployment. The signs of dislocation are legion. There seems to be little doubt that there has been an alarming increase in crimes against persons and property. The country has witnessed the costly and embarrassing exodus of thousands of its citizens. Finally, the organizations that deal regularly with the less fortunate members of the society appear to be reporting a substantial deterioration in the standard of living of the poorer members of our community. My concern here not only rests with the short-term effects of these developments but with their long-term effects on the academic performance of the young people of the country and with their eventual work performance when they join the labour force. Today's unemployment will not only mean a chronic bias towards low productivity in the future but it will also mean that the distribution of wealth and income will continue to deteriorate.

In this context, therefore, we also need to ask what is the likely effect of the VAT on the unemployment problem. Since we recognize that the short-term effects may be different from the long-term effects, we are entitled to ask whether the relevant studies have yielded results in favour of the VAT. Of course, such studies would need to spell out how unemployment is itself generated. In the absence of such studies we can only speculate that in the short term VAT will make the unemployment problem get worse, partly because it will so increase the degree of economic uncertainty that business expansion would not be very likely. If the tax is properly implemented, however, and yields a more stable flow of government revenues, it is possible that better planned government investment expenditures will provide an opportunity for an expansion in employment. Whether this expansion in employment translates into a reduction in unemployment depends on other factors including the rate of growth of the labour force and

the private-sector factor intensity that accompanies the expansion in government investment expenditure.

SECTION II: THE RATIONALE FOR THE CHANGE

General Concerns about the VAT System

Apart from the concern for the development context of the proposal to introduce a VAT system, two other general concerns can also be mentioned: the *differential implications of the system* and the *harmonization aspects of the proposal.* The differential implications refer to the fact that a VAT system must be seen in relative terms. We must compare the system with existing systems as well as with other possible systems in terms of its *revenue capability, its incidence on different income groups, its administrative costs, and its efficiency effects, in particular, its effect on national savings.*

Theoretically, of course, we expect a VAT system to be superior to an equal rate, retail sales tax, for example, in terms of efficiency because of the fact that, as a rule, producers do not share the incidence of the tax. However, it is well known that a VAT "on the books" and a VAT "on the road" may be two completely different specimens.

The seriousness with which the economics profession takes these concerns is sometimes reflected in the indepth studies which are carried out as part of tax reform exercises.[7] In respect of all the concerns surrounding the suitability of a VAT for the particular environment in question, it is clear that the specific proposal as it related to the *coverage* and to the *rate* ought to be preceded by a wide range of sectoral and consumption studies designed to provide a logical basis for a proper evaluation of the decision to introduce the new system.

As Nicholas Stern has reminded us, modern analysis of public finance has shown up the weakness of traditional one-liners, such as: "income taxes are not good for savings", "indirect taxes are regressive", "progressive income taxes promote equity", and so on. In a similar vein, Atkinson and Stiglitz [1] have shown that a target-instrument approach to tax system design could be very misleading.[8] What matters is the way the tax system is expected to impact on the particular economy involved. In the absence of

detailed analyses of the economy in question, it is tempting to suggest that these are precisely the kinds of simple notions which will inform the introduction of a system such as the VAT.

Using the IMF Shortcut?

Since it might be argued that the Trinidad and Tobago Government felt pressured to introduce a VAT system as part of its Structural Adjustment Programme, it is important to determine whether the authority of an agency like the IMF could be used as a short-cut to finding a rationale for the new system. In this respect it is convenient to have at hand a new IMF publication, *Value Added Taxation — International Practice and Problems,* written by Alan Tait, deputy director of the Fund's Fiscal Affairs Department. The truth is that in the run-up to the implementation of the VAT in Trinidad and Tobago, this book was being used almost like a bible to justify every aspect of the VAT and to refute the objections that were forthcoming. It is therefore important to ask whether the findings in Tait's book constitute a proper rationale. The answer to this question will also shed light on the question of the rationale for the VAT system *in the presumed absence of any external pressure.*[9] In other words, Tait's book should be taken seriously because the authority behind the book may be used as a substitute for objective analysis of VAT proposals in the Caribbean. At least one Caribbean study has already expressed doubts about the claims that might be made for VAT in this region.[10]

Let us therefore consider the presumed economic effects of VAT, beginning with the relationship between VAT and the general level of prices.

VAT and the Price Level

One of the most important concerns about VAT relates to the impact of the tax on the level of prices. Interestingly enough, Tait's treatment of this concern is predominantly *empirical.* He reminds his readers up front that there are simply too many variables simultaneously at work to be able to properly identify the impact of VAT on prices or even on investment or on employment. This situation is complicated by the fact that significant external shocks have accompanied the introduction of VAT in countries

where data could normally be relied upon. In the absence of an explicit theoretical framework for the study Tait's book opts for pragmatism.

It is suggested that there are at least three questions which must be considered in trying to assess the impact of VAT on the price level. These can be listed as follows:

(i) What assumptions do we make about the incidence of the tax?

(ii) Is the VAT being introduced in a revenue neutral manner?

(iii) Is labour in a position to force wage adjustments?

Incidence Assumptions

Simple partial equilibrium analysis would suggest that except the VAT is being introduced in a highly competitive environment, it is reasonable to expect that it will be borne entirely by consumers. In fact, due to the uncertainties that may prevail about compliance costs, some traders may seek to raise prices beyond what is warranted by the VAT. It is also true that ignorance on the part of consumers about previous levels of purchase taxation may also induce higher than warranted price increases. While, for example, a VAT is in principle not a cascading tax, it can very easily become one through a combination of consumer ignorance and opportunism among traders. Price level effects of the VAT will, under these circumstances, be exaggerated.

In the absence of an appropriate Social Accounting Matrix (SAM) for Trinidad and Tobago, and in the absence of better knowledge of relevant price elasticities, only crude estimates of the initial price effect of a VAT would be possible. In a very useful preliminary study the Trinidad and Tobago Central Bank has estimated that the effect on the domestic price level will be of the order of 4.5 per cent overall.[11] However, in fairness to that institution, apart from the many qualifications which were attached to their estimate, they also warned that particular areas of expenditure would be subject to "more substantial increases". Of course, it may not be politically expedient to those supporters in the front-line of the VAT debate to reveal that the expected increase in "Meals Out" was 15 per cent and that for "Services" it would be almost 14 per cent. Nevertheless, if our concern

is for the manner in which the new tax will affect the efficiency of consumption, it would seem to be particularly misleading to focus simply on the effect of the VAT on the overall price level.

A comprehensive approach would be more useful. Instead of pretending that VAT will not cause the general price level to rise significantly, we should be asking ourselves what kinds of things might be done to minimize and to mitigate any undesirable price increase. Given that the distribution of price index weights is skewed in favour of *food*, such an approach would point us initially in the direction of measures geared to keeping domestic production of food steadily increasing. In the short-to-medium term this also means that selective import substitution of high-priced items should guide our approach in the manufacturing and services sectors. There is no reason to expect that the existing price control system in Trinidad and Tobago will work any more efficiently than it has done in the past, especially when we take into account that price control is anathema as far as the international financial institutions are concerned.

Revenue Neutrality and the VAT

It is almost tautological to suggest, as Tait does, that if VAT is replacing taxes which were severely distortionary, there is some chance that the output effect of the tax could mitigate its undesirable price effects in the medium term. Of more importance, however, is the extent of the impact of VAT on the price level depending on whether the VAT turns out to be part of a reform exercise aimed at a net increase in revenues, for this would determine both the level at which the tax is brought in as well as the coverage of the tax. The more concerned the authorities are to increase revenues overall, the more likely will VAT cause a significant increase in the price level.

What therefore is the revenue concern in Trinidad and Tobago? The data indicate that government revenues have been steadily declining from a level of TT$9,477.1 million in 1982 to reach a level of TT$4,977.0 million in 1989. In nominal terms this is a decline of 47.5 per cent, while in real terms the decline is closer to 73.6 per cent.[12] On the simple assumption that governments prefer to have more revenues than less, it would be naive to

believe that increasing revenues was not one of the major objectives of the current tax reform. This expectation is confirmed by the fact that although the 15 per cent VAT rate was officially justified by proposed compensating reductions in income taxes, at the time of implementation these reductions were not fully realized.

There is another aspect to the government's revenue position which seems to place consumers in a no-win situation. For even if, as was initially suggested, the VAT was not meant to increase revenues in the first instance, the present deficit situation points to a serious problem if VAT revenues fall below expectation. For in a context where the budget deficit is itself part of an IMF conditionality package, possible reactions could include measures to increase the price of public services as well as the removal of certain production subsidies. Additionally, of course, there could be a revenue-motivated currency devaluation. In these circumstances, therefore, even a slightly wrong judgement on the VAT revenue yield could spell bad news for the price level.

Labour's Potential to Respond

It must be admitted that a once-and-for-all increase in the price level may actually be part of an equilibrating adjustment which would mean that prices should not rise continuously as a result of a VAT. Perhaps the most important consideration here is the capability of labour to push wages upwards. Of course this would depend partly on the perceived overall impact of the tax reforms on real disposable income of workers, as well as on the strength of the trade union at the time when the VAT is introduced. In the depressed circumstances of Trinidad and Tobago there should not be a major immediate wage-push effect. This does not mean that, when the signs of economic recovery become discernible, trade unions will not initiate moves to reduce the losses workers might experience under the new tax regime. Some economists have already pointed to the effect that the government's talk of an economic turnaround has had on the activity of some trade unions.[13] Although there now appears to be a kind of official double-talk about the turnaround — it is there but we cannot see it — the expectation is that 1990 will see many more wage claims being made. In this

context the VAT is likely to be more inflationary than would ordinarily be warranted.

The Relevance of International Experience

In his review of the data on 35 countries Tait came to the conclusion that while in seven countries there was a clearly significant upward shift in the price level, in only five cases did the VAT seem to spark off "an acceleration in the rate of change of the consumer price index". In the majority of cases (63 per cent) the VAT had little or no effect on the consumer price index.

Of course, regardless of what happens in a number of countries, the experience of any particular country would depend on how the economy responds. The need for policy-makers to continuously monitor price-level effects cannot be downgraded because of Tait's findings. Not only are these findings silent on the problems of comparability of the international data on prices, but they were not able to identify the effects of complementary policies introduced with the VAT. At best, Tait's empirical results are, therefore, only suggestive of the need for more research.

VAT and Distribution

On the question of the equity impact of a VAT, Tait recognizes that traditionally this has been the major stumbling block as far as the acceptability of the tax is concerned. He reminds us, however, that there are at least four considerations which should be borne in mind before coming to a final judgement on the *regressitivity* of the VAT. First, the VAT may be replacing taxes which are *de facto,* if not *de jure,* more regressive. This could be the case where taxes are nominally progressive, but where the effective degree of progressivity is neutralized for any of several reasons. In Trinidad and Tobago, for example, where it has been alleged that widespread income tax evasion persists, the progressivity of the existing tax system has been compromised. The issue, therefore, is not whether the VAT is regressive or not, but whether the VAT will serve to reduce the overall regressivity of the tax system. In principle, then, the greater the extent of income tax avoidance and evasion, the more likely will the VAT act as a corrective factor in regressivity. However, to the extent that the factors that

facilitate the current levels of evasion — social status, contacts within the Tax Administration Division — can be carried over into the VAT system the VAT need not reduce overall regressivity. Moreover, since the major purchase tax replacements are on imported, manufactured or partially manufactured items, it is still possible that the regressivity of the VAT will exceed the regressivity of the existing tax system. This is an empirical question on which the research remains to be done.

In this context it will be useful to evaluate the claim that since the VAT will allow for revenue-reducing reforms in the income tax system, it will enhance the vertical equity of the Trinidad and Tobago tax system. This raises the question as to whether the existing income tax system suffered from a problem of vertical inequity. In a background study done for the 1986 Fiscal Review Committee, chaired by former permanent secretary in the ministry of finance, Frank Barsotti, the evidence on the degree of progressivity of the existing income tax system was clearly very favourable.[14] It was revealed that the Trinidad and Tobago system was remarkably progressive, with the top 15 per cent of earners bearing 30 per cent of the tax burden, the bottom 20 per cent bearing 5 per cent of the burden, and the middle 65 per cent bearing 65 per cent of the burden! Moreover, this picture was repeated when the middle 65 per cent group was further subdivided into smaller income bands. What evidence there is, therefore, suggests that the previous system was not one where *vertical equity* was an endemic problem. The equity problems that exist would therefore most likely arise in areas of compliance and of coverage. These, as I have argued, are not problems that will be readily removed by a new VAT system.

Second, as the optimal taxation economists have always argued, what matters is the net budgetary incidence of the fiscal system.[15] In other words, if the expenditure allocations following a VAT can be made to focus more on low-income groups, in theory this would reduce the overall regressivity of the fiscal system. The problem in this regard stems partly from the haste with which the Trinidad and Tobago VAT system has been introduced. The necessary adjustments on the expenditure side of the budget do not appear to be in place. A VAT with business as usual on the expenditure side suggests that equity has not been a major consideration.

Third, according to Tait, the annual comparisons of disposable income may give quite a different picture from longer term comparisons. It would seem that this is a technical consideration which may not have much empirical relevance in the short to medium term.

Fourth, we should recall that Household Surveys typically *underestimate* income at the lower levels, thereby biasing tax incidence analyses in favour of apparent regressivity. In Trinidad and Tobago where unemployment has imposed zero-income status on so many families over the past seven years, Tait's suggestion that a VAT will be less regressive than the statistics may suggest cannot be taken too seriously.

In spite of all these caveats, there seems to be little doubt that the empirical data in a number of countries suggest that the VAT has generally had a perceived regressive impact. We can share Tait's concern that these empirical observations tend to give moral strength to calls for more zero-rating and exemptions. These latter measures not only narrow the base of the tax, thereby reducing its potential as a production-neutral revenue earner, but, under certain conditions they can be shown to be relatively inefficient means of improving consumer welfare. According to Tait, compensation schemes involving progressive income tax credits and/or negative income taxation are suggested as being superior. The problem here for the developing countries is usually one of administrative capability.

Efficiency/Neutrality

In theory, a VAT does not distort consumer or investor choices. Following Stern [10], it is even possible that a VAT can generate positive, albeit modest, welfare gains. Also, the marginal social cost of collections appears to be lower under VAT when compared with other indirect taxes. Here, however, Tait's IMF book on the VAT can be misleading. For the book leaves the non-specialist reader with the false impression that in some sense the more of the economy under VAT the closer the tax will be to meeting the neutrality objective. Of course, since neutrality is traditionally discussed in Paretian terms, it is incorrect to give the impression that there is an acceptable notion of a tax system being closer or further away from neutrality. For once we introduce a second-best concept of neutrality, that

is, a neutrality constrained by the government's need to raise a certain amount of revenue, we have to admit of a very wide range of possibilities. So it is possible for a system with only 40 per cent of the economy under VAT to be more neutral than one with 80 per cent under VAT. It is this rich array of possibilities that has yielded the judgement that a good VAT is a country-specific VAT.[16]

In the case of Trinidad and Tobago, there is an interesting situation in respect of neutrality once we agree to exempt the Financial Sector and a substantial part of the Public Sector. Given the significance of these two sectors in the generation of value-added in other sectors of the economy, we may be only fooling ourselves if we now argue, *in the name of neutrality,* that we should not exempt other sectors because we have already exempted the two sectors mentioned.

Saving and Investment

In principle a consumption-type VAT should be good for investment since it entails no addition to user-cost of capital. Also VAT affects present and future consumption equally. We should therefore have no negative impact on saving. However, none of this implies that VAT will cause saving and investment to increase in Trinidad and Tobago for the bottom line is really determined by the factors which determine investment in this country. Since it cannot be claimed that the capital market is sufficiently sophisticated to allow for the user-cost effect it is not surprising that what evidence there is suggests that in Trinidad and Tobago real income and availability of investible funds appear to be the more important determinants of saving and investment, respectively.[17] It may therefore be misleading to exaggerate the saving-and-investment effect of the VAT.

Foreign Trade

It is often suggested that in theory VAT should improve the balance of trade where VAT is imposed on imports and where exports are zero-rated. However, this depends on the interdependence between the export and domestic sectors. Exemptions elsewhere may reduce the zero-rating impact on exports. There is a need here too to keep in mind the taxes being replaced:

replacing a sales tax may have different effects from replacing a corporation tax. Data on some countries show that a VAT replacing the latter has no dramatic effect on exports. Moreover, as Gillis [7] has argued in the case of Indonesia, the effect works in the context of a sales tax where that tax has been having a cascading effect. Finally, where significant distortions exist because of systematic invoicing discrepancies, a VAT may at best have no effect whatsoever on the trade balance.

VAT and Small Business

The main concern here is the cost of compliance to small business. It has been suggested that VAT may cause cutbacks in employment in conditions where small business is the employment intensive part of the private sector.[18] Given the emphasis on small business development in Trinidad and Tobago, our concern here should be the possible disincentive effect that compliance may have. This is especially true of those businesses small enough to be facing optional VAT registration. The paper work may simply not be worth the effort. To the extent that such businesses cannot pass on their VAT costs, the system could become the cause of many small business closures. Again, the complaint here is that the required investigations have not been done prior to the implementation of the new tax system.

Final Comment on Tait's Book

While there is no question that Tait's book raises a number of questions which the Trinidad and Tobago VAT system would have to face up to, the book itself does not, and cannot, provide a substitute for detailed analytical studies geared to evaluating the possible impact of the new tax system on this country. The book points to a number of areas where our empirical knowledge about the Trinidad and Tobago economy is deficient. The suggestion, therefore, is that the VAT proposal could have been the catalyst to initiate a number of studies whose value would go beyond the specific tax reform exercise. Given that these studies have not been done, what then can be said about the prospects for the VAT? Can the fact that the government might have been under external pressure to implement the VAT system be ignored? In the light of the fact that the IMF's book on the VAT does not

supply a proper rationale for the new system, could a VAT system still work well in Trinidad and Tobago? My response to this question will essentially be positive, although my argument will be that much will have to be salvaged at this stage by seeking to adopt a rational approach to the implementation of the new system. This is one of the points taken up in the next section.

SECTION III: CAN VAT SUCCEED IN TRINIDAD AND TOBAGO?

Reaction to the VAT

It has been suggested that the reaction to new taxes conforms to a clear pattern. First there is *shock,* then there is *opposition* which is followed by *understanding.* Finally there is *acceptance* of the new taxes. The first three stages — shock, opposition and understanding — are applicable to the Value-Added Tax system recently introduced in Trinidad and Tobago but clearly whether there is acceptance or not will depend on the answers to a number of questions.

For the remainder of this paper I explore three such questions:

1) In principle, could Trinidad and Tobago benefit from adopting a VAT system?
2) What kind of VAT would be appropriate for Trinidad and Tobago?
3) What would be an appropriate schedule for implementing VAT in Trinidad and Tobago?

There is no question that the success of the VAT system will depend on the quality of answers provided both by the population and the authorities. If phenomena like evasion, under-reporting, and non-compliance are not to characterize the new system, the necessary effort must be made to clarify the three issues raised.

The Question of Principle

Would Trinidad and Tobago benefit from adopting a VAT system? What is a VAT system? A VAT system is one which identifies inputs and outputs

as eligible for taxation at specified rates, and which requires the eligible tax payer to pay the difference in the taxation that arises between the production and the selling stages. In a sense, the taxes at the input stage represent payments already made by the tax payer while the taxes at the output stage represent receipts, some of which would ordinarily belong to the government. Although in some quarters the value-added concept is still regarded as somewhat mysterious, economists have generally been very supportive of the value-added principle in the area of taxation. The basic argument is that what *value-added* provides is a tax-base that does not cause new decisions to be made in a way which reduces production or consumer welfare more than is absolutely necessary. Moreover, since it is the total-value added that makes up the country's national income, this is a method of taxation which keeps tax revenues in step with the overall level of economic activity.

These theoretical considerations, although they generally assume a properly functioning VAT system, are usually sufficient to initiate a case for VAT as a replacement for some existing tax system. Even if allowances are made for the difference between the perfection of theory and the imperfection of the real world, it can be said that VAT tends to point the economy in a better direction than comparable tax systems.

If the matter were put a little differently it could be said that there are *three* major requirements of a tax system and more than one of these may well be satisfied by a VAT system. The three major requirements are *reliability, efficiency,* and *equity.*[19] Reliability refers to the ability of a tax system to deliver an appropriate flow of revenues on a reasonably consistent basis. No government can plan properly if the revenues it expects to collect are subject to sudden or wide fluctuations. Since most government expenditures tend to be very predictable, ideally the same kind of predictability should be required from the revenue side of the budget.

In the context of Trinidad and Tobago, it is quite obvious that, for as long as government revenues are tied to the fortunes of the oil industry, there will be a level of unpredictability which could make a mockery of overall economic planning. It is therefore reasonable that, while the country should continue to maximize its earnings from the oil industry, subject to a sensible conservation strategy, it should make every effort to shift current

spending onto a more reliable basis. In this sense, the introduction of a consumption-oriented tax, such as the VAT, can be said to be a *necessary* development of the fiscal system. It is precisely for this reason that the 1986 Barsotti Fiscal Review Committee made a strong case in favour of a VAT system. However, since the link between consumption and income is very strong, *a simple shift to a consumption base is not a sufficient condition of revenue reliability.* The recommendation at the time was that the government should initiate the many studies that were necessary in order to introduce a reliable VAT in about two years' time. There is no reason to believe that the 1986 recommendation does not remain as valid today as it was then: in matters of public policy the necessary preparation before the implementation should be a prerequisite. The second question then is what kind of VAT is appropriate for this economy.

What Kind of VAT for T&T

To answer this second question the three qualities of a good tax system — *reliability, efficiency* and *equity* - must be borne in mind because it has already been shown that on grounds of reliability the VAT system has the potential of being a good tax for Trinidad and Tobago. What of the other two criteria — efficiency and equity? In evaluating the possible success of the VAT the doubts raised in these areas need to be further explored, for efficiency is the requirement that the tax system should contribute to the maximization of production in the private and public sectors, while equity is the requirement that the tax system be as fair as possible to all tax payers. But how can the efficiency or the equity of the proposed system be determined if certain basic kinds of studies have not been done, or if done have not been made public?

How is the VAT expected to interface with the production system of the country? How are the key sectors expected to react? Will the construction sector still be able to play its traditional role in the economy? Or, given the dependence of other sectors on construction, would the introduction of a VAT set off a contractionary chain effect? Similar questions can be asked in the context of the manufacturing sector. The frightening thing is that the honest answer to these questions is simply that we do not know!

In general, of course, a tax system is characterized by the structure of *its rates,* the nature and extent of *its base,* and by *its special provisions,* that is, the manner in which it seeks to address endowment or opportunity differences between economic agents. In the case of a VAT in a country such as Trinidad and Tobago there is a need to consider whether the two-rate structure — zero on some items and 15 per cent on the rest — is appropriate. This is a system with essentially two uniform rates. No doubt this uniformity was adopted largely in an effort to minimize the administrative costs of the system. However, since the modern theory of taxation indicates that optimality lies in the direction of multiplicity rather than uniformity, there should be some assurance that the administrative costs saved exceed the social costs incurred by opting for a sub-optimal system. At the very least, since multiple rates would make for lower regressivity of the VAT there should be some assurance that what was adopted was not simply the easiest way out.

With respect to the potential *tax base* — private consumption — what principles should be applied to determine which components should remain in the base and which should be excluded? The impression is given that mainly equity criteria, with a heavy dose of pragmatism, have been applied. However, in an economy which is in the throes of a downturn, should not the efficiency criteria be involved to maximize the social benefits from exploiting the differences in the consumption propensities attached to different parts of the tax base? For example, if goods and services in the construction sector were zero-rated or taxed at a lower rate than 15 per cent, would there not be a net positive impact on the rest of the economy?

Turning to *special provisions,* consideration should be given to whether rebate links between the VAT and the income tax system would not go a long way in increasing the acceptability of the new system. Such a procedure would have to be judged on cost/benefit criteria, given the expected administrative complexities, but they cannot be ruled out as long as the new system is to contribute to socioeconomic transformation.

The Continuing Need for More Detailed Studies

Much of the previous discussion has pointed to the need for more detailed studies to facilitate the introduction of the VAT system in Trinidad and

Tobago. The ideal requirement would be for the country to have a model of the economy which can then be used to draw up a list of the effects of a VAT under varying sets of assumptions. It must never be forgotten that while the revenue potential of a VAT depends on the buoyancy of the different sectors, the buoyancy of these sectors depends on the scope and the rate at which the VAT is applied. If the ideal of an available model of the entire economy does not exist, at the very least some detailed work on a few key sectors should have been done. Without such work policy-makers would be really guessing, regardless of how sophisticated the presentations on the proposals appear to be.

A similar kind of charge can be made in respect of the equity of the VAT. From all the material so far made public, it would appear that no attempt has been made to systematically estimate what the impact of VAT would be on different income groups. The evidence provided about the existing purchase tax system suggests that this system impacts about three times as heavily on lower income groups as it does on higher income groups.[20] This is precisely what is meant by a tax system being regressive: it burdens lower income people relatively more than upper income people. While it is possible that the VAT may not have such a high level of regressivity as the existing purchase tax system, because of the greater consumption of services by upper income groups, this remains essentially an empirical matter. The required incidence studies can still be of assistance in designing the kind of income-support system required during the so-called adjustment period.

Of course, it can be argued that the VAT is being introduced as part of a system designed to reduce income taxes on all groups including the lower income groups. On this point clear thinking is of utmost importance. For if, as it appears, the middle and upper income groups will benefit most from the income tax reductions, then in a supposed revenue-neutral tax reform which shifts the burden towards the taxation of consumption, it is virtually certain that the new system will be more regressive than the one it replaces. Again, without any budget studies to indicate the extent of group-burdens, the policies are being implemented in the dark.

Under these circumstances of ignorance one may want to ask why the authorities have apparently chosen to take such a great risk, moving

forward on the basis of such ignorance. Meanwhile, it would be useful to explore an alternative pattern of implementation of the VAT — a pattern which would seek to deal with many of the issues raised above. This should be explored not only because it is still possible for the system in Trinidad and Tobago to be brought onto a better implementation track, but the suggestions may be useful to other countries of the region that may soon be considering a VAT system.

An Appropriate Schedule for Implementing VAT

The question of the speed and scale of implementation of the VAT raises the important question of the need to minimize the social cost of intervention. Public policy that may be warranted on grounds of pure economic logic may yet do more harm than good if not properly implemented. From the nature of the discussion above there seems to be a prima facie case for saying that it would be a costly mistake to institute a VAT system in the manner chosen by Trinidad and Tobago. Even if there are external pressures to do so, it is still necessary to consider whether the mode of implementation would be in the nation's economic interest.

Even under the best of circumstances, VAT systems are fraught with myriad problems of implementation. First, there is the need to ensure that the VAT Administration Division is itself sufficiently prepared to cope with the volume of paper work and with the technical aspects of applying the law that governs the system. Second, there is a need to ensure that at the beginning of the system a sufficient number of VAT-educated traders are registered. Apart from all of this, however, there is always the possibility that the business population will spend a great deal of effort in devising ways and means of avoiding or delaying handing over payments to the government.[21] While there may be heavy statutory penalties for non-compliance, at a time when cash flows are not at all good, VAT collections become a source of great temptation to businessmen.

In the absence of convincing evidence to suggest that the implementation risks have been adequately addressed, it would seem that a genuine attempt to make the VAT revenue-neutral, in the light of prior adjustments in the income tax schedules, will make the tax contribute to further revenue

shortfalls. If this happens, it would mean that after the VAT is introduced, the country could find itself even more dependent on oil revenues than ever before.

In view of this possibility it seems to make sense to go for a phased implementation of the tax. In particular, the policy-makers should consider adopting a four-year schedule of implementation. This proposal is based on the recognition of four basic propositions:

a) In order to minimize administration and compliance costs, the population needs to be induced to accept the VAT as a better way of paying their taxes. This would be facilitated if the VAT is introduced at a relatively low rate.

b) Since the VAT will be addressing a specific development need of the fiscal system, revenue-neutrality, if desired, must be applied not to the VAT, but to the rest of the system. In other words, once the VAT revenue expectations are determined, it is the other parts of the tax system that must be made to adjust.

c) It will take more than one year to restructure the public expenditure allocations to offset the equity pressures for widespread zero-rating and exemptions, which themselves only serve to complicate the administration of a VAT system.

d) The introduction of the VAT while the economy is still on the decline is likely to complicate the adjustment process by exacerbating what may be an already unacceptable distribution of the burden, and by making the VAT a good basis for new inflationary pressures.

The implementation proposal being suggested in this paper can be summarized as follows:

Year 1: Set a low introductory rate of *5 per cent* and adopt a narrow *educational* range of traders, approximately 30 per cent of the eventually desired range.

Year 2: Keep the low initial rate and widen the range to about 50 per cent of the desired range of traders.

Year 3: If the learning/acceptance process is seen to be having the desired effect, the rate could be moved up to *7.5 per cent* and the range extended to include about 75 per cent of the eventual target population of traders.

Year 4: The rate could be moved up to *10 per cent* and the range of traders could be moved up to 100 per cent.

Of course, the approach suggested implies that other aspects of the government's tax reform programme will have to be put on hold or appropriately modified. For example, using the Trinidad and Tobago Ministry of Finance implicit estimate of the effective consumption tax base — TT$5.6 billion — I estimate that the VAT according to the 4-year proposal will not be expected to generate more than TT$190 million in the first year. This obviously means that the government would not have proceeded with the income and purchase tax cuts as planned for 1990.

If, for example, total private consumption hovers around TT$8.0 billion for the next few years, it is not unreasonable to expect that zero-rating, inter alia, will account for a 25-per-cent reduction in the consumption base. On an effective base of TT$6.0 billion (given my concern for the impact of the tax on lower income consumers), and using 10 per cent as the maximum rate, VAT revenues will *eventually* yield TT$600 million. My first contention is that the attempt to go for this level of VAT revenues from the start will impose more costs on the society than the government actually receives in revenues. A gradual movement from around TT$190 million in the first year to the TT$600 million target by the fourth year is likely to incur less resistance. This, in turn, will pave the way for a smoother and less costly collection experience when the tax settles down.

My second contention is that even if the government establishes a revenue target of TT$6.0 billion over the next few years, the VAT should not be forced to yield more than 10 per cent of this level. A balanced distribution of revenues seems to be attainable without pushing the fiscal system beyond the threshold of *tolerable regressivity.* Comparing the latter (recession) half of the decade of the 1980s with the earlier (boom-phase) half, there should be no difficulty in justifying a distribution as indicated below.

Suggested Distribution of Government Revenues
TT$ billion

Revenue target		6.0
Individuals	1.2	
Non-oil Corporations	0.5	
VAT	0.6	
Other Taxes	0.6	
Non-tax (excl. Royalties)	0.5	
Oil Sector	2.1	
Capital Receipts	0.5	

In each case, the revenue level suggested is within our reach. In the case of the oil sector, I have deliberately sued a low estimate in spite of the optimistic production expectations that now prevail. Also, in the case of individual income taxes, I have suggested a level of taxation which corresponds to less than 15 per cent of the total compensation to employees. The other revenue components are set at levels consistent with those obtained in some of the lean years of the past decade.[22]

There are a number of advantages to this balanced, gradualist approach to implementing the VAT:

a) First, the population will be given sufficient time to adjust its behavioural responses and will, therefore, be less likely to expend resources in planning to evade the tax.

b) Another advantage is that, with a ceiling rate of 10 per cent, the case for zero-rating will be much weaker and, with a more "educated" economic community, the case for exemptions would also be weakened.

c) The move towards higher levels of revenue will therefore depend more on the widening of tax-base and less on the tax-rate.

d) With the opportunity presented for a better quality of implementation, the incidence of delinquency or non-compliance will be lessened thereby reducing the social cost of administering the new tax system.

CONCLUSION

In this paper I have attempted to provide a systematic evaluation of the new VAT system introduced in Trinidad and Tobago on 1 January 1990. I have argued that while moving to a consumption tax, such as the VAT, is a necessary development of the fiscal system, it is certainly not sufficient to deal with the major problem of revenue stability in an open economy such as Trinidad and Tobago. I have also argued that, given the serious problems of efficiency and equity that are likely to be unleashed in the absence of appropriate studies, the question of implementation acquires special significance. In this regard, I have suggested a phased implementation to allow for wider acceptance among the population and for lower administration costs. While I admit that there may be some pressure on the government due to its need to resort to IMF balance of payments support, my suggestion in the interest of national economic stability is *festina lente* — hasten slowly.

NOTES

[1]The size of the country is less than 2,000 square miles. Its population in 1988 was less than 1.2 million, and its 1986 level of trading activity amounted to TT$9.9 billion (US$2.75 billion), or 60.7 per cent of its GNP. (The population data are taken from [5] and the trade and GNP data are taken from [3].

[2]The adoption of the practice of variable interest rates and the hegemony of LIBOR are but two relatively recent developments which have impacted significantly on the fortunes of the so-called developing countries. The tendency of concessional creditors like the World Bank to vary rules of "graduation" has also made an important difference to countries in this règion.

[3]See [8], p. 14.

[4]See [13], p. 32.

[5]At the University of the West Indies we are engaged in two kinds of studies — one set dealing with the possible impact of VAT on households and another set dealing with the effect on particular sectors, beginning with Construction and Agriculture. Resource limitations in respect of research assistance have meant that progress has been very slow. It is now known that the National Insurance Board has initiated an internal study on the impact of the VAT on the National Insurance System (NIS). This is a particularly timely study since it recognizes something that the policy makers have either overlooked or ignored: the fact that, with a comprehensive system such as the VAT, the appropriate revenue base for the public sector must include the NIS. It simply does not make sense to have an increase in central government revenues which is matched by a decrease in NIS collections. Since this is a real possibility when the VAT is introduced at a time when incomes and employment are falling, we need to study this situation more carefully.

[6]Trinidad and Tobago has now joined the group of so-called developing countries that report unemployment rates in excess of 20 per cent, and there are no convincing indications that the prevailing extent of unemployment will be significantly reduced in the foreseeable future. See the Central Bank's data in [4], p. 5, where the unemployment rate is given as 22.3 per cent, or 103,800 persons.

[7]For a proper account of the Indonesian procedures see Gillis in [7].

[8]See [1] Chapter 14, Section 14-2.

[9]We refer to Alan Tait's book, [11].

[10]See Wendell Samuel in [9].

[11]See the paper by Penelope Forde and Arjoon Harripaul in [4].

[12]The data up to 1987 are obtained from the Central Bank [3]. The 1988 and 1989 data were obtained from the 1990 Budget Speech.

[13]Lloyd Best was reported by the news media to have argued that the militant activity of the trade unions in the oil industry during the last quarter of 1989 was the direct result of the expectations created by repeated claims of an economic turnaround by senior government spokesmen.

[14]See Report of Subcommittee on Revenues and Expenditure, chaired by Joseph Pounder, former Commissioner of Inland Revenue in Trinidad and Tobago, mimeo, 1986.

[15]See, for example, Nicholas Stern in [10] where the point is made in several ways.

[16]This Paul Barioch-type sentiment is dominant in the work of Malcolm Gillis [7] and John Due [6] who have tended to concentrate more on implementation than on the generalities of VAT in the developing countries.

[17]Consider, for example, the investment equations in the macroeconometric model by Unanan Persad [12]. After exploring the possibility of using a Fisher user-cost approach, the author had to settle for formulations which relate investment to capital inflows and to GNP.

[18]See Brittan's UK 1985 study referred to in [11].

[19]Usually specialists refer to the first property as *buoyancy,* which indicates the responsiveness of the revenue system to changes in the tax base and the tax rates. We have chosen the term reliability to reflect the need to put limits on responsiveness when the movement is contractionary.

[20]See the 1983 IMF Financial Management study on Trinidad and Tobago. Here the information used came from Household Surveys in the early and middle seventies, but there is no reason to believe that the relevant measures changed dramatically over time.

[21]It is interesting to note that Tait [11], in discussing the weakness of retail sales taxes, was willing to grant that at a 5 per cent level there is little or no incentive to evasion or non-compliance, at 10 per cent such an incentive probably exists, and at 15-20 per cent there ought to be a high expectation of evasion. In our view there is no reason why the same analysis should not be applied to the VAT.

[22]The component revenue figures used for comparison were obtained from [2] and the Bank's new publication, [[3].

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An Overview of Jamaica's Fiscal Reform Programme

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Introduction

This paper presents an overview of Jamaica's Fiscal Reform Programme, with the main focus being on the industrial incentive schemes and the new tariff system. In the first instance, the paper summarises the historical perspectives of Jamaica's industrial fiscal reform programme and discusses the economic considerations that brought about the need for reviewing some of the industrial incentives that were in place.

Secondly, a summary of the fiscal reform programme is presented in relation to:

(i) the new tariff system;

(ii) corporate income taxation;

(iii) personal income taxation;

(iv) the indirect internal taxation system.

Thirdly, an overall assessment of the new tariff system and its likely implications for the future direction of the Jamaican economy is presented.

Historical Perspectives

Apart from sugar and rum, Jamaica's manufacturing base really started during the war years when imports were virtually cut off from the island. Up to that time, the economy was mainly an agriculturally based one.

In the post-war period of economic development in Jamaica, fiscal incentive programmes were formulated and implemented as a major policy

instrument for inducing investments and production in the industrial sector, the mining sector, the non-traditional export sector and, to a lesser extent, the agricultural sector.

The Industrial Incentives

The Textile Industry Encouragement Law of 1944 had a tremendous impact on the Jamaican Industrial Sector. That Law granted to investors special depreciation allowances, duty-free concessions on imported capital goods and on imported raw materials. It also set the stage for the development of subsequent industrial incentives schemes, which were more general in character.

The Pioneer Industries (Encouragement) Law, 1949, had similar concessions to those of the Textile Industry Encouragement Law; however, there were additional incentives, namely, that funds "set aside from special capital allowances may be distributed free of taxes within a period of eight years".

Subsequent to the Pioneer Industries Law, 1949, came the Industrial Incentives law (I.I.L.) and the Export Industry Encouragement Law (E.I.E.L.) of 1956. Income tax holidays of up to nine years were granted to manufacturing companies under the I.I.L. depending on the level of local value added while under the E.I.E.L. companies received up to ten years tax incentive periods. In addition, under either incentive programme, if the company was located in designated areas, the income tax incentive period could go up to fifteen years.

During the incentive period, it was not necessary to take depreciation allowances. Companies operating under both the I.I.L. and E.I.E.L. were also granted duty-free concessions on imported capital goods, imported raw materials and spare parts. Other features of the I.I.L. and the E.I.E.L. were:

(i) that firms operating under either law could carry forward losses incurred during the tax holiday for a period of six years after the expiry date of the incentive period;

(ii) after the incentives period, firms could charge against income an initial allowance not exceeding 20 per cent of the original capital

expenditure, and also would commence taking depreciation allowances on the original cost of the investment.

Under the Harmonisation of Fiscal Incentives Schemes within CARICOM, firms were granted partial relief from liability to pay Income Tax on profits related to export performances if the enterprise's tax incentives period had expired, or where the enterprise did not benefit from incentives under either the I.I.L. or the E.I.E.L.

In the post-1956 era, investments and production in the manufacturing sector were undertaken largely by firms operating under either the I.I.L. or the E.I.E.L. The firms operating under the I.I.L. produced primarily for the domestic market and to a lesser extent the CARICOM market, while the E.I.E.L. firms produced exclusively for the export markets.

Main Findings/Recommendations of Studies on The Industrial Sector

Ayub found in his study (1981) on the development of the manufacturing sector in Jamaica that the post-war industrial incentives programmes played a significant part in the development of the sector, especially up to the mid-1960s. After this period they played a less significant role because of the imposition of quantitative restrictions on imports and the adoption of trade and exchange rate policies which offered relatively high levels of protection to manufacturers.

It was Ayub's contention that the prevailing industrial incentives in Jamaica were "excessively generous, even though their cost to the central government (in the form of revenue losses arising from corporate tax revenue foregone, individual income tax foregone on distributed dividends and customs duties exempted) was substantially less than was generally alleged".

That study called for a modification of the then industrial incentive legislations to give a shorter tax exemption period with some provisions for extension, if necessary, based on some performance criteria.

The Ranis Study like the Ayub Study concluded that the levels of effective protection and the prevailing industrial incentives given to the

productive sectors in CARICOM countries such as Jamaica, did not enhance domestic value added and employment creation in areas such as agriculture and the food and beverage processing industry. Instead, such incentives favoured "industrial products depending more on imported intermediate inputs where the combination of high tariffs on final goods with zero or low tariffs on intermediate goods induces the screw-driver industry phenomenon, i.e. industries with very low ratios of value added to sales, calculated at world prices".

One of the policy recommendations of that study was for a gradual reduction in the overall level of protection offered to industrial production in CARICOM in order to facilitate improvement in both domestic and international competitiveness, "especially in the growth sensitive non-durable consumer goods industries". The study suggested that such a policy could be implemented through a combination of mechanisms including:

(i) harmonization of tariffs between the Common External Tariff (CET), the Eastern Caribbean Common Market (ECCM) and Belize tariffs, but this should be harmonized at the lower ECCM rather than the higher CET levels;

(ii) a gradual reduction of common tariff levels harmonized across countries and commodities over a period of time;

(iii) a reduction of quantitative restrictions under a common harmonized protective policy scheme, probably first on producers' goods then on non-durables, and finally on durables.

After the change of political administration in Jamaica in 1980, the new Government entered into discussions with the World Bank and agreed on a five-year Structural Adjustment Loan Programme known as the S.A.L. The implementation of that programme came about in phases known as S.A.L. I, S.A.L. II, etc. with each succeeding phase carrying forward policy programmes initiated previously, as well as embarking on new policy programmes.

One critical segment of the Structural Adjustment Programme called for a reduction in the levels of protection being enjoyed by the industrial sector, thereby opening local industries to greater competition, forcing

firms to become more competitive or go out of existing inefficient areas of economic activities and get into those areas in which they are more efficient, competitive and export-oriented.

The implementation of the new industrial policies commenced with the removal of products that were under Quantitative Restrictions (Q.Rs) and for which import licences had to be granted for their importation. Most of the products that were removed in the initial round were inconsequential. However, those products which were of some significance had to be replaced on the restricted list of products, for example, some garment products.

It was at that time that the Government of Jamaica through the Ministry of Industry and Commerce and the Planning Institute of Jamaica in association with the World Bank decided to undertake a comprehensive study on those firms producing products that were on the import restricted list, to:

(i) determine the extent of cost competitiveness of the products, and to identify which products had export potential based on international competitiveness;

(ii) recommend a phased elimination of the products from the restricted list, in order to minimise any disruptive effects on the firms in terms of employment output, and profitability;

(iii) determine and quantify the retooling needs of the firms that might have been affected by the removal of Q.Rs.

Based on the findings of that study, a more orderly system of removal of products from Q.Rs was put into place and reference prices were recommended for products in the Garment, Footwear and Agricultural Sectors. The "retooling needs" of the affected firms were identified and quantified, resulting in the establishment of the Rehabilitation Fund to provide assistance to the relevant manufacturers in upgrading their plant and equipment for the export market. Third Country export market studies were also done by the Government through the National Planning Agency (now Planning Institute of Jamaica) and the Jamaica National Export Corporation (J.N.E.C.) to help firms identify markets in which their products were price competitive. Some of the manufacturers made good use of the findings of those market studies.

During the Structural Adjustment period, especially between the years 1983 and 1985, the substantial fall in export earnings from the Bauxite/Alumina Sector (down by 56 per cent from approximately US$314 million in 1981 to US$139.0 million in 1985), and the significant increase in the fiscal costs of servicing the external debt pressured the Government to seek out new areas for export growth and revenue support.

In 1984, the Government accelerated its deregulation programme on the Manufacturing Sector by releasing a larger than expected number of products from the restricted lists. As a revenue earning measure, the Government also levied a 6 per cent Additional Stamp Duty on raw materials imported by certain recognised manufacturers. The World Bank in association with the Planning Institute of Jamaica carried out a study on the Manufacturing Sector to assess the impact of the 6 per cent Additional Stamp Duty on production for exports, as it was the view that the then devaluations were strong enough to remove any negative impacts of the 6 per cent Additional Stamp Duty on the competitiveness of export production, especially to hard currency areas.

The study concluded that the 6 per cent Additional Stamp Duty eroded not only the manufacturers' export price competitiveness but also their relative profit position. Based on the findings and recommendations of that study, the Government implemented "a draw-back scheme" to compensate manufacturers exporting to hard currency markets for the 6 per cent Additional Stamp Duty paid on the imported raw materials used in production for exports.

As a result of tighter revenue constraints due to factors such as:

(1) further substantial fall out of revenue from the Bauxite/Alumina Sector;

(2) rising debt servicing costs, while operating within specific I.M.F. monetary and fiscal targets under the Economic Stabilization programme of 1984-1985,

the industrial sector was again called upon to carry a larger share of the adjustment costs. In this regard, the 6 per cent Additional Stamp Duty on imported raw materials was increased to 16 per cent in 1985. However, exporters to hard currency markets were given a rebate on this tax as an

incentive to encourage and shift export of manufactured products to these markets.

In the third Structural Adjustment Loan Programme (S.A.L. III) agreed on between the Government of Jamaica and the World Bank, one component of the package called for the undertaking of a "comparative Advantage and Incentives Study". The findings of that study should form the basis for redesigning Jamaica's trade and industrial policies. That study was micro-oriented with concentration on the Manufacturing Sector, Jamaica's trade policy within the context of CARICOM and the Common External Tariff (C.E.T.) and Jamaica's Fiscal Incentives Policy Programme. The major findings of that study were:

(1) On the average, the level of protection which the tariff system (i.e. Common External Tariff and the Stamp Duty) provided to industries in Jamaica was moderate; however, they were complex, distortionary and were applied in an arbitrary manner.

(2) The tariff system encouraged misallocation of resources and tended to discriminate against efficient producers.

(3) The prevailing tariff system inadequately compensated exporters, discriminated against domestic suppliers of intermediate goods and encouraged imports.

(4) There was no protection against dumping in the existing tariff system.

(5) Those firms operating under the I.I.L. received considerably higher rates of return than those in the general Manufacturing Sector, suggesting that "most of the benefits are appropriated in the form of economic or monopoly rents by the firms receiving the incentives".

The major policy recommendations of that study were:

(1) "The replacement of the present dual regime of CET and Stamp Duty by a single *ad valorem* tariff and rate equalization aiming ultimately at 25 per cent to be paid on all non-CARICOM imports."

(2) Independent of origin, luxury goods that have high revenue potentials (and for income redistribution purposes) should be taxed under the Excise System.

(3) The introduction of a uniform *tariff rebate system* based on the f.o.b. value to exporters who do not operate in the Free Zone and who are not under the I.I.L. or the E.I.E.L. This rebate should be for duties paid on imported raw materials and the duty component on domestically produced intermediate imports. Such a system should be simple in its administration.

(4) "The institution of an Anti-Dumping Committee with the power to levy Countervailing Duties" using a system of reference prices.

(5) No new approvals should be granted to firms under the I.I.L. or the E.I.E.L., but firms already operating under the provisions of both Acts should continue until the expiration of the benefits.

(6) Allow provisions for an indefinite carry forward of losses for firms which are not under either the I.I.L. or the E.I.E.L.

(7) Maintain the provision of the Georgetown Agreement that "allows corporate taxes to be reduced in proportion to the percentages of sales outside CARICOM".

(8) The Government should establish an "Adjustment Assistance Fund" to compensate manufacturers for short-term adjustment costs for rehabilitation of capital and retraining of the labour force. Disbursements should be based on the evaluation of business plans.

A major short-coming of that study is that it did not give an indepth macro analysis of the likely impact of the proposed tariff reform measures on the economy.

The Reforms of the Tariff System

Arising out of the findings and recommendations of the Comparative Advantage and Incentives Study, the Government of Jamaica subsequently presented its Tariff Reform Policy Programme which is expected to be implemented over a four-year period ending March 1991.

Objectives of the Programme

(1) In the first phase of the programme, the Government expects that the reforms should increase the proportion of dutiable imports from 21 per cent to 34 per cent.

(2) At the end of the period, there should be a simplification of the tariff system and reduction in the wide spread of rates from the 0 per cent to 200 per cent range to a narrower range of 5 per cent to 30 per cent.

(3) There is to be an elimination of exemptions and ministerial remissions of customs and stamp duties, with the exceptions of:

- cases of national disasters,
- charitable programmes, emergency situations, gifts to Government, health and welfare programmes approved by the minister,
- temporary imports,
- international agreements and protocols,
- oil imports,
- bauxite imports,
- CARICOM imports,
- bank and currency notes and coins,
- University of the West Indies,
- 807 type imports.

Specific Aspects of the New Tariff System

By the end of 1991 when it is expected that the reforms should be fully in place, the system should have the following specific elements:

(a) 5 per cent import duty on imports by the utility companies as is specified in the second schedule of the Customs Tariff Act.

(b) 10 per cent aggregate import duty on raw materials.

(c) 20 per cent aggregate import duty on capital goods.

(d) 30 per cent aggregate import duty on consumer goods.

(e) An Export Tax Rebate of 7.5 per cent of the f.o.b. value of the export proceeds.

The first phase of the implementation programme entails the following policy measures:

(i) the Export Rebate of 7.5 per cent of the f.o.b. value of exports to Third Country markets;

(ii) the payment by utility companies of the maximum 5 per cent import duty;

(iii) reduction of the Additional Stamp Duty on imported raw materials from 16 per cent to 10 per cent;

(iv) charging a maximum 68 per cent aggregate of customs and stamp duties on all imports with the following exceptions:

— where the CET is greater than 68 per cent, the CET is the applicable duty

— some specific products (mainly agricultural items) which now attract stamp duties of 40 per cent and over, and which are charged against special reference prices.

(v) a 95 per cent Additional Stamp Duty chargeable on 45 specific products (mainly agricultural products) which no longer have reference prices attached to them, and no longer benefit from Q.Rs;

(vi) the removal of an additional 55 items from the Quantitative Restrictions List;

(vii) removal of another 25 specific items from the import restriction list, but which can be imported only by the state-owned and operated Jamaica Commodity Trading Company (JCTC);

(viii) a specific list of agricultural products which are still under Q.Rs and attract the 95 per cent Additional Stamp Duty;

(ix) the formation of an Anti-Dumping Committee with representatives of interest groups and the government to adjudicate cases of dumping;

(x) the formation of a tariff Reform Secretariat to effect the "transitional arrangements for the implementation of the Tariff Reform Programme, and to assist the firms identified for restructuring and modernization to develop plans for bankable projects".

The Government estimated that its net tax intake from the first phase of the Tariff Reform Programme would be about J$32 million and would be used to offset some of the revenue costs incurred from the reduction in the rate of corporate taxation from 45 per cent to 33 1/3 per cent.

The Tariff Reform Programme has been somewhat generous to the category of finished imported consumer goods, which now attract an aggregate customs and stamp duty of 68 per cent. When the consumption duties are applied on an *ad valorem* basis to this aggregate duty, the industrial sector in Jamaica, it would seem, still operates within a protective tariff barrier. However, the reform programme has been less generous to the capital goods and intermediate categories of imports.

The rate of tariff reduction on imported capital goods and spare parts is much lower than that on finished goods, and this has produced confusing signals to manufacturers. At present, the level of custom and stamp duties paid on imported capital equipment is 57.5 per cent and the abolition of duty exemptions on imported raw materials has in effect put new investment projects in the manufacturing sector on a less competitive cost curve, especially if the product to be produced will be sold on the domestic or CARICOM markets.

However, if the import content of the new project is 50 per cent or less, and the products are produced and sold in Third Country markets, the 7.5 per cent Export Rebate would allow for a rebate of the duties paid on the imported raw materials plus a rebate for some of the duties paid on capital equipment and spare parts.

Reforms of Corporate Income Taxation

Significant amendments have been made to the system of Corporate Income Taxation in Jamaica, and this has been an integral part of the country's Fiscal Reform Programme. The amendments were incorporated in Act 3 of 1987. The main purposes of the reforms of the corporate income taxation system were to:

(i) make the system simpler;

(ii) make the system more equitable;

(iii) broaden the tax base.

The main provisions in the Reformed Corporate Income Taxation system are:

(i) Abolition of the two-tier Company Profits Tax (35 per cent) and the Additional Company Profits Tax (10 per cent), and this is replaced by a single rate of 33 1/3 per cent.

(ii) The Special Income Tax of 10 per cent for Banks which was introduced in 1984 has been retained.

(iii) The rate of tax on Life Insurance Companies has been retained at 7½ per cent of "Investment Income Less Management Expenses", also the Premium Tax has been retained at ½ per cent of 2 per cent depending on whether or not the Company is "regionalized".

(iv) Companies are now allowed to carry forward losses indefinitely until fully utilized against income.

(v) A Dividend Tax Rate of 33 1/3 per cent.

In the reforms to the Corporate Income Taxation System, there is no longer any distinction between tax rates for agricultural companies which usually paid a 25 per cent Company Profits Tax and a non-agricultural company which usually paid a 35 per cent Company Profits Tax.

The lower single tax rate of 33 1/3 per cent compares favourably with those prevailing in other larger CARICOM Countries (Barbados — 45 per cent, Trinidad — 45 per cent), and also those applicable in some developed countries (U.S. — 34 per cent, U.K. — 35 per cent). However, countries like Hong Kong and Mexico have lower corporate income tax rates. in the former country, the rate is 18.5 per cent while in the latter the rate ranges from 5 per cent to 42 per cent depending on the level of profits. The 33 1/3 per cent dividend tax on resident shareholders is a double taxation on corporate income. This aspect of the reforms biases the financing of companies by way of debt instead of by way of equity since interest is a deductible expense to the company for tax purposes.

Although Company Profits Tax are now being taxed at a lower flat rate thereby allowing for higher levels of retained earnings, when dividends are

are distributed to shareholders and such dividends are further taxed at the 33 1/3 per cent rate, the shareholder will only be in a marginally better position.

Reforms of Personal Income Tax

The reforms of the personal income tax system were presented in the Income Tax Amendments Act (No. 2) 1986, and came into effect on January 1, 1986. The main provisions in the reform programme were:

(1) A single flat rate of 33 1/3 per cent on personal income in excess of $8,580.

(2) A withholding tax of 33 1/3 per cent on interest income received by individuals on deposits in Banks, Building and Co-operative Societies and institutions registered under the Protection of Depositors Act.

(3) Abolition of the tax credit system, under which individuals could claim tax reliefs for a fairly wide range of items.

The reforms of the personal income tax system have brought about an important tax break for persons over 65 years of age. For such persons, the first $23,580 of their income is exempted from tax.

Some important changes have also been made in relation to allowances received for housing, entertainment, and motor vehicles. The overall effect of the reforms of the personal income tax system has been to increase the nominal/disposable incomes of those from the middle, down to the lower end of the employed labour force, while increasing the tax take from those persons with income from the middle up to the top end of the employed labour force.

Reforms of the Internal Indirect Taxation System

The first phase of the fiscal reform programme concentrated on the border tariffs (customs and stamp duties), personal and corporate taxation. However, the specific policy reforms that relate to the internal indirect taxation system have not yet been finalised.

The present internal indirect taxation system consists of:

- Excise duties with varying ad valorem rates which are levied on goods produced and sold on the domestic market and contribute abut 1 per cent of total recurrent revenue.
- Consumption duties with varying rates which are levied on locally manufactured goods and on imported goods and which are responsible for approximately 26 per cent of total recurrent revenue.
- A retail sales tax which is levied at ad valorem rates on the sale at the retail end or importation on certain consumer goods, e.g., television and motor cars, and which contributes approximately 1 per cent of total recurrent revenue.
- Other internal taxes (e.g. hotel tax, travel tax, domestic stamp duties, motor vehicle licences, entertainment duty, Betting, Gaming and Lotteries' Duties, fees and levies, telephone tax, education tax, contracts levy, land property tax). These taxes combined contribute approximately 8 per cent of the total recurrent revenue.

In Part I of the Government's White Paper on the Tax Reform Programme, with respect to the indirect tax structure, it is proposed that the present Excise Duty, Retail Sales Tax, and most of the consumption duty shall be replaced with a value-added tax at the manufacturer and large distributors' level. The new tax would be called the General Consumption Tax (GCT).

As proposed in the White Paper, the main features of the GCT would be:

(a) A uniform rate — as far as is possible to simplify compliance and administration and reduce the economic distortions created by the existing rates.

(b) It would be applied to all manufactured and imported commodities other than those which have been excluded or get exemption.

(c) Exemptions would apply to goods such as:

  (i) commodities which are basic necessities and widely used by the lower income groups;

  (ii) commodities used largely in agriculture e.g., fertilizer and animal feed;

(iii) sales for export.

The paper also proposed that a few categories of goods that are now subject to consumption duty or excise duty (e.g. cereal grains, condensed milk, cornmeal, flour) would be free from the GCT.

The proposed GCT system would have similar features to the Income Tax System, but the main distinguishing feature would be that income tax is a tax on income or wealth, whereas the GCT would be a levy imposed on the sale of goods and services.

Owing to the fact that the GCT is a consumption-oriented tax, theoretically, it has the potential to reduce the propensity to consume and conversely to increase the savings propensity in the economy, thereby fostering the level of capital formation and economic growth.

At the production end, the proposed GCT would apply a uniform treatment to imports and locally produced goods. This would have the effect of reducing the level of effective protection on import substitution production. Where domestic producers have paid GCT on production inputs, but such producers are registered as zero-rated "taxable persons", it is proposed that the GCT should be refunded.

Given the extent of the skewed distribution of income and wealth in Jamaica, the GCT has to be skilfully designed so as not to place a relatively higher tax burden on the lower income groups.

The proposed reforms of the internal indirect taxation structure as outlined in the White paper, if implemented with no substantial modifications, could bring about a more economically efficient and a simpler indirect taxation system, without any substantial initial increases in revenue.

However, an answer to the question, "What would be the likely impact of the proposed reforms of the internal indirect taxation system on the economy in terms of employment, balance of payments and balance of trade effects?", could not be attempted in this paper since the specific policies to be implemented are not yet known.

Some Macro Impacts of the New Tariff System

Any assessment of the effects of the new tariff system on the industrial and tourism sectors in terms of investment, and on the economy at the macro level in terms of balance of trade and payments, shifts in impact and export composition and growth, and pressure on the exchange rate can only be preliminary at this stage.

In the Tourism Sector the current buoyancy of investment activities relates to projects which were approved under the Hotel Incentives Act. With the flurry that went on among investors in the tourism sector to get their projects into the Ministerial Approval Committee before the deadline date for the termination of benefits under the Hotel Incentives Act, it is reasonable to conclude that the duty-free concessions on imports under the Hotel Incentives Act played an important role in the investor's investment decision. In the case of the manufacturing sector which is a main target of the tariff reform programme investment in new activities is currently on the quiet side.

Some manufacturers have responded positively to the deregulation policies and the opening up of the domestic markets by trying to increase exports to Third Country markets. Some have either closed/scaled down their manufacturing operations, or have now become importers of the goods which they or other manufacturers usually manufacture locally.

While only a preliminary assessment of the effects of the new tariff on the economy at the macro level would be possible at this stage, a somewhat more definitive assessment could be made about its effects on the industrial sector. This is so because the new tariff system is only the second phase of the deregulation programme for the industrial sector which started in 1982.

Therefore, the performance of the Manufacturing Sector during the period 1983 to 1987 would reflect the effects of the earlier policies of Q.R. removal and the anticipated effects of lower levels of protection for industries in Jamaica.

In the area of non-traditional manufacturing, the subsectors that have shown the best levels of export performance are Processed Foods, Beverages and Tobacco and Miscellaneous Manufactures. Miscellaneous Manu-

factures consist mainly of 807, Cut, Make and Trim apparel exports which are produced in the Free Zone areas.

In U.S. dollar terms, non-traditional manufactured exports grew from $13.8 million in 1983 to $14.5 million in 1986 or by 5 per cent while non-traditional exports to Third Country markets grew by 119 per cent from $47 million in 1983 to $104 million in 1986.

Miscellaneous Manufactures was principally responsible for this good growth performance in exports to Third Country markets. In 1983, this group of exports contributed 22 per cent of exports to Third Country markets and by 1986 it was responsible for 55 per cent. Processed Foods, Beverages and Tobacco also had significant growth performance during the period.

In 1983, of a total export value of US$17 million of Processed Foods only $5.5 million or 32 per cent went to Third Country markets. However, in 1986, the total export value of Processed Foods was US$18.4 million of which 60 per cent or US$11 million went to Third Country markets.

However, it has been the experience of a number of Jamaican manufacturers that have tried to shift from the domestic and CARICOM Markets to Third Country markets that, although their products are price competitive, the non-tariff barriers to entry into those markets are very significant.

Incidences of such experiences have been quite glaring in markets such as the United States and Puerto Rico, notwithstanding the existence of the C.B.I. trade arrangements.

At the macro level, over the period April-September 1987 as compared with 1986, the rate of growth in merchandise imports has been twice that of merchandise exports. Merchandise imports (c.i.f.) grew from US$479.3 million to US$640.5 million or 33.6 per cent, while merchandise exports grew from US$297.5 million to US$348.7 million or 17.2 per cent.

Raw materials and capital goods have accounted for the bulk of the increases in imports but a significant share of the imported raw material related to imports of textiles, fibres and their waste, textile yarn fabrics, articles of apparel and clothing which suggest some buoyancy of investment activities in these subsectors. On the export side, again it is the export

of Wearing Apparel that has been the main driving force behind the growth in non-traditional exports.

The rate of growth (42 per cent) in net receipts in the Service Accounts of the Balance of Payments has not been strong enough to offset the deterioration in the trade gap (a widening of 60.5 per cent) over the comparable April-September period for 1986 and 1987. Overall, the current account situation worsened by roughly 100 per cent from US$51.4 million to US$102.3 million over the comparable period.

It is therefore possible to conclude that the reform measures that have been applied to the industrial sector (Q.R. removal, tariff reductions and export rebate) have resulted in greater emphasis being placed on production for Third Country markets. Simultaneously, these policies have placed firms with relatively high import content, producing primarily for the domestic markets in less cost competitive position, thereby creating some casualties within this segment of the industrial sector.

The level of fall out in subsectors such as Footwear, Garments and Textiles has resulted from the fact that manufacturers producing for the domestic market have to pay the existing Excise and Consumption duties, which are not paid on comparable imports coming in through Informal Commercial Traders. On the other hand, the sharp deterioration in the current account situation and the inability of export receipts to grow fast enough to meet the growth in import demand will certainly raise the following issues/questions for serious consideration, analysis and perhaps for some policy revisions:

(i) Have the initial reductions in the border tariffs have been too significant or not?

(ii) How realistic is the four-year implementation period for the new tariff regime?

(iii) In the face of growing protectionism in the major Third Country export markets, the extent of the external debt obligations, and the likely recession in the U.S. and other industrial economies, will the export sectors have the capability to support import demand levels at 10 per cent aggregate import duty on raw materials, 20 per cent aggregate import duty on capital goods

and 30 per cent aggregate import duty on imported consumer goods?

(iv) Given the importance of the underground economy in Jamaica and the high import propensity of the economy, can demand management policies of high interest rates and tight liquidity be effective in curtailing the growth in imports, without stifling investment activities?

(v) What are the costs and benefits of pursuing a differential interest rate regime policy in order to keep up the growth momentum in the export sectors of the economy?

Conclusions

General conclusions which can be drawn from this overview are:

(1) The reforms have very commendable features; for example, the new system is simpler to administer and is more equitable.

(2) (i) While the policy objectives of the industrial incentive reforms are sensible, the implementation strategy seems irrational. A more rational implementation strategy would be to have, in the first phase of the tariff reform programme, significant reductions of tariffs on production inputs rather than on final goods.

(ii) This is necessary to give those firms that have the potential to get into new hard currency markets some time to retool, redesign and re-package their products, increase their levels of efficiency and get "their feet" into the potential Third Country export markets. Export market development is not something that happens overnight. At the same time, this strategy would enable the firms to cope better with the increased competition on the domestic market.

(3) In the second phase of the tariff reform programme, reductions on tariffs on final goods should be accompanied by reductions in the internal indirect taxes of excise and consumption duties, given the significance of the underground import economy in

Jamaica. Much of the imports coming in through the underground economy are seconds or close-out sales, which in fact represent some form of dumping on the domestic market.

(4) Finally, it would appear that the first phase of the tariff reform package was designed with some optimistic implications for its impact on the country's balance of payments and balance of trade. However, the empirical situation does not support such optimistic expectations and this seems to be an area for critical review on the eve of the first year of the programme.

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Income Tax Reform in Barbados (1977-1987)

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Introduction

This article looks at the major reforms and adjustments in the Barbadian tax system during the ten-year period between 1977 and 1987. The most important development in this system is the shift in emphasis from income taxation to indirect taxation. This reorientation started in the early 1970s but came to a head with with wide-ranging tax reforms and adjustments in the budgetary proposals of July 1986 and 1987. This article discusses the personal income tax reforms between 1977 and 1985, paying close attention to the factors influencing these reforms. This is followed by a discussion of the theoretical rationale for income tax cuts to set the stage for an examination of the wide-ranging tax cuts of 1986, including reductions in corporation tax.[1]

The other sections of the paper examine the rationale for large discretionary changes in the indirect tax system in 1987. We pursue the argument that the indirect tax system was manipulated rather than reformed since there was no real attempt to rationalize the system. The paper ends with a discussion of earmarking and the development of the levy system during this period.

Gradualist Income Tax Reform (1977-1985)

The principal factors influencing income tax reform between 1977 and 1985 were initially the inflationary impact of the Oil Crisis of 1973, as well as a conscious policy by the state to build a service-economy by reducing

the incidence of personal income tax. Between 1973 and 1977, there was no significant reform of the income tax system. During the latter period, Government was primarily concerned with contractionary stabilization policy to curb consumption expenditure and correct the balance of payments. It was only after 1977 that income redistribution, by way of income tax reform, was regarded as a fundamental aspect of the Government's budgetary policy.

The most important reform in the income tax system prior to 1986 was the introduction if a tax credit system in 1977. The primary purpose of the tax credit system was to reduce or remove completely the incidence of income tax for the lowest income groups. For example, a tax payer of $6,000 per year or less, whose net tax due was less than $60 in income year 1976, was not required to pay income tax. Table A1, Appendix A, lists the changes under the tax credit system.

Other reforms in the income tax system between 1977 and 1985 can be described as gradualist in nature. Slight adjustments were made to the top rate of income tax and the income tax bands were widened to accommodate wage changes. In fiscal 1979/80, a maximum marginal rate of 70 per cent was charged on incomes over $30,000. The bands were widened in fiscal 1980/81, but high marginal rates remained on incomes over $30,000.

An evaluation of the income tax reforms between 1977 and 1985 shows that middle and upper income groups did not benefit significantly from the tax adjustments. The tax credit system eased the burden for large numbers in the lower income groups. It is estimated that the reforms of 1980/81 freed 29 per cent of the labour force at the bottom of the tax scale or 30,000 people from the income tax net.[2] The discussion will demonstrate that the substantial tax cuts of 1986 reduced considerably the tax liability of middle and upper income groups.

Table 1 shows the annual projected cost to the revenue of income tax concessions between 1977 and 1985. These projected costs were highest in 1980 when the political directorate reduced the emphasis on income taxation and increased significantly the indirect tax burden. In that year $24.0 million in income tax concessions were balanced by an increase of $24.1 million in indirect taxes comprising mainly consumption taxes.

TABLE 1. PROJECTED REVENUE IMPACT OF DISCRETIONARY TAX CHANGES ($m)

Year	Income Tax Concessions	Indirect taxes and Levies
1977	-3.3	7.8
1978	0.6	3.1
1979	-11.4	2.4
1980	-24.0	24.1
1981	-18.7	2.8
1982	-2.0	22.6
1983	-2.7	24.9
1984	-14.6	30.2*
1985	8.0	29.7**

Source: Financial Statements and Budgetary Proposals for the years 1977-1985.
* Comprises stamp duties ($19.0m). Consumption Tax ($3.0m), levies and other indirect taxes ($8.2m).
** Stamp duties ($10.0m), levies and other indirect taxes ($19.7m).

Thereafter, discretionary income tax changes were mostly negative except for 1985, while discretionary changes in indirect taxes and levies were mostly large and positive. The latter phenomenon is primarily explained by contractionary stabilization policies between 1981 and 1985. The ratio of indirect taxes and levies to total tax revenue rose from 46.3 per cent in 1977 to 58.6 per cent in 1985. Personal income taxation as a ratio of total tax revenue fell from 30.1 per cent in 1977 to 23.3 per cent in 1985. The sharp rise in the burden of indirect taxes and levies was aided by the heavy imposition of stamp duties in 1984 (Table 1, footnote).

Gradualist Reform and Tax Buoyancy

This section examines briefly the impact of gradualist tax reform on the buoyancy of the system. A rough comparison with previous time periods would be helpful. Analyses for earlier time periods show a tendency for

total tax revenue in Barbados to vary almost proportionally with income. That is, the author found a buoyancy coefficient of 1.09 for total tax revenue during the period 1965-1980 and 1.04 for the period 1946-1965. In the 1965-1980 period, overall tax buoyancy was sustained by the strong growth of the income tax, the buoyancy of which was usually greater than unity. The buoyancy of indirect taxation was usually less than unity. These findings showed that the income tax, particularly after 1965, and up to the early 1970s, was a fairly reliable, though burdensome instrument of financing.[3]

Further analysis for the period 1973 to 1985, a recessionary period which almost coincides with the era of gradualist tax reform, reveals a reversal of the previous trend. The author estimated a buoyancy coefficient of 0.85 for income taxation and 1.3 for indirect taxation. The buoyancy coefficient of total taxation was 0.68. The analysis leads to the view that overall tax buoyancy was no longer sustained by income tax collections. The tax reforms of 1977 to 1985 significantly reduced overall tax buoyancy despite the rapid growth in indirect tax collections. These findings have some implications for the financing of the fiscal deficit.

The Theoretical Rationale for Tax Cuts

The analysis here attempts to locate the theoretical underpinnings of the massive tax cuts of 1986. There re two basic approaches to the analysis of tax cuts. The first is the Keynesian approach which is demand-side centred. The second is the supply-side neoclassical approach. A broad version of the latter approach is sometimes discussed under the caption of supply-side economics. This section outlines these two approaches in order to gauge the extent to which they informed Barbadian policy-makers.

The Keynesian aggregative approach to the analysis of tax cuts is based on the heavy dependence on the first order income effects of a tax change.[4] A tax cut increases disposable income and the demand for output. These first order effects work their way through the economy leading to increases in investment and employment. However, the view is valid that a tax cut by itself cannot generate increases in aggregate output. Real output expansion depends on an increase in production inputs and/or more effi-

cient use of existing factor inputs. Real output is therefore a function of a number of factors including managerial efficiency and scale economies at the micro level. These micro variables, which are crucially important in small systems, are sometimes not adequately dealt with in Keynesian aggregative analysis.

On the demand-side, tax cuts in the Keynesian framework must be accompanied by a reduction in government expenditure. This is to avoid crowding out of private sector activity. Additionally, the money supply must increase to accommodate higher levels of spending in the private sector. An expansionary monetary policy must therefore accompany across-the-board tax cuts if output increases are to be realized. The specific implications of the Keynesian approach for the open economy will be examined later for Barbados when we assume the existence of a balance of payments constraint.

The supply-side approach to tax cut analysis is based on the neoclassical specification of the first order price effects of a tax change.[5] This approach is concerned with the cost of work effort vis-à-vis leisure, and the price of saving relative to current consumption. Particularly, the approach posits that taxes on income decrease work effort, enterprise and saving. Reductions in personal income taxes increase the propensity to save and invest as well as work effort. Reductions in corporation taxes raise net of tax rates of return leading to re-investment in new enterprises.

Most research on the impact of supply-side economics has been done in the free market U.S. economy.[6] An extreme version of supply-side economics is that an across-the-board cut in tax rates would produce an increase in tax revenues. That is, work effort and savings behaviour would respond to the incentives, thereby offsetting the loss in tax revenue. As Thurow points out, supply-siders believe that the free market would adjust quickly in he short run and the incentive effects would be large and positive.[7]

The Laffer curve concept is the centrepiece of supply-side economics.[8] As tax rates increase, tax revenues expand, but after a certain point, increases in tax rates become unproductive and the revenues decline. The precise empirical point where tax rates become unproductive will vary for

different economies. Although some empirical work has been done on the impact of a tax cut on labour supply in the U.S. economy,[9] there are no previous empirical studies to show the extent to which a tax cut would increase work effort, saving and investment in Barbados. Any analysis of the Barbadian case on the supply side must therefore be highly tentative.

Supply siders accept the monetarist view of the relation between inflation and the money supply in closed systems. They advocate monetary restraint to curb inflation since the latter erodes the incentive impact of a tax cut.[10] This last consideration is not as important in the Barbadian case because the money supply is endogenous and inflation is largely imported. Further, the principal impact of any money creation by the Central Bank is on the balance of payments rather than the price level.

Like the Keynesians, supply-siders argue that reduced government expenditure should accompany tax cuts. However, this principle relates to their view that there should be minimal government regulation of the economy and decreased welfare spending consequent upon tax cuts. Increased incentives to individuals in the private sector are supposed to lead to less reliance on the public sector.

Two important points of reference are the so-called Thatcher and Reagan experiments which contained elements of supply-side economics as well as monetarism. These experiments embraced a number of elements, two of which informed the July 1986 Budget in Barbados. These are as follows:[11]

(1) Restricted rate of growth of the money supply.

(2) Large across-the-board tax cuts on earnings and income.

(3) Firm management of government expenditure.

(4) Less government regulation.

Careful analysis shows that elements (2) and (3) of the Reagan and Thatcher programmes were also present in the Barbados July 1986 Budget. Although the last budget proposed cuts in expenditure, it was not clear exactly what line of items of current expenditure would be cut.[12] A major aspect of the Democratic Labour Party's (DLP) election campaign was the discussion of privatization or disinvestment of certain public sector enter-

prises which can be embraced by element (4). However, no firm privatization strategy was laid out in the July 1986 budget.[13]

It should be noted, however, that the impact of tax cuts requires both demand- and supply-side analysis. In this respect, more formal theoretical work than presented here would require an integration of the Keynesian and Neoclassical approaches. Suffice it to say, the Barbadian income tax cuts seemed to embrace both analyses. It was thought that an upsurge in spending would generate an increase in manufacturing output. Reductions in corporate taxes were believed by policy-makers to provide an impetus to the economy on the supply side. The discussion will now focus on the 1986 massive tax cuts.

Comprehensive Tax Reform 1986

The year 1986 was characterized by two sets of budgetary proposals. The April 1986 budget was put forward by the Barbados Labour Party (BLP) Government before it lost power in May 1986. The July 1986 Budget comprised the new budgetary measures of the ruling Democratic Labour Party (DLP) Government. This section discusses only the income tax reform measures of these budgets paying particular attention to the massive tax cuts of the July 1986 budget.

The April 1986 budget was a continuation of the gradualist reform strategy. The principal features of this budget were the abandonment of the tax credit system and the abolition of income tax for all persons earning below $10,000. Additionally, the top rate of income tax was reduced to 50 per cent (see Appendix A, Table A3). The cost to the revenue was $12.1 million which was even smaller than some income tax concessions in previous years (see Table 1). The reforms, however, reduced the progressivity of the system and can be regarded as an advance over the previous tax credit system. The criticism is however valid that the first three bands of the tax scale remained relatively narrow, despite reforms at the top and the bottom.

The Massive Tax Cut of July 1986

The most important features of the July 1986 Budget were the basic allowance of $15,000, and the abolition of tax for persons earning $15,000

or less.[14] This allowance significantly lowered the effective income tax rate defined as the ratio of tax payable to gross annual income. However, the allowance by itself does not distinguish between tax payers on the basis of financial responsibilities. The increase in other allowances was designed primarily to benefit the middle and upper classes who presumably save more. The tax bands were also widened to accommodate the $15,000 allowances (Appendix A, Table A3).

The effective income tax rate for a Jamaican married person under certain assumptions,[15] was compared with that of a Barbadian married person, assuming the basic $15,000 allowance. Table 2 shows that the effective income tax rate for the Barbadian tax payer is a low 8 per cent compared with 29 per cent for a Jamaican married person in 1986. The effective income tax rate for the same Barbadian tax payer would have been 15 per cent on the basis of the 1985 tax structure.

Further analysis shows that the maximum effective income tax rate for Barbadians, on the basis of the July 1986 tax structure, rises from a low of zero on a gross annual income of $15,000 to 22.3 per cent on $55,000 annual income (Table 3). These rates are even much lower than the Jamaican example. Actual effective rates are even lower for individuals claiming allowances in excess of $15,000. For example, we calculated the effective tax rate for an individual taxpayer earning a gross $55,000 annually with total allowances of $17,500. The effective rate was 20.2 per cent.

The relatively low effective tax rates implied a heavy cost to the fiscal revenue. The July Budget proposed that the revenue costs would be offset by a $14.0 million cut in current expenditure, and cuts in capital expenditure effected by a rescheduling of the capital works programme. As mentioned above, it was not clear what line of items of expenditure would be affected.

The view is presented here that although it is desirable to curb the rate of growth of total expenditure, it is not always easy to achieve an absolute cut over a fiscal year. There has been a tendency in Barbados to overestimate current expenditure significantly, and under-estimate revenue, so that government saving is sometimes much larger than projected. However, the recurrent costs of welfare services and salaries create a built-in tendency for

TABLE 2. EFFECTIVE TAX RATE FOR MARRIED PERSON (BARBADOS) ASSUMING BASIC $15,000 ALLOWANCE (1986)

Gross Annual Income	$25,000
Minus Minimum Allowance	$15,000
Taxable Income	$10,000
Tax payable ($10,000 x 20%)	$ 2,000
Effective tax Rate ($2,000 ÷ $25,000)	8%
Jamaican Effective Tax Rate*	29%

**Source:* The Editors, "Personal Tax: Jamaica and the Caribbean," *Caribbean Finance and Management,* Vol. 1, Winter 1985, No. 2.

TABLE 3. MAXIMUM EFFECTIVE TAX RATES FOR SINGLE PERSON OR MARRIED PERSON FILING SEPARATELY (1986)

Gross Annual Income ($)	Maximum Effective Tax Rate (%)
15,000	0.0
25,000	8.0
35,000	12.9
45,000	17.7
55,000	22.3

Source: Calculated from tax tables, Budgetary proposals July 1986, Barbados. The basic $15,000 allowance was employed.

expenditures to rise. An expenditure outcome below estimated levels may not necessarily indicate a genuine expenditure cut. The British Green Paper, which accompanied Thatcher's 1984 radical tax reform budget, recognized this built-in tendency for expenditure to rise, and the resistance to expenditure reductions.[16]

Corporation Tax Cut

The corporation income tax (CIT) was reduced from 45 per cent to 35 per cent in the July Budget leading to a revenue loss of $12 million. A reduction of the top rate of CIT to the pre-1976 level of 40 per cent would have been more reasonable to stem the heavy revenue loss and contain the fiscal deficit. The Barbadian case is similar to the British precedent established in Thatcher's 1984 Budget. This budget reduced the British CIT from 50 per cent in 1984 to 45 per cent (1985), 40 per cent (1986) and 35 per cent (1987). Smaller companies were subject to a reduced rate of CIT.[17]

The purpose of the CIT reduction was to induce profitable companies to re-invest their surpluses or to encourage a flow of new capital into the corporate sector. According to W.A. Lewis,[18] a rising share of the capitalist surplus makes for development, depending on the orientation of the capitalist class. A buoyant industrial capitalist class, which is willing to take risks and re-invest its profits, favours capitalist development, Profit-financed capital formation is more rapid, the larger the industrial capitalist class. In the Barbadian context, the capitalist class comprises mainly foreign investors, small indigenous businesses and manufacturers, as well as the traditional indigenous planter and commercial classes. Reductions in the CIT will have more benefits for the commercial companies.

The proposal of the July Budget for a graduated corporation tax, with effect from income year 1987, must be examined carefully against its revenue costs. Graduated income tax rates are designed to offer relief to small businesses by graduating the rate according to size of profits. However, Lent and Goode have pointed out that graduated company rates provide the opportunity for avoidance of income tax through multiple incorporation.[19] That is, rather than operate a single business, a firm may find it more convenient to incorporate separate branches, each of which

enjoys the benefit of lower rates. This problem can be tackled by allowing controlled companies to file consolidated returns. However, the 1987 budget did not introduce a graduated tax rate structure. Therefore, one can describe the corporation tax cut as an adjustment rather than a genuine reform.

Revenue Feed-Back Effects of Tax Cuts

In a previous related paper, the author discussed some of the likely macro-economic effects of tax cuts, particularly negative balance of payments effects.[20] It is difficult, however, to measure the precise macro-economic impact on output and employment in the Barbadian case without an explicit theoretical model. That task is made even more difficult by the fact that the 1986 tax cuts were followed nine months later in 1987 by heavy indirect tax increases which have an opposite stagflationary impact.

An interesting alternative line of inquiry is to examine the indirect tax revenue feed-back effect consequent upon the initial expansionary effect of the income tax cuts. The tax cut was a factor contributing to the 5 per cent growth of the Barbadian economy in 1986. It cannot be stated precisely what proportion of the increase in indirect taxes was due to the natural growth of the economy, or to the expansion due to the tax cuts only. An examination of the change in revenue between fiscal 1985/86 and fiscal 1986/87 was undertaken in order to include the tax cut given in the April 1986 Budget.

The data in Table 4 show that there was an increase in the rate of growth of consumption taxes and import duties during fiscal 1986/87. This was partly attributable to the increase in consumption spending in the last half of 1986. In the context of the economic expansion in 1986, there was an increased rate of growth of corporate taxes despite the fall in the corporation tax rate. The analysis also shows that because of the sharp fall in income tax collection ($57.6 million) the rate of growth of total tax revenue was reduced from 11.9 per cent in fiscal 1985/86 to 2.9 per cent in fiscal 1986/87.

The model, however, achieved the objective of reducing the rate of growth of current expenditure from 11.9 per cent in fiscal 1985/86 to 0.1 per

TABLE 4. TAX AND EXPENDITURE CHANGES

	Fiscal 1986/87		Fiscal 1985/86	
	$m	% Change	$m	% Change
Consumption Taxes	20.9	20.9	4.1	4.2
Import Duties	18.7	19.3	12.7	15.1
Stamp Duties	11.0	14.6	26.7	54.8
Corporation Tax	14.5	25.5	6.1	12.0
Personal Income Tax	-57.6	-42.8	9.3	7.4
Total Tax Revenue*	16.9	2.9	70.7	13.9
Current Expenditure	0.9	0.1	66.5	11.9
Capital Expenditure	19.0	13.0	11.9	8.9

Source: Economic and Financial Statistics, Central Bank of Barbados, 1987.

*Includes other tax items such as property tax, excise tax and hotel and restaurant tax.

cent in fiscal 1986/87. The overall fiscal deficit was held to $122.3 million in fiscal 1986/87 compared with $125.5 million in fiscal 1985/86.

New Taxation (1987)

The model of tax cuts required either a reduction of public expenditure, or strict control of its rate of growth. Despite the success achieved in curbing current expenditure, the difficulty of controlling the rate of growth of capital expenditure led to the introduction of heavy new indirect taxation in the 1987 budget. New taxation was also necessary because of the slow-down in the rate of growth of total tax revenues. It should be noted that no real attempt was made to reform or rationalize the system of indirect taxation. The heavy increases in indirect taxes, particularly consumption taxes, were designed to dampen consumer demand, thereby stemming the outflow of foreign exchange and improving the balance of payments.

The rate of increase in consumption duties varied from 5 per cent to 15 per cent. In the case of food items, such as imported fish, fruit and

vegetables, the rate moved from zero to 15 per cent on extra-regional imports. The consumption duty rate on intermediate goods such as chemical products, textiles, fabrics and leather goods rose from 5 per cent to 10 per cent on both local, regional and extra-regional goods. A special rate of 30 per cent was imposed on garments imported into Barbados from outside the Caribbean. The estimated revenue from these increases was $14.0 million.

The consumption tax increases will have the same inflationary impact as a general sales tax levied at the import stage, and will also lead to certain adjustment costs in terms of the income distribution. In the distribution sector, the tax increases will have a pyramiding effect as firms apply additional mark-ups to the taxed goods. The price of the goods to the final consumer will rise proportionally higher than the percentage increase in the tax. Even though consumption taxes have a price effect, it is difficult to predict precisely their impact on the overall inflation rate, because of other factors influencing inflation such as exchange rates, wage rates and so forth. It is also arguable that the overall income distribution will show a tendency to deteriorate because of the comprehensive nature of the consumption tax increases. Many of the goods, especially food items and garments, are normally consumed by lower income groups.

Policy-makers also employed the stamp duty, not only to augment revenue, but to achieve some expenditure switching from extra-regional imports to CARICOM goods. Stamp duties were reduced on CARICOM imports into Barbados from 12 per cent to 10 per cent. At the same time, stamp duties on extra-regional imports rose from 12 per cent to 15 per cent. The adjustments in the stamp duty regime were expected to raise additional revenue of $11.0 million. It is difficult to predict the outcome of this measure since Barbadians show a strong bias for extra-regional imports. However, the higher stamp duties on extra-regional goods will raise manufacturing and building costs because most raw materials in these sectors are imported from outside the region. The increase in stamp duties on raw material counteracts the cost cutting measures of the 1986 July budget.

New indirect taxation was accompanied by adjustments in the levy system to reduce personal disposable income, a policy which runs against the July 1986 massive income tax cut. The increase in the income-based

levies such as the health, transport, training levy and the new employment levy reduces disposable income and recaptures part of the revenue lost through the massive income tax cut of July 1986. These levies together with National Insurance contributions constitute 9.75 per cent of income, an increase of 2.25 per cent payable by employees (see Table 5). These levies, which are imposed in the form of payroll taxation, were expected to raise $23.4 million. Further, the various levies are no longer allowed as a deduction for income tax purposes. This adjustment will further reduce disposable income.

TABLE 5. PER CENT DISTRIBUTION OF NATIONAL INSURANCE AND LEVIES

	Employee %	Employer %	Total %
National Insurance	3.00	3.00	6.00
Non-Contributory	2.00	2.00	4.00
Employment Injury	—	.25	
Unemployment Benefit	.50	.50	1.00
Severance Fund	—	.25	.25
Health Service Levy	1.50	1.00	2.50
Training Fund	.50	.50	1.00
Transport Levy	1.75	.25	2.00
Employment Levy	.50	.50	1.00
	9.75	8.25	18.00

Source: National Insurance Office, Barbados, April 1987.

Conclusions

The conclusions attempt to identify the lessons that can be learnt from the Barbadian case. These are as follows:

(1) The Barbadian case saw a switch in the emphasis from direct to indirect taxation. The policy changed from one to gradualism in the period 1977 to 1985 to an aggressive tax cut policy in 1986.

(2) The Barbadian case shows that a policy of tax cuts must be accompanied by a sharp reduction in current expenditure. This is necessary to compensate for the slowdown in the rate of growth of total tax revenue and slow the rate of growth of the fiscal deficit.

(3) There is no strong evidence to show that the tax cut policy achieved significant macroeconomic goals. The unemployment rate remained high at 18 per cent in 1987, the manufacturing sector remained depressed and there was considerable pressure on the balance of payments owing to a decline in export earnings.

(4) The heavy increase in indirect taxes in 1987 seems to show a reversal of the 1986 expansionary fiscal policy. The imposition of heavy indirect taxes is stagflationary whereas tax cuts are expansionary.

(5) The position is that a policy of fiscal gradualism is preferable in an open economy to a policy of aggressive massive tax cuts, especially if these cuts are followed by heavy doses of indirect taxes and levies.

NOTES

[1]This article borrows substantially from and further extends the analysis of the author's previous paper, "Barbados: Income Tax Reform: An Analysis of Two Budgets in 1986", *Bulletin for International Fiscal Documentation*, Vol. 41, April 1987.

[2]Barbados: 1980 Budgetary and Financial Proposals.'

[3]See Michael Howard, "The Economic Development of Barbados (1946-1980)", unpublished Ph.D. Thesis, U.W.I., 1986.

[4]Our Analysis in the next three paragraphs is highly indebted to N.B. True, "The Economic Effects of Tax Changes: A Neoclassical Analysis", in R.H. Fink (ed.) *Supply-Side Economics: A Critical Appraisal*, Maryland, University Publications of America, 1982.

[5]True, *op. cit.*, pp. 39-41.

[6]See Michael Evans, "New Developments in Econometric Modelling: Supply-Side Economics", in Fink, *op. cit.* Evans shows that his supply-side model had a positive impact on employment by way of an income tax cut.

[7]L.C. Thurow, *Dangerous Currents: The State of Economics*, Chap. 5, New York, Vintage Books, 1984.

[8]See M. Moszer, "A Comment on the Laffer Model", in Fink, *op. cit.*, pp. 204-205.

[9]J. Hausman, "Labour Supply" in H. Aaron, J. Pechman (eds.) *How Taxes Affect Economic Behaviour*, Washington: Brookings Institution, 1981, p. 27.

[10]W.P. Orzechowski, "Monetary Aspects of Supply-Side Economics", in Fink, *op. cit.*, pp. 418-419.

[11]See Thurow, *op. cit.*, p. 129, and J. Burton, "The Thatcher Experiment: A Requiem?" in Fink, *op. cit.*, p. 294.

[12]The DLP Manifesto, 1986, which preceded the elections reported that "all ministries will be asked to identify expenditure cuts equivalent to 2 per cent of the approved Current Estimates of Expenditure". The manifesto stated further that "under no circumstances will there be a reduction in the services or jobs provided by Government''. DLP Manifesto, General Elections, 1986, p. 6.

[13]No explicit statement was made on Government disinvestment either in the DLP Manifesto or the July 1986 Budget. The Manifesto stated that the DLP would "ensure that Government-owned commercial enterprises, other than the Transport Board, cease to be a drain on the public purse". The July Budget merely pointed to the inefficiency of Government-owned commercial enterprises.

[14]It was proposed that persons whose total annual income was greater than $15,000 and

whose allowances and deductions did not amount to $15,000, be allowed to claim $15,000 in allowances and deductions. Persons whose allowances exceeded $15,000 were allowed to claim the full amount of these allowances and deductions.

[15]See the Editor's "Personal Income Tax: Jamaica and the Caribbean", *Caribbean Finance and Management,* Vol. 1, Winter 1985, No. 2. This article calculated the income tax payable by a married person for Jamaica, under its new income tax system, effective January 1986. It was assumed that the taxpayer earns U.S. $12,500, lives in a rented house, pays 5 per cent of his salary for pension or life insurance, has no savings and one child is under 12 years, the other over 12. To avoid complication, we compared this model taxpayer with a Barbadian benefiting from the minimum allowance of $15,000.

[16]For useful comments on the British Green Paper (CMnd 9189, HMSO) see H.M. Treasury, *Economic Progress Report,* No. 166, March/April, 1984.

[17]A.R. Prest and D.J. Coppock (eds.), *The U.K. Economy,* London: Weidenfeld and Nicolson, 10th Edition, 1984, p. 110. See also H.M. Treasury, *Economic Progress Report, op. cit.,* p. 5.

[18]W.A. Lewis, "Economic Development with Unlimited Supplies of Labour'', in A.N. Agarwala and S.P. Singh (eds.), *The Economics of Underdevelopment,* London: Oxford University Press, 1958, p. 429.

[19]G. Lent, "Corporation Income Tax Structure in Developing Countries", *IMF Staff Papers,* Vol. XXIV, No. 3, November 1977, p. 737. Also R. Goode, *Government Finance in Developing Countries,* Washington: The Brookings Institution, 184, p. 112.

[20]M. Howard, "Barbados: Income Tax Reform: An Analysis of Two Budgets in 1986", *op. cit.* It can be argued that the degree to which the domestic investment efffort can be sustained as a result of massive tax cuts is determined by the availability of foreign exchange to purchase imports. This is so because domestic savings must be supplemented by foreign exchange to finance imports. The fall off in earnings from domestic exports in 1986 contributed to a $25.0 million fall in foreign assets. See Central Bank of Barbados, *Annual Report,* 1986.

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APPENDIX A

TABLE A1

Year		
1977	—	Introduction of a tax credit of $60 for all resident tax payers with gross income of less than $6,000 per year to apply to income year 1976.
1979	—	Increase in tax credit to persons with gross income of less than $6,000 per annum from $60 to $100 for income year 1979.
1980	—	Increase in tax credit from $100 to $300 for persons with gross income of $6,000 or less and grant of credit of $100 to persons with incomes in excess of $6,000, but less than $8,000.
1982	—	Increase in tax credit from $300 to $360 for persons earning a gross income of $6,000 or less. Introduction of a tax credit of $240 for persons with incomes in excess of $6,000 but less than $7,000. Increase in tax credit to $120 for persons with gross incomes in excess of $7,000 but less than $8,000.
1984	—	Increase in tax credit from $360 in lowest category to $400. The limit of the lowest category was raised from $,000 to $7,500. Increase in the tax credit to $250 for persons earning less than $8,500 per annum but more than $7,500 per annum. This meant the abolition of income tax for persons earning less than $145 per week.

Source: Barbados: Financial Statements and Budgetary Proposals for the years 1977, 1979, 1980, 1981 and 1984.

APPENDIX A

TABLE A2

INCOME TAX STRUCTURES (1979-1984)

Rate Structure Fiscal 1979/80		Rate Structure Fiscal 1980/81		Rate Structure Fiscal 1983/84	
Taxable Income $	**Rate %**	**Taxable Income $**	**Rate %**	**Taxble Income $**	**Rate %**
Up to 3,000	10	Up to 5,000	10	Up to 5,000	10
6,000	20	10,000	20	10,000	20
8,000	30	15,000	30	15,000	30
10,000	35	20,000	40	20,000	40
12,000	40	30,000	50	30,000	50
16,000	50	40,000	60	Over 30,000	60
30,000	60	Over 40,000	70		
Over 30,000	70				

Source Barbados: Financial and Budgetary Proposals for Years 1979, 1980, 1983.

APPENDIX A

TABLE A3

INCOME TAX STRUCTURES (1985-1986)

Rate Structure Fiscal 1985/86			**Rate Structure* Fiscal 1986/87**			**Rate Structure** Fiscal 1986/87**		
Taxable Income $		**Rate %**	**Taxable Income $**		**Rate %**	**Taxble Income $**		**Rate %**
Up to	5,000	10	Up to	6,000	10	Up to	15,000	20
	10,000	20		11,000	20		25,000	30
	15,000	30		18,000	30		35,000	40
	20,000	40		30,000	40		55,000	45
	30,000	50	Over	30,000	50	Over	55,000	50
Over	30,000	60						

* Rate Structure of April 1986 Budget.
** Rate Structure of July 1986 Budget.

Source Barbados: Financial and Budgetary Proposals for Years 1984, 1985, 1986.

Fiscal Reform in Grenada — A Reconstructive Analysis

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Introduction

The island of Grenada became the focus of world attention in October 1983 when, following a period of internal political unrest, the United States made a military intervention. Following this intervention, Grenada became the subject of technical and financial assistance on the part of international agencies including the International Monetary Fund (IMF) and the United States Agency for International Development (USAID).

Since it was obvious for some time that Grenada's fiscal system was not providing the government with sufficient revenues to cover its expenditures there seemed to be a *prima facie* case for urgent fiscal adjustment. On the expenditure side it was necessary to consider whether the traditional roles of the government, and hence traditional expenditure obligations, were to be upheld. On the taxation side it seemed necessary to consider whether the system of taxes in place was conducive to economic growth and efficiency on the one hand, and to equity, simplicity and sufficiency on the other.

A number of preliminary suggestions for fiscal reform by the IMF and USAID are reported to have been made and, with the help of the latter, a team from Syracuse University was recruited to provide a new fiscal package for Grenada.[1]

Given the traumatic context of this reform exercise and the possible relationship between Grenada's acceptance of an externally influenced reform package and the availability of external financial assistance to Grenada, it may not be obvious that a *reconstructive analysis* is necessary,

for what is in place is a *fait accompli,* and one which was probably more externally than internally motivated.

However, reconstructive analyses are not new to economics. It is useful to recall that in the early days of cost-benefit analysis, most of the major studies were reconstructive. They were done *after* projects had already been selected or completed. The work of Foster and Beesley, for example, was to expected to make a difference to the London underground Victoria Line, but was supposed to serve at least two far-reaching purposes. First, it was important for economists to be able to make use of the specific analytical skills required for coming to a judgement about major investments. From a purely scientific point of view, the value of such skills is neutral to whether they are applied before or after a particular project has been chosen. In any case the practical situation is hardly ever one where there is an automatic correspondence between the results of a scientific economic analysis and the policy decision actually implemented.

Second, such analyses allow economists to better identify the reasons for the failure or success of certain projects, thereby increasing the stock of useful knowledge. Furthermore, by retaining the link between scientific analyses and practical or existing situations, economists are in a better position to determine both the scale and the focus of corrective modifications when these are deemed to be required.

Applying this reasoning to the Grenada fiscal reform situation, it therefore seems important to reflect on three issues:

(i) whether the objective conditions of the time warranted fiscal reform;

(ii) whether the reforms adopted were properly related to the broader objective of economic recovery; and

(iii) whether specific modifications are now indicated.

The rest of this discussion constitutes an attempt to address these three issues. In Section I, two aspects of the pre-reform objective conditions: the broad *macro-economic* conditions and the specific *fiscal* situation are addressed. In Section II, the manner in which the fiscal package was implemented in relation to the Grenada recovery effort are considered,

along with a few general economic principles relevant to fiscal reform. Section III evaluates specific measures and attempts a prognosis with recommendations.

SECTION I

Macroeconomic Performance and Fiscal Trends in Grenada, 1970-1985

There are four significant sub-periods which make up the sixteen-year span, 1970-85, in Grenada. The period 1970-74 marks the last five years before independence. The period 1974-79 covers not merely the first few years of independence, but the eventual removal of the Eric Gairy government and the emergence of the New Jewel Movement (NJM) by means of a bloodless coup in 1979. The period 1979-83 marks the full duration of the reign of Maurice Bishop and the People's Revolutionary Government (PRG) which ended in the death of Bishop and the introduction of US military forces into Grenada. The last period, 1983-85, saw efforts of an interim administration and an elected New National Party government, with assistance from external sources, to reinstitute parliamentary democracy, and to reorganise the economy of Grenada.

Because of severe data limitations I do not present continuous series on all the economic indicators selected for discussion and in many cases continuous series were made possible only by combining data from different sources. No doubt there may be problems of coverage and definitional consistency but where the constituted series seemed to behave properly I have chosen to ignore these problems. I consider first the basic single indicator of performance: the gross domestic product (GDP).

In Table 1 I show the GDP data in nominal, real and real per capita terms. The index and population data used to construct the latter two series have also been put in Table 1.

The table allows us to consider the growth in the different variables. Using centred three-year averages it is noted that real GDP increased from $125.3m to $137.7m between 1971 and 1978 and fell from $137.7m to $129.8m between 1978 and 1984. For the entire period, the GDP increased by 3.6 per cent, or at an average annual rate of 0.24 per cent.

TABLE 1. GDP, NOMINAL, REAL AND REAL PER CAPITA, 1970-1985

Year	Nominal GDP $m EC	Consumer Price Index, cpi (1979=100)	Real GDP $m EC	Population (millions)	Real Per Capita GDP $ EC
1970	55.2	41.8	131.9	0.094	1,403.2
1971	57.5	46.8	122.5	0.094	1,303.2
1972	60.2	49.4	121.6	0.095	1,280.0
1973	61.8	56.8	108.8	0.096	1,133.3
1974	67.1	80.8	82.5	0.098	841.8
1975	80.4	84.1	94.9	0.100	949.0
1976	96.8	88.6	108.4	0.100	1,084.0
1977	110.9	93.1	118.7	0.100	1,187.0
1978	135.5	97.6	138.2	0.101	1,368.3
1979	156.3	100.0	156.3	0.102	1,532.4
1980	159.5	135.4	116.4	0.102	1,141.1
1981	204.2	159.4	126.6	0.102	1,241.2
1982	234.8	174.4	133.8	0.102	1,311.8
1983	234.6	185.1	126.7	0.102	1,242.2
1984	265.0	195.1	135.2	0.102	1,325.5
1985	260.4	200.5	127.6	0.103	1,238.8

Sources: (i) U.N. Statistical Yearbook (several issues).
(ii) Grenada Central Statistical Office (computer printouts).
(iii) Computed.

Notes: The cpi is a spliced index combining the index, based in 1964, with a later index based in 1979.

In real per capita terms the picture is interesting. The growth rate between the middle and the beginning of the period is 2.5 per cent or 0.36 per cent per year. Moreover, the rate of growth between the end of the period and the middle was -6.9 per cent, with the overall rate between the end and the beginning of the period being -4.5 per cent or an average annual decline of 0.3 per cent.

In other words, the basic indicator of macro-economic performance presents a rather bleak picture of the Grenada economy. Population grew by just over one-half of one per cent annually but the GDP grew by less than one quarter of one per cent on an annual basis. So real per capita GDP actually declined over the period.

Prices presented a picture of a steady upward movement, growing by 110.6 per cent over the first half of the period and by close to 100 per cent over the second half of the period. The overall increase in the price level was 320.9 per cent or an average of 21.4 per cent per year.

Data on employment in Grenada are not reliable since no adequate surveys have been done since the early 1960s. The 1985 government estimate put the level of employment in 1984 around 30 per cent.[2] It is known, however, that during the Bishop era an effort was made to use public employment as a direct way of dealing with the serious unemployment problem in the country.

Turning finally to Grenada's balance of trade picture we begin to get a clue to the poor performance of the economy over the period. Available data for the period 1965-85 show that in every year the balance of trade was negative. For the period 1970-85 net exports, defined as export minus imports, moved from a level of -$32.5m EC to -$81.0m EC peaking at -$106.4 in EC in 1982.[3]

It would seem that herein lies the key to understanding the predicament of the Grenada economy, for Grenada is a small island with a modicum of natural resources and has to supply the amenities of life for a population of around 100,000 people.

Basically, economic activity centres around the agricultural sector with bananas, cocoa and nutmeg as the country's most important exports.

The problem of the Grenada economy is the problem of most of the Caribbean economies: with a very narrow resource base and with the increasing difficulty of getting into (export) manufacturing, how can the economic system be maintained at a socially (and biologically) tenable level of performance?

At this stage, it is pertinent to ask whether reforming the fiscal system is really a critical desideratum for a country such as Grenada.

Without prejudging the issue, it would be useful for us to consider the performance of the fiscal sector over the period under study.

Although it is customary in public finance studies to present time series on public expenditure and taxation in current times, it would seem that a proper economic appraisal of the fiscal sector should be carried out in real terms. As Beck (1982) has pointed out, there will always be problems in selecting appropriate deflators for expenditure and taxation. However, once it is admitted that deflation of current figures is appropriate, and where only one deflator exists, the nature of the problem changes. What is now necessary is to ensure that the real figures computed not only make economic sense, but are capable of being used in the kind of analysis which is undertaken here.

In the case of Grenada, as with many other countries, the only continuous index of prices is the retail price index or, as it is sometimes called, the consumer price index (CPI). Use of this index to deflate public expenditure value would require the assumption that the greater part of such expenditure ends up in the hands of consumers who operate in markets for which the particular CPI is relevant. Eventually, the assumption will include that the units which measure changes in consumer welfare are similarly appropriate for measuring real changes in the level of public expenditure.

While there would seem to be little or no difficulty in making these assumptions in the case of expenditure in any Caribbean economy, the matter is to so simple when we turn to taxation levels.

The first complication arises from the fact that some taxes are imposed at the input stage and others at the output stage. Ideally, there should be both

an input price index and an output price index to arrive at the real levels of taxation. Alternatively, to the extent that the structure of taxation reflects the structure of the gross domestic product at factor cost, a GDP deflator to arrive at real tax revenues should be used.

However, there is only index and this is the price index. Applying this to current tax revenue levels assumes that the amounts collected by the government would have otherwise been spent on private consumption. There is some difficulty here since clearly some of the taxes collected may otherwise have gone to private investment. However, if we assume, with the Latin American shadow-price theorists, that all opportunity costs, including the opportunity cost of investment, can be measured in consumption units, *we can then interpret tax revenues as comprising both a direct and an indirect component of consumption foregone.* This would mean that on a time series basis the consumer price index would retain enough validity as a deflator for tax revenues.

In the table overleaf the real revenue and expenditure data for Grenada in aggregate terms are presented, making use of the consumer price index as the deflator. The budget balances are also presented in similar terms.

Column 1 of the table indicates that while the average real tax revenue level was EC$42.3m for the first three years of the period, it was EC$47.4m for the middle three years and EC$45.9m for the last three years. In other words, there was a slight average annual increase of around 1.7 per cent for the first half of the period and a slight average annual decrease of 0.5 per cent for the second half of the period. In general terms the real level of tax revenues showed only a very slight tendency to increase over the entire period. Taking the period as a whole, the average annual increase in real tax revenues was 0.6 per cent increase in the GDP. In other words, on the average, taxes were increasing two and a half times as fast as the GDP itself!

Turning to real expenditure, the pattern seems to have followed a steady trend upwards. The first three-year average was EC$68.7m, the middle three-year average was EC$76.5m, and the closing three-year average was EC$85.4m. In other words, for the first half of the period the average annual increase was close to 1.6 per cent, while for he second half it was close to 1.7 per cent. For the period taken as a whole the corresponding rate of increase was 1.6 per cent.

TABLE 2. REAL REVENUES, PUBLIC EXPENDITURE AND BUDGET BALANCE, 1970-1985

Year	Real Tax Revenue $m EC (1)	Real Public Expenditure $m EC (2)	Real Budget Balances Current Account $m EC (3)	Overall $m EC (4)
1970	45.4	55.4	-2.6	-10.0
1971	38.8	77.1	-7.9	-38.3
1972	42.6	78.7	-2.6	-31.1
1973	36.1	67.8	0.2	-31.7
1974	18.7	48.5	-6.9	-29.8
1975	22.2	50.0	-6.1	-27.8
1976	29.9	63.1	-10.3	-33.2
1977	39.8	59.1	2.1	-19.3
1978	47.3	75.0	-3.1	-27.7
1979	55.1	95.4	1.2	-40.3
1980	42.1	70.9	-1.7	-28.8
1981	39.1	86.3	-0.9	-47.2
1982	42.4	99.9	1.6	-57.5
1983	43.9	90.0	3.7	-46.1
1984	44.6	78.6	0.6	-34.0
1985	49.2	87.5	0.9	-38.3

Source: Computed from Grenada Central Statistical Office, Computer Printout.

Note: Real recurrent expenditure (RRE) can be computed as
RRE = Col. 1-Col. 3 and

With an average rate of increase of 1.6 per cent per annum in expenditure and 0.6 per cent in taxation, it is not surprising that the overall budget deficit itself grew steadily over the period. For the first half of the period the deficit grew in real terms from EC$26.5m to EC$29.1m as between the first and the middle triennia. This reflected an average annual increase of 1.4 per cent. For the second half of the period the corresponding growth was from EC$29.1m to EC$39.5m, reflecting an annual increase of 4.7 per cent. The full-period overall deficit was therefore characterized by an average annual increase of 3.3 per cent. It should be noted that while the current account balance fluctuated between deficit and surplus, the aggregate current account balance was negative.

To the extent that revenue sufficiency is an important objective of any fiscal system the combined behaviour of the major fiscal variables certainly pointed to the need for modification.

Taking a slightly different angle, and recalling that government action usually suggests an attempt at social welfare maximization, we should also consider the behaviour of the major fiscal variables in per capita terms. Table 3 uses the information in Table 2 to arrive at the real per capita values for the relevant variables.

According to the table, per capita tax collection started at a three-year average of EC$448.1, and after growing to EC$468.8 by the middle of the period, reverted almost to its original level at EC$448.5.

Real per capita expenditure showed a more steady pattern, rising from EC$728.5 at the beginning of the period to EC$756.3 in the middle of the period, and eventually reaching an average of EC$824.2 by the end of the period.

The per capita budget deficit followed a pattern similar to expenditure. Beginning at EC$280.4 in the first triennium, it rose to EC$287.5 by the middle of the period and climbed to EC$385.7 by the end of the period.

We present a comparison of the growth rates of the major fiscal variables in table 4. It should be recalled that the growth comparisons are made by computing the three-year average values at the beginning, the middle and the end of the period. All the comparisons relate to real values.

TABLE 3. REAL PER CAPITA TAX REVENUE, PUBLIC EXPENDITURE AND BUDGET DEFICITS, 1970-1985

Year	Real Per Capita Tax Revenues $ EC	Real Per Capita Public Expenditure $ EC	Real Per Capita Overall Deficit $ EC
1970	483.0	589.4	106.4
1971	412.8	820.2	407.4
1972	448.4	775.8	327.1
1973	376.0	706.3	330.2
1974	190.8	494.9	304.1
1975	222.0	500.0	278.0
1976	299.0	631.0	332.0
1977	398.0	591.0	193.0
1978	468.3	742.6	274.3
1979	540.2	935.3	395.1
1980	412.7	695.1	282.4
1981	383.3	846.1	462.7
1982	415.3	979.4	563.7
1983	430.4	882.4	452.0
1984	437.3	770.6	333.3
1985	477.7	849.5	371.8

Source: Computed from Tables 1 and 2.

TABLE 4. PERCENTAGE GROWTH RATES IN KEY INDICATOR VARIABLES

	Period		
Variable	**1970-78**	**1978-85**	**1970-85**
GDP	9.9	-5.7	3.6
Per capital GDP	2.5	-6.9	-4.5
Tax Revenues	12.1	-3.2	8.5
Per capita tax revenues	4.6	-4.3	0.09
Expenditure	11.4	11.6	24.3
Per capita expenditure	3.8	10.3	14.5
Overall deficit	9.8	35.7	49.1
Per capita deficit	2.5	34.2	37.6
Price level	110.6	99.8	320.9

Source: Computed from Tables 1, 2 and 3.

This table presents a picture which seems to satisfy the O'Connor [5] definition of *fiscal crisis.* For while, in per capita terms, the tax base itself fell over the entire period by 4.5 per cent, real tax revenues were virtually the same at the end of the period as they were at the beginning. In the meantime, expenditure rose over the period by 14.5 per cent and the budget deficit by almost 38 per cent.

This situation became even more unsustainable in the latter half of the period. For while in the first half, per capita taxes had risen by 4.6 per cent and expenditure by 3.8 per cent, in the second half taxes had *fallen* by 4.3 per cent and expenditure had risen by 10.3 per cent. No doubt the socialist thrust of the Bishop regime had exacerbated the fiscal situation over the post-1979 period. Whether the regime would have been able to turn the situation around can now only be a matter of conjecture. The fact remains that the economic and fiscal situation at the time of the US intervention was not one that could persist for much longer.

To the extent that fiscal reform can be seen as part of a new economic strategy, and to the extent that it is incorporated as part of a new economic plan, the Grenada situation clearly warranted such reform.

Ideally, of course, as Gillis [3] has argued, tax reform should not be put off until a crisis is upon the fiscal system. However, the truth is that the political will to undertake significant reforms is usually not found except in crisis situations. The key point here, however, is that the reforms should be part of a new economic package, otherwise the effort made would be like putting new wine into old bottles.

On this score, how do the Grenada reforms measure up? Were they part of a new set of policies and were they appropriate to the task of economic recovery? We turn to this question in the next section.

SECTION II

Fiscal Reform and Economic Recovery

After the military intervention in Grenada in October 1983 an interim government was installed and undertook a holding operation until the elections in December 1984.

It should be pointed out at the outset that the Interim Administration had taken certain measures to steer the economy away from its recent socialist experience. Certain government enterprises were divested and a new package of investment incentives was offered to private investors. Measures were also taken to reduce the government indebtedness to the commercial banks. The infusion of some EC$6.75 million into the banking system signalled an end to very tight liquidity conditions which had prevailed for the two years or so before 1984.

The interim administration also reduced its borrowing from the private sector by some 15 per cent and attempted to impose stricter controls on public expenditure.

No doubt these actions were made possible by the foreign aid flowing into the country after the intervention.

From the point of view of *economic strategy,* it seems clear that the interim administration had one major goal in mind — that of reducing the

role of the government and expanding the role of the private sector in the economy of Grenada. The specific measures taken were all consistent with this goal.

It is interesting to note, for example, that at a time when the country had undergone a certain amount of physical destruction as a result of the military intervention, public investment was reduced in nominal terms by some 16 per cent. Apart from the continuation of work at the Point Salines Airport little else was done. It is also instructive to note that during the period of the interim administration approximately 95 per cent of public investment expenditure was externally financed, clearly an unsustainable situation.

It would be true to say, therefore, that the interim administration, although enunciating a clear strategy, and although taking measures consistent with that strategy, really offered no new plan of recovery.

When the new elected government presented its Budget in April 1985 this was the first real opportunity for lifting the veil on the outline of a new plan. Clearly in the five months after the elections no one could expect a full-fledged detailed statement of how the government envisaged the economic recovery to take place.

Instead of the outline of a new plan, however, the 1985 Budget strongly reiterated the strategy adopted by the interim administration and again proceeded to spell out measures which were consistent with the basic goal of reducing the role of the government. It was in this context — a context apparently dominated by Grenada's recent experiences and by the efforts of Western nations to provide aid to Grenada - that the issue of fiscal reform was introduced.

The Budget Speech, after referring to "the weak budget structure" and the need for "responsible fiscal management", revealed that:

"Studies conducted both by the International Monetary Fund and the consultants funded by the United States Agency for International Development have all recommended the urgent need for fiscal reform in Grenada, if the economy and the public finances are to become viable."[4]

It is to be noted that the new government announced its intention "to take a comprehensive approach to planning the economy of [the] country"

and accepted that "fiscal reform alone, is not sufficient to assure the stability of Grenada's economy". In fact, the specific objectives of the government's approach to the economy were listed as:

(a) Providing a framework for growth of the economy towards attainment of self-sufficiency;

(b) Reduction of unemployment;

(c) The control of inflation, and raising the living standards of the people.

The intention to plan was reiterated in more detail in the next Budget — that of February 1986 — the Budget which revealed the first phase of the new fiscal regime.

In this 1986 Budget mention is made of the creation of a National Economic Council which had already prepared a Draft of the National Development Strategy. The four areas emphasized in the strategy were listed as:

1. Revitalization and diversification of agriculture;
2. Expansion of tourism;
3. Export promotion;
4. Incentives for manufacturing.

However, although the allocation of resources for implementing the strategy had not yet been determined, the Government was proceeding with its programme of privatization. Plans were announced for turning eighteen state-owned enterprises over to private ownership. At the same time measures were taken to remove a number of import restrictions, abolish certain price controls and expand the range of incentives for private investment.

It is interesting to note that although all these far-reaching resource allocation and distributive measures were being taken *prior* to enunciation of an economic plan, the government held to the view that "the principal thrust of the 1986 budget ... lay in the Fiscal Reform Programme".

Given this apparently informal relationship between fiscal reform and economic planning, it seems reasonable to assume that the immediate

fundamental object of the official reform package was to contribute to closing the gap between expenditure and tax revenues, for much of what was presented as separate from the reform package really amounted to measures to reduce and/or control public expenditure. The tax reforms were, for their part, expected to yield higher revenues. In other words, the complete fiscal reform package must be seen as including a number of the separate fiscal measures taken, as well as those measures specifically relating to taxation. Once we take this approach to the reform package it is possible to link the reform package more formally with the government's thinking about how economic recovery was expected to be brought about.

In the following diagram we attempt to summarize the nature of the relevant connections.

As the diagram illustrates, the recovery effort will be initiated by fiscal and other measures. The latter will include, of course, monetary as well as commercial measures.

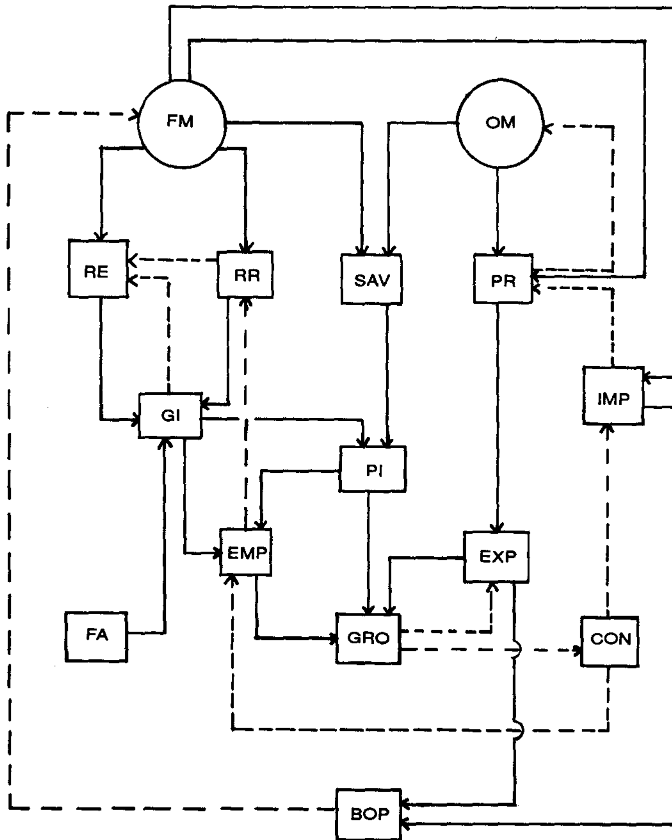
According to a number of statements made by the government the fiscal measures are supposed to lead to new levels and new patterns of revenue and expenditure. Public investment will continue to depend on foreign assistance together with government revenues, but efforts will be made to keep shifting out recurrent into capital expenditure.

On the taxation side the fiscal measures are supposed to impact favourably on domestic savings which should in turn impact on investment. Of course, there are also direct fiscal measures to influence investment. These influences are supported by public investment with an infrastructure bias.

The investment effects of the fiscal measures are then transmitted to employment and to output. Both fiscal and non-fiscal measures are expected to restrict inflation and thereby foster exports which in turn will also enhance growth.

So far all the influences noted are ultimately aimed at fostering growth. What is not clear is what is expected to happen once the growth process is revived. For one thing, the openness of the economy, together with the fiscal measures taken to liberalise imports, will mean that once

Figure 1: Possible Model of Economic Behaviour Incorporating fiscal Measures



SYMBOLS:

FM:	FISCAL MEASURES	OM:	OTHER MEASURES
RE:	RECURRENT EXPENDITURE	RR:	RECURRENT REVENUES
GI:	GOVERNMENT INVESTMENT	PI:	PRIVATE INVESTMENT
EMP:	EMPLOYMENT	SAV:	SAVINGS
GRO:	GROWTH	BOP:	BALANCE OF PAYMENTS
EXP:	EXPORTS	IMP:	IMPORTS
CON:	CONSUMPTION	FA:	FOREIGN AID
PR:	PRICE LEVEL		

growth has started the balance of payments will be under pressure as before. The multiplier effects on consumption and employment will keep up the demand pressure on imports.

Although not explicitly stated, it would seem logical to expect that the balance of payments effect of the economic recovery will require further modification in the fiscal system.

In the diagram we portray officially stated or officially implied effects by solid lines and additional expected effect by dashed lines. In one sense the dashed line that shows the feedback from the balance of payments to the set of fiscal measures has both theoretical and methodological significance. This is the feedback that will provide a basis for a regular review of any fiscal measures introduced.

What the large number of dashed lines does indicate, however, is the incompleteness of the government's approach to the planning process. Fundamental to this process is some understanding of what the primary and secondary effects of policy on key variables will be. Williamson [9] has reminded us that in all 'good' economic policy what we are aiming for is the correct balance. A similar point is made by Ahluwalia [1] who suggested that since some of the secondary effects may be undesired, this knowledge becomes critical in deciding on the intensity or the longevity of certain measures.

Our emphasis on the need to see the fiscal measures as embedded into an explicit economic model, and therefore potentially part of an overall economic plan, stems from the view that economic theory should not be thrown overboard once fiscal reform exercises begin.

In the matter of fiscal reform, there is always a strong temptation to be practical, to be pragmatic, and to be responsive to the specifics of a given situation. While no claim can be made that the business of fiscal reform is the exclusive domain of economists, it is also equally invalid to suggest that measures which would most certainly affect the way the economy functions should not undergo the kind of scrutiny which the application of economic theory can provide.

From the modern literature on public finance, for example, we know that statements like "indirect taxes are regressive" or "increasing income

tax will harm economic growth" are only true under very specific conditions. They therefore cannot serve as a principled basis for making particular choices abut the type or the level of taxation.

The principles which can be derived from economic theory and, in particular, the theory of optimal taxation, can serve as a basis for designing reform packages. For as Stern [7] has reminded us, "the optimum is the state of affairs from which no beneficial reform is possible; thus the theories of optimality and of reform are very close".[5]

Let us consider what Stern [7] calls *the three general principles* emerging from the theory of optimal taxation.

The first principle states that if distributional concerns are not taken into account then *economic efficiency requires that tax revenues be raised from taxing goods or factors of production with low elasticities of demand or supply.* This is essentially the basic Ramsey [6] result. It must be pointed out that this principle implies that if the relationships of complementarity and substitutability suggest that a small increase in indirect taxation will yield a substantial increase in revenues, then the tax must be imposed accordingly. There is no presumption that moving further in the direction of indirect taxation must be welfare-reducing. This, after all, is what the theorem of second-best has taught us.

The second general principle states that *if a particular concern with distribution or market failure is to be addressed then this must be done in as direct a way as possible.* The idea here is that since taxes, for example, will work through the production system, unintended effects are inescapable. However, if the tax instrument is directed at the root cause of the concern the more effective it will be. The point that must be borne in mind is that a distributional instrument can have important non-distributional consequences, and these cannot be ignored in the name of the need for the distributional instrument.

The third general principle is related to the second. This principle states that *in a second-best world the aim is to get a proper balance between distributional and efficiency objectives.* It is just not possible to treat both sets of objectives without recognizing that what is optimal for each set depends on what specific assumptions are made about the degree of

desirability of the other. If, for example, it is known that the revenues derived from indirect taxation will be concentrated on the needs of lower income groups, then the taxation of necessities will be more acceptable than if expenditures are expected to be non-discriminatory.

Using these three principles as well a the government's stated objectives criteria, we can now proceed to evaluate the actual fiscal reform implemented in Grenada. We turn to this in the next section.

SECTION III

Evaluating the Grenada Fiscal Measures of 1986 and 1987

Expenditure Reform Measures

On the expenditure side, with one exception, the major changes indicated by the government were of an institutional kind. The Accounting Division of the Ministry of Finance was to be strengthened for the initial purpose of bringing the government's accounts up to date. In 1986, the accounts for 1975 had not yet been completed!

It was also part of the purpose of the government to upgrade the skills at the Ministry of Finance to ensure that better monitoring and control of expenditure could be exercised. In fact, the 1987 Budget reports that performance measurement criteria had already been introduced in respect of spending by the major Ministries.

Since many of these proposals and measures have not been adopted for a long enough period, it is impossible to determine what difference they have made to the expenditure system.

However, there is one major change in the approach to expenditure which deserves further comment. The reference here is to the government's repeated emphasis on the need to *reduce* expenditure, beginning with the privatization of certain state-owned enterprises and a substantial reduction in public employment.

There are a few points which must be made in this regard. First, since the fiscal reform exercise will involve the raising of revenues it must be remembered that optimality in respect of taxation depends on what assump-

tions are made about the level and the pattern of public expenditure. The revenue target would, of course, depend partly on what role the government sees for itself in the process of economic development.

A pragmatic economic approach to the question of government's role would suggest that an explicit evaluation of the costs and benefit of government's prospective interventions must be attempted. In analyzing the role of public enterprises in less developed countries, Jones [4] has reminded us that the weaker the entrepreneurial thrust, the greater the benefit of government intervention is likely to be.

In the particular context of the Grenada economy, private sector activity has mainly concentrated on importation of final goods and on the distribution of such goods. Since these activities have been profitable and still remain so, there is no reason to believe that this pattern would change. The manufacturing sector is still very negligible and is therefore not likely to make any significant contribution to economic development for some time. The reason here is partly the higher rates of return to importing activity, and partly the fact that the economy simply does not have the foreign exchange needed to purchase the required intermediate inputs. There are therefore three options facing the economy. Given the fledgling nature of the private domestic sector, the burden of economic development must rest, for the foreseeable future, either with *the government* or with *the foreign private sector* or *both.* However, if the foreign private sector is given a dominant role, the government will need to provide the kind of fiscal incentives which may put in doubt the very objective of such a strategy. A number of studies have questioned the efficacy of foreign private investment as a major factor in the development of Third World countries.[6]

While one must make allowances for the recent bitter experience of Grenada at the very end of the Socialist PRG regime, *the option of a liberal Western-democratic government, supervising a mixed economic system and respecting the right and freedom of individuals to own property, should not be ruled out.* In the long run, no economy can depend on mainly foreign assistance for its survival and development. It is therefore important to foster the kind of economic system which is likely to be sustained. In the case of Grenada and countries in a similar position, the appropriate devel-

opment model seems to be one which might be termed the *inverse-Wagner model.*[7] For while Wagner alerted the profession to the possibility of a Pacman type public sector swallowing up larger and larger shares of the GDP, the inverse-Wagner model would be one where, as the quality of public sector performance improves, the quantitative significance of the sector would decline.

A model of the type suggested would therefore set specific time-related objectives for public expenditure and treat such expenditure as an integral input into the transformation process. *The criterion of successful transformation will then be a declining level of warranted public expenditure.*

The general argument in respect of public expenditure holds importantly in the case of public employment. the truth is that there is no available objective *economic* analysis which can now be used to test whether the Grenada Public Service is overstaffed or not. On the one hand, the government states that many government departments are short of the required number and calibre of personnel. On the other hand, a team of foreign accountants employed to make recommendations at a time when the government was in a fiscal crisis, reported that some 1,150 filled posts and some 820 unfilled posts were redundant or superfluous.[8]

The situation seems to be as follows. Until the Grenada government can identify and cost those activities which it should reasonably engage in for the purpose of fostering the economic development of the country, it does not make sense to engage in reducing or expanding public expenditure as a matter of principle. Of course, in a practical situation where funds are very low, reductions will have to take place. However, that is different from making reductions on an ideological basis without thinking through the logical effects of such reductions on the performance of the economy. In matters of public policy a distinction needs to be made between *emergency measures and measures of principle.* It is not clear that the Grenada proposals have made this distinction in respect of public expenditure.

Taxation Reform Measures

The major feature of the reform measures in 1986 was the abolition of the Individual Income Tax and the Company Tax. These were replaced by a

value-added tax (VAT) and a business levy. The new measures actually reduced the number of taxes from twenty-one to seven. The detailed measures are reproduced from the relevant budget speeches in the appendix.

It is perhaps fair to point out that partial efforts at modifying the tax structure were made over the period 1978 to 1983. These are summarized in Table 5.

What the table shows is an attempt to derive more revenues, and presumably to limit imports further, by increasing the rates of specific indirect taxes. The increase in the company taxation rate from 45 per cent in 1978 to 55 per cent by 1983 presumably reflects a revenue concern as well as a distributional concern. It is noteworthy that no adjustments were made in individual income taxes.

To further put the 1986 reforms in perspective it is useful to consider the structure of revenues which prevailed over the period 1970-1985. Tables below present the shares of different tax categories in total revenues (Table 6) and in the gross domestic product (Table 7).

Table 6 shows clearly that indirect taxes and, in particular, import duties were the major source of revenues to the government, with duties contributing more than 50 per cent of revenues for thirteen years of the sixteen-year period. Export duties were seen to be increasingly less important and income tax seemed to remain in the range 25-35 per cent for most of the period.

What is revealed in these hypothetical calculations is the importance of being able to trace the effects of fiscal measures on the major economic variables. The government has announced its intention to make use of a *forecasting model* in the future and the expectation is that revenue projections will then be done on a more scientific basis.

By 1987, the facts did show that both the VAT and the Business Levy projections were vastly overestimated. That is not the focus of the present critique. Rather,what is important is the ability to learn from mistakes made. Except we clearly indicate the basis upon which projections are made, we will have only an accumulation of errors without any indication as to how we can do better.

TABLE 5. MAJOR CHANGES IN THE TAX RATES, 1978-1983

Tax and Year		Rate
1978:		
Company Tax	:	Tax rate raised from 45% to 50%.
Stamp duty on Imports	:	Tax rate raised from 5% to 7.5% of C.I.F.
Foreign Exchange Tax	:	Tax rate raised from 2.5% to 5%.
Purchase Tax	:	Introduced at the rate of 20% on Radios and TV.
1980:		
Withholding tax	:	Introduced at rates of 20-25% on non-residents.
Ticket Tax	:	Tax rate raised from $10 to 5.1% of the ticket value.
1981:		
Stamp duty on Imports	:	Tax rate raised from 7.5% to 10% C.I.F.
Consumption Duty	:	On gasolene the rate increased from $0.9 per gallon to 7.5% on Landed Cost.
Mator Vehicle Tax	:	Tax rate increased from 25% to 30% of market price.
1982:		
Company Tax	:	Tax rate raised from 50% to 55%.
Stamp duty on Imports	:	Tax rate raised from 7.5% to 12.5% and to 17.5% of C.I.F.
Consumption Duty	:	Tax rate on gasolene increased from 7.5% to 17.5% on Landed Cost. Rates on beer and liquor increased.
International Airport Levy	:	Introduced at the rate of 2% of C.I.F.
1983:		
Stamp duty on Imports	:	Tax rate raised from 17.5% of C.I.F. aggregate C.I.F.
Consumption Duty	:	The base expanded to aggregate of C.I.F.
International Airport Levy	:	The rate raised from 2% to 5% C.I.F.
Motor Vehicle Tax	:	Tax rate increased from 30% to 40% of market price.

Sources: Budget speeches, Documentation Centre, Ministry of Finance, St. Georges.

TABLE 6. PERCENTAGE SHARES OF TAX COMPONENTS IN TOTAL TAX REVENUE, 1970-1985

Year	TAXES (Percentages)					
	Income Tax	Export Duty	Direct Taxes	Import Duty	Other Indirect	Total Indirect
1970	27.2	9.6	36.8	56.1	7.1	63.2
1971	31.1	8.1	39.2	53.6	7.2	60.8
1972	35.0	8.3	43.3	50.0	6.7	56.7
1973	26.6	6.6	34.1	63.8	2.1	65.9
1974	30.6	16.5	47.1	35.0	17.9	52.9
1975	26.1	22.7	48.8	36.6	14.6	51.2
1976	29.4	21.7	51.1	34.1	14.8	48.9
1977	32.1	23.0	55.9	40.0	4.1	44.1
1978	34.7	22.1	56.8	29.2	14.0	43.2
1979	20.1	16.2	36.4	57.2	6.4	63.6
1980	29.9	8.7	38.7	54.6	7.3	61.3
1981	29.3	9.6	38.9	53.4	7.7	61.1
1982	29.6	6.2	35.8	55.9	8.3	64.2
1983	26.5	5.4	31.9	56.9	11.2	68.1
1984	27.7	4.2	31.9	55.1	13.0	68.1
1985	26.2	3.7	29.9	56.6	13.5	70.1

Source: Computed from:

(i) Grenada Statistical Digest, Statistical Office (several issues);

(ii) Computer Printouts, Statistical Office;

(iii) ECCM Annual Statistical Digest (several issues).

Table 7 illustrates that while the overall tax effort rose from 18.7 per cent of GDP to 29.1 per cent, an increase of around 56 per cent, the direct tax effort increased by only 33 per cent, while the indirect tax effort rose by 70 per cent.

TABLE 7. SHARES OF TAXES IN GDP, 1970-1985

	TAXES (Percentages)				
Year	Income Tax	Direct Taxes	Import Duty	Indirect Taxes	Total Taxes
1970	5.1	6.9	10.5	11.8	18.7
1971	6.6	8.4	11.5	13.0	21.4
1972	6.5	8.0	10.2	10.6	18.6
1973	6.0	7.7	14.6	15.1	22.8
1974	5.1	7.8	2.0	3.0	10.8
1975	4.2	7.9	1.7	2.4	10.3
1976	5.3	9.3	1.9	2.7	12.0
1977	5.4	9.5	0.6	0.7	8.8
1978	6.6	10.8	0.8	1.2	12.0
1979	5.5	9.9	15.6	17.4	27.3
1980	9.1	12.8	15.9	17.9	30.7
1981	7.8	11.2	13.5	15.4	26.6
1982	8.8	11.3	16.1	18.5	29.8
1983	8.2	10.7	17.1	20.5	31.2
1984	8.6	10.6	16.7	20.7	31.3
1985	7.6	9.2	16.1	19.9	29.1

Source: Computed from:

(i) Grenada Statistical Digest, Statistical Office (several issues);

(ii) Computer Printouts, Statistical Office;

(iii) ECCM Annual Statistical Digest (several issues).

Comparing the first triennium of the period with the middle triennium, the buoyancy measure is 1.22. When the middle triennium is compared with the last triennium the corresponding measure is 0.56. The buoyancy over the entire period, that is, between the first and last triennia, is computed as 1.63. The buoyancy is here measured as a total elasticity index. It is noteworthy that the only buoyancy measure less than 1.0 emerged for the period when both taxes and GDP were declining in real terms. The measures do indicate, however, that taxes responded reasonably well as total activity levels changed.

The first question which arises is whether the information available justified the abolition of the income tax in order to introduce the VAT. We have already seen that the theory of optimal taxation has demonstrated that the movement away from direct taxes towards indirect taxes need not be welfare-reducing. If the movement has a substantial revenue earning capacity, and if the revenues derived are aimed at increasing real incomes specifically for low income groups, then even a complete removal of direct taxation may be warranted.

In the Grenada context here were certainly high revenue expectations, although the basis for these expectations had not been spelled out. What was required, of course, was a demonstration that the added disposable income generated from the abolition of personal income taxation would have a quantifiable impact on consumption. It was also necessary to indicate what fraction of consumption spending would *officially* fall under the VAT, and given possible administrative problems, what fraction would *actually* fall under the new tax. Based on these calculations the 20 per cent rate would then be applied and the revenue projection could be made.

It turns out that if we make the following assumptions the expected VAT revenues of $42.61m could be justified:

i) Expected GDP, 1986 = $280m (nominal)

ii) Consumption ratio = 0.90

iii) Taxable fraction of consumption = 0.845

While the first two assumptions are reasonable, it is most likely that the taxable fraction of consumption is much lower than 84.5 per cent. The actual VAT collected suggests that the fraction is closer to 50 per cent.

What is revealed in these hypothetical calculations is the importance of being able to trace the effects of fiscal measures on the major economic variables. The government has announced its intention to make use of a *forecasting model* in the future and the expectation is that revenue projections will then be done on a more scientific basis. The days of back-of-the-envelope calculations in Ministries of Finance should have long been over.

By 1987, the facts did show that both the VAT and the Business Levy projections were vastly overestimated. That is not the focus of the present critique. Rather what is important is the ability to learn from mistakes made. Except we clearly indicate the basis upon which projections are made, we will have only an accumulation of errors without any indication as to how we can do better.

In an effort to reduce the alleged regressivity of the VAT, the Grenada government has adopted an extensive list of zero-rated and exempted items. It has already been argued that efficiency and distributional considerations need to be properly balanced, based on an assessment of different taxation scenarios. However, it must be remembered that the revenue objective needs to be treated in a similar matter.

Following the general principles enunciated in the previous Section of this paper, it now seems advisable that the appropriate course of action for Grenada would be to let the VAT apply to as wide a base as possible and earmark VAT collections to be spent in areas where lower income groups benefit most. To attempt to use the VAT, in the present low-revenue context, as a powerful distributive instrument is probably on balance, a sub-optimal strategy.

We turn finally to the question of the income tax itself. While the abolition of this tax was probably very timely from a political point of view, it must be stressed that in the search for an optimal structure of taxes the abolition of income taxes may only be justified if rates of indirect taxation are set relatively high. In this respect, the prognosis for Grenada is for ever-increasing levels of VAT if income taxes are not reintroduced.

In the short run the government may try to bridge the gap by controlling and reducing expenditures. However, the pressures of economic development will continue to demand certain inescapable levels of govern-

ment expenditure. This means that in a situation like Grenada's where existing revenue levels are less than 50 per cent of current expenditure levels, the required expenditure adjustment will not be feasible. Moreover, as we have already suggested, such an adjustment may not even make good economic sense.

In order to make the VAT perform more efficiently and to realize its full *economic* potential, it therefore seems that the Grenada government has no option but to reintroduce some form of income taxation. With the ongoing improvement in the tax administration arm of the government, such a move should not be too costly or too difficult. The choices that will then have to be made in the search for a tax structure most conducive to the development of the country will be made under a less severe set of constraints.

The many adjustments that have already been made in the VAT attest the known principle that, in the matter of tax reform, simplicity and equity constitute one important trade-off. Other relevant trade-offs are between efficiency and equity as well as between equity and revenue potential. Since these trade-offs are inescapable, no good purpose is served by the abolition of one of the more flexible instruments available, namely, the income tax.

NOTES

[1]See page 13 of the *Grenada Budget Speech*, 1985.

[2]See page 6, *Grenada Budget Speech*, 1985.

[3]These trade data have been obtained from several issues of the *Economic Survey for Latin America*, ECLA. They do not match exactly with data from other sources but the basic trends are uniform across different sources.

[4]Same as note 2.

[5]Stern [7], p. 373.

[6]See, for example, Weisskopf [8] who argues that such inflows tend to systematically work against the fostering of domestic savings.

[7]See Beck [2] for a discussion of the Wagner hypothesis.

[8]*Grenada Budget Speech*, 1985, p. 12 and *Grenada Budget Speech*, 1986, pp. 20-21.

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The Dominican Approach to Tax Reform

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During the period 1977-1986,[1] many changes were made to the tax system. Some taxes went through their entire life cycle. Generally, taxes were imposed out of a need to meet government's demand for expenditure. The changes made displayed an inverse relationship between the direction of change of direct taxes on the one hand, and that of indirect taxes on the other.

Prior to the reform, direct taxes and indirect taxes averaged 35.7 per cent and 64.3 per cent, respectively, of total tax revenue. Income tax on individuals accounted for 26.2 percentage points of direct taxes and consumption tax and import duties 36.2 and 17.1 percentage points, respectively.

As of 1974, agricultural incomes were totally exempt from income tax. This exemption also unofficially extended to workers on estates who paid no income tax although they contributed to the Social Security Scheme. On average the agricultural sector accounted for 29 per cent of GDP (at factor cost) over the period. Moreover the manufacturing and the services sectors were still in their infancy and relied on massive amounts of incentives from Government. These included tax free holidays, and duty free importation. They therefore contributed relatively little to revenue. The incidence of taxation fell heavily on the wage earners in the public sector and the easily identifiable enterprises in the private sector. Manpower and organizational limitations made it difficult to expand the tax base to include the self employed.

Tax Reform Study indicates that Dominica's tax effort is on the high end of the scale. The paper shows that Dominica and Grenada had the

highest tax effort in the O.E.C.S. territories and that their International Tax Comparison (ITC) indices were significantly above those for other O.E.C.S. countries.

The tax system also displayed some elasticity. In a paper presented by Hodge Oliver also as part of the study the elasticity of the system was estimated at 1.05. The items that contributed most to this coefficient were Income Tax individuals (1.11) and Income Tax on Enterprises (1.16).

However, Government's ability to generate public savings remained limited and Public Sector investment, estimated at 15 per cent of GDP in FY 1986/87, has had to be financed largely with external assistance. The Public Sector has accounted for, and continues to account for, the largest share of total investment and most of the impetus for growth. It was felt that a new approach to incentives to the private sector was required. Government therefore embarked on a structural adjustment programme of which the tax reform is a key element.

It is fair to say that the tax system that existed by FY 1985/86 did not allow government to raise revenues in a reasonably equitable and efficient manner and with reasonable administrative ease in order to raise the growth rate. The life span of taxes was becoming increasingly shorter, and at least one was announced and never implemented because of insufficient analysis of its impact. In other words Dominica had reached a stage where it became very difficult to raise additional taxes. Against this background the "Tax Reform Study" was commissioned in mid-1986. This study found the weaknesses of the existing tax system to be:

(a) The existence of too many taxes on more or less the same tax bases.

(b) Too many year to year changes to the system.

(c) The code's attempt at too many fancy differences in the way the same taxes were applied to different sectors.

(d) The schedules of allowable depreciation for income tax purposes were too illiberal and anachronistic.

(e) Too many indirect taxes were placed on business inputs.

(f) The bulk of indirect taxes were at the point of importation rather than later in the distribution chain, thereby increasing the carrying costs on inventories.

(g) The exclusion of agricultural income from income tax.

(h) The absence of taxes on the ownership of real property.

(i) Marginal rates of personal income tax were too high at all income levels from the standpoint of economic activity.

In designing the package to rectify these problems, the reform was guided by a few broad principles.

1. The benefits of taxing income after it is earned rather than taxing the inputs to the production process that generates incomes in the first place. Based on this principle the importance of the Income tax within the system was recognized.
2. The adoption of an incremental or marginalist approach rather than a wholesale upheaval of the entire revenue system, which guided every tax measure that was recommended.
3. The expedience of adopting to settle for "second best" solutions that can be depended upon to produce revenues, in preference to a theoretically more elegant approach that is difficult to administer. Mostly in observance of this principle, a 3 per cent turnover tax at the wholesale and retail levels was introduced rather than a Value Added Tax, or a Retail Sales Tax.

The following measures were proposed in respect of indirect taxes:

1. The elimination of the 5 per cent stamp duty[2] on imports.
2. The unification of the customs service charge[2] at 1 per cent.
3. The elimination of the consumption tax on machinery, equipment, tools, raw materials, office machines, computers, packaging material, office supplies, and the unification of the remaining imports at 20 per cent except for cars, consumer durables, petrol, alcoholic beverages and tobacco — which would continue at their existing rates.

4. The increase of the 1 per cent wholesale and retail stamp tax to a 3 per cent wholesale and retail sales tax, and the extension of the tax to petrol, which was exempt from the stamp duty.

In respect of income taxes, the study recommended:

1. Raising the tax threshold from $3,700 to $10,000.
2. Increasing the income threshold to which the top bracket rate applies from $25,000 to $50,000.
3. Reducing the number of marginal rates from 9 to 3.
4. Elimination of all exemptions and allowances in the calculation of chargeable income under the personal income tax except for mortgage interest.[3]
5. Unification of the corporate income tax rate at 40 per cent.[4]
6. Allowing tax credits equal to 10 per cent of the cost of all non-residential private investment in plant and equipment.
7. Extending personal and corporate income taxes to agricultural incomes.[5]
8. Initiating real estate property tax.[5]

The bulk of the measures proposed were implemented as proposed although there were instances where the actual measures implemented varied slightly from the form proposed. Hence the tax study presented very strong economic arguments for the corporate and income tax to apply to net agricultural incomes, but the banana development levy was imposed on gross receipts. Similarly the corporate tax rate was unified at 35 per cent rather than the 40 per cent recommended.

There was a strong commitment on the part of government to institute a real estate property tax by FY 1988/89 and to introduce a credit system to remove the inequities and inefficiencies created by the cascading nature of the 3 per cent turnover tax that replaced the 1 per cent stamp duty on wholesale and retail sales. There was also a strong commitment to redesign the depreciation rate schedules in the income tax act so that they may reflect more realistic economic lives of fixed assets.

Very early in the design of the programme, the aim was to introduce a package that would be revenue neutral. The structural adjustment programme assumed that the reform would be revenue neutral. As soon as it was realised that the reform could not be revenue neutral, emphasis shifted to minimising the revenue loss (even if that meant a little untidiness in the design of some of the measures), and the duration of these losses.

The tax reform study estimated that the changes made to the tax system would raise GDP growth rate to 15.3 per cent in the first full year of the reform, and to 10.5 per cent, 8.1 per cent, and 7.1 per cent in the 2nd, 3rd, and 4th full years, respectively, of the reform. It was also estimated that the net revenue effect after fiscal recovery would become positive after the third year of the reform (1989/90). Much of this growth would depend on the response, by the private sector, to the incentives that have been provided through the tax reform, to save and invest.

NOTES

[1]1977-1986 represents the period for which comparable data are available.

[2]Both the stamp duty and the customs service charge were measures introduced in FY 1985/86 to recoup losses from changes made to marginal tax rates and to the level of allowances in the same year. The manufacturing sector had successfully lobbied to have the tax reduced to 1 per cent on the value of inputs.

[3]This measure served, in part, to reduce administrative burdens, to simplify the structure of the tax and to help finance the reduction of marginal rates and the increase of the tax threshold.

[4]Prior to the Tax Reform a two-tiered rate system existed. Manufacturing firms were chargeable at 30 per cent, and all other companies were chargeable at 45 per cent.

[5]Both these measures will help finance the reductions in the marginal tax rates, will broaden the tax base and will foster the development of a more equitable tax system.

The Administrative Aspects of Tax Reform

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This paper, "The Administrative Aspects of Tax Reform", addresses the administration of Income Taxes. It begins with a brief comment on the Tax System and the role of the Tax Administration.

Tax System

Originally the tax system was devised to raise revenue necessary for funding the activities of Government. However, with the passage of time and the development process, taxation has evolved into a fiscal instrument used by Government to achieve its social, economic and political objectives; e.g. re-distribution of income, granting incentives for desired industrial and commercial activity, increasing employment, provision of dwelling houses, exports, etc. Of course, tax policy could also include disincentives to discourage undesirable economic activity, e.g. transfer pricing.

Tax Administration

For the purpose of administration, it is necessary that tax policy be translated into tax laws. Responsibility for the administration of Income Taxes rests with the Board of Inland Revenue. The Tax Administration has a dual role or mission, viz.:

1. Revenue Collection
2. Monitoring of tax laws

With regard to revenue collection, it is desirable to collect all taxes payable by law at the least possible cost. To achieve this, ancillary goals are established. These are:

(a) to facilitate and encourage voluntary compliance with the tax laws and to foster the self-assessment system.

(b) to administer the tax laws efficiently and effectively so as to deter tax evasion and tax avoidance.

Tax laws must be monitored so as to determine whether the desired policy objectives are achieved and to identify loopholes therein.

Tax Reform Process

Tax reform embraces the planning, formulation and implementation of changes in the tax system to accomplish specific objectives. These changes may be significant, they may be enactment of special provisions, technical changes in the tax laws or changes in tax rates. In recent times the interdependence of the policy-maker and the tax administrator is widely appreciated and gradually the tax administrator is becoming increasingly involved at the planning stage. Contributions include inter alia:

1. Provision of statistical data for analysing the effectiveness of the tax system.
2. Cost estimates of proposals which seek to reduce tax burdens.
3. Identification of ambiguities in the law and drafting errors which affect its application.
4. Proposals for amendments to the laws to allow for greater effectiveness.

The success of tax reforms especially those which involve major changes or enactment of special provisions depends largely on the resources available to implement them. These include information, personnel expertise and instruments of implementation, i.e. audit, collection and enforcement. It follows, therefore, that reform proposals should include necessary tax administration reform with anti-evasion and anti-avoidance objectives in mind.

The following implementation tasks must be performed by the Tax Administration:

1. Preparation of new tax forms to incorporate changes.

2. Preparation of explanatory documents.
3. Institution of new procedures or updating existing ones.
4. Training employees on new laws and duties.
5. Education of tax payers on changes in law and effective dates.
6. Writing new computer programmes or amending existing ones.

In addition to the afore-mentioned implementation tasks, the Tax Administration participates in the legislative process which is the key to the implementation tax reform proposals. Proposals, though enunciated in the Budget Speech, are not effective unless legislation is enacted. Generally, provision is made for the immediate collection of new taxes introduced in the Budget by means of a Provisional Collection of Taxes Order which is published as a legal notice. By law, amendments to the Order must be made within twenty-one days from the date of the notice while the necessary legislation must be enacted within four months.

Budget pronouncements of new proposals are not usually sufficiently in-depth for full appreciation of what is intended. Drafting personnel must therefore be fully briefed and provided with all relevant information to enable them to have a clear and thorough understanding of the intention of the policy-makers and the desired results so as to properly and unambiguously frame the new laws. This is achieved through consultation with both the policy-maker and the tax administrator.

Other Activities

Towards the achievement of its goals, several activities must be undertaken by the Tax Administration. Compliance-based activities include audit, collection and enforcement.

Audit

Audit seeks to ensure that returns and related statements submitted by the taxpayer are accurate and true. Earlier it was stated that one of the goals of the Tax Administration is to foster the self-assessment system. The self-assessment system which has been adopted by most tax administrations requires tax payers to compute their tax liability. Though the onus for

computation is placed on the tax payer, it is the responsibility of the Board to verify the income reported and expenses and allowances claimed.

Naturally, given the size of the tax population and the available human resources, only a small percentage of returns are audited annually. Nevertheless this activity does act as a deterrent to tax evasion since the tax payer cannot be certain that his/her return will not be selected for audit. Predetermined criteria are used for the classification of returns for audit.

Audit activity comprises office audit, field audit and special investigations. Office Audit is performed principally on returns of employees and is concerned mainly with the verification of expenses and allowances claimed. Field audit is applicable to corporations and self-employed persons and is conducted at the office premises of the tax payer where all books of records and source documents should be available. Unlike office audit, the verification of income is paramount.

Special Investigations is concerned with a 100 per cent audit examination with the intention of prosecution and is applicable in instances where fraud is suspected.

Collection

There exists machinery for payment of taxes currently prior to assessment. They include —

1. P.A.Y.E. system whereby deductions are made from employees' emoluments by employers who have a legal obligation to remit deductions to the Board by a specified date.
2. Quarterly Instalment system requiring corporations, self-employed persons and persons with income other than employment income to make payments on a quarterly basis. Payments are based on the previous year's chargeable income.
3. Final settlement of balance of tax payable and based on the tax payer's computation. Payment is required to be made on submission of the return.
4. Withholding Tax system which requires persons making payments to or on behalf of non-residents to withhold tax therefrom and remit same to the Board by a specified date.

Delinquent Accounts

Accounts are delinquent when payments are outstanding after the due date for filing or the due date for payment after an audit. However, the delinquency is not established before the return of audit adjustment is processed. Procedures are established for the identification of delinquent accounts within a reasonable time after their establishment. Two reminder notices are issued to delinquent tax payers before enforcement action is pursued. There are also procedures for visits by field collectors for significant amounts.

Enforcement

Where the aforementioned procedures fail to obtain positive response, enforcement action is pursued. Such action includes:

1. Distraint
2. Garnishment
3. Filing of a judgment debt
4. Court prosecution.

Non-filers

In the pursuit of non-filers, administrative arrangements are in force which require persons applying to certain Government departments and State enterprises for licences, certificates, approvals, etc. to furnish their Board of Inland Revenue file number. This forces unregistered persons to apply for a file number and be identified by the Board. Persons entering into certain business agreements are also required to report relevant details of payments made for services rendered. Additionally, occasional field surveys are conducted to detect unregistered persons. Action taken against non-filers includes court prosecution and raising of estimated assessments.

Penalties

As a deterrent, the tax laws provide for the imposition of penalties for failure to file returns and make remittances and interest for late payment of taxes.

Institutional Arrangements

For the performance of certain tasks relating to the encouragement of voluntary compliance and the monitoring process, special units have been established —

1. *Tax Administration Improvement.* This unit is responsible for the establishment, revision and monitoring of operational procedures. Monthly operational reports are required and these are collated and analysed for the preparation of management information reports.

2. *Legal.* This section provides legal assistance with the formulation and interpretation of tax laws. The audit process involves to a large extent the application of the law which at times is not an easy task, especially in cases where the tax payer has calculatingly arranged his business transaction in such a way as to get around the law to minimize his tax liability. In such cases legal advice is necessary to ensure that the audit can withstand the scrutiny of the Court in the event there is an appeal.

3. *Tax payer Relations.* The fostering of the self-assessment system and implementation of tax reforms require that tax payers be educated on the basic laws, their rights and responsibilities under the Income Tax Act. This is achieved by means of seminars, lecture demonstrations, school programmes and media programmes.

4. *Tax payer Assistance.* Here assistance is given.to tax payers in the completion of their returns and calculation of their tax liability. Enquiries pertaining to other aspects of their tax transactions are also dealt with.

5. *Internal Audit.* Here lies the responsibility of monitoring all aspects of the operations of the Department — procedures, systems, internal controls, etc.

6. *Training.* A most important factor for the successful implementation of reforms and efficient and effective performance of activities is personnel expertise. The development of this exper-

tise is achieved through training. The Training Unit is responsible for the training of new recruits, refresher courses, training programmes on the introduction of new laws and tax measures and the identification of training needs.

In addition to these units, committees have been formed for specific purposes —

1. *Legislative Committee.* This Committee has specific responsibility for monitoring the tax laws, identifying loopholes and areas for improvement. Provision is made for the receipt of suggestions from all members of staff for consideration.
2. *Forms Committee.* All forms utilised in the department are examined as necessary by the committee and recommendations made for changes, replacements, etc.
3. *Human Resources.* This Committee is responsible for examining personnel requirements, both current and future and to make recommendations accordingly. It is also concerned with the preparation and revision of job specifications.

In all cases recommendations are made to the Board by which approval must be granted before changes can be implemented.

4. *Data Processing.* This Committee concerns itself with setting priorities for the computerisation programme and examining EDP needs.

Automated Data Processing

In 1982 the Board's computer system was installed. Prior to that date the masterfile and tax payers' accounts were computerised, computer services being provided by the National Computer Agency. The introduction of computer technology has contributed significantly to the operations of the tax administration. Though not fully computerised, several tasks are now being performed by the ADP system, the principal ones being —

1. Processing of returns and audit adjustments
2. Maintenance and updating of tax payers' current accounts

3. Generation of delinquent account notices and delinquent return notices
4. Quarterly instalment notices
5. Preparation of taxpayer arrears account
6. Progressive payment listings
7. Tax payer history in respect of returns filed and processed
8. Masterfile maintenance
9. P.A.Y.E.
10. Cheque reconciliation
11. Tax Exit certificates
12. Work-in-progress
13. Objections

The Management information system is being currently computerised. However, statistical data are being collected and stored to facilitate the provision of useful information for Management and policy purposes.

Some Fundamental Issues Related to Fiscal Harmonisation in the Caribbean Community

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Introduction

While interest in, and steps towards, fiscal reform in the Region have increased within recent years, there is little evidence that plans for reform relate to the successful operation of CARICOM or more specifically are seen within a context of regional fiscal harmonisation. General concern over public finances — both revenue and expenditure — and fiscal policy tend to be viewed as national rather than regional jurisdictional matters and all Member States, particularly their treasuries, are loath to hand over any part of their fiscal sovereignty.

The fact is, however, that within a common market area (like CARICOM) characterised by policies and provisions towards internal free trade, a common external tariff and elimination of barriers affecting mobility of capital and services, fiscal harmonisation issues and national fiscal reforms are closely intertwined and directly affect each other.

This Paper attempts to analyse some fundamental issues surrounding fiscal harmonisation in the light of recent fiscal reforms and to examine some actual examples of fiscal harmonisation in the Region, as well as the scope for further harmonisation. Section 1 of the Paper looks at key theoretical and legal aspects of fiscal harmonisation in CARICOM while Section 2 reviews the operations of some harmonisation instruments as described in the Treaty establishing the Caribbean Community. Section 3 provides a brief examination of the implications and scope for increased fiscal harmonisation in the Region.

Theoretical and Legal Aspects of Fiscal Harmonisation

Fiscal sovereignty as the right to raise and control taxes and public expenditure and generally to determine fiscal policy is a vital element of overall national sovereignty. Fiscal harmonisation impinges on this right in the sense that it calls for some approximation or convergence of fiscal policies and operations in Member States where the national tax systems:

(a) show marked dissimilarities due to their development over long periods in line with national characteristics and policies;

(b) tend to favour domestic production;

(c) have their own balance between direct and indirect taxes, tax on essentials, exemptions, provisions for subsidies and direct payments to the less favoured of the population.

In customs unions and common markets, the major objectives are the abolition of internal frontiers and approximation of direct and indirect taxes to create a free, united market where goods, services and people can move freely to where they enjoy genuine and comparative advantage. This means that revenue from previous taxes on regional goods disappears and variation of revenue gains from taxing extraregional goods is restricted by a common external tariff. This also means that the more fiscal barriers that are removed internally and conditions for free movement of capital and labour are united and ensured, the more the reduction in the latitude which Member Countries previously had to arrange their own external relations in accordance with certain agreed social and economic objectives, as well as their domestic economy policy.

In such a context, the questions to be asked are: Is harmonisation necessary? Is it the best environment for economic operators and for determining one's development path? Would it stimulate any more enterprise, competition and trade? How to minimise the possible adverse effects on budgetary flexibility and revenue flows?

Perhaps, the logical starting point is to re-examine the objective function in terms of welfare in the Common Market and in terms of the main objectives of fiscal policy, i.e.

(a) efficiency in resource allocation to enhance growth;

(b) stabilisation of economic conditions;

(c) distribution of wealth that is socially acceptable and economically functional while maximising well-being.

The evaluative framework containing qualitative and quantitative data weighted by technical (and political) considerations will then look like this (first developed by Dosser):

	Scope of the Welfare Function						
	Non Union Condition	Union	Countries in Union				
Criterion			1	2	3	4	5
a) Short-run allocative efficiency							
b) Internal and external stability							
c) Growth							
d) Distribution effects							
e) Other aims							

From the above framework, harmonisation can be defined in terms of a pattern of pluses and minuses which yields net positive gain. It can be approached either by:

(a) Fiscal equalisation which aims at complete uniformity of tax systems and rates in Member Countries. This enhances internal competition.

(b) Fiscal standardisation which aims at setting ideal standards for tax systems and rates based on efficiency and equity studies.

(c) Fiscal differentiation which aims at deliberate maintenance of tax rate differentials to influence economic activity or development in particular countries.

Within the Common Market, the approach to and link between harmonisation, tax revenue and renunciation of sovereignty can be viewed at two extremes:

(i) Condition of minimum tax harmonisation where the authority of the individual Member State is maintained except insofar as obvious distortions in the conditions of competition have to be prevented, removed or compensated.

(ii) Condition of maximum tax harmonisation where the authority to control tax revenue is reduced and where comprehensive financial adjustments due to revenue gains or losses in Member Countries are required in accordance with overall policies in employment, industrial growth, etc.

Movement from condition (i) to (ii) above can be done in stages since the idea is not to create an ideal fiscal system for the Member State, but more an empirical and flexible (within certain bands) system. Fiscal harmonisation as such can be seen as both a process and a stage at any point in time involving adjustments of national fiscal systems to conform with a set of common economic objectives in the Common Market.

Legal Aspects

In order to construct an analytic framework to examine fiscal harmonisation, it is essential to work with the set of economic objectives enunciated or implied in the Treaty establishing the Caribbean Common Market. These objectives are:

(a) the strengthening, coordination and regulation of the economic and trade relations among Member States in order to promote their accelerated, harmonious and balanced development;

(b) the sustained expansion and continuing integration of economic activities, the benefits of which shall be equitably shared taking into account the need to provide special opportunities for the LDCs;

(c) the achievement of a greater measure of economic independence and effectiveness in dealing with states, groups of states and entities of whatever description.

Articles 15, 17 and 18 call for the abolition of customs duties, internal taxes, export duties and other revenue charges on goods from other Member States. While the objective here is the creation of conditions for the free flow of goods and increased competition, it can also be interpreted in terms of allocative efficiency.

Article 31 provides for the establishment of a Common External Tariff in respect of all commodities imported from Third Countries. The objective is to equalise tariff rates while providing a certain degree of protection to regionally produced goods. This could be interpreted in terms of growth and development in the Region.

Articles 35-37 call for the removal of barriers and extension of preferential treatment to facilitate the free flow of capital and services. Again this could be interpreted in terms of efficiency in resource allocation across the Region.

Article 40 enjoins Member States to harmonise legislation and practices which directly affect fiscal incentives to industry, agriculture and tourism. It also requires Members to examine the possibility of approximating income tax systems and rates with respect to companies and individuals. The objective functions in this article are related to allocative efficiency and growth.

Article 41 encourages Member States to approach negotiations on agreements for the avoidance of double taxation both with Third Countries and among themselves on a set of mutually agreed principles with appropriate differentials to favour the LDCs. Allocative efficiency and redistribution of wealth are the operative functions in this article.

Articles 52, 54, 55, and 57 provide for derogations and preferential treatment to be given to the LDCs with respect to the implementation of the provisions enunciated in the previous articles. Redistribution and growth are the prime objectives of this particular set of articles (part of the Special Regime for the LDCs).

In the cases of the Common External Tariff and the removal of internal barriers, the harmonisation process has adopted the equalisation approach; in the other cases, there is widespread use of the differentiation approach. A brief examination of the actual operation of these instruments is provided in the next Section.

Operations of Some Harmonisation Instruments in CARICOM

(a) Removal of internal fiscal barriers to free intraregional trade ... Articles 15, 17, 18.

At the outset it should be noted that the Treaty provided for certain derogations and exemptions to be granted to the LDCs in the implementation of these Articles. These derogations and exemptions covered particular products and product groups for a specified period, in most cases up to ten (10) years after the signing of the Treaty. By 1983, however, the commitment to the total removal of all such internal barriers by all States had not been fully honoured. Moreso, since 1983, some Member States have imposed additional fiscal charges (stamp duties) on all imports including regional goods either in retaliation for previous imposition by other States or to bolster revenue earnings. At present, most of these duties have been removed from regional goods though the conditionality of reciprocity had to be applied in many cases.

While the Common Market is still not free from internal charges and barriers, it should be noted that among the OECS group of countries there is an understanding for totally free and unrestricted movement of goods by January 1988 and within CARICOM a similar undertaking has been made for October 1988.

(b) Establishment of a Common External Tariff ... Article 31

The implementation schedule for the CET required an equalisation of all rates in Member States by 1985. This schedule, however, has not been met and at present there exist four (4) tariff structures in the Common Market — the CET as applied by the MDCs; the tariffs applied by the OECS countries except Montserrat; the tariffs applied by Montserrat and the Belize tariff.

The economic recession of the early 1980s and the response by Member States through structural adjustment measures have led to a reconsideration of the precise role of the structure and specific rates with respect to the CET. There is agreement that the restructuring of the CET should make it simpler, more geared towards protection than revenue raising and

more supportive of regional efforts to keep production costs low, engender efficiency and encourage international competitiveness. It is expected that convergence of tariff rates in all Member States will take place when a decision on the new structure for the CET is made.

(c) Internal Barriers to the Movement of Capital and Services ... Articles 35-37

While no specific instrument for implementation of these articles was designed at the time of the signing of the Treaty, Member States were enjoined to grant preferential treatment to the movement of regional capital and services and to establish a scheme for regulating such movement. The CARICOM Enterprise Regime, designed since 1974, is currently being finalised as the main instrument dealing with the establishment of regional companies and movement of capital and services in the Common Market. Full agreement, however, has not been reached on the fiscal arrangements relating to the Regime.

(d) Harmonisation of Fiscal Incentives ... Article 40

The present scheme has been in operation since 1973 and covers only incentives to industrial enterprises. Incentives relate to specific relief provisions for dealing with income tax, payment of customs duty, income tax liability on export profits, depreciation allowances and dividend payments. Eligible enterprises are divided into four categories based on the level of local value added in their production. The extent and duration of benefits (incentives) vary according to the categories of enterprises and according to their geographic location, with the LDCs being allowed more favourable terms.

In operational terms, the scheme has resulted in substantial development of the manufacturing sector in the LDCs (compared with what existed in 1973). Production, however, was mainly geared to the markets in the MDCs and, with contraction of these markets especially since 1982, a number of the enterprises established as a result of the scheme have collapsed. Additionally, given the thrust towards greater efficiency and export competitiveness in all Member States, the scheme is being compre-

hensively reviewed to make it more attractive to investors, to grant equal treatment to local and foreign investors and to be broadened to include enterprises in agriculture, tourism and services.

(e) Negotiation of Double Taxation Agreements . .. Article 41

The provisions of this Article have not been activated to any large extent and though DTAs have been signed with some Third Countries, these have not been negotiated "on the basis of a set of mutually agreed principles" as stated in the Treaty.

In summary, while legally the Common Market has in place a number of instruments and articles which provide clear evidence of fiscal harmonisation, implementation of these has not been very impressive. Current reviews and studies being undertaken on the role of these instruments in the light of the changed economic conditions of the 1980s and the new development thrust in the Region, favour an intensification rather than a diminution of efforts towards greater fiscal harmonisation.

III. Considerations for Further Fiscal Harmonisation

Quite apart from the fulfilment of commitments and total implementation of instruments as laid down in the Treaty, further harmonisation in the Common Market depends, to a large extent, on one critical factor - a conscious decision by all Member States to move closer towards full Common Market arrangements or to maintain arrangements permitting a range of differentials in respect of the LDCs. The analysis in the above-named Section shows that in many instances the differentiation rather than the equalisation or standardisation approaches has been operative in fiscal harmonisation. Deepening of the Common Market as it relates to further harmonisation would need to answer the following questions:

(a) whether and to what extent currently existing differences in the public finance practices of the Member States make it difficult to fully establish a Common Market and to create and maintain in it conditions similar to those in an internal market;

(b) what possibilities exist for eliminating those differences which particularly impede the operation of the Common Market and what are the trade-offs necessary in the elimination of those differences;

(c) what mixture of other macro-economic policy instruments (financial, employment, balance-of-payments, etc.) are necessary to work in concert with the objectives of fiscal harmonisation and compensate a Member State which may be adversely affected.

Comprehensive analysis of specific taxes in each state especially in view of committed fiscal reform programmes can either follow or inform decisions on the overall considerations described above. Such analyses can look at:

(a) taxes on earnings from economic activity, e.g. corporation tax, withholding tax, and double taxation agreements which influence investment decisions, growth and the future structure of the regional economy;

(b) income tax and social security provisions which theoretically can influence migration and labour mobility in the Common Market;

(c) value-added and turnover taxes which add substantially to cost of the domestic product and may be discriminatory;

(d) effective as against statutory tax rates in each country which influence the particular approach to harmonisation.

Conclusion

Unharmonised tax systems and rates in the Common Market lead to costs of production and returns on investment that may interfere with competition and distort the allocation of resources. The answer, however, is not the complete unification of the varying tax structures but an approximation of these structures based on empirical data so as to avoid serious budgetary/revenue dislocations. Such an approximation could be approached in stages

— perhaps starting with fulfilment of the fiscal harmonisation obligations of the Treaty and then proceeding to harmonisation in other fiscal areas.

In CARICOM, fiscal harmonisation is not the most critical factor influencing competition, trade, industrial development or labour mobility. However, appropriate, structured and empirically-based approaches to fiscal harmonisation can serve quite effectively to advance the movement towards a truly common market.

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