EXECUTIVE SUMMARY

(1) The 4% Cess in its present form is unacceptable because:

a) of its potentially adverse effects on the cash flow of businesses

b) it is unfair to hotels and other companies operating on a tax free basis under tax holiday legislation

c) it is unfair to persons who are importing for their own use rather than for business purposes

d) it creates more bureaucracy

e) rather than levelling the playing field in favour of legitimate importers, it does the exact opposite. The Cess would achieve a levelling of the playing field if it is only applied to those importers who do not make tax returns

If we are to persist with the 4% Cess, then it should be agreed that the Cess payments can be used to offset quarterly tax payments, rather than waiting until the end of the Year. A system should be established whereby companies operating on a tax free basis, such as hotels, and companies either operating at a loss or with insufficient profits to recover their cess payments by means of a tax credit, should be entitled to claim tax refunds in cash.

(2) The Alternatives

(1) Clearly, the least painful way for the Government to generate the revenue it needs is to increase compliance at the ports of entry. In this paper, it is estimated that this should generate some $7 billion in revenue - twice the anticipated net yield from the 4% Cess. Moreover, it would level the playing field.

(2) A reduction in Government expenditure would be the next least painful way of replacing the 4% Cess. It would also have the advantage of not dampening down economic activity to the same extent as a tax hike would do. Additionally, it would have no inflationary effect.

(3) The Advance GCT proposal, which is similar in concept to the 4% Cess, would be much easier to implement than the Cess. However, if a rate of 4% Advance GCT would not generate sufficient income to replace the projected yield from the Cess, **as a last resort**, consideration might have to be given to a hike in the standard rate of GCT.

(4) The Document anticipated that a hike in the standard rate of GCT from 15% to 17.5% would yield $3.5 billion - roughly the same amount as the estimated yield from the 4% Cess. However, with the drastic reduction in the number of exempt and zero rated items, the increase in the rate should generate substantially more revenue. Perhaps this surplus could be used to restore exempt or zero rated status to a number of sensitive items, which have been the subject of much public concern.

(5) Consideration should again be given to the possibility of a tax amnesty. Perhaps we should study why such an amnesty was so successful in Ireland.

(6) Reintroduce a withholding on dividends paid to non residents. This would generate more revenue than the anticipated $550 million arising from the withdrawal of the tax credit for the issuance of bonus shares. Given that the latter measure is anti-growth, perhaps this tax credit should be restored and the loss of revenue replaced by the reinstatement of the withholding tax on dividends paid to non residents.

(7) Consideration should be given to raising revenue from an energy equalization and conservation tax, taking advantage of the likely reductions in oil prices in the coming months. The size of the vehicle one drives is probably a better indication of ability to pay than almost any other yard stick. Thus, an energy tax is arguably a much more progressive tax than our attitude to the taxation of gas would suggest.

(8) Consider legalizing Casino Gambling using the sale of licences, in the same manner as the sale of the cell phone licences, to generate revenue in the shortest time possible.

(9) Accelerate and expand the Government's plans for the Privatization of Government enterprises and other assets.

Roy and Keith Collister

Economic and Taxation Committee

27 April 2003

THE 4% CESS

Preamble

The proposed 4% Cess to be charged on all imports inclusive of capital goods and raw materials has met with strong opposition from the Private Sector. However, the announcement of the Cess by the Minister of Finance when he opened the budget debate did not come as a complete surprise to the Private Sector. The idea had originally surfaced in what was termed a **"Discussion Document"** (referred to hereafter as the **"Document"**) which was circulated to the members of the Economic Policy Committee of the PSOJ by its then Chairman. The Document was unsigned but it bore all the hallmarks of a Ministry Paper. However, it did not use the term **Cess** - instead it referred to the proposed imposition as **Advance Income Tax on Operations (ATO).** Moreover, it spelled out, in much greater detail than Ministry Paper 19, the reasoning underlying the proposal, its advantages and disadvantages and indeed how it would work.

The Document refers to a PIOJ study which indicates that the informal economy *"represents 40% of GDP"*. On the other hand, the Minister, in his speech, suggested that the informal economy represented only 30% of GDP, when he concluded that *"of the real economy only 70% of activities are included in the tax net"*. The Minister explained that *"in several cases importers have no interface with the tax authorities after the goods leave the ports."* This comment is in line with the Document which opines that a large part of this commercial activity escapes the income tax net and further that much of this commercial activity is dependent on goods that *"legitimately pass through the ports"*. The use of the word "legitimately" implies that proper duties and advance GCT are paid on these imports - whether this is in fact the case is in many instances questionable.

An Income Tax Credit

Be that as it may, because the Cess would be treated as a credit against income tax when the importer has filed his income tax returns, the Minister observed that *"From the perspective of the importer who systematically files returns, this Cess would have minimal impact, only in so far as it affects his cash flow"*. This is a qualified version of the following comment in the Document *"if implemented efficiently, it does not affect the operations of entities that comply with the existing income tax regulations."* But this qualification is a major consideration! Nevertheless, it is difficult to quantify the effect on an importer's cash flow because it is unclear as to when he will be able to use the tax credit arising from the Cess. Ministry Paper 19 states *"Tax payers would be able to claim a credit for the Cess against their income tax liability for the year of assessment in which the Cess was paid. Where the return for the year of assessment is not filed by December 31, following the filing date, that is March 14, no claim would be allowed in respect of the Cess paid."*

This wording implies - and many in the Private Sector seem to have assumed - that the tax credit can only be used when the importer has filed his tax return. However, the Document suggests otherwise when, under the heading, **Implementation**, it states *"Customs would be obliged to levy a 2% - 4% ATO in addition to customs duty and GCT. The importer would receive an ATO certificate that can be used as a credit on tax payable or as a basis for a refund or to offset any income tax estimated to be due at the end of that quarter against the ATO paid"*.

Mitigating the Potential Cash Flow Burden

Certainly, if the objective of the Cess is to tax evaders, whilst minimizing the impact of the Cess on legitimate importers, it would seem unconscionable not to allow the Cess to be used to offset quarterly tax payments. Indeed, the Document, whilst acknowledging the potential cash flow burden on companies to be a disadvantage of the proposal, plays down its adverse effect because of what it terms a *"Mitigating Factor"* i.e. that *a company, whose income tax payable is based on profits earned in a quarter, would be paying a portion of this income tax on average six weeks earlier than would otherwise have been the case.* It further states that *"If income tax is not applicable because of a loss on operations or some other factor, then the company would be refunded on average 6 weeks after paying the ATO."* Of course, if the potential cash flow burden is as limited as the "Mitigating Factor" implies, then the positive impact of collecting income tax six weeks earlier would be equally limited. Indeed, if collecting income tax earlier is the objective, this could be achieved simply by bringing forward the date when quarterly tax payments fall due.

Based no doubt on the notion of the above Mitigating Factor, the Document cites amongst the advantages of ATO (Cess) is that it *"matches the payment of tax more closely with the time at which the profits are made".* It is submitted that it does the exact opposite! Profits are not made when goods reach the port of entry - profits are only realized when the goods have been sold and paid for. Thus an importer, who carries an average of two months stock on hand and gives his customers 60 days credit, would not make a profit on the goods until four months after he had suffered the Cess at the port of entry. In short, ATO (Cess) is what it calls itself - **Advance** Income Tax on Operations - not **Concurrent** Income Tax on Operations. In short, the potential cash flow burden on companies cannot be dismissed so lightly - as has just been pointed out, it could take possibly 4 months or longer before the profit on goods subjected to the Cess at the port of entry is actually realized.

Moreover, the potential cash flow burden is likely to impact most severely on the importers of basic commodities. Importers of basic commodities operate on mark-ups closer to 10% than the 50% assumed in Paragraph 3.1 - Example of the Document. More to the point, the net profit on handling these commodities is almost certainly less than 2%. Hence, with a Cess of 4%, the importer would be paying a Cess equal to more than twice the net profit realized on handling the basic commodity. Clearly, this would constitute an intolerable burden on his cash flow.

Other Disadvantages

The Minister in his speech states the *"only persons who will have a net loss, compared to their present situation, will be those who have not been making income tax payments".* However, according to Ministry Paper 19, the Cess will only be treated as a tax credit against income tax *"where goods are imported for business purposes".* Thus, someone, such as a salaried employee whose income is taxed at source, a retiree or anyone else not actually in business, who imports say a computer for personal use, would not be able to claim a tax credit. Hence, as far as the salaried employee or the retiree is concerned, it is an additional duty rather than an advance payment of income tax. This begs the following 2 questions:

- should not all those who file their income tax returns be entitled to a tax credit, not just those importing for business purposes.

- Is the fact that, in these circumstances, the Cess is in reality a duty not in contravention of the WTO regulations?

Other disadvantages identified in the Document are:

- that the proposal would be administratively challenging because *"There are thousands of companies and individuals that import commercial goods and implementation of the ATO would require the construction of a parallel bureaucracy to monitor its implementation."* Thus, we would be establishing another parallel bureaucracy just at the time when the Legs and Regs Committee of the Jamaica Chamber of Commerce, in conjunction with USAID, has just installed an executive in the Prime Minister's Office for the express purpose of reducing bureaucracy.

- that companies not required to pay income taxes e.g. hotels benefiting from incentives and those involved in certain forms of agriculture would be adversely effected when they import goods - how this problem would be addressed is not stated?[1]

Exemptions
It is proposed that exemptions would not apply to any category of goods or any industry. The only exemptions from the Cess being where goods are imported by:

1. The Government
2. Diplomats
3. International Organisations
4. Passengers (up to an allowance of US$500)

Presumably, this is in order to keep it simple. (It is widely recognized that GCT would be much simpler to administer if there were no exemptions.) However, this means that the computation of the duty and taxes payable on imports would be computed on different bases i.e. Advance GCT and the Cess would apply to some goods, whilst others would be subject only to the Cess. In short, the Cess would be complicating, still further, the procedure for clearing goods.

A Level Playing Field?
It would appear that Government believed it could win the support of the formal Private Sector for the imposition of the Cess by using the argument that, with only minor adverse implications for their businesses, it would level the playing field in their favour. On the other hand, the formal Private Sector is of the view that the measure would have major adverse effects on their businesses and would make the playing field even less level than it

[1]The Minister of Finance, in closing the budget debate, made it clear that the 4% Cess will only be recoverable as a tax credit not by means of a refund. It would therefore appear that companies operating tax free under incentive legislation and companies operating at a loss (or indeed companies whose tax liability is less then the amount of the Cess they have paid) will be unable to recover these amounts. Clearly, this is unacceptable and a system for obtaining refunds should be introduced.

is at present. This view is supported by PWC who, in their Tax Newsletter of 17 April 2003 state: *"The imposition of a Cess on all imports is likely to further disadvantage importers who comply with existing import regulations. If the conventional wisdom is correct, that a high percentage of imports either evade duties at the ports altogether or are severely undervalued, then the Cess will constitute an additional competitive advantage for those who do not comply - those who play by the rules will suffer another major disadvantage."*

Conclusion

The conclusion to be drawn from the above is surely that, if it is decided to proceed with the introduction of the Cess, it should only be applied to importers who are not making tax returns and paying their quarterly instalments. To quote again from the PWC Newsletter, *"we can't help wondering why it should be beyond the capability of the Revenue to chase up those importers who "have no interface with the tax authorities after they leave the ports", in the Minister's words. After all, importers must produce TRN numbers and Tax Compliance Certificates before they clear their imports, so their whereabouts must be known to the Revenue. Why can't the procedures for ensuring that they do pay their corporate taxes, including estimated taxes and GCT before their shipments are cleared, be strengthened and reinforced, rather than penalizing the mostly compliant taxpayers."* Hence, it should be administratively possible to use the Cess as a penalty imposed on those who do not comply with the tax laws rather than penalizing tax compliant importers as well. In other words, it should operate as an **Alternative** Minimum Tax - not an **Additional** Minimum Tax applicable to those who are already meeting their tax obligations.

THE ALTERNATIVES

The disadvantages of the proposed 4% Cess have been examined in some detail above. However, given the need for the Government to generate the additional revenue projected by the Minister of Finance in his Budget Speech, what are the alternatives to the Cess? Clearly, as the PWC newsletter implies the starting point for the enhancement of the revenue has to be *increased compliance at the port of entry*. This point is considered hereunder.

Increased Compliance at the Port of Entry

According to the Document, "The government collects only a fraction of the correct customs duties and GCT applicable to goods that pass through the ports of Jamaica. In many cases, those who evade and the methods they use are known. However, due to a combination of a lack of will and/or intimidation a "blind eye" approach is used towards these persons and companies." Revenues from international trade, whilst 8% above the previous comparable period for the first nine months of last year (or approximately in line with inflation suggesting no significant improvement in compliance), were 7% or $1.57 bn below projections of approximately $21 bn in taxes from international trade excluding travel taxes. If we assume that, similar to the informal economy estimates, only 60% of goods imported pay their legitimate taxes, then moving the compliance rate only up to 70%, and using a 9% inflation rate, would lead to a 25% increase in nominal revenues, or approximately an additional $7 billion beyond estimated annualized full year revenues for the full financial year.

The Document continues "The government cannot expect to meet its fiscal targets by solely increasing the burden on the legitimate importers and will have to vigorously pursue measures that close the gap at the ports of entry:

(i) Fast-track the implementation of advanced x-ray equipment at the ports (*This has been part of the Memorandum of Understanding with the Private Sector for over three years and has still not been implemented*).

(ii) Seek to subcontract collection to international firms with experience in custom operations in "rough" developing countries *e.g. Crown agents or other private sector firms that use experienced former Customs agents and/or ex-military from developed countries."*

Other Measures proposed in the Document

The Document referred to at length in this paper does not confine itself to a discussion of the merits and demerits of the Cess. It also spells out a number of alternative measures which we believe merit consideration. These are:

1.0 Reduce Waste in the Public Sector

From the standpoint of the taxpayer, the least painful means of dealing with the Budget Deficit is to cut Government expenditure. The starting point should surely be the implementation of the measures and proposals contained in the Nettleford, Orane and other reports. Certainly, this would lead to a reduction in public expenditure.

The potential for a reduction in Government expenditure where the Government is dedicated to the task was illustrated in a recent Gleaner article entitled "From Celtic Tiger to Carib Tiger". This article examined in some detail how the Irish Government, finding itself in the midst of a financial crisis in 1987 made a determined effort to cut Government expenditure. To quote from that article:

The whole expenditure - control exercise worked well - and just how well was shown from the figures when they emerged. In October (1988) the estimates were published, as promised, ***and the government had achieved a six per cent reduction in nominal spending - a new record****. MacSharry (the Irish Minister of Finance) points out that "It should also be noted that* ***this was particularly impressive politically in that it was a minority government that achieved this level of expenditure reduction****, and it showed a huge level of long term determination and follow through".*

2.0 Advanced GCT ("A-GCT")

As was indicated above in the section on the 4% Cess, a large subset of the informal economy consists of entities engaged in legal commercial activities that are able to evade income tax on profits generated from those activities. In many cases, this commercial activity is dependent on goods that legitimately pass through the ports where taxes on further value-added activities that make use of those goods is evaded.

The objective of the Cess was to capture much of the income tax evaded in this way. However, some of these entities that are able to evade income tax in the manner are also able to evade GCT on the final sale of their goods to their customers. This section of the Document proposed a similar method to capture GCT on the valued-added component by paying an Advanced GCT ("A-GCT") on goods imported through the ports.

It was estimated that the A-GCT at the level of 2.5% could generate at least an additional $1 billion in revenue.

2.1 Example

Assume that an entity can import goods with c.i.f. value of $40 custom and other duties of $10 are assessed - giving cost of goods of $50 on which, the entity pays GCT of $7.50 (15%). Assume further that the entity sells the goods for $75 (50% markup or 33% margin) and collects $11.25 in GCT from the customer. Then, the entity would pass on a further $3.75 to the government, which is the difference between his "input" and "output" tax ($11.25 - $3.75).

In this example, the government collects a total of $11.25 from the overall transaction - $7.50 at the port and $3.75 on resale. In many cases, however, though GCT may be appropriately assessed and collected at the port, GCT compliance at the level of the final transaction is partial.

To ensure a greater level of compliance, it is proposed that the government collects a larger portion of the GCT at the port (as an advance), while collecting the same amount overall.

In the example above, assume that the advance is 2.5%. Then the entity would pay GCT of $8.75 at the port (17.5% * $50) and on resale at $75 the entity would collect $11.25 in GCT, but would only be required to pay $2.50 to the government.

2.2 Advantages

The advantages of the A-GCT are:

- (i) It is not an increase in tax, nor is it a "new" tax.
- (ii) It is non-inflationary
- (iii) It has huge potential of increasing government revenue quickly
- (iv) It broadens the GCT tax net to include tax on value-added profits that currently escape the tax net
- (v) Helps to level the playing field among competitors, some of whom unfairly escape GCT on value added sales
- (vi) It relies on the GCT system which should result in straightforward implementation

2.3 Disadvantages

Some disadvantages are:

- (i) If there are exemptions, the incentive to mislabel goods would be higher
- (ii) Potential negative cash-flow impact on companies although this is mitigated by the system of monthly GCT returns

2.4 Implementation

The government could modify the income tax system to apply the principle and mechanics used in "taxation at source".

2.4.1 A-GCT Certificate

The importer would receive an A-GCT certificate that can be used as a credit on GCT tax payable or as a basis for a refund or to offset any GCT refunds that may be due.

2.4.2 Exemptions

The A-GCT would be applicable to all goods that attract GCT. The document seemed to regard the Cess (or ATO) as a means of picking up the taxes on the profits of companies and individuals which were being evaded. On the other hand, the advanced GCT proposal was intended to pick up the GCT on value added which is being evaded. The Advanced GCT proposal has the following advantages over the Cess:

- It is not an additional tax being imposed at the port of entry - it would merely involve a change in the GCT rate. Thus, it would be less complex.

- The means by which the importer recovers the GCT advance is already built into the system i.e. he would recover the additional 2.5% in exactly the same way as he recovers the 15% he pays at present.

- Thus the tax system is not complicated further as it would be by tax credits and refunds for the Cess.

- As the importer is able to recover the advanced tax on a monthly basis his cash flow will not be adversely affected to the same extent - perhaps, a disadvantage from Government's point of view.

However, the main disadvantage from a Government standpoint is the fact that a 2.5% advance tax on items subject to GCT will yield a lot less than a 4% Cess across the board. According to the Document, a 2.5% advance GCT would raise about $1 billion. This did not take account of the extensive widening of the categories of goods and services subject to GCT. Thus, the estimate of $1 billion may be on the low side. Nevertheless, this would clearly be inadequate to replace the revenue it was expected to generate from the 4% Cess. Indeed, even at 4%, Advance GCT may be inadequate to meet the Government's needs. If this be the case, **as a last resort**, consideration may have to be given to an increase in the GCT rate.

3.0 Increase the GCT Rate

According to the Document, increasing the GCT rate from 15% to 17.5% could be expected to raise approximately $3.5 billion[2].

Advantages

(i) Easy to implement
(ii) Measurable impact

Disadvantages

(i) The increase would be inflationary and may lead to higher interest rates (but so might the Cess)
(ii) This measures has a disproportionate negative effect on pensioners and the poor (but so would the Cess)
(iii) This measure may dampen consumption and lead to contraction of the economy (but so might the Cess)

[2] GCT for the 2000/2001 year was $22 billion. Source: ESSJ 2001

Alternative Proposals not addressed in the Document

(I) A Tax Amnesty

When this was introduced in Ireland in 1987, it raised more than fifteen times what was forecasted in the Budget. The idea was strongly opposed by the Revenue Commissioners and Finance Officials, who were sceptical about its chance of success and concerned about the principle being conceded. It had been tried before in Ireland and yielded little, whilst an amnesty for tax dodgers and defaulters seemed to be sending the wrong signals. After all, here were people who, in some cases as employers, had collected their employees' PAYE receipts and failed to pass this money to the state, a circumstance which may sound familiar to Jamaicans.

The inspiration for the amnesty was the Irish Finance Minister's experience in his constituency office. People were constantly coming to him and saying: "I want to put my tax affairs in order. I can pay the tax but I can't pay the penalties and interest".

Because of the failure of previous amnesties, it was believed in Ireland that the proposed 1987 amnesty would not work. However, this amnesty was different from previous ones in that the Government was waiving interest and penalty charges on tax outstanding. The amnesty was in fact a huge success, and in the final week of the nine month period there were 40,000 callers to the Revenue offices in Ireland. It may even be an idea to front load the amnesty to reflect the time value of money, so that people paying within three months get an additional 5% off, people paying within six months pay their original obligation, whilst people paying just before the nine months expiry date have to pay the full amount plus 5%. This "Tax Incentive Scheme" might conservatively be expected to raise at least $4 billion.

(II) Withholding Tax on Dividends Paid to Non Resident Shareholders

When the dividends of listed companies were exempted from withholding tax, this exemption applied not only to dividends paid to resident shareholders but also to dividends paid to non resident shareholders. This raises the question "why should Jamaica forgo tax revenue, when it can ill afford to do so, when other countries receiving dividends from Jamaica do not reciprocate"? Indeed, we are not aware of any countries (other than tax havens) which do not apply a withholding tax to dividends paid to non-residents with those located in tax havens being subject to the highest rates of withholding tax. Certainly, our Caricom partner, Trinidad & Tobago - which some 15 years ago abolished the double taxation of dividends - still applies a withholding tax to dividends paid to non residents. Barbados also imposes a withholding tax on dividends paid to non - residents. Moreover, we understand that even President Bush's proposal to eliminate the double taxation of dividends, by the removal of the withholding tax on dividends, does not extend to dividends paid to non - residents. In short, the re-imposition of withholding tax on dividends paid to non - residents would only put Jamaica back into step with common practice. We have not quantified the amount of additional revenue that this measure would generate, but we estimate from the latest Bank of Nova Scotia Jamaica annual report that, applying the double taxation treaty rate of 15% to dividends paid to Canada would yield $177 million.

In any event, such a measure would be unlikely to influence adversely the commitment to Jamaica of non - resident direct investors such as the Bank of Nova Scotia, Carreras, Cable and Wireless, Berger and Goodyear. In the light of the above, it appears that we have nothing to lose and everything to gain by re-introducing the withholding tax on dividends paid to non-residents.

(III) A Energy Equalization Tax

Whilst appreciating that the taxation of energy, gas in particular, is highly sensitive from a political standpoint, there is surely a strong case for biting the bullet, given the difficult financial position in which the Government finds itself. Presumably, the reason for the limitations placed on the taxation of gas is that increases in gas prices put up the cost of transportation and this feeds through into every component in the cost of living of the poor. However, there are many items more likely to have a greater direct impact on the lives of the poor than additional taxes on gas, specifically items and services, which were previously exempt or zero rated? Other points to consider are:

- The taxation of gas is a major source of Government revenue in most countries - consequently even in metropolitan countries like the UK, which are self sufficient in the production of energy, vehicle drivers pay more than double what we pay for gas.

- Energy imports comprise a large proportion of our imports (US$640 million) and accordingly contribute materially to our trade deficit. At the same time, as Minister Paulwell observed recently, energy conservation is not our strong suit. Thus, if higher prices encourage us to consume less gas and concurrently swell the coffers of the Revenue, we would be ahead on both counts.

- Given that we have just been through a period of very high oil prices, which prices are expected to fall significantly, now might be an opportune time to adopt such a measure. It could take the form of a Energy Equalization tax, whereby retail gas prices are maintained at the current level with the surpluses arising from any reductions in oil prices being absorbed by the above Energy Equalization tax.

(IV) Legalisation of Casino Gambling

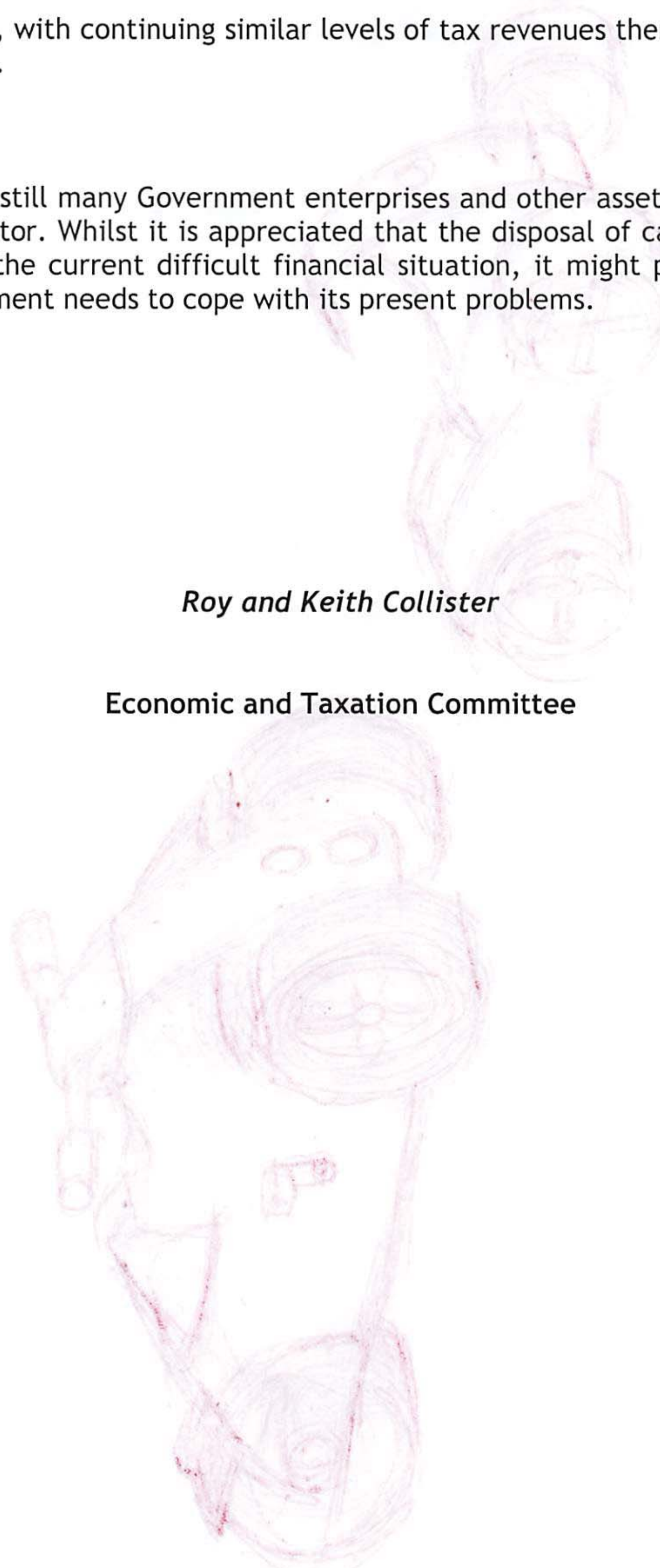
The category Local Betting, Gaming and Lottery apparently brought in nearly $700m in the first three quarters of last fiscal year, and this revenue is solely from local gamblers (with undoubtedly worst social consequences than Casino's, particularly if only foreigners were allowed to gamble in Casino's as in Bahamas.) The legalization of Casinos would, at minimum, quadruple the current tax revenues[3] brought in from this area (check Bahamas experience), as well as creating additional tax revenues from the expansion of the tourist industry. Whilst it would require time for the Casinos to be set up and generate revenue, an exclusive Casino licence could be auctioned this year for Kingston, Negril, Montego Bay, Trelawny, Ocho Rios, and Port Antonio, with the potential for generating a total windfall similar perhaps to the auction of the cellular phone licenses in 1999 e.g. perhaps

[3] This does not take into account the GCT imposed on Gaming by the Minister of Finance when he closed the Budget Debate.

between J$2-4 bn, with continuing similar levels of tax revenues thereafter as the Casinos began functioning.

(V) Privatization

Finally, there are still many Government enterprises and other assets which could be sold to the Private Sector. Whilst it is appreciated that the disposal of capital assets is a one-shot windfall, in the current difficult financial situation, it might provide the breathing space the Government needs to cope with its present problems.



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