NEW DIRECTIONS IN BAHAMIAN ECONOMIC POLICY:

SOME THOUGHTS ABOUT TAXATION

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Distinguished Rotarians and Invited Guests,

It is said that "death and taxes are inevitable." The difference is that death occurs but once, while taxes are a daily affliction. Today, tomorrow, next week, and next month you will pay one or more of the following taxes: company fees and registration, motor vehicle tax, departure tax, import tax, stamp tax, export tax, property tax, payroll tax, and a raft of fees and charges. The import tax, which generates 63% of tax revenue and 57% of combined tax and non-tax revenue, is especially onerous. It shows up in the price of virtually everything you buy, whether directly in imported goods or indirectly in locally-produced goods that use imported materials (unless you live in Freeport). Make no mistake about it: The import tax is a massive sales tax that hits low-income Bahamians especially hard.

If "death and taxes are inevitable," then new and higher taxes are equally inevitable. The coming years will see a higher ceiling on payroll taxes for the National Insurance Board, a new tax for a contributory unemployment insurance scheme, and yet another new tax for catastrophic health insurance.

Despite what you may regard as heavy taxation in The Bahamas, by world standards your islands are both a "low tax" jurisdiction and a "tax haven." Bahamians pay about 20% percent of their national income to the government in one form or another, compared with much higher shares of 35-60% in the United States and Western Europe.

What makes The Bahamas a "tax haven" is the absence of direct taxation. There is no income tax, capital gains tax, gift tax, wealth tax, or estate tax. Bahamian can earn income without regard for personal income taxation. Instead, they pay taxes when that income is consumed.

No system of taxation is perfect, including that of The Bahamas. Indeed, there are several flaws with the current revenue system, which I want to talk about today.

First, the heavy reliance on import duties has reached the limits of its capacity. The tax is widely evaded. It results in a high cost of living. It is seriously regressive. It encourages Bahamians to fly to Miami to shop to buy stereos, clothing, furniture—you name it, they buy it there. In its recent tariff reform, the government has recognized the need to simplify the tariff and lower its rate structure. These pressures will continue.

Another problem is that reliance on import duties conflicts with the Central Bank's system of exchange control, as I explain momentarily.

Second, the payroll tax has been abused. Under the goal of establishing a public pension scheme, the payroll tax has facilitated a massive buildup in public debt, which has been spent largely on government consumption. The payroll tax amounts to Bahamians robbing themselves tomorrow to finance current consumption—eating one's cake and planning to have it, too. The National Insurance Board's promise to pay pensions depends on earnings from its portfolio of government debt. That stream of future earnings is not collateralized by "real" assets, but rather by "fictitious" assets of public debt, which, bluntly put, is an unfunded liability of taxpayers.

In economic terms, the present value of the NIB's assets is zero. At some future date, the Bahamian economy will be unable to afford the high level of taxes required to honor the unfunded liability of the NIB. This means that the real value of pension benefits will steadily decline in years to come until the public pension system is effectively bankrupt.

Let me acknowledge that I'm not the first person to explore the tax system of The Bahamas. In addition to inquiries conducted by the Inter-American Center of Tax Administrators during the 1990s, in 1991 the Council of Economic Advisers, five distinguished Bahamians including the current Minister of Finance and Planning, issued its "Report on Taxation in The Bahamas." It was a wide-ranging review of recent budgetary performance and options for additional taxation. It rejected the imposition of income or sales taxes and sought to sustain the heavy reliance on import duties, with slight modifications in the revenue base of the country. The report shied away from recommending any comprehensive reform of tax and non-tax sources of revenue.

The report focused on "recurrent" revenue and expenditure and paid virtually no attention to capital expenditure, which has been a major source in the rising public debt. Down playing capital expenditure presents a more optimistic view of the public finances than is justified by looking at the total picture. The underlying notion is that borrowing to finance capital expenditures can be repaid from the earnings of capital investment. Unfortunately, governments rarely set prices at levels that are sufficient to cover current operating costs, much less an allowance for the cost of capital, and The Bahamas is no exception in this regard. And much of what is labeled capital investment is, in fact, consumption.

The CEA also recognized that the government has systematically spent more than it has taken in since independence. Despite the steady growth in total revenue from about 14% of GDP in 1980 to more than 20% today, public spending has grown even faster. At the end of 1996, the direct national debt amounted to $1.24 billion, up sharply from $780 million in 1991, and total public debt stood at $1.54 billion. These trends are worrisome as the residents of Jamaica would be quick to advise. The government is thus under constant pressure to find new or additional sources of revenue and is forced to sell long-term government debt to finance its chronic deficits, which amounts to nationalizing domestic savings.

Debt repayment and interest payments on the outstanding debt constitute a substantial portion of annually recurrent expenditure. Total estimated outlays in the 1996/97 budget on interest and principal repayments amount to $178 million, which constitutes 23% of a total of $767 million in planned recurrent expenditure. Money spent on debt service and repayment is not available for spending on roads, schools, or health care.

It is important to debunk the notion that "the debt is owed to ourselves." If that were true, it would be a license to incur unlimited debt. After all, we would just owe ourselves more money and our liabilities would be offset by our assets. The fact is that the debt must be serviced and repaid out of current taxation, and those taxes constitute a disincentive to private sector business activity. If there were no public debt in The Bahamas, there would be room for dramatic tax reform and reduction, the government could abolish exchange control virtually without risk, and money would be available for infrastructure and other critical public requirements.

Composition of revenues

While the total tax burden is an important factor in any country's economic climate, the composition and rates of taxation are equally important. How dependent is the country on one or two revenue sources? How high are rates of taxation? The Bahamas relies too heavily on one source, import duties.

Import taxes and stamp taxes make up almost three-quarters of tax revenue. The International Monetary Fund assisted the government with a review of its tariff schedule, and an improved customs regime was implemented in 1996. Departure, property, selective services, and motor vehicle taxes contribute the remaining major shares. Fines, forfeits, and administrative fees supply the majority of non-tax revenue. Income from public corporations paid into the central treasury is negligible, suggesting that public enterprises are not being run on a commercial basis, i.e., not earning a real market rate of return.

A key problem with the revenue structure is that any decline in imports puts enormous pressure on the public finances. But there is another important reason why heavy dependence on imports is undesirable as the most important source of tax revenue. The country's revenue system is in conflict with its system of exchange control. Rising imports generate higher revenues. But rising imports also drain foreign currency reserves. The Central Bank regards a certain minimum level of foreign reserves—several months worth of imports—as necessary to insure the US$1 = B$1 exchange rate. Thus, the possibility of higher revenues from import duties conflicts with the Central Bank's exchange-rate policy. If reserves decline, then economic policy decisions must be taken to slow imports (e.g., raise domestic interest rates). The Central Bank issued such a warning in autumn 1995 as foreign reserves declined to worrisome levels. Thus, maintaining parity between the Bahamian and U.S. dollars may compel a reduction in imports, which consequently reduces the chief source of state revenue. There is no corresponding mechanism that simultaneously reduces expenditure. In fact, there may be pressure to increase expenditure (because falling import duties reflect a slowdown in economic activity).

Tax Reform

The main options to the current tax system include direct taxation (income taxes on individuals and business firms, gross premium taxes), indirect taxation (sales taxes, value-added taxes, excises), greater reliance on payroll taxes, and much greater reliance on fees and charges.

The Bahamas is not alone as a low tax, tax haven jurisdiction. Its rivals include Bermuda, Hong Kong, the Cayman Islands, the Channel Islands, and numerous other small nations and territories. There are valuable lessons to be learned from the revenue systems found in these other jurisdictions. I have had the opportunity to visit and speak with tax authorities in each of these jurisdictions. I'd like to share with you some observations from Bermuda and the Channel Islands of Jersey and Guernsey.

Bermuda. Let's begin with Bermuda, a fellow Caribbean nation, that lives off tourism and offshore insurance services.

Bermuda differs from The Bahamas in one important respect. It has avoided the buildup of a large public debt. By law (the Government Loans Act 1978), the total public debt, including loan guarantees, cannot exceed 10% of revenue. The current legislative cap is $185 million, but the actual amount of debt is $78.3 million, along with $35.4 million of guarantees on borrowings of the Bermuda Housing Corporation, which makes low-cost housing loans. Debt and guarantees outstanding of $128.5 million are less than 7% of GDP and debt service payments constitute about 2% of public expenditure.

In terms of the overall tax burden, Bermuda resembles The Bahamas in that central government revenue has ranged from a low of 16.9% of GDP in 1977/78 to a high of 20.9% of GDP in 1991/92 during the past 20 years.

Bermuda, like The Bahamas, regards itself as a tax haven. It imposes no income, capital gains, wealth, gift, or inheritance taxes. No transfer taxes are imposed on non-resident entities.

The difference is found mainly in the composition of revenue. The primary sources of revenue and the share each contributes in fiscal 1995/96 were as follows:

- Customs $134.5 million   (31.6%)
- Payroll Tax $107.4 million   (25.2%)
- Companies Fees $31.1 million   (7.3%)
- Land Tax $22.5 million   (5.3%)
- Passenger Tax $20.5 million   (4.8%)
- Vehicle Licenses $15.5 million   (3.6%)
- Stamp Duties $17.4 million   (4.1%)
- Hotel Occupancy $11.9 million   (2.8%)
- Immigration $11.5 million   (2.7%)
- Post Office $8.4 million   (2.0%)
- All Other $45.4 million   (10.6%)

The trend lines in the main revenue sources are worth noting.

Customs Duty. Customs duty as a percentage of government revenue fell from 58.7% in 1970/71 to 43.4% in 1980/81 to 36.8% in 1990/91 to an all-time estimated low of 31.6% for 1995/96. Although customs duty will rise in dollar values, its share of total revenue is likely to decline in future years as tariff reform in Bermuda follows global trends toward harmonization. Bermuda implemented a major tariff reform that took effect on February 14, 1994. The rate schedule was simplified and rates of duty were imposed at 0%, 8.5%, 10%, 15%, 22.5%, and 33% depending on the item in question. For some items, a specific dollar rate of duty is imposed.

The customs duty is levied on cost plus packaging, but does not include insurance and freight. The geographical configuration of Bermuda, and the relative simplicity of the tariff code, make enforcement relatively easy, although there is growing concern in Bermuda that the remaining high duties on imports are encouraging shopping in the United States. (Does this refrain sound familiar?)

Payroll Tax. On April 1, 1995, Bermuda combined its hospital levy and employment tax into a single payroll tax. It is levied at a standard rate of 11.5% on cash and benefits paid to employees, and is collected on a quarterly basis. Employers can, at their discretion, collect up to a maximum of 4% from employees' remuneration. Self-employed persons are required to assess themselves for the purpose of the payroll tax. International companies may choose to report actual salaries or an assumed remuneration figure assessed against each employee.

The scope of the payroll tax is now nearly universal and it will soon become the leading source of central government revenues. The payroll tax is not specifically earmarked for a government-run pension or social insurance scheme, and is thus not a tax vehicle to buy government debt, as in The Bahamas. Certain items remain exempt from the tax such as employers' contributions to social insurance, the hospital insurance plan, approved retirement plans, hospital schemes, life insurance schemes, workmen's compensation schemes, and compulsory tips in hotels. Over the years, its scope and size have steadily grown, and one might expect the remaining exemptions to gradually disappear.

A general strategy of revenue collection is to impose as many direct fees and charges as can be levied on specific services (e.g., a 4% gross fee on income on persons providing corporate services to exempted businesses without a physical presence in Bermuda; banking license fees; professional licenses; land taxes that collect a portion of the capital gains on resales by non-Bermudians to other non-Bermudians; stamp duties on residential properties, etc.) There are no plans to impose a direct income, capital gains, wealth, or gift tax.

The Channel Islands. Let me conclude this geographical tour with a brief mention of the tax systems found in the Channel Islands of Jersey and Guernsey. The Channel Islands derive more than half their income from offshore financial services, with the balance principally from tourism. The relative size of their public sectors approximates that found in The Bahamas. The main difference is that Jersey and Guernsey rely heavily on a 20% flat tax on income, which includes a substantial personal allowance to exempt low-income households from the tax, instead of customs duties. Neither jurisdiction imposes a sales tax, VAT, an estate tax, a wealth tax, or capital gains tax.

Compliance with the Channel Islands' income tax is near universal and it is cheap to collect. The flat rate of 20% has remained intact for more than 50 years. The tax forms are simple and short. Due to the substantial personal allowances, the system is mildly progressive. The Channel Islands suggests that personal income tax can, and I stress the word "can," be compatible with a low-tax regime.

Offshore firms pay an annual registration fee, rather than any tax on overseas earnings.

Recommendations for Tax Reform in The Bahamas

Although I am best known for my advocacy of a flat-rate income tax in the United States, I am not eager to recommend an income tax for The Bahamas. The Bahamas derives considerable benefit from its "tax haven" status and it is not clear how Bahamians and the offshore sector would regard an income tax. Therefore, any shift to a tax regime as found, for example, in Jersey and Guernsey requires serious thought.

Here goes:

First, I would consider expanding the payroll tax, as has been the experience in Bermuda, which is the most ready source of higher revenue. The collection system is in place and works reasonably well. *However, and this is a big caveat, the revenues obtained from any new or higher payroll taxes must take the form of general revenue, rather than serve as a vehicle to to buy more government debt as is now the case with the National Insurance Board.*

How can this use of additional payroll tax receipts be assured? Parliament would have to enact a law which stipulates that any new revenue from higher payroll taxes be offset by a corresponding reduction in import or other taxes. It would also be desirable for Parliament to enact a balanced-budget law, which stipulates that the proceeds of revenue from additional payroll tax receipts, over and above the current rate, could not be used to buy new government debt.

Second, to go a little further, I would explore the imposition of a uniform value added tax, or VAT, as a comprehensive substitute for import taxes. VAT has been the revenue workhorse in many transitional, developing, and middle-income countries. The IMF has broad expertise and experience in its installation and implementation. It is a tried-and-proven system of revenue collection. If imposed on the economy's full range of goods and services, the rate can be kept low and the retail price of many goods in The Bahamas will fall, thereby expanding retail trade, with its associated employment. Money that now flies off to Miami will remain in The Bahamas. The current import tax is levied only on goods, not services, which narrows its tax base, and therefore requires high rates. High rates in turn encourage smuggling and evasion.

VAT is preferable to a retail sales tax because it is self-enforcing and more difficult to evade. Each party in the production and distribution system leaves a paper trail that makes it virtually impossible, *in a fully computerized system*, for any seller to avoid collection and transfer to the Treasury. Many countries with incomes and literacy standards well below that in The Bahamas have successfully installed VAT systems.

It would take time, at least three years, to install a VAT. But sooner or later the creaky customs regime will require a complete overhaul. Adherence to a hemispheric free trade agreement in the future will also require that the customs regime be dismantled and replaced with some form of domestic taxation. The sooner any well-designed reform begins, the better.

Third, the government should price all services, where possible, on a commercial basis. The public corporations should be privatized as quickly as possible, with the proceeds of privatization directed solely to reduce public debt, and the government's fee structure should be annually reviewed and updated.

Fourth, and perhaps first on any list, the government must consult widely with the public as it considers tax revision and tax reform options. The support of all sectors of the Bahamian people is necessary for the success of any serious change in the current tax system.

Finally, to do nothing and allow the current tax system to linger indefinitely is to ask for fiscal trouble in the years ahead. Sound public finances are an essential ingredient in any economic environment. The Bahamas needs to get its fiscal house in order, and addressing the problems of the current tax system is part of that effort.

Thank you very much for your kind attention.