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Comprehensive Tax Reform in Jamaica

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When the fiscal situation of a country gets too far out of control, government will often call for a comprehensive review of the tax system to try to get back on a sustainable path. Jamaica is just such a case. The Government of Jamaica called in 2005 for a tax reform to address the fiscal problems. The articles in this special issue of Public Finance Review, and this overview, describe the analytic work that was undertaken to support Jamaica’s comprehensive tax reform efforts. The contributions here are in the approach taken, in the analytic work, and in the lessons from these efforts.

Keywords: tax reform; horizontal and vertical inequities; neutrality; microsimulation modeling; CGE modeling

1. Introduction

Tax reform in any developing country is a challenge. Public service needs put upward pressure on government budgets while the competitive investment climate appears to be calling for lower taxes. Economic growth is often too slow to support an “adequate” revenue growth, and trade liberalization and international capital mobility constrain options for tax reform. Some developing economies have reacted to the situation by overborrowing, or by making unwise tax choices on grounds of revenue exigency. Others have panicked at the thought of losing economic base or political favor and have given in to the demands of special interest groups for tax preferences. When the fiscal situation gets too far out of control, government will often call for a comprehensive review of the tax system to try to get back on a sustainable path.

Jamaica is just such a case. Fiscal deficits have been the norm over the past decade. As shown in table 1, public debt as a percentage of gross domestic product (GDP) grew to 142 percent by 2003-2004 (Bahl and Wallace 2004). Real GDP growth was lackluster through 2001, but there has been improved economic performance beginning in 2003. Still, per
capita real GDP was lower in 2004 than it was in 1994. There was a belief that, in part, the tax structure led to this weak economic performance. While taxes as a share of GDP are about 24 percent, which is in line with a simple average of tax burdens across small countries, there is a perception by many Jamaicans that taxes are “too high.” For those who comply with the tax laws, this perception may be a reality. The combination of these factors—large deficits, a slow growing economy, and a perception of high and unfair taxes—means that families and businesses are operating on tight margins and will resist tax structure changes that might increase their burdens.

The government called for a tax reform to address such problems. The articles in this special issue of Public Finance Review, and this overview, describe the analytic work that was undertaken to support Jamaica’s comprehensive tax reform efforts in 2005. The contributions here are in the approach taken, in the analytic work, and in the lessons from these efforts.

2. Approach

There are not hard and fast rules about the best way to do a tax reform study. Numerous experts and international institutions have led tax reforms, and in some cases, the lessons learned have been written down. Examples are Goode (1984); Gillis (1989); Harberger (1989); Bahl (1991); Thirsk (1991); McLure and Zodrow (1996); Bird, Poterba, and Slemrod (2005); and the World Bank (1991). A review of these studies leads to the not-so-surprising conclusion that there is not complete agreement on the best approach to tax reform. While the thinking about the elements of good tax structure (e.g., fairness, neutrality, revenue adequacy) has not changed all that much, the setting in which tax reform must be packaged has changed quite a lot. In particular, increased capital mobility and trade liberalization have significantly limited the options for tax structure redesign, and there is more hesitancy to recommend source based taxes on capital income and high statutory rates.

The result has been some change in the emphasis on various elements of the tax structure. Owens (2005) listed the following among the trends in tax reform among OECD countries: “green” or environmental taxes, simplification in taxes, and changes to tax systems that promote investment and growth. This has led to reduced corporate and individual income tax rates and expanded tax bases achieved by eliminating or reducing targeted relief programs and various loopholes and exemptions. Another trend noted by Owens is reduced taxes on dividends and a general increase in the reliance on consumption taxes.
## Table 1

**Performance of the Jamaican Economy: Selected Indicators**

<table>
<thead>
<tr>
<th>Year</th>
<th>Real GDP (in J$ million)</th>
<th>Real GDP Per Capita (in J$)</th>
<th>Percentage Change in Real GDP (IMF Definition)</th>
<th>Public Debt as a Percentage of GDP</th>
<th>Fiscal Balance as a Percentage of GDP</th>
<th>Fiscal Balance as a Percentage of GDP</th>
<th>Budget Balance as a Percentage of GDP</th>
<th>Primary Surplus as a Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-1993</td>
<td>240,507</td>
<td>99,383</td>
<td>1</td>
<td>115.3</td>
<td>-2.4</td>
<td>-0.1</td>
<td>2.2</td>
<td>12.0</td>
</tr>
<tr>
<td>1993-1994</td>
<td>244,580</td>
<td>99,829</td>
<td>1.7</td>
<td>119.6</td>
<td>-2.4</td>
<td>-0.2</td>
<td>1.6</td>
<td>11.8</td>
</tr>
<tr>
<td>1994-1995</td>
<td>248,912</td>
<td>100,774</td>
<td>1.8</td>
<td>101.2</td>
<td>-2.2</td>
<td>-2.0</td>
<td>3.9</td>
<td>13.3</td>
</tr>
<tr>
<td>1995-1996</td>
<td>248,964</td>
<td>99,586</td>
<td>0.0</td>
<td>96.9</td>
<td>-4.1</td>
<td>-0.8</td>
<td>2.5</td>
<td>10.8</td>
</tr>
<tr>
<td>1996-1997</td>
<td>246,139</td>
<td>97,288</td>
<td>-1.1</td>
<td>79.8</td>
<td>-14.2</td>
<td>-12.0</td>
<td>-5.7</td>
<td>5.6</td>
</tr>
<tr>
<td>1997-1998</td>
<td>244,579</td>
<td>95,913</td>
<td>-0.6</td>
<td>84.2</td>
<td>-6.8</td>
<td>-15.6</td>
<td>-9.6</td>
<td>1.9</td>
</tr>
<tr>
<td>1998-1999</td>
<td>242,377</td>
<td>94,310</td>
<td>-0.6</td>
<td>86.0</td>
<td>-7.2</td>
<td>-13.7</td>
<td>-11.9</td>
<td>5.4</td>
</tr>
<tr>
<td>1999-2000</td>
<td>245,836</td>
<td>94,917</td>
<td>1.1</td>
<td>100.0</td>
<td>-4.9</td>
<td>-4.1</td>
<td>-8.1</td>
<td>9.4</td>
</tr>
<tr>
<td>2000-2001</td>
<td>247,792</td>
<td>95,305</td>
<td>0.8</td>
<td>100.7</td>
<td>-1.2</td>
<td>1.0</td>
<td>-4.5</td>
<td>11.5</td>
</tr>
<tr>
<td>2001-2002</td>
<td>250,359</td>
<td>95,557</td>
<td>1.0</td>
<td>132.1</td>
<td>-2.7</td>
<td>-5.2</td>
<td>-5.6</td>
<td>7.8</td>
</tr>
<tr>
<td>2002-2003</td>
<td>255,198</td>
<td>97,404</td>
<td>1.9</td>
<td>140.5</td>
<td>1.0</td>
<td>-7.3</td>
<td>-7.6</td>
<td>7.3</td>
</tr>
<tr>
<td>2003-2004</td>
<td>260,302</td>
<td>98,599</td>
<td>2.0</td>
<td>142.8</td>
<td>1.0</td>
<td>-7.4</td>
<td>-7.0</td>
<td>11.1</td>
</tr>
</tbody>
</table>

Source: GDP data are from the Ministry of Finance and Planning, Jamaica, www.mof.gov.jm, unless otherwise noted.

c. Fiscal balance is current and capital revenue and official grants received, less total expenditure and lending minus repayments. Data are from World Bank (2004).
d. Fiscal balance is the difference between total revenues and total expenditures. Data are calculated using data from the Ministry of Finance and Planning, Jamaica, www.mof.gov.jm.
e. These estimates are based on International Monetary Fund data.
There also are different ideas about how the research itself should be approached. Some take the view that each tax should be restructured to meet the tests of a good tax and that this will add up to a good tax structure. Others take a more comprehensive view and argue that it is the systemwide effects that matter. There also are differences in the view about what ought to drive restructuring (e.g., equity, economic efficiency, simplification). Finally, there appear to be differences about whether tax structure redesign can take place without a careful study of the tax administration system.

The approach taken in this tax reform was guided by the following rules:

- It would be comprehensive, and “system” impacts would be viewed as important as the impacts of changes in individual taxes. Comprehensive reform puts every piece of the tax structure on the table for review and puts each at risk in terms of being a candidate for reform. It also takes a broader view in terms of assessing impacts. For example, it is more important for the tax system to achieve the desired degree of vertical equity than for every tax in the system to be vertically equitable.

- The work would be empirical and would make use of detailed data drawn from government files and various tax accounts. The goal would be to simulate the impact of alternative reforms to demonstrate the trade-offs involved. Econometric estimation, microsimulation analysis, and computational general equilibrium (CGE) modeling were all involved in this analysis. The reform options should be based on detailed study of the laws and administration underlying each tax. We firmly believe the Casanegra de Jantscher (1990) axiom that “tax administration is tax policy.”

- The final package recommended would be revenue-neutral but would be heavily weighted toward reforms that address economic efficiency issues. This choice is based on what we see as the major issue that tax policy change can address: the correction of some biases in investment and consumption choices that the tax system has put in place.

3. The Setting

In the 1980s, Jamaica enacted a major tax reform. At that time, Jamaica was struggling with weak economic growth, a tax system that was perceived as unfair and arbitrary, and bouts of social unrest. The 1980s reform ushered in a flat rate individual income tax that significantly reduced the number of exemptions and allowances and established a value-added tax (the general consumption tax, or GCT). The next decade was a time of relative prosperity in Jamaica, when gross domestic product expanded and investment increased. However, since 1993-1994 low economic growth has damaged
Jamaica in many ways: slow growth in jobs and real wages, limited new
government revenues to address social and infrastructure investment needs,
and a flagging confidence on the part of investors. The unemployment rate
has remained in the 15 percent range. The percentage of the population with
income below the poverty level, though down in recent years, is still greater
than 15 percent. One question to be addressed in this tax reform analysis is
whether and to what extent the tax system contributed to these problems and
how tax reform might alleviate some of the stress.

Jamaica also is constrained in its reform options by several exogenous
factors. There are a number of tariff agreements that cannot be changed in
the near term, negotiated incentive packages that cannot be terminated in
the short run, deficits and debt burdens that must be reduced, and preferen-
tial tax treatments that have been around long enough to have become both
accepted and entrenched. Any proposed tax reform must be cognizant of
these complications.

On average, tax revenues have kept pace with GDP over the past decade,
automatically in some years and because of legal changes in other years.
The deficit has arisen because of a demand for government spending (the
cost of servicing the heavy debt burden and coverage of a wage bill for a
growing public employment sector) that requires a GDP elasticity much
greater than unity. Based on an international comparison, we come to the
conclusion that Jamaica is not a high-taxing country but note that it places
an unusually heavy emphasis on income taxation.

Who pays Jamaican taxes? Overall, the pattern is progressive. Jamaican
households in the lowest decile pay 24 percent of their (estimated personal)
income in taxes, while those in the top decile pay 39 percent (Alleyne 2006
[this issue]). By international standards, this is a significant degree of pro-
gressivity. The implication of this finding is that the tax reform program
need not be driven primarily by vertical equity considerations.

4. Tax Structure

The Jamaican tax structure is weighted heavily toward income taxes
(more than 40 percent of total taxes). The largest share of income tax is the
flat-rate pay-as-you-earn (PAYE) tax on labor, comprising more than 20 per-
cent of total tax revenue. The corporate income tax is at a flat rate of 33 1/3
percent. The remaining taxes include taxes on dividends, interest, and the
self-employed. In addition to a company and an individual income tax, there
are five payroll taxes, variously levied on employees and employers. The
latter include the Human Employment and Resource Training (HEART) tax, whose revenues are earmarked for manpower development; and the Education Tax, which is a general fund revenue source. The remaining three payroll taxes are for pensions and housing.

Property is taxed in three ways. A stamp duty and a property transfer tax are levied on sales of real property and the transfer of financial instruments. The real property tax is levied only on land values, under a complicated, graduated rate structure. Together, these property taxes account for only 4.7 percent of total tax revenues.

Indirect taxes consist primarily of a value-added tax (GCT) and a set of special consumption taxes (SCTs) or excises. The former is characterized by an extended list of zero-rated and exempt items and is levied at a basic rate of 15 percent. The latter raises revenues primarily from fuel, tobacco, and alcohol.

Taxes on international trade include basic tariffs and various surcharges on imports (e.g., an additional stamp duty and a customs user fee). These account for about 8 percent of total taxes and are low by international standards.

A snapshot of the tax structure identifies some potential difficulties for economic development—high taxes on labor, which may cost Jamaica in terms of competitiveness; a relatively high corporate income tax rate; and a number of holes in the system such as the extended list of zero-rated and exempt items for the GCT. We turn next to a more detailed discussion of the problems of the system.

5. Problems with the System

The basic structure of Jamaican taxes is sound. The individual income tax is a flat-rate tax with a standard deduction, social security is financed with a payroll tax, the property tax is levied on land, the major indirect tax is a value-added type, there are excises on the sin consumption items (drinking, smoking, and driving), and there is not an unusually high reliance on taxes on international trade. These are all desirable features to have in a modern-day tax system. The need for a tax reform is driven by serious problems with the structure of each of these taxes and perhaps with how the tax system is balanced between direct and indirect taxes. In fact, there is much to reform.

5.1. Tax Administration Is Weak

For many years, Jamaica has been plagued by problems with its tax administration. Some in Jamaica have termed it a “culture problem,” meaning
an unwillingness of citizens to accept the idea that the payment of taxes is a civic responsibility. The Jamaican tax administration is still reaching for the easier “tax handles” in that it lives off the revenues from PAYE income tax revenues, interest income taxes that are withheld by banks, and GCT collections from a relatively small number of firms. Much of the legal tax base goes untapped. This situation gives rise to horizontal and vertical inequities, revenue loss, and an erosion of confidence in the fairness of the system.

Other problems with the tax administration have their root causes in the tax structure: the tax base has been narrowed by preferential treatments, certain features of the system distort economic choices and harm resource allocation, and over time the rate and base structure have become complicated. The structural and administrative problems are not independent. Complication in the rate and base structure makes administration more difficult and reduces the compliance rate.

5.2. Is There a Revenue Problem?

When the government took on a significant amount of debt to deal with the bankruptcy of much of the financial sector, it assumed responsibility for pushing revenue mobilization to considerably higher levels than would otherwise have been the case. In fact, between 1998 and 2003, the level of taxation increased from 22.1 percent of GDP to 24.5 percent. The fiscal situation at present suggests (to some external observers) that this level of taxation may not be high enough (Artana and Naranjo 2003).

The government has continuously run a budget deficit over the past decade. While this seems to have been better controlled in recent years, it still amounts to about 2 percent of GDP. To address the debt service problem and to reduce the deficit, the government has committed to a primary surplus of about 14 percent of GDP in the medium term. By some estimates, this will require an increase in revenues equivalent to nearly 2 percent of GDP in the next fiscal year (International Monetary Fund 2004a, 12-13). If this revenue shortfall is not resolved through expenditure reductions, or additional collections of arrears, or if the economy does not grow out of it, a tax reform package will need to be accompanied by a revenue enhancement package. A reasonable goal is for any necessary revenue enhancement, particularly a rate increase, to be applied to a sound tax structure. In short, a good fiscal rule might be to get the structure right first, then discuss the needed discretionary increase in tax rates.
5.3. The Tax System Is Too Ad Hoc

Jamaican tax policy has become increasingly focused on meeting the needs and wishes of specific sectors and individuals. In many ways, it has become overly friendly to some taxpayers. A considerable amount of tax exoneration has been granted to firms, very specific items of consumption (e.g., school bags), and sources of income (e.g., gratuities). As the system has moved away from a rule-based approach toward one that is characterized by numerous “special treatments,” the goal of fairness in taxation has been compromised. The movement away from a rule-based system, and toward less transparency in the tax system, sometimes invites corruption. Transparency International (2004) placed Jamaica 74th among 146 countries ranked in 2004 (where a lower rank signifies less corruption). In a comparison of corruption in Caribbean countries, Kaufmann, Kraay, and Mastruzzi (2003) ranked Jamaica 13th of 20 countries (where 1st is least corrupt) and showed that Jamaica’s standing has slipped in the past four years.

The tax regime has become more ad hoc in three important ways: the granting of discretionary waivers, formal tax relief, and administrative practices that lead to a differential treatment of certain individuals and certain companies. All of these lead to revenue losses and introduce an element of unfairness into the tax system, which may in turn reduce overall compliance with the system.

5.4. The Tax Base Is Too Narrow

The “comprehensive” tax base has been narrowed in two important ways. One is legal and may take the form of exemption or preferential treatment. The other is because of administrative failures.

An analysis of the tax expenditures in the Jamaican revenue system suggests a revenue cost in excess of 60 percent of the tax revenue actually collected in 2002-2003 (Bahl and Wallace 2004); that is, for every J$100 of revenue collected in Jamaica, another J$60 is formally given in tax relief. This number does not include the losses due to tax evasion.

The tax base is also markedly narrowed by tax evasion and by an enforcement program that is unable to catch up with the hard-to-tax. We estimate that individual income tax revenues could be at least 50 percent higher if the self-employed were fully compliant. We also find that some combination of a low rate of voluntary compliance and a low rate of coverage has led to only about 17 percent of profits being reported for company income taxation in 2003. The average “true” effective tariff rate of 10.8
percent is well above the collected rate of 5.3 percent. The collection rate for the property tax is less than 50 percent.

5.5. Tax Incentives Are Used Widely and with Little Formal Evaluation of Their Effects

The Jamaican government has long believed in its ability to pick winners in economic development. Judging by its actions, the government has long believed that taxes are an appropriate policy instrument to use in attracting investment. In fact, the government does not know the full extent of the incentives it has given; nor are these tracked on a regular basis. The tax reform project estimates that the number of separate incentives and remissions number nearly two hundred thousand, and the amount of tax forgiven is equivalent to about one-fifth of total government tax revenues in 2003. The policy question is whether the time has come to scale back and rationalize this program or whether it should be continued in its present form as a key element of national industrial policy. This choice is not an easy one, either in terms of the economics or the politics.

The tourism sector is particularly troublesome with respect to the question of incentives. On one hand, tourism is an important export sector of the economy. Conceptually, its inputs might be properly zero rated under GCT. Instead, the tourism sector is given a number of different incentives, including duty-free imports, GCT relief, income tax breaks for payment of gratuities, and corporate tax exoneration. If there is an overarching objective to the incentive package provided, it is not clear what it is. The sector itself argues strongly that it must retain the preferences it receives, if it is to remain attractive to investors (Jamaica Promotions Corporation [JAMPRO] 2004).

The international agencies that advise Jamaica are not as enthusiastic about the value of these targeted incentive programs. A recent Inter-American Development Bank (IADB) report (Artana and Naranjo 2003) is skeptical about the impacts of the various incentives provided and proposes that the government bring these under careful review. A recent International Monetary Fund mission suggested “the removal of the many exemptions that narrow the consumption tax base and the elimination of reduced rates and other features that complicate the tax system” (International Monetary Fund 2004a, 13). A government study proposes a repeal of the existing legislation and adoption of an approach that is more broad-based and targeted on investment in infrastructure, human capital, and research and development rather than specific industries (Development Council 2001).
5.6. The Tax System Introduces Many Horizontal Inequities

Horizontal inequities in the Jamaican tax system have weakened confidence in the tax regime and arguably may have encouraged some taxpayers to look for avenues of nonpayment that will have negative consequences for revenues.

The many horizontal inequities in the Jamaican tax system include the following:

- Some individual income tax payers receive nontaxable allowances while others either do not receive allowances or receive them at a lower rate. The result can be very different tax burdens, even for households with the same income.
- Some consumers face very different GCT rates than others (e.g., in the case of the purchase of motor vehicles).
- The company income tax discriminates among firms, largely because of the array of favorable tax preferences that are given to some.
- Relief on import duty is provided for some goods but not others, due mainly due to negotiated special treatments.
- The absence of a capital gains tax gives a decided advantage to capital income versus other forms of income.

5.7. The System Is Overly Complicated

There are numerous features in the Jamaican tax system that add to its complexity:

- For the property tax, eleven property value categories are specified, and caps on the maximum amount of property tax to be paid are specified for each value class.
- On the surface, Jamaica’s GCT has a simple rate structure: 0 and 15 percent. In practice, Jamaica does not have a uniform rate GCT but rather a complicated system with multiple rates.
- The tariff structure is complex. There are ten basic tariff categories, but within each there are numerous exemptions and the rates can vary widely. In addition, several other taxes are imposed on imported goods.
- There are five payroll taxes, with separate administrations and separate rate and base structures. Two of these, the HEART tax and the Education Tax, are simply additional income taxes.

Each of these special treatments has the potential to complicate the tax system. Complication, in turn, leads to higher administrative costs, more arbitrariness
in administration, and an erosion of confidence in the tax system. Taxpayers are prone not to pay a tax that they do not understand, they shy away from full compliance when compliance costs are high, and they are more likely to escape paying their full tax obligation when the government is given a complicated job of classifying taxpayers and monitoring their compliance.

5.8. The Tax System Generates Significant Efficiency Costs

The Jamaican tax system introduces a great number of distortions in relative prices. For example, the efficiency of the individual income tax is significantly compromised by six features of the tax structure: the differential taxation of capital income, the difference in the corporate and individual income tax rates, the availability of allowances, incentives for certain industries, special tax treatment for certain sectors (tourism), and the proliferation of noncompliance.

The corporate income tax fails the economic efficiency test by its favored treatment of certain investment choices and even certain sectors of the economy. The result is that some investment decisions are led by tax considerations rather than by market forces. The property transfer taxes in Jamaica are widely decried as an impediment to a properly functioning market. A tax rate of 13 percent is large enough to discourage the transfer of land, to find means of transfer to avoid the tax, or to stimulate an aggressive appeal for discretionary relief. The combination of tariffs, GCT, and SCT rates and exemptions give rise to numerous tax rates for similar goods.

A CGE model developed for this project shows that the distortions in the present tax system create significant excess burdens. For example, raising an additional 1 percent of GDP in revenue from the present GCT structure versus a broad-based GCT imposes an additional deadweight welfare loss of J$1.8 in consumption for every J$1 in revenue raised.

6. Comprehensive Reform: A Structural and Rebalancing Package

This tax reform project identifies and evaluates a comprehensive tax structure reform that could address these problems. This reform package is focused on tax neutrality, with the goal of reducing or eliminating those distortions that lead to a misallocation of resources and may compromise economic growth and competitiveness. It involves a restructuring that reaches
nearly every tax in the system. It presumes that a generally lower tax rate, applied to a broader tax base, is a better economic development strategy than targeted incentives. It also proposes this would be a more efficient way to tax, yielding the same amount of revenue at a lower cost to the economy. The proposed reduction in the property transfer tax rate would reduce an impediment to market-driven property transactions, a reduced CIT rate would increase the after-tax return to capital, and the removal of preferential treatments would improve the competitiveness of the Jamaican economy by allowing the market to direct investments toward those areas where capital is most productive.

It also proposes a more aggressive policy of shifting revenue-raising reliance away from income taxes and toward consumption taxes to broaden the base of taxation.

6.1. Components of the Rebalancing Reform

1. The revenue productivity and the fairness of the GCT could be addressed by eliminating all nonexport zero rates other than those required by international convention and eliminating a significant amount of the present exemption list. The latter would include at least the exemptions on utilities, construction and real estate, and transportation. We estimate that this base broadening might yield as much as J$7 billion, depending on how far the government is willing to go in removing exemptions. In addition, the general GCT rate could be increased from 15 to 16 percent, to raise about J$2 billion in new revenue. In total, this package might increase revenues from the GCT by about J$9 billion (Edmiston and Bird 2007 [this issue]).

2. A unification of the “collected” tariff rates at a level closer to the statutory (applied) rate of 10 percent might be considered. We propose consideration of the elimination of duty remissions and exemptions for imports, to gain additional revenues of J$1 billion (Maskus and Rioja 2007 [this issue]). Since only about 50 percent of potential tariffs are now collected, there should be ample room for increasing tariffs by this amount.

3. Three changes could be introduced in the SCT, primarily as revenue measures. First, subject all motor vehicles to the standard rate of GCT, and then impose a structure of SCT rates based on engine capacity. Second, adjust SCT rates to be equivalent to 1999-2000 levels in inflation-adjusted terms and index these rates to inflation. Third, impose a standard rate of GCT on the SCT-inclusive motor fuels base. The total revenue gain from these SCT/GCT initiatives is J$7.1 billion (Edmiston and Bird 2007).

4. The government could enact a major reform of property taxation with the adoption of a J$300,000 threshold, a flat rate of 1 percent, and an annual indexing of taxable property values. The revenue increase from the rate and base change is estimated at J$600 million and the indexation should yield an
increase in revenues of about 9 percent per year for the period between general revaluation (Sjoquist 2007 [this issue]).

5. Abolish the Stamp Duty and Property Transfer Tax. Replace this with a capital gains tax on real property transfers. The revenue cost (assuming no incremental revenues from the capital gains tax in the short run) would be J$2.8 billion (Bahl 2004).

6. Adopt a threshold of J$250,000 for the individual income tax and index this amount. The revenue cost of this option is J$4.5 billion or about 17 percent of PAYE revenues, and the indexing further increases the cost after the first year by an additional 2.3 percent per year. A total of ninety thousand taxpayers could be eliminated from the PAYE tax rolls. The main benefits of this change are administrative ease and a reduction in the number of individuals on the tax rolls. A threshold as high as J$250,000 would make many of the allowances in the income tax system redundant, and these could be formally abolished. Finally, dividends of nonlisted corporations could be exempted from tax. The revenue impact of this change for corporate and individual income taxpayers is approximately J$900 million (Alm and Wallace 2007 [this issue]).

7. A tax on realized capital gains could be considered. One possibility would be to introduce the capital gains tax at a nominal rate and phase in the full rate over a three-year period as administrative capability improves. This option would be considered along with a capital gains tax on real property and all gains could be taxed at a uniform rate (Rider 2007 [this issue]).

8. The Education Tax and the HEART tax are labeled payroll taxes but in reality are additional income taxes. There would appear to be no good justification for retaining them as separate levies. Abolishing both at 2003 levels would result in a revenue loss of J$7.2 billion. The earmark for HEART (for manpower training) could be retained in the consolidated fund (Alm and Wallace 2007).

9. With respect to CIT and incentives, the government could do the following: eliminate all incentives (CIT, GCT, duties) but with a grandfather clause, harmonize the CIT and PIT rates at 25 percent, and adopt a special CIT rate for hotels at 10 percent. This reform would broaden the tax base and make the tax system more neutral. It would cost J$1.4 billion in revenue. Over the longer term, as the incentives expired, there would be a revenue gain (Rider 2007).

6.2. Impacts of the Structural and Rebalancing Package

This package would be approximately revenue-neutral but would lead to a significant rebalancing of the tax system toward indirect taxes. Tax reductions, mostly income and payroll taxes, would be equivalent to about 18 percent of revenues but would be nearly offset by increases in indirect taxes. This “reform surplus” (J$0.9 billion) would leave some room for a
more gradual phase-in of income tax cuts or for the inevitable problems with tax administration in the reform year.

Overall, this reform should lead to a broadening of the overall tax base. The rebalancing approach shifts the tax burden toward consumers and therefore would reduce the progressivity of the tax system (see figure 1). Households included in the bottom 40 percent of income earners would see an increase in taxes equivalent to about 3 percent of income. This is a result of increases in consumption taxes. It is also because many of these households are presently out of the individual income tax net and illegally out of the payroll tax net, and so they would not receive offsetting relief from the income or payroll tax reductions. Is this decline in progressivity a damning criticism? The answer here is no. For one thing, the overall distribution of tax burdens remains progressive, as may be seen from figure 1. For another, the better way to subsidize the position of the poorest households is probably on the expenditure side of the budget where they can be better targeted to receive benefits. In fact, a social fund of J$755 million would be adequate to offset the increased indirect tax liability for the lowest four income groups. This is another potential use of the “reform surplus.”
This package of reforms would make the tax system administratively easier to deal with and fairer in the horizontal equity sense, largely because of the removal of preferential tax treatments. With respect to the latter, after a grandfather period for existing incentives, all companies would be treated the same, and all would be subject to a lower overall rate of tax.

Administrative costs should fall because the higher thresholds for the individual income and property taxes will remove many taxpayers from the rolls. The property transfer tax and stamp duty, the Education Tax, and the HEART tax would be eliminated, all of which would significantly reduce administrative complexity. The tax on motor vehicles would be moved to a much less complicated regime. On the other hand, the adoption of a capital gains tax is a clear move toward complication and higher administrative costs.

Finally, budget practices and fiscal planning could also benefit from this reform program. The elimination of discretionary relief from the tax system would make revenue outcomes more certain. Moreover, most tax expenditures would be taken to a zero base and reevaluated on their merits.

The rebalancing reform has positive effects on economic development and on incentives for investment. Basically, it shifts the tax burden away from labor. This could reduce one comparative disadvantage to Jamaican competitiveness. It also removes some tax-induced distortions to methods of doing business in that it would eliminate the property transfer tax and stamp duty, harmonize the individual and corporate income tax rates, and eliminate the differential treatment of taxing dividends on nonlisted companies. The tax preference for capital income would be eliminated by introducing a capital gains tax. The phasing out of the incentive scheme will

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level the playing field in terms of removing the favored treatment of some sectors relative to others. The drawback to this approach is the same as noted above: the possibility that the present level of incentives is required to maintain the competitiveness of the tourist industry.\textsuperscript{10}

We have simulated the effects of this reform program with the Jamaica CGE model, reported in table 2 (Light 2004). In the steady-state, with mobile labor, individuals are expected to move to the formal economy due to the reduction in income and payroll taxes.\textsuperscript{11} This dampens the pretax wage by 3.4 percent, but the overall return to labor increases by 2.8 percent due to higher labor productivity due to expanded capital stock and reduced taxes on labor.

Under this reform, overall output increases by 0.9 percent in the long run due to reductions in the cost of labor and expansion of the capital stock. Sectors faced with the highest increases in the GCT, and those that have heretofore benefited from preferential treatment tend to be the ones whose output falls. However, sectors that do not face GCT increases and that have a high share of labor inputs fare better.

The results for the foreign trade sector suggest a decline in both imports and exports relative to the present system. The export decline is due to the assumption that the pre-reform trade balance not change.\textsuperscript{12} This explains the reduction in the value of exports that follows the reduction in imports resulting from higher taxes on imports in the structural reform. In fact, one would expect that lower labor prices and increased capital would enhance the competitive position of Jamaican exports and thereby reduce the trade deficit, and our model simulations support this result (Light 2004).

\textbf{6.3. Risks}

There are risks associated with any reform program. First, the estimated revenue gains might not materialize. In particular, government data on the magnitude of zero rating under the GCT may be overstated, or the overall collection rate may fall while the tax administration is learning the new system. Second, the removal of the tax subsidy to the tourist sector (and others) might make them less competitive and reduce export earnings. Third, the grace period for eliminating tax incentives may never be allowed to end by the body politic, hence a major base-broadening initiative would be lost.

There are also political risks, in particular the risk associated with removing preferential treatments to favored sectors of the economy and the unpopularity of increasing the tax on motor fuels.\textsuperscript{13} Mitigating the political risks could be the proposed elimination of the Education Tax and the
HEART tax and the increased threshold for the individual income tax, which would remove many lower income workers from the tax rolls.

7. Lessons for Tax Reformers

Some general lessons about “how to do tax reform” might be drawn from the work of this project.

First, the government must see the project as its own and not that of a donor or even that of a technical assistance research team. There must be a champion for the reform, and clearly the champion ought to be a power bloc within the government. The principal advocate for doing such a reform study should be the Ministry of Finance. The Ministry should be advised by an appointed, representative private sector group that is commissioned to work with the technical team and form its own recommendations. This is exactly the process that was followed in Jamaica. The theory here is for ownership of the program to rest jointly with the government who will impose the tax and bear the political risk, and with the private sector who will ultimately comply with the new tax system. The technical team should assist the government and the private sector commission in developing recommendations but during the course of the study should not offer independent views. These lessons about the process were well learned during the tax reform work of the 1980s and were applied again in the recent effort.

Second, the technical assistance team should have the right mix of skills and experience and, above all, should have expert credentials. There is something powerful about drawing on the international experience, and the technical assistance team should have the ability to bring this experience to the discussion a relevant way. Most countries have little desire to copy another tax structure, but there is great comfort in getting a thorough assessment of what has worked elsewhere and what has not. The Jamaica research team brought such credentials to this work.

Third, the technical assistance team must bring hard data analysis to the discussion, and in that way, much of the mythology associated with critiques of various components of the tax system can be discredited. This tax reform study carried out quantitative tax burden studies based on modern incidence assumptions, microsimulation modeling to estimate revenue impacts associated with various rate and base changes, CGE modeling to develop estimates of the impact of tax structure change on the economy, and so on. This is not to say that the estimates we make are not open to challenge. However, we
can say that the analysis and recommendations here are largely supported by empirical evidence.

Fourth, tax reform should not be hurried. It takes time to get the technical proposals properly in place, and the public debate needs time. The Jamaica research reform project required about a year to do the analytic work and to disseminate the findings to the tax reform committee and to the government. Even this may be too short a time period.

Fifth and perhaps most important, the success of a comprehensive reform should not be judged based on whether government immediately adopted the study recommendations. Comprehensive tax reform often requires new thinking about tax structures. Governments, and the population at large, are not good at reacting quickly to such big changes in policy. Sometimes after a debate of several months, what was a radical-sounding idea when first introduced becomes a regular part of the discourse. The hope of most tax reformers is that the sequence involves a completed study, then recommendations, then implementation of the reform program shortly thereafter. Usually this does not happen because it takes time for new ideas to be absorbed. The implementation of a major tax structure revision may not take place until years after the initial seeds were planted. It is necessary for a blueprint for comprehensive tax reform to be developed, but political and administrative constraints may mean that it is implemented over a period of time. As Gillis (1989, 510) has so properly documented, “delayed reform is not necessarily lost reform.”

In the case of the Jamaica reform, several—but not all—of the main recommendations were introduced by the government in the 2005-2006 budget:

- The property tax reforms adopted closely followed the recommendations of the report: a flat rate structure and a threshold were adopted.
- The GCT rate was increased to 16.5 percent, nonexport zero rated goods were moved to the exempt class, and the threshold for payment was raised.
- The individual income tax threshold was increased to nearly J$200,000 (the projected recommendations ranged from J$140,000 to J$500,000).
- Corporate tax simplification, along the lines recommended by the project, was part of the 2005 reform.

These changes do not add up to a comprehensive reform in the sense that we have defined that term. The 2005 reforms do not appear to be focused on a particular objective, and there does not seem to be a strategy of fitting the various changes together into a coherent package. One way to look at it is that the 2005 tax changes were more in the nature of a number of piecemeal
fixes for specific taxes. The primary goal was less efficiency considerations than revenue considerations. As might be expected in an election year, some of the most politically charged of the possible reform options (e.g., the removal of preferential treatments) were left out.

Another way to look at the 2005 package is that it is a first step in a comprehensive reform package. In fact, the Minister of Finance stated that the budget proposals were impacted by two significant developments: the need to balance the budget and the comprehensive review of the Jamaican tax system (Ernst & Young 2005). The ministry paper on “Revenue Measures” (Ministry of Finance and Planning 2005) added that the first phase of the reform was expected to lead to a more simple tax system and to enhance compliance.

In fact, the major tax changes introduced in 2005 are consistent with the direction of the comprehensive proposals, and some are identical. Nearly all are on the menu of reform options suggested by the reform program. The case can be made that the 2005 changes are a first step in the right direction. Some of the changes made correct inefficiencies and unfairness in the tax system. The more optimistic tax reformer might see these changes as consistent with what might be observed in the case of a phased-in implementation of a comprehensive reform. Indeed, the minister stated in his budget speech that the 2005 changes were the first step in a four-year program.

The 2005 reforms differ in magnitude from the comprehensive reforms that had been proposed. The rebalancing and structural reform proposals were approximately revenue neutral, whereas the 2005 tax changes were designed to produce a J$9.4 billion revenue increase. However, the 2005 tax changes were true to the goal of shifting emphasis from income taxes to indirect taxes, similar to the rebalancing package.

These comparisons provide good evidence that the reform study had an important impact on the 2005 tax changes. A better test of whether the proposed comprehensive reform will take is observation over a period of years. If government policy is true to the minister’s word, the 2005 tax changes are the first installment on a comprehensive reform.

Notes

1. This perception might be influenced by the fact that tax burdens are generally lower in Latin America.

2. A useful handbook on tax policy design is Shome (1995), and a good discussion of the issues is in Bird (1992). These ideals of tax systems go back at least to Adam Smith’s 1776 *The Wealth of Nations*. Slemrod and Bakija (1996) used these traditional principles to make the case of what is wrong with the U.S. federal income tax system.
3. The real property tax is a central government levy, but the revenues are shared with local
governments.
4. We take a broad view of tax expenditures here (i.e., that “normal” taxation would pro-
vide for no exemptions or deductions from the tax base). We treat zero rating of exports as normal practice, and we do not count these as tax expenditures.
5. “Coverage” is the ratio of statutory or chargeable income, as defined in the tax code, to
total profits in the economy as reported in the National Income and Product Accounts.
6. This would be problematic, of course, because some tourism sector services are consumed
domestically and imported “inputs” might too easily find their way to domestic retail outlets.
7. Nontaxable allowances have been a feature of the Jamaican individual income tax since
the 1970s. They grew in use at a time when Jamaican tax rates were very high. For a discus-
sion of this history, see various papers in Bahl (1991).
8. A more detailed discussion of the Jamaica computational general equilibrium (CGE) model and the results discussed in this section are found in Light (2004).
9. Other possibilities have been raised by the government-appointed tax reform committee
and the general public. A menu of ninety-five tax structure reform options were evaluated in
the course of this research and are listed in Bahl and Wallace (2004). In addition, numerous
desirable administrative changes were proposed and evaluated.
10. There does not exist an objective and comparative analysis of the effects of government
policy on the competitiveness of the Jamaica tourist sector.
11. There is another scenario that is not accounted for in the CGE model. Some smaller
firms may be induced to move into the informal sector because of the higher effective rate of
consumption tax.
12. There is a trade model embedded in the CGE model. An assumption in this model is
that the current account trade balance is held constant at the prereform level. Under this sim-
lifying but necessary assumption, if imports decline due to increases in the tax rate on
imports, the value of exports also must decline to satisfy the requirement that the trade balance
remain constant. A dynamic version of the model has not been developed, but such a model
would incorporate the expected expansion of exports in the face of expanded capital stock,
lower labor costs, and output growth (Light 2004).
13. The indexation of the property tax base also poses some risks because it will appear to
be grossly unfair if there are differential growth rates in actual land values across parcels.
14. See also Bahl (1991) and Gillis (1989) for a discussion of this issue.

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