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The Tax Reform in Jamaica

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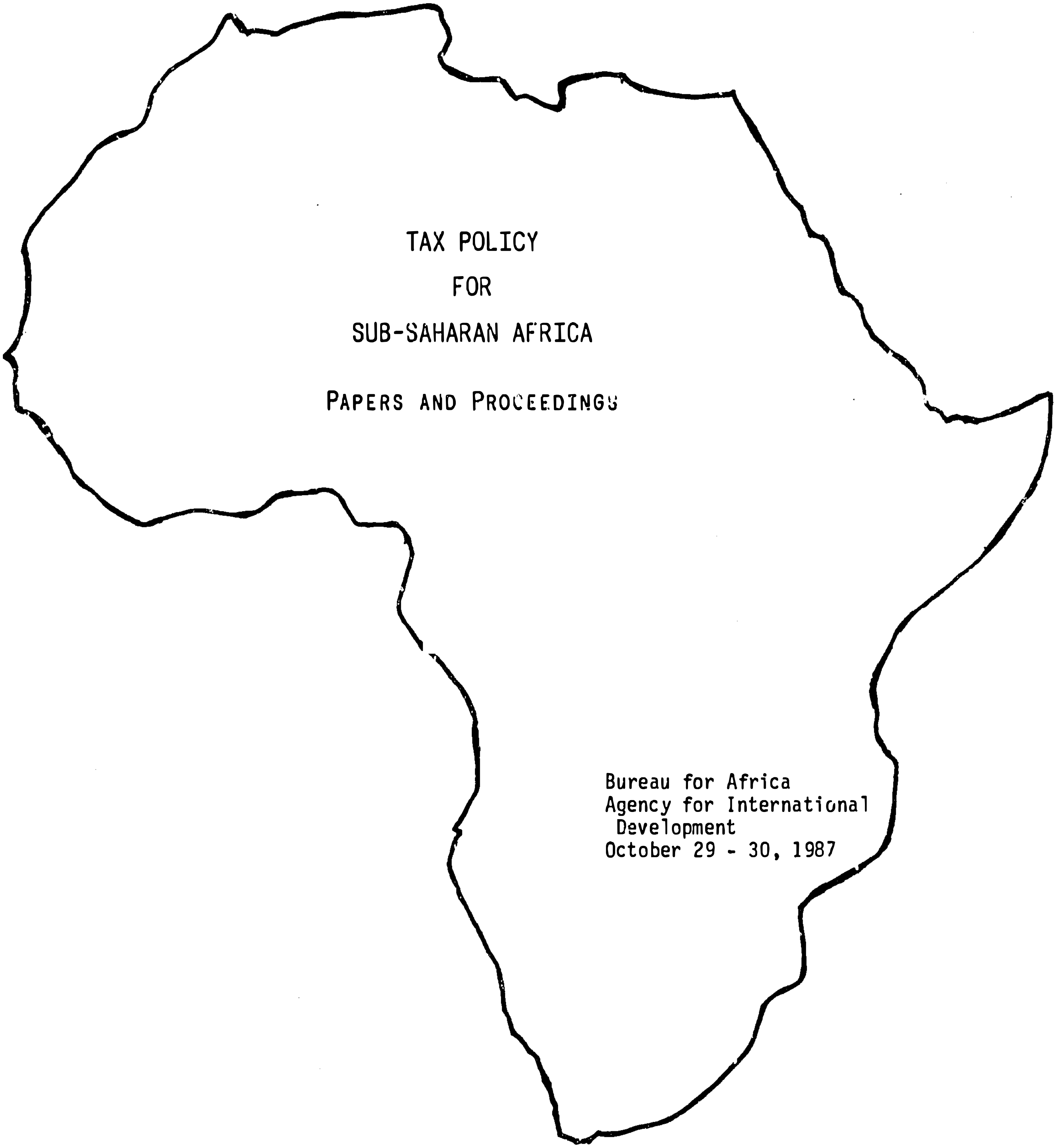

TAX POLICY FOR SUB-SAHARAN AFRICA

PAPERS AND PROCEEDINGS

Bureau for Africa
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PREFACE

These papers and proceedings summarize the Tax Policy Seminar for Sub-Saharan Africa sponsored by the Africa Bureau of the U.S. Agency for International Development (USAID). The seminar was convened October 29-30, 1987 in the U.S. Department of State. USAID wishes to extend deep appreciation to all the participants without whose presence the seminar would not have been the outstanding success that it was. In this regard, we wish to single out for praise (a) Brookings Richard Goode -- past director of the IMF Fiscal Affairs Department, (b) Kevin O'Connor -- Chief of the IMF's Financial Institutions Division, (c) Professor John Due of the University of Illinois, (d) Pradeep Mitra who represented the World Bank's Public Economics Division, (e) IMF Senior Economist Leif Muten, (f) Counsellor for Taxation for the IMF Lotfi Maktouf, (g) USAID Economists Samuel Skogstad and Richard Greene, (h) Syracuse University's Roy Bahl, and (i) Jacqueline Damon -- Economist for the IMF's Northwest Africa Division. A great deal was learned from the sessions, all of which were well received. Considerable information was exchanged in the spirited and lively question and answer periods that followed the formal presentations.

USAID was extremely pleased with the number of people who showed up for the seminar. The primary audience for the seminar was to be the Africa Bureau's overseas Missions, and indeed most of the Missions were represented. However, also in attendance were (a) high level officials from the IMF and World Bank, (b) leading academics, and (c) individuals in non-profit organizations and the private sector. Moreover, a number of U.S. government agencies were represented in addition to USAID including the Overseas Private Investment Corporation, State, Treasury, and the Internal Revenue Service.

We wanted the seminar to be as much as possible "hands-on" in nature. Hence, the primary focus of the seminar was implementation of tax reform programs. Four sessions dealt directly with the issue while the remainder peripherally discussed the topic. Although the session on the Jamaican tax reform chaired by Messrs. Bahl and Skogstad at first glance appeared out of place in a seminar focusing on Sub-Saharan Africa, valuable lessons were learned from that session that could be extended to Sub Saharan Africa.

We also wish to apologize for some unevenness in the presentations that appear in these papers and proceedings. Some of the materials in our document are in the form of formal papers; these papers elaborate and expand on the subjects covered orally. All the other materials in these papers and proceeding are derived from edited transcripts of the oral presentations.

Don Harrison

THE TAX REFORM IN JAMAICA

Roy Bahl*

The Government of Jamaica began a major reform in its income tax structure in 1986. A complicated, narrow-based individual income tax, levied under a progressive statutory rate structure, was replaced by a broad-based, flat rate tax. In 1987, the company income tax was also simplified and its rate reduced from 45 percent to match the new individual income tax rate of 33-1/3 percent. To keep step with the structural reform, the organization of the Revenue Services has been completely revamped, a comprehensive program of revenue agent training has been established, and a full computerization of the tax administration is well underway.

First indications are that the program is a success. The structural reform seems to have gained general acceptance from the public, government revenues are up, the business sector of the economy is performing better than in recent years, and there has been a noticeable improvement in tax administration. However, the reform program is far from complete. A general

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* Maxwell Professor of Political Economy, Syracuse University. This work draws from the research results of the Jamaica Tax Reform Project, and especially from James Alm and Roy Bahl, "An Evaluation of the Structure of the Jamaican Personal Income Tax," Jamaica Tax Structure Examination Project Staff Paper No. 15, Metropolitan Studies Program, The Maxwell School (Syracuse, NY: Syracuse University, December 1984 (revised March 1985); and Roy Bahl and Matthew Murray, "Income Tax Evasion in Jamaica," Jamaica Tax Structure Examination Project Staff Paper No. 31, Metropolitan Studies Program, The Maxwell School (Syracuse, NY: Syracuse University, November 1986).

consumption tax of the value-added type has been designed to replace much of the present, complicated system of five separate indirect taxes, and a total overhaul of the payroll tax has been proposed. In both cases the accent is on simplication, fairness, and revenue neutrality. Finally, any comprehensive tax reform needs protection from abuses and loopholes that tend to creep back into the system, and the Jamaican reform is no exception. A program to close off the reemergence of loopholes is under consideration.

The tax reform project was carried out jointly by the Revenue Board of the Government of Jamaica and the Metropolitan Studies Program of the Maxwell School at Syracuse University. The Co-Directors of the project were Canute Miller, Chairman of the Revenue Board, and Roy Bahl, Maxwell Professor of Political Economy at Syracuse University. The research staff included Jamaica's top tax analysts and several of the most experienced public finance scholars and practitioners in the world. The project began in mid-1983 and the collaboration ended in September, 1987. Funding for the project was provided by A.I.D., but the US government was not an active partner in the substantive end of the work.*

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* A set of 36 staff papers from the project are available from the Metropolitan Studies Program, Maxwell School, Syracuse University, Syracuse, New York 13244-1090.

THE ECONOMIC AND POLICY SETTING

The Jamaica case may dispel a longstanding myth about comprehensive tax reform--the proposition that it cannot take place in a weak economic setting. Severe economic problems had to be confronted during the period of the tax reform, and the government could not keep its attention focused solely on restructuring the tax system and improving the administrative setup. The following will give some idea of the calls on economic policy during this period.

-- There was a serious exchange rate disequilibria which eventually led to a devaluation, beginning in 1983.

-- The bauxite industry collapsed, depriving the government of a major foreign exchange earner. The performance of tourism, the other major foreign exchange earning sector, was spotty.

-- There was a substantial government deficit (no lower than 8 percent of GDP). This is an especially important policy issue because the government is a major employer of unskilled workers, hence expenditure retrenchment (vs. revenue increases) would be a very difficult path.

-- There was a heavy debt service burden, averaging over 45 percent of export earnings in the mid-1980s.

-- Both the inflation rate and the unemployment rate remained high during most of this period.

-- The International Monetary Fund and the World Bank brought pressure on the government to take drastic measures to control the size of the fiscal deficit and to reform its tariff structure.

-- It was reasonable during this period to suppose that a US tax reform was in the offing, and that the lower US corporate tax rate would force a reduction in the Jamaican corporate tax rate.

In short, there was a great deal of pressure to find ways of raising more revenue to solve some of the government's immediate problems. The prospects of having to raise tax rates in the short run to eliminate a revenue shortfall would seem incompatible with the goal of developing a structural reform that would gain broad public support and stimulate new private investment.

But not all was negative. Prime Minister Seaga was elected in 1980 with a mandate to "free-up the economy," and there was much to free up. The foreign trade sector was characterized by quotas and licensing to restrict imports and compensate for a fixed and overvalued Jamaican dollar. An inherited import substitution growth strategy and a very complicated tariff structure were in place, and there were substantial price controls, government ownership of some traditionally private sector activities, and very high marginal income tax rates. The Prime Minister's economic strategy of replacing government controls with market forces fit very well with a structural tax reform program designed to "get the prices right." Moreover, the Seaga administration won an overwhelming majority in Parliament in a 1984 election. This enhanced the possibilities of eventually passing a tax reform bill. Another stimulus to action in this area came from the external donors--the United States government, the World Bank, and the IMF--all of whom were enthusiastic about Jamaica's plans for tax reform. Finally, the Jamaican income tax had become so onerous, so obviously unfair, and so out of control that there was substantial public sentiment for a major overhaul of the system. In many ways, then, the time was right for tax reform.

THE TAX POLICY STRATEGY

At the outset of the project, assessment of Jamaica's tax problems pointed to three issues. First, taxes were too high. This is a normative statement and requires some qualification. Taxes were too high by comparison with other countries at similar levels of income and foreign trade. More important, however, is that the Jamaican system taxes such a narrow base that the average and marginal rates of taxation had to be very high to generate an adequate revenue yield. For example, a value added tax, equal in yield to the present indirect tax system and using the same exemptions as existed in 1983, would have required a rate of about 20 percent, a rate considered very high. Another example is that the top marginal personal income tax rate was 57.5 percent (not including payroll taxes) and was reached at the relatively low income level of J$14000 (U.S.$1=J$5.5).

The second basic problem was that the tax structure was deficient. It was complicated and therefore difficult and costly to administer and there were important disincentives inherent in the rate and base structures. Interest was tax free but dividends were taxed twice, there was a high income tax rate on formal sector (PAYE) labor income but the self-employed went virtually untaxed, the high marginal tax rates produced a substantial incentive for evasion and avoidance, many types of imports were exempt from the indirect tax system, and so on. The system was also characterized by poor enforcement which compounded the inequities. The problem was simply that the Jamaican tax structure had evolved over a period of time in a very haphazard manner--as much because of year-to-year IMF pressures to solve budget deficits as for any other reason. By 1983 the issue was clear. The government had gone as far as it could with piecemeal tax reform and the time was right for a comprehensive overhaul of the tax structure.

Third, the administration of the tax system was weak. There were too few trained tax administrators, salaries were not competitive with the private sector, and there was limited opportunity for advancement. These administrative problems were heightened by the complicated system, which was difficult to administer in any case, and by outmoded procedures. For example, there was no manual for income tax administration, nor were there procedures in place to assess the self-employed or to use third party information to detect nonreporting or under-reporting. Audit activities were limited and not productive,and the administration of the income and payroll taxes was not integrated. Finally, the administrative system was manual rather than computerized and there was general disarray in the record-keeping.

In the face of these problems, the Tax Project took the view that the highest priorities were (a) simplification of the system and (b) making the tax structure more neutral with respect to consumer and investor choices. The policy direction of these objectives is clear: establish broader based, flatter rate taxes that are more easily administered. The basic hypothesis is that the price effects introduced by non-neutralities in the Jamaican tax system do matter, i.e., the tax system has contributed to a reduced work effort, increased capital and labor mobility from the formal to the self-employed sector, led to thin capitalization, promoted capital flight, encouraged consumption relative to investment, and created a larger underground economy.

The project did not take the view that the correct tax reform strategy was to develop a system that would lead and "fine tune" economic policy. The general position taken was that the market and not tax treatment should dictate business and individual economic decisions, especially in light of the weakness of the tax administration. Experience with the existing system, which is in more of an interventionist tradition, was that progessive rate structures were not generating a progressive distribution of tax burdens, complicated provisions for payroll taxes of the self-employed could not induce them to make payments, tax incentives for overtime were being abused and not leading to increased overtime work, a system of nontaxable perquisites had become a major loophole rather than a tax relief and was beyond the control of the income tax administration, etc.

This assessment of problems and definition of objectives of the project led to a three-part program for the tax reform: policy analysis to restructure the system, improved administrative procedures, and the establishment of a training program. The basic tenet of the Tax Project was that the reform should be comprehensive and that the administrative improvements should follow the policy changes. To try to improve the administration of a system so deficient as that in Jamaica clearly would have been counterproductive.

THE INDIVIDUAL INCOME TAX

The individual income tax base, in theory, included all sources of income except bank deposit interest. In practice, there was no tax on capital gains and most self-employed income was outside the tax net. There were two rate structures--depending on whether income was above or below J$7000. The top marginal rate was 57.5 percent (Table 1). When payroll taxes are taken into account, the marginal tax rate on a relatively low Jamaican income (J$14000) was well in excess of 60 percent. There was no standard deduction but taxpayers could qualify for 16 separate tax credits (Table 2). These credits had been added to the tax system over a period of years, for purposes that ranged from personal allowances, stimulation of savings and home ownership, and even employment of helpers in the home. Because the credits were not indexed to inflation, their value had been substantially eroded during the early 1980s. The income tax administration did relatively little monitoring of the credit system.

The base of the tax was further eroded by the practice of permitting employers to grant nontaxable prequisites ("allowances") to employees. These perquisites were a matter of negotiation between employer and employee (including government ministries) and it was not required that they be reported to the Income Tax Commissioner. There was a greater deal of speculation about the magnitude of allowances--some prominent Jamaican analysts argued that the allowance-taxable wage ratio averaged as much as 40 percent.

TABLE 1

CURRENT RATE STRUCTURE OF THE INDIVIDUAL INCOME TAX

Statutory Income[a]	Marginal Tax Rate
If Income is Less Than J$7,000	
J$ 0 - 4,000	0
J$4,001 - 7,000	.70
If Income is More Than J$7,000	
J$ 0 - 7,000	.30
7,001 - 10,000	.40
10,001 - 12,000	.45
12,001 - 14,000	.50
14,001 and over	.575

[a] "Statutory Income" is the tax base for the personal income tax. It is the amount that is entered on the personal income tax return. It equals the sum of income from employments and offices; pensions; rent of land, houses, or other property; dividends, interest, annuities, discounts, estates, trusts, alimony, or other annual payments arising within Jamaica; sources outside Jamaica; sources not stated elsewhere; and trade, business, profession, or cultivation of land or farming; less capital allowances.

SOURCE: Income Tax Department.

TABLE 2

SUMMARY OF CREDITS FOR PERSONAL RELIEF: 1983

Credits	Amount	Limit of Credit
Personal Allowance	J$600	Not applicable
Wife Allowance	J$140	Not applicable
Wife's Earned Income Allowance	40 percent of wife's earned income	J$320
Children Allowance	J$100 (J$120 for university students)	Not available if child's income exceeds J$200 (J$300 for university students)
Female Relative	J$40	Not applicable
Dependent Relative Allowance	J$40	J$80 (for two relatives); not available if relative's income exceeds J$200
Maintenance and Alimony	40 percent of maintenance or alimony, whichever is less	J$160
Life Assurance Relief	60 percent of premium paid	10 percent of statutory income; 4.2 percent of principal amount;
J$360		
Pensioner's Allowance	J$400	Not applicable
Donations	40 percent of donations	2 percent of statutory income
Capital Growth Investments	60 percent of investments	J$360
Mortgage Interest Relief	40 percent of mortgage interest	J$60
Medical Expenses Relief	40 percent of medical and dental expenses	J$40
Subscription for Shares	60 percent of subscription for shares	J$360
Household Helper	J$4 per week	J$208
Special Credit	J$156	Vanishes at income of J$12,000

SOURCE: Income Tax Department, Government of Jamaica.

The analysis of reform options required first estimating the number of taxpayers, taxable incomes, nontaxable perquisites and tax credits--all by income class. This was done by drawing a large random sample of Jamaican taxpayers and manually recording data on taxable income, tax credits, tax liability, etc. from the files on each individual. The Prime Minister organized a special survey of employers to estimate the value of notaxable allowances by income bracket. This was supplemented with a sample survey of a large number of self-employed individuals to determine the extent of evasion by nonreporting. The results of this analysis, reported in Figure 1, indicate that about half of potential individual income tax liability was not covered in the tax net. Moreover, as described in Figure 2, higher income Jamaicans- many outside the PAYE system-tended to avoid or evade a substantially higher percentage of their tax liability than did lower income families. The progressivity of the statutory rate structure was all but negated by evasion and avoidance.

Simulation of alternative rate and base structures, with a revenue neutral target in mind and with simplification and neutrality as primary objectives, led to the following reform program:

-- Replace the 16 tax credits with a standard deduction of J$8580 per year.

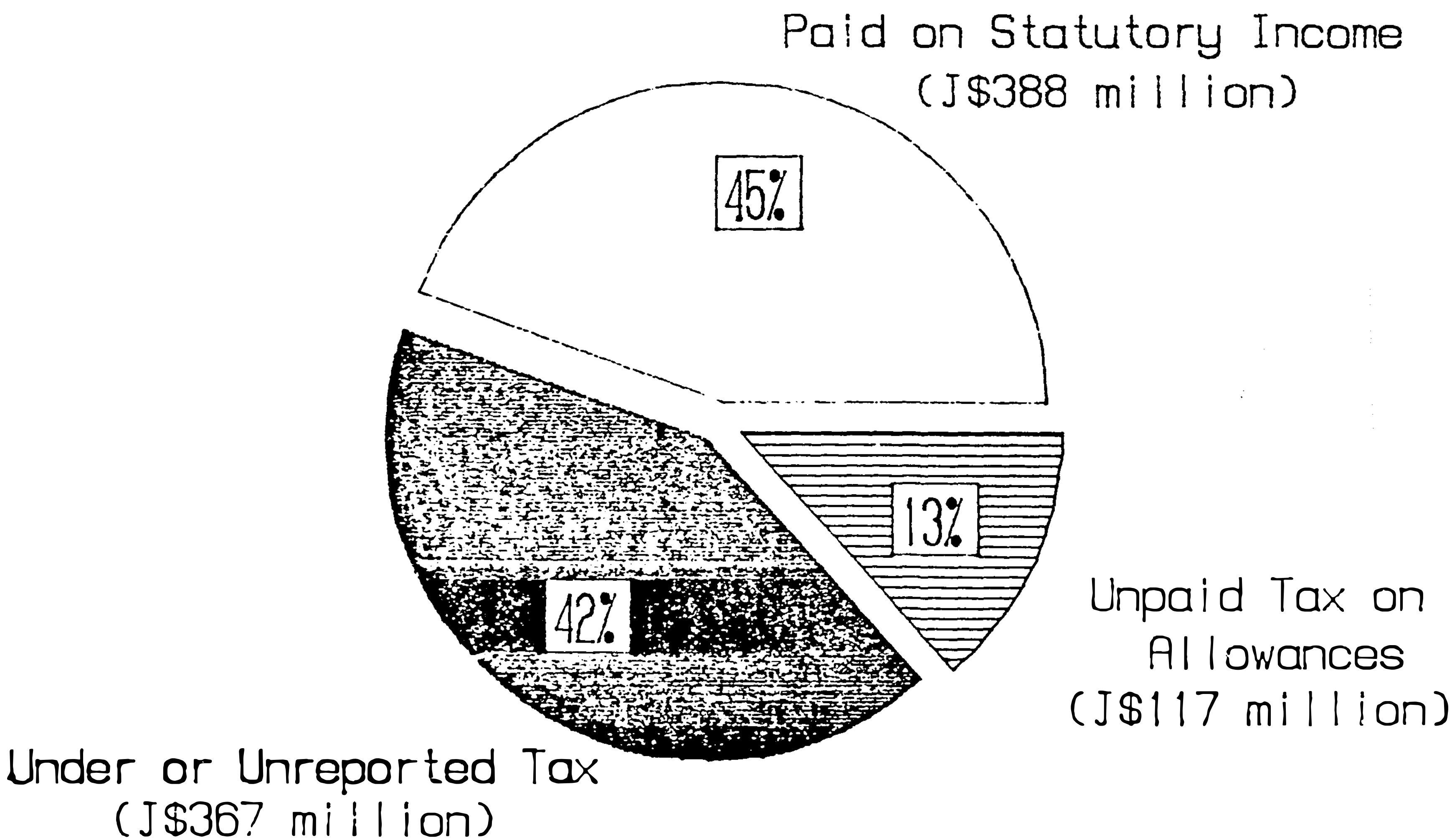
-- Replace the present rate structure with a flat rate of 33-1/3 percent.

-- With a few exceptions, bring all nontaxable allowances into the base.

-- Include bank deposit interest (above some ceiling) in the income tax base.

FIGURE 1

REVENUE POTENTIAL FROM TAXED AND NONTAXED INCOME IN 1983

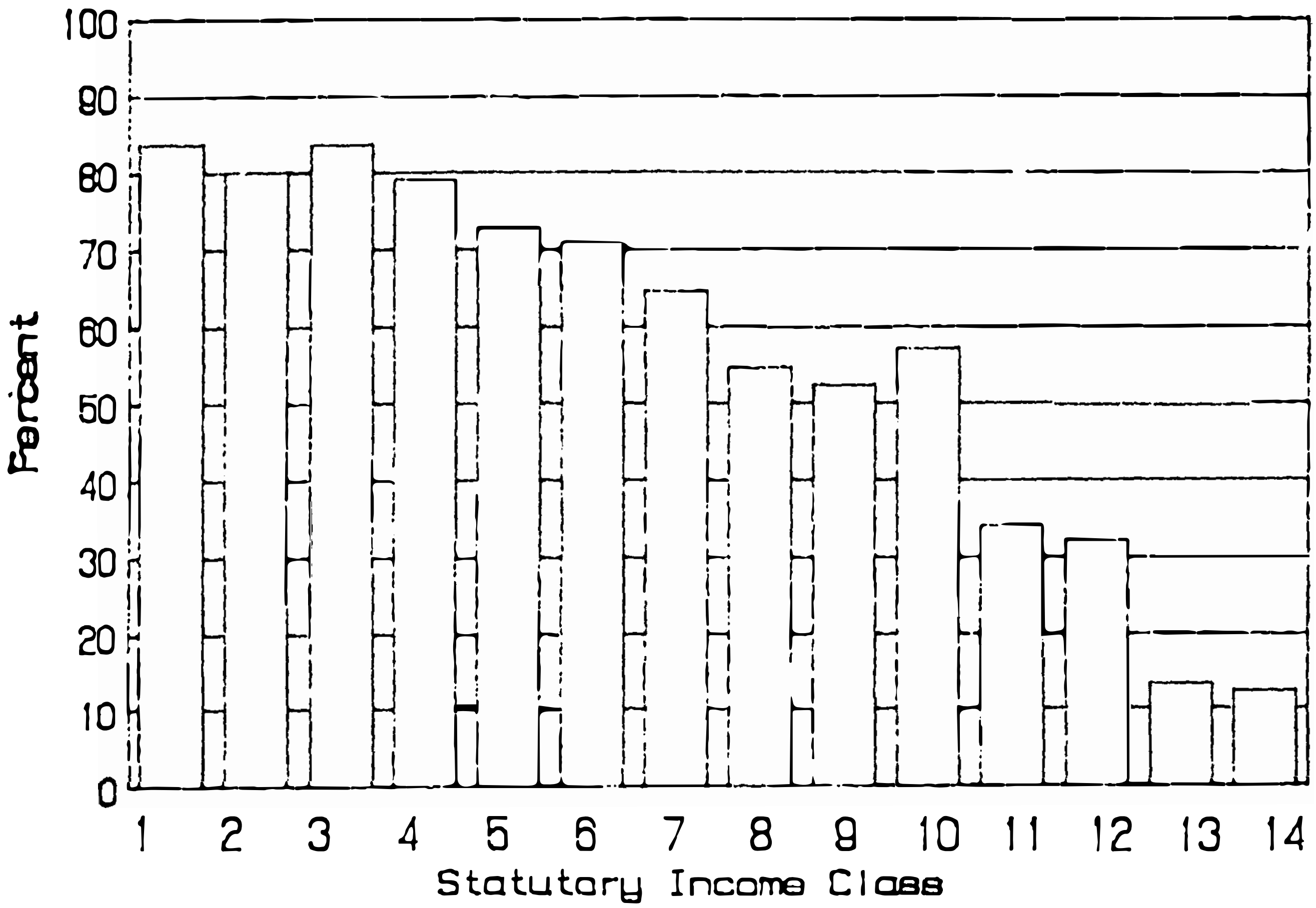


Source: JTSEP

FIGURE 2

TAXES PAID ON STATUTORY INCOME

(as a percent of Total Taxes Payable)



Source: JTSEP

Key:

1 = Under J$2000
2 = J$2001 - 4000
3 = J$4001 - 6000
4 = J$6001 - 8000
5 = J$8001 - 10,000
6 = J$10,001 - 12,000
7 = J$12,001 - 14,000
8 = J$14,001 - 16,000
9 = J$16,001 - 18,000
10 = J$18,001 - 20,000
11 = J$20,001 - 25,000
12 = J$25,001 - 30,000
13 = J$30,001 - 50,000
14 = Over J$50,000

The Government enacted the tax reform after a Tax Reform Committee of private sector citizens spent several months scrutinizing and amending the proposals. The Committee, made up of union, business and public interest group representatives, reached consensus that the flat tax seemed more fair than the present system and recommended its adoption to the Prime Minister. The income tax reform became effective at the beginning of 1986 and was almost totally operative by the end ofthe first quarter.

THE COMPANY INCOME TAX

Prior to reform, companies paid a basic rate of 35 percent plus an "additional tax" of 10 percent, but the additional could be offset against withholding tax on dividends. To complicate matters further, there was separate treatment for agricultural companies, incentive firms and financial institutions.

This system led to three basic problems. First, the tax was complicated, not easily administered, and was unfair to certain types of firms. Second, it discriminated in favor of debt and against equity finance. The "optimal" dividend distribution rate for a firm was about 27 percent of profits--above this amount "additional" profit tax liability would be due. Moreover, in the eyes of investors, dividends were taxed twice (as company profits and as taxable personal income) whereas interest received from savings accounts was not taxed. Third, the reduction in the top personal income tax rate to 33-1/3 percent and the reduction in the US corporate rate brought new pressures to lower the company tax rate.

The Government enacted a comprehensive reform of the company tax in 1987 that did address these problems. The tax rate was reduced to 33-1/3 percent and the "additional tax" was eliminated. This removed the disincentive to larger dividend distributions, and, though the Government did not eliminate the double taxation of dividends, it did bring interest income into the tax base thereby removing another disincentive to equity finance.

A SUCCESSFUL INCOME TAX REFORM?

No effort has yet been mounted to systematically monitor the impacts of the flat tax reform, i.e., to try to estimate the separate economic effects of the tax reform. The major problem, of course, would be to try and separate the effects of tax changes from the effects of everything else that is affecting the Jamaican economy. Still, from the macro evidence, there is some indication of success. Perhaps the best indicator is the lack of any continuing public discontent with the tax reform. The press has not been critical, the political opposition has not raised substantial objections, labor seems to be pleased with the relatively high standard deduction and with the equality associated with a flat rate, and the business community clearly has benefited from the lower company tax rate. To be sure, there was initial resentment to taxing interest income--this led to exemption for small deposits--and there was the expected grousing from special interests about the loss of tax preferences. The important point, however, is that the public seems to have adjusted to the initial shock of the change, and, though taxes are never as low or even as fair as citizens would like, the new system would appear to be much more palatable than the previous one.

Have the income tax reforms stimulated the economy in 1986 and 1987? Something has. Corporate profits are up--through August 1987 the 16 largest listed companies are reporting post-tax profits 84 percent higher than the same period last year. The Jamaican stock exchange has had record growth during 1986 and 1987. The market index went from 941.5 at the end of 1985 to 1499.8 at the end of 1987 and now stands at 1757.7 (9/22/87). Of course, the tax reform has been only one of a number of positive factors affecting the Jamaican economy. The interest rate has dropped from 23 percent at the beginning of 1986 to 16.7 percent by latest available figures for 1987. The real growth in exports was up by 10.3 percent in 1986. The rate of inflation declined from 25.7 percent for all of 1985 to 15.1 percent for 1986 and was running at 7.1 percent for the first five months of 1987. On basis of available evidence, no one could argue the extent to which these changes are due to the tax reform, but many would be prepared to argue that so favorable a performance of the Jamaican economy could not have taken place under the old regime.

The revenue neutrality target of the reform has been attained, perhaps even surpassed. Comparing the same quarter in the first year of the reform (1986) with 1985, PAYE collections were up 9.7 percent; in 1987, the same comparison shows a 17.9 percent increase over 1986. Total company and personal income taxes in the second quarter of 1987 were running about 18 percent above second quarter 1986 collections--a substantial increase in real terms. Some part of this increase is due to administration. The simpler income tax system has made it possible for the income tax department to concentrate more on enforcement of the system and there is evidence of a more effective audit and examination activity. More vigorous audit activities have led to a tripling of additional taxes and penalties over 1986.

Finally, there is the question of the fairness of the new reform. The Tax Project has estimated that the combination of the lower, flat rate, the J$8580 standard deduction and broadened base did not increase the regressivity of the system. Indeed, improved administration holds the promise of making the new system more progressive than the old.

The reform is not without problems- no reform ever is. Perhaps the major problem is that the door was left open for abuse on some perquisites--the housing allowance, the travel allowance, and uniform allowances. There already appear to be some misuses of these provisions for nontaxable income, and, if they continue to grow, they could compromise the fairness of the new structure and bring pressure for a rate increase. Provision has not yet been made to index the standard deduction, and this could be another important policy problem, especially if the rate of inflation were to return to higher levels. To mitigate the burden on lower income savers, there is no tax on interest of bank deposits of J$2000 or less. This could encourage some splitting of deposit holdings by higher income depositors. While these are all potential problems, all can be dealt with by continuing policy review.