Session III. Improving Tax Policy in the Caribbean

Countries face the challenge of how to maintain a competitive tax system, while also raising the revenue required to fund public spending. This session reviews the broad contours of tax policy for the Caribbean, with a focus on two issues that have proved especially challenging in the region: how to effectively and efficiently tax tourism; and the appropriate approach to investment tax incentives. For a destination country, tourism has different components that could be taxed, including: the land and structures of resort properties; the wages of employees of tourism businesses; the profit of hotels and other businesses providing goods and services to tourists; the consumption of goods and services by tourists; the arrival of a tourist at a port or airport; and the importation of tourism-related goods and services. Despite businesses' demands for tax incentives, more important drivers of investment decisions include the availability and quality of workers; the legal and regulatory environment; infrastructure; and security / public safety. For policymakers to ward off lobbying, they need to be confident that their overall framework and policies are competitive. In the Caribbean region, cooperative actions can also provide large collective benefits.

Moderator: Nigel Clarke, Minister of Finance, Jamaica

Panelist 1: Michael Keen, Deputy Director, Fiscal Affairs Department, IMF
Panelist 2: Louisa Lewis-Ward, Head of Tax, Barbados and the Eastern Caribbean, KPMG
Panelist 3: Joe Matalon, Chair of ICD Group Holdings
Panelist 4: Frank Comito, CEO and Director General, Caribbean Hotel and Tourism Association

I. Tourism Taxation: Introduction

There are substantial economic rents associated with tourism in the Caribbean and charging high fees for access to scarce, location specific features is a very efficient way to raise revenue. High fees to access overcrowded destinations are efficient as they both raise revenue and allocate access to those that value it the highest. Rather than addressing overcrowding by capping the number of cruise ship visits (e.g., as done by Dubrovnik), more countries could charge fees (e.g., Rwanda charges USD 1,500 for international visitors to see mountain gorillas in their natural habitat). The Caribbean has the competitive advantage of proximity to a large population that craves an escape from winter, yet competition between jurisdictions – a race to the bottom – within the region allows the private sector to capture most of the economic rents associated with this competitive advantage.

The largest components of tourist expenditures are international transportation and accommodation. Next are a variety of smaller expenditures on taxis, tour guides, souvenirs, activities, and meals. Taxing the profits associated with air transportation is challenging, while the highly competitive market for local tourist services is characterized by small businesses with significant entry and exit. That focuses effective revenue generation from tourism on the taxation of tourist accommodation and charging appropriate fees for both publicly provided activities and for access to unique location specific cultural or natural features.

The taxation of stays at international hotel chains and vacation rentals is subject to administrative challenges. Transactions are often processed outside the destination country, international hotel chains can utilize internal transactions to move profits between jurisdictions, and scattered vacation rentals can be more difficult to monitor. But useful tax handles remain, as the waterfront property and the buildings themselves cannot be moved and mechanisms exist to effectively determine the price paid by a tourist for their short-term accommodation.

II. What Are Good Tax Bases for Tourism Dependent Economies in the Caribbean?

Tourism dependent economies in the Caribbean share features that make some tax bases more preferable to tax than others. In addition to minimizing potential negative impacts on economic growth and social welfare, tax systems need to be set up in a way that minimizes the cost of compliance for taxpayers and the cost of administration for the government, while making tax avoidance and evasion as difficult as possible.

A well-designed VAT is the preferred tax for raising substantial revenues with the smallest negative effect on economic growth. The best practice involves collecting VAT on the broadest possible range of goods and services and at each stage in the production and distribution chain and then providing a credit to a registered taxpayer for the VAT they paid on their business inputs. By collecting VAT at each stage, a substantial portion of the revenue associated with an untaxed final supply has already been collected. For example, an *unregistered* retailer will have paid VAT on: the goods that they imported or purchased from a wholesaler; the retail space that they rent; and the electricity and mobile phones that they use. As a result, VAT exemptions for business inputs should be considered tax relief for the informal economy; administration of input tax credits, nonetheless, remains a work in progress in many countries.

Recurrent taxes on land and residential property have the desirable features of being both efficient and progressive. Taxing land more heavily does not reduce its quantity, so the tax creates fewer economic distortions than most other taxes. Residential property ownership also tends to be concentrated among upper-income households, so a proportional tax on the value of improved residential property collects relatively more revenue from the wealthy. The taxation of the improved value of commercial property, however, is a less efficient source of tax revenue as it discourages income earning capital investment.

Taxing income at the individual can be a potent revenue source and an effective mechanism for improving the distribution of income. The main goals of a personal income tax are thus to raise sufficient revenue in a way that minimizes economic distortions while fairly distributing the tax burden. Two main concepts of fairness are usually distinguished: horizontal equity (individuals in similar circumstances are treated equally by the tax system); and vertical equity (individuals with greater capacity to pay taxes, as measured by their incomes, should pay a greater level of tax, usually more than proportionately more).

Unfortunately, the most damaging taxes for economic growth are common in the Caribbean: production or transaction-based taxes that are insensitive to profits (e.g., Stamp Duty on property transactions); or unrelieved tax imposed on business inputs (e.g., customs duties). Transactions taxes widen the gap between buying and selling prices, which reduces market liquidity and thereby affects the allocation of assets, labor mobility and social welfare. The result is a substantial reduction in trading and longer hold periods. Housing transaction taxes lead to a misallocation of the housing stock by discouraging young families from upsizing their housing and by discouraging retiree households from downsizing. In contrast, a recurrent property tax has no impact on mobility or the allocation of assets.

III. Tax Incentives: Minimizing the Economic and Fiscal Damage

It would be preferable to not provide any tax incentives, secure in the knowledge that the country's core tax system and other policy frameworks are competitive.[1] But it is understood that tax incentives are seen as necessary for attracting certain investments, and that the absence of any specific package would likely lead to the re-introduction of even more damaging discretionary relief. Caribbean countries need to ensure that their investment tax incentives are not considered harmful tax practices.

If contemplated, tax incentives should relate to those tax bases that are either less robust or more economically damaging. Specifically:

- *Transaction Taxes*. Stamp duties and property transfer taxes impose significant efficiency costs through resource misallocations and are thus a suitable target for exemptions or repeal.
- *Corporate Income Tax*. Incentives based on costs incurred directly increase the likelihood of investment, whereas incentives related to profits (e.g., tax holidays) primarily provide windfall gains to businesses that would have invested in the absence of the incentive. In lieu of tax

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[1] "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment", A, Report to the G-20 Development Working Group by the IMF, OECD, UN and WORLD BANK, https://www.oecd.org/tax/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment.htm

holidays, qualifying projects could be provided with the following incentives: expensing for capital investments; and an extended loss carry-forward period plus no limit on the ability to use losses to reduce current-year taxable income to zero combined with limits on interest deductibility. Corporate income tax applies to projects once they are generating operating profits and the combination of expensing and full loss carry-forwards allows the taxpayer to delay paying corporate income tax until the value of the initial capital investment has been recovered through operating profits.

- *Non-Resident Withholding Taxes*. In a country with a corporate income tax, a full exemption from withholding tax on payments of dividends could be considered. Exemptions from withholding taxes for tax deductible payments such as interest, royalties, and management services should be time-limited and capped (or avoided altogether), as a withholding tax is often the only mechanism for ensuring source country taxation.
- *Customs Tariff*. Taxes on business inputs are amongst the most harmful for economic growth. A full exemption from Customs Tariffs imposed on business inputs (e.g., construction materials) is advisable; the general elimination of these tariffs could also be considered. No tax relief should be provided for imports destined to be consumed by employees of the project, for example personal automobiles.

Governments should *avoid* tax incentives related to the most economically efficient and administratively resilient tax instruments. This includes:

- *Excise Taxes.* No exemptions for alcohol, tobacco or fossil fuels. The objective of these excise taxes is to increase the price of consuming a harmful product.
- *Value-Added Tax and Recurrent Property Tax.* No exemptions. These tax bases are amongst the most economically efficient sources of tax revenues and they are relatively difficult for taxpayers to avoid or evade.
- *Personal Income Tax*. No exemptions for employees of a favored project. Such relief is gratuitous, undermining the fairness of the tax system and the tax morale of individuals not eligible for relief.

IV. Summary

Raising revenue from tourism activities involves: (i) effective application of the standard tax system to the sector; (ii) charging appropriate fees for publicly provided activities and unique location specific cultural or natural features; and (iii) imposing special taxes and levies only when they can generate significant revenue in an administratively efficient manner.

Efficiently raising revenue from tourism activities requires a focus on the taxation of land, consumption, and employment income. Investment can be encouraged through eliminating the taxation of business inputs (e.g., Customs Tariff, transactions taxes) and ensuring that any tax on mobile corporate profits is generous towards capital investment and applied at a competitive rate.

Increasing competitiveness is a multifaceted challenge with no quick fixes. Generous tax incentives only appear to offer a quick solution to an underlying structural problem. Construction activity boosts the local economy, and some jobs are created in the hotel industry. Generous tax incentives not only leave root causes of structural problems untouched, they also deprive the government of the revenue needed to address them. Exploiting the overlap between structural reform priorities and non-tax determinants of investment decisions can yield important results. Combatting crime, increasing qualification of the labor force, and creating unique value propositions can advance competitiveness while at the same time attract investment.[2]

V. Issues for Discussion

1. Regional coordination could increase revenues.
    - What can be accomplished in the short-term?
    - What types of taxes or fees could be targeted? For example, could countries maintain a minimum landing fee for each cruise ship passenger that disembarks?
2. What have been positive country experiences with efforts to streamline tax incentive frameworks?
3. Why has it been difficult to implement a rules-based and transparent approach to tax incentives at the national level?
4. What can countries in the region do to better coordinate, and eventually harmonize, their tax incentive frameworks?
5. Tax reform is politically difficult but necessary to improve economic, social and fiscal outcomes.
    - For those countries that have undertaken reforms, what was key to the success or failure of the reform effort?
    - Where are the critical gaps in tax administration and how can countries quickly improve collection?
    - What tax policy questions are the most pressing – for governments, business, and households?

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[2] See Srinivasan et al (eds) (2017) Unleashing Growth and Strengthening Resilience in the Caribbean, in particular chapter 2: Chamon et al. Reinvigorating Growth in the Caribbean, for a discussion of impediments to growth in the region.

Annex I: Summarizing the Impacts of Different Tax Bases

	Relative Growth Friendliness	Helps Achieve Progressivity	Leakage	Recommended for Small Caribbean Countries
Recurrent Property Tax	Land taxation is growth friendly, taxing commercial buildings discourages investment	Recurrent taxation of the improved value of residential property	None	Essential
VAT	Growth friendly	No	Minimal	Essential
Customs Tariffs	Damaging	No	Minimal	Maybe
Stamp Duties	Damaging	No	High	No
Excise Taxes	Depends on good	No	Manageable	Yes (fossil fuels, tobacco, alcohol)
Personal Income Tax	Somewhat negative	Best mechanism	Potential for informal employment and some tax planning by wealthy	Yes
Corporate Income Tax	Negative	Supports a progressive personal income tax	Substantial tax planning opportunities	Yes, unless the top marginal personal income tax rate is low
Note: The Table summarizes the impacts of applying different taxes in the region and this may result in simplification and some loss of detail, however this does not affect the overall impacts highlighted.				

Annex II: Operationalizing Tax Incentives

Best practice in operating a system of tax incentives involves accountability and transparency, an emphasis on rules over discretion, and effective monitoring and evaluation. Specific elements include: explicit prescription in tax statutes; clear eligibility criteria that could support a rules-based approach; the centralization of authority over tax incentive approvals; and ongoing evaluation of performance and results to ensure that the program is meeting the country's goals. These principles can increase the public's confidence that each taxpayer will be treated fairly relative to their competitors and neighbors, while eliminating the discretion and opacity that create corruption vulnerabilities. Best practices include:

- A country's investment code should explicitly prohibit the contractual provision of a tax exemption by any agent of the government and specify the eligibility criteria for each different tier of incentives.

- For those projects that meet the eligibility criteria, the legislation should require that the financial implications of each proposed tax incentive be thoroughly analyzed prior to debate and approval by Cabinet.

- The decision of Cabinet to approve one of the tax incentives allowable under the legislation should be gazetted. In addition, the public provision of information about the conditions and value of each discretionary tax incentive will allow unions and other third parties to help monitor the related conditions and could help mitigate the competitive inequities that are so harmful to the business climate.

A standardized, rules-based incentives package should be developed. A single package that would be available to any qualifying project is preferred to sector-specific packages, because sector-specific packages would lead to pressure from one sector to obtain any better concessions that were available to another sector, as well as for discretionary exemptions for sectors not covered by the available packages.

Providing tax incentives for long periods of time inappropriately binds the hands of future governments, and tax savings beyond 10 to 15-years into the future likely have minimal discounted net present value for investors. Customs and transaction tax exemptions, for example, should be limited to the development (e.g., construction) phase.

After investment, the authorities should continue to monitor businesses, to ensure compliance with the conditions of the project, and to provide the information and data necessary to evaluate the tax incentive program. For example, taxpayers must be required to file an income tax return annually so that the authorities can assess the revenue cost of the incentive and minimize tax planning opportunities during the period following the expiry of the tax incentive. The tax administrator should also periodically carry out audits to ensure that tax incentives are not abused. The Customs administrator should, similarly, have an effective program of post-clearance audits, to help ensure that goods imported with preferential treatment under a tax incentive are not diverted

to unapproved uses. Responsible agencies should also monitor projects so that other important non-tax provisions or commitments in the agreed and approved project are being maintained (for example, on employment generated or on standards of service).

Annex Box. Reforming Tax Incentives: Grenada and Jamaica Experiences

Recent IMF-supported programs in Jamaica and Grenada provide case studies of credible efforts to reform tax policy, including tax incentives, in the region. The focus of the reforms was to broaden the tax base, reduce rates, and move to a transparent, rules-based system for granting incentives to narrow the scope for discretion.

In Jamaica, the main reform for the tourism industry was the Fiscal Incentives Act (FIA) 2013. The FIA reduced both tax rates and tax expenditures by repealing several sectoral incentive programs including the Hotel Incentives Act. Key features of the FIA included:

- Reduction of the corporate tax rate to 25% from 33.33%;
- Employment tax credit, nonrefundable tax credit totaling the sum of all statutory payroll levies;
- Significant scaling back of discretionary waivers;
- Adjustments were made to depreciation allowances and loss carry forwards; and
- To encourage transition to the new regime, existing tourism projects had the option to either retain their exemption and pay the general consumption tax at the standard rate of 16.5% and giving up access to the employment tax credit, or moving to the new regime, continuing to enjoy a lower general consumption tax, and accessing the employment tax credit.
- A Large-scale Projects and Pioneer Industries Act that limits total incentives that may be applied for pioneer industries to a cumulative total 0.25% of GDP.

Grenada undertook a comprehensive reform of the tax incentive regime with the introduction of the 2014 Investment Act (with further amendments in 2016) and a series of amendments to the individual tax acts in 2015-16. The legislative amendments removed discretion in the granting of tax incentives and codified specific incentives into Grenada's tax laws.

- The new framework provides tax incentives targeted at qualifying investments in priority sectors including tourism. The Income Tax Act provides for a 100% investment allowance (usable over a ten-year period) for corporate income tax, which permits investors to recover qualifying investment costs through operating profits before paying corporate income tax.
- Changes to VAT supported investment in an administratively resilient manner: a VAT suspension regime was established for goods imported to undertake investment in a priority sector.

In Jamaica and Grenada there is no evidence that the reforms to the incentive regime has negatively impacted foreign investment in the economy, particularly in tourism. In Grenada the successfully implemented IMF-supported program resulted in a significant turnaround in Grenada's economic performance and the FDI to GDP ratio increased averaging 12.6% of GDP in 2017-18 compared to an Eastern Caribbean Currency Union average of 9.1% of GDP.