THE RELEVANCE OF THE VALUE ADDED TAX TO ECCU MEMBER COUNTRIES

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INTRODUCTION

The member countries of the Eastern Caribbean currency union (ECCU) depend on indirect taxes, in particular taxes on international trade and transactions as their main source of revenue. However, the international trend towards trade liberalisation has threatened this traditional revenue source. The introduction of the Common External Tariff (CET) in most ECCU countries has resulted in the gradual reduction in the maximum rate of import duty from 45.0 per cent to 25.0 per cent.

ECCU countries have adopted policies to neutralise the loss in revenue from the reduction in import duty. The consumption tax on selected items has been adjusted upwards and some countries have adjusted the rate of the customs service charge. Constrained by an already narrow tax base, the avenues for adjusting existing taxes without distortionary effects on the economy would be exhausted.

International institutions such as the World Bank and the IMF are encouraging countries, particularly those undergoing structural adjustment programmes, to implement the value added tax (VAT) as a means of simplifying the tax structure and enhancing revenue in the medium term. Within CARICOM, three countries - Trinidad and Tobago, Grenada and Barbados - have implemented the VAT. In this context, the pressure will intensify on ECCU countries to implement the VAT, especially in light of the impending CARICOM single market and economy.

THEORETICAL ASPECTS OF THE VALUE ADDED TAX

A value added tax is levied on the value that a producer or retailer adds to his raw material or purchases, excluding labour, before selling the new product or service. It is collected at each stage in the production and distribution process and the burden is expected to be borne by the consumer. It is a broad based tax and should be implemented with few exemptions and zero rated goods.

There are three types of VAT, namely *gross product*, *income* and *consumption*. The various types of value added taxes are influenced primarily by the treatment of capital goods in the tax base. Of the three, the consupmtion based variant is most widely used.

The consumption type VAT allows deductions for all inputs including capital assets in calculating the tax. Therefore, gross investment is deductible and the tax base is equivalent to total private consumption.

The consumption type tax is neutral in respect to the production technique, be it labour or capital. This is because both factors of production are excluded from the tax base. In addition, the tax favours the development of an export sector as all exports are totally exempt from taxation. The consumption based value added tax is also said to be more administratively feasible.

CURRENT DEBATES ON THE VALUE ADDED TAX

The merits and demerits of the VAT are widely debated. Four arguments have been put forward in favour of the tax:

- Revenue Potential;
- Neutrality in Implementation
- Efficiency;
- Simplification of the Tax System.

Revenue Potential

The VAT is appropriately described as a broad based tax. In its pure form, the tax is implemented with few zero-rated items and exemptions, which ensure that the tax base is comprehensive. Because the tax is levied on a buoyant base, it creates a valuable source of revenue, particularly for countries with a limited income tax base and countries that encounter problems with the implementation of the property tax.

Neutrality in Implementation

A single rate value added tax with few exemptions and zero rated goods is considered non-distortionary or neutral with respect to economic behaviour. Consumers are not encouraged to change their pattern of consumption as the tax is applied on a comprehensive base. Additionally, if VAT on capital goods is fully credited, firms are not encouraged to change their method of production.

Efficiency

The tax is economically efficient as it is levied on the value added and avoids the cascading effects of some indirect taxes. It replaces numerous inefficient, distortionary and badly administered taxes. The introduction of an entirely new tax system creates the opportunity to revamp the administrative mechanism for the existing tax system.

Simplification of the Tax System

The VAT replaces complicated systems of indirect taxes levied at various rates and administered by various institutions. In addition, the VAT helps with the reduction in tax evasion because the invoice system is used as a control mechanism through the audit trail it creates.

The disadvantages of the VAT are generally related to the difficulties of administering the tax and the distributional effects of the tax.

In relation to the macroeconomic variables, VAT has a favourable impact on export earnings, but contributes to higher prices during the period of implementation.

VAT and Macroeconomic Variables

Inflation

Countries have experienced higher rates of inflation with the introduction of VAT, generally associated with the higher dependence on indirect taxes and the process of shifting the burden of indirect taxes to the consumers. Ignoring variations in price and demand elasticities, it is generally argued that price rises by the net effect of the VAT. This rarely occurs in practice. The impact on price is further complicated as businesses may take the opportunity to increase prices for reasons not associated with the VAT.

Exports

Exports are zero-rated in the VAT systems, which means that they are completely free from taxes. It is therefore argued that the VAT has a favourable impact on exports and could improve the country's balance of payments.

Some CARICOM countries have experimented with the implementation of VAT with varying degrees of success.

THE VAT IN TRINIDAD AND TOBAGO

The introduction of the VAT in Trinidad and Tobago was an integral part of comprehensive tax reform accompanied by the elimination of a number of indirect taxes.

The tax was levied at 15.0 per cent, after taking into consideration the rates of value added tax existing in other countries. The VAT was expected to be a broad based consumption tax, levied on domestic consumption as exports are zero-rated. In consideration of the distributional impact of the tax and for administrative reasons, some goods and services were exempt or zero-rated, among them staples such as flour, rice, milk, bread and cheese.

To eliminate the small firms that do not maintain proper records, the threshold for the VAT was initially established at TT$75,000 and later raised to $150,000. Services considered difficult to tax were excluded from the tax base, including insurance and banking services, and legal services. Medical and dental services were exempt. In addition to the exempt and zero rated goods, the sale of land and intangible assets such as stocks and securities, which do not constitute consumption, were excluded from the tax base. A number of taxes on domestic transactions were maintained. These include the hotel accommodation tax, the insurance premium tax, the financial services tax and the property tax.

The VAT office, within the Board of Inland Revenue, was established to administer the tax, which was implemented in January 1990. Prior to implementation extensive publicity campaigns were undertaken. The VAT office conducted training programmes for taxpayers, who were given the responsibility for collecting the VAT.

As a result of the tax credit system, there is need for refunds. The VAT office administers the tax refunds. The proportion of tax refunds as a percentage of VAT collected, continues to be an area of concern to the administration. Tax refunds are estimated to be approximately 30.0 per cent to 45.0 per cent of tax collection, which is considered high by international standards. A portion of the refund is related to tax credit granted on investment by petroleum companies.

The tax threshold of $150,000 exempts many small businesses. They are not required to register and although VAT is paid on purchases, they cannot claim the VAT paid on purchases and cannot charge VAT on sales. In the case of farmers, their products are zero-rated in the VAT system and they are granted a credit for taxes paid on their purchases.

The possibility of claiming taxes on input may have been an incentive for small enterprises and farmers to register. The large number of small taxpayers seems to be a burden to the tax administration, and the VAT office is now trying to eliminate some of the small taxpayers.

Construction is considered a taxable service. Therefore, contractors are required to pay VAT on input and charge VAT on output. The nature of the service is such that the value added is not easily verified and hence the output tax may be estimated to be significantly lower than the input tax, requiring the department to pay refunds to the contractors. The construction of residential homes is exempt from VAT and while the contractors pay taxes on input, they cannot claim the tax paid or charge tax on the sale of homes.

The yield from the VAT in Trinidad and Tobago has been generally higher than budgeted. However, the buoyancy of the tax system, which measures the growth in tax revenue as the economy expands, has been lower than anticipated. The high element of tax refunds, which is estimated at 30.0 per cent to 40.0 per cent of collections, may have contributed to the low tax buoyancy. In addition, capital goods and exports are zero-rated. To the extent that investment and exports contribute to economic growth, the buoyancy of the tax is significantly reduced.

THE VAT IN GRENADA

In Grenada the consumption type VAT, based on the credit system, was introduced in 1986 as part of a comprehensive redesign of the tax system. A number of arguments were put forward for the tax reform, namely:

- The existing tax system was complex;
- There was a haphazard distribution of tax burden among the population;
- Difficulties were encountered in effectively administering the tax system.

The Laffer Curve Theory that “lower taxes leads to higher revenue yield” was the foundation of the fiscal reform.

Among the fundamental changes to the tax system was the abolition of personal and corporate income taxes. In the new tax system, a business levy replaced the corporate income tax, and a value added tax, a modified land value tax and a petrol levy were introduced. The following taxes were maintained as part of the new tax system.

- The common external tariff
- The foreign exchange tax
- The motor vehicle tax
- Licences.

Reacting to the loopholes in the VAT legislation, the VAT was constantly amended. In 1988 the tax legislation was amended in an attempt to simplify the tax and the administrative mechanism for assessment and collection was strengthened. In that year a separate office was established for the implementation of the tax. In the following year the VAT was removed at the wholesale and retail levels and placed on importers and manufacturers. This was due to the difficulties experienced by the Inland Revenue Department in collecting the tax at both wholesale and retail levels. Eventually, the authorities resorted to the implementation of the tax at the port, in a manner similar to the previous consumption tax.

The VAT in Grenada was a failure. This was primarily related to the poor planning for the implementaion of the tax. In addition, the granting of concessions to various interest groups complicated the administration of the tax.

The VAT is administratively demanding. Its implementation should be preceeded by:

- Extensive education campaigns;
- The training of tax administrators;
- Proper tax administration;
- A comprehensive registration system;
- Appropriate legislation.

The lack of preparatory work, accompanied by constant amendments to the system, accounted for the failure of the VAT in Grenada. The VAT was not properly implemented and therefore conclusions cannot be made on its performance. In a system where the tax administrators and the public are not prepared for the implementation of the tax, the policy is almost doomed to fail.

How Relevant is The Value Added Tax to the ECCB Territories?

The relevance of the VAT to ECCU member countries is examined in the context of the planned movement towards a single market and economy. This requires the elimination of distortionary taxes and the harmonisation of tax bases among the member countries.

Within the direct tax structure, income tax and property tax need to be harmonised. The indirect tax structure also varies in the member countries of the ECCU. The variation in rates is accompanied by differences in administrative procedures. The consumption tax is a major source of revenue. However, in relation to exports, member countries do not have an efficient system for rebate on taxes paid on inputs into production. This is in the context of free trade within CARICOM where some countries have implemented a VAT and their exports are zero-rated. This development implies that the exports, in particular manufactured exports from ECCU countries, have a cost disadvantage relative to their CARICOM partners.

The existing consumption tax in most ECCU member countries is generally applied to goods. The services sector, which is the growing sector in the ECCU, is generally outside the tax net. Among the productive sectors the contribution of agriculture to GDP has been declining, while the contribution of the manufacturing sector to GDP has remained relatively small. In contrast, there has been an expansion in the tourism industry and other service industries such as informatics, banking and financial services and other professional services.

Specific taxes are applied to services and these include the hotel accommodation tax, the insurance premium tax, entertainment tax and the ticket tax. The indirect tax system is not applied on a comprehensive tax base of goods and services. The introduction of the VAT will broaden the tax base.

In this context, ECCU countries face the alternatives of either adopting tax regimes similar to their CARICOM partners, or establishing regimes with features similar to the other CARICOM countries. They can either introduce a VAT or modify the consumption tax. Modification of the consumption tax will involve broadening the tax base and incorporating an efficient system for the rebate on taxes paid on exports and capital goods. On theoretical grounds, the adoption of a VAT is ideal. However, an examination of the nature of the economies in conjunction with the main features of the tax, and in particular, the difficult aspects of administering the tax, suggests the need to strengthen tax administration prior to the implementation of the tax. In addition, extensive education campaigns will need to be undertaken.

Another consideration in the implementation of the VAT is the regressive nature of the VAT system. The introduction of the VAT should be accompanied by a comprehensive review of the tax system to ensure that it is not too burdensome on the poorer section of the population.

Given the administrative systems in ECCU countries and the nature of the economies, a minimum planning period of three years is required prior to implementing the tax. The following are preconditions for the successful implementation of the VAT:

- Strong political will;
- Extensive and effective education campaigns;
- Appropriate legislation;
- Skilled tax administrators;
- Adequate computer system; and
- An effective tax auditing system.

Recommendations for ECCU countries

The following general features of the tax structure are recommended for member countries of the ECCB.

Taxes on Income and Profits

Personal Income Tax: should be levied with a basic threshold with approximately three tax brackets and minimum exemptions and deductions. The maximum income tax rate should be approximately 35.0 per cent.

Corporate Income Tax: levied at a maximum rate of 35.0 per cent and integrated with the tax on personal income.

Taxes on Property

Levied on the market value of property

Taxes on Domestic Goods and Services

The General Consumption Tax or The Value Added Tax: levied at a basic rate of 10.0 or 15.0 per cent. The tax will include the hotel accommodation tax, travel tax and other domestic goods and services. (The financial sector should be exempt).

Licences: Generally granted on the permission to use goods and perform services.

Taxes on International Trade and Transactions

Import Duty: in keeping with regional and international agreements.

Customs Service Charge: levied on all imports at a rate that is less than 5.0 per cent.

Embarkation Tax: Paid by persons departing from the airport.

Cruise ship Passenger Tax: Levied on cruise ship passengers.

Improvement in Administrative Systems

The existing system of tax collection could be improved by:

1. Ensuring comprehensive taxpayer registration;

2. Issuing a tax number which can be used for paying all taxes and for other government transactions;

3. Greater use of third party information such as banks, national insurance schemes to improve the coverage of taxpayers;

4. Greater collaboration among the tax collecting agencies;

5. Continued emphasis on improving tax administration.

Conclusion

A comprehensive value added tax is economically efficient and hence desirable. The main constraint to the implementation of the tax is its administrative demands. Firstly, a cadre of trained personnel is needed to effectively implement the tax. The tax is based to a large extent on self-assessment. Taxpayers must be acquainted with the calculation of tax liability and must be willing to pay their fair share. This requires extensive consultation and effective educatioin and publicity campaigns aimed at ensuring tax compliance. The record keeping demand is tremendous but this is required to accurately determine tax liability. The tax is technically sound. However, public education is important and the tax administration needs to be thoroughly prepared to implement the tax. In particular, it requires strong political will and very skilled tax administrators. It is also necessary to calculate the potential yield from the VAT compared with the existing system of indirect taxes.

The views expressed in the preceeding article are those of the author and do not necessarily reflect the ECCB's position.