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The Case of Jamaica**

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From Income to Consumption Tax?: The Case of Jamaica

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Introduction

The “flat tax revolution” that has taken Eastern Europe by storm over the last decade and the proliferation of proposals in the U.S. represents a substantial change in the focus of the income tax.² Under these various reforms, income taxation has moved from a system of progressive rates with complicated deductions, exemptions, and special treatment, to a tax system with broader bases and lower (flat) tax rates, and in some cases, closer integration of individual and business taxation. In most countries that have moved to flat taxes, the base is income, while the U.S. proposals focus on consumption as the preferred tax base. The discussion of the merits of such a change in taxation as it relates to developing countries is not so

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² According to *The Economist* (April 14, 2005), the “new revolution” in flat taxes began with Estonia’s adoption of a flat rate income tax in 1994, see Table 1. As will be discussed later, these are more appropriately called flat rate income taxes and differ from our definition of “flat taxes.”

far along as is the “evidence” that is used to support the move toward consumption based taxation in more developed economies.

In this paper, we analyze the case of developing a country that has been involved in a long-term comprehensive tax reform. One might argue that Jamaica is a good case study of the fiscal realities of moving from a conventional tax system to a flat tax system. However, through the reforms of the 1980s, 90s, and into 2005, the objective was not to implement a consumption tax. In two reforms in the 1980s-early 1990s, Jamaica adopted a flat rate income tax, and a single rate value added tax, in order to redress some problems that had grown up in the system and to plot the next step in comprehensive tax reform. The first question we raise is whether these changes in fact moved the tax system closer to a consumption tax. Again in 2005, Jamaica considered comprehensive tax reform. We raise the same question: would the full adoption of this proposed reform have moved Jamaica closer to a consumption tax? Finally, we ask the question of what remains to be done with the Jamaican tax system to convert it to a tax on consumption and whether it is a worthy goal in the case of a developing country.

The paper proceeds as follows. In the next section, we define what *we* mean by a flat tax and how this differs from a flat rate income tax and provide a discussion of the basic merits of a flat tax system. The third section tracks the changes in Jamaica’s income tax, and its impacts. In the fourth section we discuss the necessary steps to move to a full consumption tax. In the conclusions, we examine the lessons that might be learned from the Jamaican experience. In particular, we point out that limits on the Government’s discretion in reforming the tax structure, and the detail of the tax administration, may lead to a greater gap between the theory of flat taxation and its realization than most have thought. We also point out that the revenue-driven

and efficiency-driven reforms, as may be the norm in most developing countries, can move the tax structure away from a consumption tax.

What is a flat tax?

The concept of flat taxes has a long history in tax policy. According to the Wikipedia encyclopedia, a flat tax is ‘*a tax system that taxes all entities in a class at the same rate and on a broadly defined base*’ (Wikipedia, http://en.wikipedia.org/wiki/Flat_tax). Such a tax typically features low rates and it also has a limited number of deductions and exemptions, or none at all. The marginal tax rate for a flat tax remains constant as taxable income rises.

In practice, there is a good deal of confusion regarding the term “flat tax,” which can lead to misinterpretations and unrealistic expectations of policy proposals. We start by defining a “flat tax” along the lines of the Hall-Rabushka (H-R) (1980, 1985, 1995) proposal.[□] The H-R flat tax is a tax on consumption but it is levied through a postcard tax return, one for individuals and one for businesses. This postcard tax return requires the taxpayer to report their wage income plus pension and retirement benefits, and provides a deduction for family status and for dependents in the case of individuals. Businesses would report gross revenues and deduct allowable costs (wages and salaries, pension benefits, purchase of goods, services and materials, and purchases of capital equipment, but not fringe benefits). All income is therefore subject to consistent treatment and is taxed at one rate (above the standard deduction/personal exemption level).

[□] We take the H-R proposal as a convenient starting point for our discussion. There was by no means the first flat tax type proposal based on the taxation of income. Among those to whom flat tax ideals are attributed are: John Stuart Mill, Milton Friedman (1962), David Bradford (1986). However, in some cases, those supporters envisioned a flat rate income tax and not necessarily a consumption based flat tax.

How is this kind of tax a consumption tax? If we start by defining the relationship among income, consumption, and savings, we can easily determine whether or not a tax is a tax on consumption, income or both:

$$\text{Income} = \text{consumption} + \text{savings}$$

A tax that excludes savings will be a consumption tax—a tax that taxes comprehensive income will effectively tax some consumption and some savings. A cash-flow expenditure tax is a consumption tax in which taxpayers report all income and deduct savings (this is not necessarily a flat *rate* tax).⁴ The H-R flat tax exempts savings from taxation, and is therefore a consumption tax and is similar to a cash-flow expenditure tax. Theoretically, a flat tax that exempts personal savings is equivalent to a single rate consumption-type VAT, which is a tax on value added by labor and capital and allows for the expensing of capital. By our reckoning, all flat rate taxes are not consumption taxes but a consumption typically must be a flat rate tax.⁵ Our interest in this paper is the consumption tax as a flat tax.

The treatment of capital is critical to the consumption versus income base of a tax. In the case of the H-R flat tax, individuals are not directly taxed on the returns to their investments. Businesses fully deduct the purchase prices of assets (including buildings, land, etc.), but they must also include the sale of assets as taxable income. Interest and dividends are not business deductions, so, effectively, the returns to capital are taxed once at the business level. Theoretically this may reduce the cost of capital and increase savings. This also may require elimination of other “duplicative” taxes such as payroll taxes, property taxes, transfer taxes, etc.

⁴ See Meiskowski (1997) for a discussion of a specific cash-flow expenditure tax: <http://www.treasury.gov/offices/tax/policy/library/ota26.pdf>

⁵ As will be seen later, a consumption tax as a flat tax yields potential benefits in terms of economic efficiency and administrative efficiency. If a consumption tax has multiple rates it loses the ability to tax all income equivalently and in our view of the world, becomes something closer to a comprehensive income tax.

For proponents of HIR type flat taxes, the treatment of capital income is one of the most critical components of any such proposal (along with simplification of the system). For purposes of our discussion, the HIR type flat tax is what we will call a “true” flat tax, noting that this is our distinction.

Many countries that are perceived as having moved to a flat tax system in fact have moved only to a flat *rate income* tax system. This distinction is important since a number of these flat rate income tax systems do not lead to a significant change in the cost of capital.⁶ Therefore, they are not equivalent to a consumption tax. The economic effects of flat rate income taxes will not be the same as the impacts of a consumption tax. □

To add to the confusion over semantics, there are other tax proposals that have been branded as “flat tax” proposals or types of flat taxes. These have proliferated in the U.S. over the past decade. For example, in the U.S., there have been calls for a “FairTax” which is a flat rate tax on consumption levied as a retail sales tax.⁸ The “Xtax” is a variant of the HIR flat tax that introduces a progressive marginal tax rate structure for individuals □ the business tax rate is the same as the highest individual tax rate.⁹

The economic benefits of a pure flat tax, as discussed by Hall and Rabushka and others, have been untested in practice as no country that we know of has moved to a pure flat tax.

Simplification of the tax system and resulting reduction in the costs of tax administration and a

⁶ This may be due to less than full integration of the corporate and individual income tax, which may yield double taxation of interest and/or dividends, or if significant tax holidays exist, a comprehensive flat income tax rate reform may actually increase the cost of capital if capital was largely exempt in previous law. In developing countries a combination of tax evasion and tax holidays and tax exemptions could in fact lead to very little taxation of capital to begin with (Bahl and Wallace, 2005).

□ This is not to say that a pure consumption tax is the only tax that leads to efficiency gains, etc. Most good tax reforms attempt broaden tax bases and lower tax rates in an effort to reduce relative price differentials.

⁸ The proposal is attributed to Rep. John Linder and was introduced to Congress in 2005 as H.B. 25. Bickley (2005) provides a useful summary of recent U.S. “flat tax” proposals, many of which are consumption based proposals. He documents 10 flat tax type proposals introduced in the U.S. Congress between 2001 and 2005.

⁹ The “Xtax” proposal is attributed to David Bradford (1986). A helpful summary of the flat tax and Xtax proposals is available from the President’s Advisory Panel on Tax Reform: <http://www.taxreformpanel.gov/>.

possible increase in compliance are among the major benefits of a move to a consumption based flat tax. However, there are expected economic benefits as well. Efficiency gains are expected because of changes in the relative prices of consumption versus saving, labor versus capital, types of capital, etc. Some of these gains may be translated into increases in economic growth as well.¹⁰

The possibility of adopting a consumption tax in a developing or transition country is especially intriguing to economists. The reduction of administrative costs is important, and when the relative price of capital falls, there are expected increases in economic growth. In practice, however, no country has moved to a pure flat rate consumption tax. Therefore, we cannot do an *ex post* evaluation of impacts.

What we might do, however, is study a country that has undertaken major tax reforms and ask whether it has moved in the direction of a consumption tax and whether the direction of change has yielded benefits to the country.

Jamaica's Flat Rate Income Tax

Jamaica introduced a flat rate individual income tax in 1986. It considered improvements to this tax again in 2005. The questions we raise is whether these reforms and proposed reforms have moved Jamaica closer to the flat tax norms.

¹⁰ Auerbach (1991) reports potential increases in output of 2 to 4 percent over the first nine years of a pure flat tax and 4 to 6 percent over the long run. As discussed by Gale (1998), the H.R. flat tax is not pure because of the personal deduction/exemption. Gale also notes that many of the benefits of a pure flat tax could be achieved under a reform of the current US system. And, we note, that the size of the potential efficiency gains in any case depends on the *relative* price changes—so where a country starts pre-reform will define the overall gains in any reform.

The Pre-Reform System in the 1980s

The pre-reform Jamaican individual income tax was far from a tax on comprehensive income (Break, 1991; McLure, 1984). Capital gains were not taxed, the base was not adjusted for changes in the price level, imputed income escaped the tax, as did many allowances or fringe benefits paid to employees, 16 tax credits available to taxpayers and much capital income was exempt from the tax. The tax base was also reduced by widespread tax evasion, especially among the self-employed. Estimates of the amount of income actually subject to the individual income tax suggest that less than one-fourth of GDP was covered.

The rate structure of the individual income tax was both high and steeply progressive. The statutory tax rates as of 1984 are shown in Table 2. With respect to the individual income tax proper, marginal tax rates rose from 10 percent on the first J\$1,000 of statutory income to 55 percent on income above J\$4,000. In 1984, a special notch was created to provide relief to taxpayers earning less than J\$1,000—in effect, those earning less than J\$5,080 and having no credit claims beyond the personal and special credits were exempt from tax.

Such a progressive rate structure has significant advantages. If effectively administered, it might increase the Government's potential for redistributing income from rich to poor and for generating greater revenues as incomes grow. On the other hand, it may also provide significant disincentives to work effort, domestic investment, saving, and to compliance. The Government attempted to offset some of the disincentives to work effort in the formal sector by mandating a maximum tax rate of 10 percent on overtime pay, but the basic disadvantage remained: Jamaican taxpayers reached the 55 percent rate at a relatively low income level.

The 1986 reform of the individual income tax was comprehensive. The key elements of the 1986 reform program were:

1. The credit system was replaced by a standard deduction of J\$8,580.
2. A flat rate tax of 1/10 percent replaced the progressive rate structure.
 - Fringe benefit type allowances were made taxable as ordinary income, with some exceptions.
4. The preferential treatment of overtime income was eliminated.
5. Interest income, above a certain level, was made taxable.

Impacts of the Flat Rate Income Tax Reform

The income tax reform became effective in 1986 and the flat rate individual income tax has remained in effect since that time. Clearly it was a strong improvement over the previous system in removing some unwanted distortions in relative prices, in reducing administrative burdens and in terms of revenue enhancement.

Did this reform lead to significant welfare gains? And, did it move Jamaica closer to a consumption tax?

With respect to the question of welfare gains, it is no simple matter to prove the case that tax-induced distortions in relative prices had resulted in a significant welfare loss. Roughly, the welfare loss is proportional to the product of the size of the distortion in relative prices and the compensated price elasticity of demand (or substitution) for the good (or factor) in question. It turns out that the magnitude of neither term is easily estimated, especially in developing countries. The net change in relative prices that is caused by the existing tax code is difficult to estimate because several different provisions in the tax structure may be involved and because all may not affect relative prices in the same direction. As for the second term, there is very little evidence on the compensated price elasticities of substitution in developing countries but what

there is suggests an inelastic response to relative price changes.¹¹ And, then, there is our question. Did the removal of these distortions move Jamaica closer to a consumption tax?

Labor Supply. Estimates of the substitution effect for industrialized countries suggest little aggregate work effort in response to changes in the tax rate. There is very little empirical evidence on this question for developing countries, but most studies find relatively small price elasticities. The largest we found in the literature is for urban labor in Mexico (Gong and van Soest, 2001, find a wage elasticity of $\frac{1}{3}$ for men). Other estimates for labor elasticities in Sri Lanka, Egypt, and Russia (Martinez, et. al. 2006) find the own price elasticity to be small for labor.

In Jamaica, the impact of the tax rate on work effort may have been of some consequence for two reasons. The first is that the tax rate was high, hence the labor supply response could be significant even if the price elasticity were very low. Second, the compensated price elasticity of labor supply may have been larger than thought, because Jamaican workers have options other than to accept the tax liability. They may remain within the PAYE sector and evade or avoid payment of taxes, or they may migrate from the formal to the informal sector of the economy. With an unemployment rate in the neighborhood of 20 percent during this period, these responses would seem more realistic than the choice of more leisure time or migration abroad.

The 1986 reform did reduce the marginal tax rate on workers significantly, it led to improvements in administration because of the simplification of the tax structure, and it reduced possibilities for avoidance by closing down the options to deduct non-taxed fringe benefits and to take tax credits. While no estimate was made of the aggregate effect on work effort in the formal sector, a reasonable argument is that it has been positive.

¹¹ A good review of this literature is contained in the essays in *Supply Side Tax Policy: Its Relevance to Developing Countries*, edited by P. Gandhi (Washington: International Monetary Fund, 1987).

Capital-Labor Choice. The pre-reform tax system appears to have favored capital relative to labor, though the magnitude of the distortion is difficult to estimate because so many different taxes and subsidies were applied.

Before the 1986 reform, the average effective combined rate of income and payroll tax rates was on the order of 22 percent of statutory income, and the combined top marginal statutory rate was over 65 percent. The price of capital was relatively low in that interest income was not taxed, and dividends and capital gains were either exempt or for administrative reasons, not fully included in the tax base. The weight of the evidence would seem to be with the argument that the tax system had increased the relative price of labor. The size of the distortion may be quite large, hence the tax system may have had a substantial effect on resource allocation, even if the elasticity of substitution is small.

The 1986 reform likely narrowed the gap between the after tax returns to capital and labor.

Saving. Private saving and investment choices were affected by the pre-reform tax structure, though again the magnitude and net direction of the effects are not so clearly seen.

Consider the following "package of effects" that were part of the pre-reform system:

- The marginal personal income tax rates were graduated and reached high levels for those individuals with high marginal propensities to save.
- Income tax credits were offered to those who would participate in specified types of savings programs.
- There were three compulsory payroll savings programs. For those who participated, the average contribution for a private sector worker was about 11 percent of compensation.
- Interest income was not taxed, but dividends were taxed under both the company and individual income taxes.

- Lax tax administration meant that a large portion of the self-employed sector completely evaded income taxes, and therefore paid a marginal tax rate of zero. Since many of these are higher income Jamaicans, the effect was to increase the rate of private saving.
- Retained earnings of companies were taxed at a lower rate than were distributions.

The tax system also affected the structure of investment, though it is not clear that the effects were large. In theory, dividends were taxed at a marginal personal rate of 55 percent income and were subject to the basic corporate rate of 15 percent. This double taxation of dividends, coupled with the tax free status of interest income, is alleged to have led to a thin capitalization for Jamaican companies. There was also a bias in favor of real estate investments because the annual property tax was levied at almost a nominal level and because capital gains from land sales were effectively untaxed.

The 1986 reform corrected, or reduced some of these distortions. The lower marginal tax rate dampened the distortive effects of double taxing dividends and interest income was brought into the tax net. The high tax rates that discouraged individual savers was reduced, but compulsory payroll savings programs were retained. The overall effects of this reform on aggregate savings is not an easy call.

Tax Evasion and Avoidance. Every income taxpayer faces the choices among tax evasion, tax avoidance, and fully reporting income. The potential rewards for successful evasion or avoidance under the pre-reform system were considerable—the 55 percent marginal tax rate and the tax component of the various payroll levies. The opportunities for avoidance were certainly present. Jamaican companies awarded employees nontaxable emoluments, apparently without seeking government approval, and were able to both raise the take-home wage and reduce the firm's liability for the employer share of payroll taxes. Another vehicle for avoidance

was the declaration of overtime income, which was not monitored by income tax authorities. Self-employed Jamaicans more often captured these benefits by outright evasion, taking advantage of the inability of the Income Tax Department to enforce the tax.

The 1986 reform lessened the rewards for avoidance by lowering the income tax rate. And, by cutting off some of the avenues for avoidance—non-taxable fringe benefits and a preferential tax treatment of overtime income—it likely increased the compliance rate.

Implications for Equity. Relative price distortions not only impose an efficiency cost on the economy, they introduce an unfairness in the system that most taxpayers find even more objectionable. This clearly was the case with the previous income tax system in Jamaica. The self-employed were given favored treatment by the income tax administration and paid little or no individual income tax, while those enrolled in the PAYE system were forced to cope with what appeared to be onerous burdens. Even within the PAYE sector, private sector workers had a better opportunity to avoid tax through the receipt of allowances and overtime earnings. On average, a public sector worker paid a higher rate of individual income tax on total compensation than did a private sector worker.

The price distortions in the system also compromised vertical equity. Those who gain the most from income tax evasion are in the upper income classes. Allowances tended to be concentrated in the higher income brackets, and even overtime income was claimed heavily by those who one would expect to be salaried rather than hourly wage earners. Jamaicans with unearned income (interest and dividend income) paid a lower effective tax rate and, since they tended to be concentrated in the higher brackets, this tax preference tended to reduce the overall progressivity of the system. The net effect of the 1986 reform was to make the burden distribution of the individual income tax more progressive.

Tax Administration. The complexity of the pre-reform system made the assessment and audit function of tax officials difficult, a problem that is compounded by the shortage of skilled staff in virtually all of the tax departments. Complexity also raised compliance costs for taxpayers and in so doing either wasted important private sector manpower or gave an additional incentive for tax evasion and avoidance.

Prior to the 1986 reform, the individual income tax included two separate rate structures and a preferential rate for income earned by working overtime hours. There were 16 allowable income tax credits and an even greater number of nontaxable perquisites or "allowances." The forms used to establish an employee's credit entitlements were rarely if ever updated and almost never monitored by either the employer or the Income Tax Department.

Clearly there was a reduction in complication due to the 1986 reform. The tax administration was freed up to concentrate more on collections and on identifying the tax base. This is part of the explanation for the significant increase in revenue that resulted from the reform program.

Consumption Tax Features?

The objectives of the individual income tax reform were more consistent with taxing a comprehensive income base than with moving toward a tax on consumption. The taxation of interest and dividend income and capital gains was not integrated, and the focus was on taxation of this income at the individual level. Business investment was not expensed under the reform system. This treatment of capital under the reform, while possibly efficiency enhancing, was not consistent with a consumption tax (or pure flat tax). On the other hand, labor income was more

fully taxed by bringing previously non taxable fringe benefits into the tax base and a flat rate tax was applied to labor income.

The Unfinished Reform Agenda

The Jamaican income tax reform, though it went much further than most tax structure revisions, left some needed structural changes undone.

The major structural problem with the 1986 Jamaican reform was that it left open some loopholes. The tax treatment of allowances for automobiles, housing, and especially uniforms and laundry gave away too much in some cases and is unclear in others. Predictably, a sample survey taken in the first year of the reform showed a movement in compensation toward the “nontaxable” allowances.

A second problem was that the reformed individual income tax was too income elastic, i.e., its revenues automatically increased at about twice the rate at which income increased. This inevitably brought pressure on the Government to enact discretionary changes to bring about tax relief for labor.

Third, the tax treatment of dividends was not reformed, and public companies continued to be subject to a different treatment than private companies. Fourth, payroll taxes were kept in place, hence labor was heavily burdened relative to capital. Finally, there was no movement toward taxing capital gains.

The Proposed Reform in 2005

A comprehensive reform program for 2005 addressed a next round of individual tax reforms. This reform program addressed three issues:

Individual Income Tax

The proposed 2005 reform would move away from reliance on the individual income tax as a source of revenue. Three revisions were proposed to the individual income tax. First, broaden the base of the individual income tax by eliminating all non-taxable fringe benefits in favor of reimbursable expenses only. Second, raise the threshold and index this amount. This may be thought of as a way to compensate families for a basic standard of living. Third, harmonize the individual and income tax rates at a flat rate between 25 and 31 percent (depending on revenue targets).

Capital Gains Taxation?

A tax on realized capital gains was recommended as part of the 2005 package. This reform option would eliminate what is arguably the major loophole in the current income tax base. It is important that this be considered because the present system gives those who have the wherewithal an opportunity to transfer income to a non-taxed category. This is unfair, it distorts investment choices and it imposes a revenue cost that must be picked up by other components of the tax system. Because capital income typically accrues to higher income individuals, a capital gains tax would lead to an increase in the progressivity of the income tax system. A tax on capital gains could include realized gains on real property, equities, and other financial assets.

Jamaica's Other Structural Changes

As noted above, the move to a consumption tax entails more than reform of the individual income tax. In fact, the reform of the Jamaican tax system in the 1980s and the proposed reforms in 2005 covered all taxes in the system. The question we raise is whether they continue to move closer to a consumption tax.

Payroll Taxes. Of the five payroll taxes levied in Jamaica, the education tax and the HEART trust fund tax, are more in the nature of general taxes on wages than they are contributions. The 1986 reform called for rolling these levies into the individual income tax, but this recommendation was reŕected. The 2005 proposals made the same recommendations.

If both taxes were absorbed into the present income tax structure, the flat rate would increase from its present level of 25 percent to nearly 2 percent. This would have implications for the rate of corporate tax. If the base of the individual income tax expanded because of other reforms, the required rate increase would be smaller.

Corporate Income Tax: 1980s

Before the 1986 reform, the company income tax was levied at a basic rate of 45 percent on chargeable income. In addition, there was an “additional company profits tax” of 10 percent levied on the same base. Companies were required to withhold tax of 15 percent of the value of dividends paid, but could credit these withholdings against ACPT liability.

There are many exceptions to this basic treatment of companies resident in Jamaica. Financial institutions are taxed under a separate and very complicated regime, as is the case in most countries. Separate incentive legislation provides for a different rate and base of tax for incentive companies, and preferential treatment is given in the taxation of public enterprises.

The 1986 reform set out to address a number of problems.

- The tax rate of 45 percent would be too high if the individual income tax rate were to be lowered to 2 percent.
- The company tax structure was overly complex, with the consequence that it imposed high compliance costs on payees and a high cost of administration on the Government. The tax structure was biased in favor of certain types of investment decisions (e.g., debt vs. equity) and certain types of firms (e.g., incentive firms and some public enterprises).

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Proposed Changes. The most important component of the proposed reform in 1986 was to reduce the tax rate from 45 percent to 15 percent. The advisors and the Government's Tax Reform Committee further recommended that dividend distributions to residents be exempt from individual income tax. Among the strong arguments in favor of this proposal are that the system would be greatly simplified and thus more easily assessed and monitored. It would become a 15 percent tax on companies and no longer would include a withholding on the personal tax liability of their shareholders.

More important, this reform program would reduce one component of the tax incentive to employ debt and along with the rate reduction and the proposed elimination of the transfer tax on capital gains arising from the transfer of corporate shares, would all but eliminate the tax disincentive to distribute earnings. Under these proposed reforms, both distributed and retained corporate income attributable to resident Jamaican individuals would be taxed at the same rate as any other income earned by these individuals. In other words, full tax integration would effectively be achieved for this class of shareholders. The simplicity of the new personal income tax would permit this without a complicated imputation and credit mechanism.

Adopted Changes. The Government adopted the recommendations that the company tax rate be reduced to 15 percent and that the withholding tax on dividend payments to non-residents be retained. The proposal to exempt dividends from personal tax liability, however, was rejected. The Government instead decided on a separate entity approach whereby company profits and dividends each would be taxed at 15 percent, the latter under a withholding

system. The Government thus passed on the opportunity to fully (and simply) integrate the income tax.

Wozny (1991) modeled the impact of these changes and concluded the following:

- Corporate income would bear a lower overall tax burden than it had under the pre-reform system, but because the tax burdens on other forms of income have been reduced by a greater degree, corporate source income will be relatively disadvantaged, especially when distributed. The end result of this discrimination would be a lower supply of funds for equity investments, compared to what would have existed if the full integration proposal had been adopted.
- The lowering of the corporate tax rate from 45 to 31 percent in 1986 would increase the post-tax return on corporate investment and stimulate growth in the sector and in the demand for corporate equities.

It is clear that post-1986 reforms in Jamaica, there remained much to be done to reduce the distortions to investment choices attributable to the tax system. In particular, the change in the relative tax treatment of debt versus equity investments was not made in a manner consistent with “getting the prices right” because full double taxation of dividends was adopted. Another problem was that the system has not been restructured to deal with the problems of inflation: depreciation allowances and interest expense remained unindexed and FIFO valuation of inventories remained the practice. The movement toward a consumption based tax is much less evident from the 1986 corporate tax reform.

The Corporate Income Tax: 2006

The proposed corporate tax reforms in 2005 focused on a number of changes aimed at leveling the playing field and reducing the cost of capital. The first was to harmonize the corporate income tax rates and the individual income tax rates, at the level of the flat rate individual income tax (25 percent). The second was to eliminate all incentives under the

corporate income tax. Third, it was proposed to tax realized capital gains. The reforms also suggested elimination of the large network of tax holidays and exemptions of the corporate income tax system. A more extreme reform recommendation was full elimination of the corporate income tax.

Domestic Indirect Taxes

Jamaica's indirect tax system in the 1980s was very complicated and did not resemble the modern versions now seen in most countries. From a revenue standpoint, the most important component of the system is the consumption duty, which is levied on the value of imported and domestically produced goods and is collected at the import and the manufacturing stage. The other two domestic indirect taxes, retail sales tax and excise duties, were insignificant in terms of revenues raised. Two taxes were levied on the import base: customs duty and stamp duty on inward customs warrants. The customs duty proper was a relatively small revenue source. However, with significant rate increases beginning in 1984, the stamp duty had become a major fiscal instrument.

This structure led to numerous problems:

- Administrative problems with the indirect tax system were in part due to its complexity. The five taxes were levied under separate acts, were administered by different divisions within the Customs and Excise Department, had different licensing and return requirements and even required separate recordkeeping systems. The bases taxed were not the same, nor were the rate schedules which are a mixture of *ad valorem* and specific ones.
- Jamaica's system of indirect taxation did not fit the neutrality goal. It led to distortions in the relative prices of consumer goods from what would have been the case in the absence of taxation, it gave enterprises an incentive to alter their methods of doing business, and it offered some degree of inefficient protection to domestic producers.

- The revenue-income elasticity of indirect taxes was low by comparison to that for public expenditures, for at least two reasons. First, the tax base excluded much of the rapidly growing service sector and about 80 percent of imports. Second, the tax rate structure had not fully shifted from a specific to an *ad valorem* basis, and so was not as “automatically” responsive to income and price level growth as otherwise would be the case.

The 1986 proposal was to introduce a value added tax (the GCT) to replace the present system of indirect taxes. The base of the tax would include importers, manufacturers and large distributors, with the value-added feature of allowing a credit for taxes paid on inputs. Exporters would be zero-rated and the major consumption items for low income families would be excluded from tax, but otherwise there would be few exemptions. In 1990, the government adopted this form of value added tax. However, it retained the stamp duty and property transfer taxes and added a series of special consumption taxes levied on “sin” items including alcohol and tobacco.

By the time of the comprehensive reform proposals of 2005, the base of the GCT had been eroded. Numerous items had crept in to the zero rating category, and the exemption list had grown. The rate structure had become more complicated, and the incentive regime for some sectors had been extended to cover the value added tax. The main proposals in 2006 were to:

- Simplify the rate structure by removing differential rates,
- Eliminate zero rating for all but exports
- Reduce the exemption list to include only necessities.
- All full credit for all capital input purchases

These changes were focused on simplifying the system and reducing the effective rate differentials among types of goods and reducing the burden on capital income. The Government

did introduce a number of reforms in their 2005–06 budget and moved in the direction of a more comprehensive consumption tax by moving non-export zero-rated goods to the exempt category, and increased the rate on the tourism sector to 8.25 percent—above the previous preferential rate of 6.25 percent.

Conclusions: A Consumption Tax?

Is a “true flat tax” or consumption tax in Jamaica’s future? How close would the Jamaican system have come to being a consumption tax if the Government adopted all of the proposed 2005 reforms, after beginning their own “flat tax revolution” in 1986? What benefits might we expect from movements toward a consumption tax?

One answer to these set of questions is that Jamaica’s tax system has continued to move in the direction of a consumption tax over the past twenty years. Wages and fringe benefits have moved toward being fully taxed, and the additional payroll taxes would be removed. However, not all payroll taxes are out, corporate and individual income taxes are not integrated and capital income is not treated consistently among types of capital and between types of owners and users.

Why move toward a consumption tax? As mentioned briefly earlier, a consumption tax may have efficiency benefits above and beyond previous tax reforms in Jamaica. A consumption tax, whether imposed on the sources side via the H&R “postcard” tax return or a cash-flow expenditure tax or a broad-based VAT, will increase the price of current consumption relative to savings. Many models suggest that this will lead to increases in savings which in turn will reduce the cost of capital and encourage investment, entrepreneurship and economic growth (Auerbach, 1991; Hall and Rabushka, 1995). However, in a case such as Jamaica, it could very well be that due to tax exemptions, tax holidays, lack of enforcement, etc., the actual user cost of

capital is quite low and more effective taxation and tax administration, while reducing statutory tax rates, could increase the effective tax rate on capital. We simply do not have enough information on the total leakages in the system to know, definitively, whether a consumption tax would be good for Jamaica's economy. Theoretically, it has merit. The administration aspect of a consumption or "pure flat tax" may be its most redeeming quality. If a tax system really attempts to tax all income once and can do it through one instrument, we would expect that the tax administration could potentially do a better job than monitoring and enforcing a whole host of taxes. There has been relatively little empirical research on this aspect of consumption taxation, although some evidence suggests that consumption taxes are somewhat lower cost in terms of administration (Evans, 2000, U.S. Annual Report, 2002 *IRS Data Book*, 2000, Ebrill et al. 2001).

In Jamaica, Light (2004) shows that a broad-based consumption tax is superior in terms of welfare effects and the average cost of capital than the 2000 tax system in Jamaica and a pure labor tax system. This lends some credibility to the potential welfare (and possible growth effect) enhancements due to a tax on consumption. However, this ignores the distributional impacts of a pure flat tax or consumption tax. It is likely that pure consumption taxes would be more regressive than Jamaica's current income/consumption tax system (Alleyne et al. 2004). If redistribution is an important part of the tax mix, consumption taxes might be expected to co-exist with some form of income tax. In a world where income taxes and value added taxes must both be part of the tax structure, the Jamaican tax structure still would require a few additional changes in order to approach the consumption tax model.

2. Harmonization of corporate and individual rates. While these rates diverge, there will always be behavioral impacts related to forms of incorporation and potentially to the effective tax rate on capital. Jamaica has considered harmonizing these rates but has not done so, primarily due to revenue concerns.

- Dividends: Some dividends are double taxed and some are not. Dividends paid by companies listed on the Jamaica Stock Exchange are not taxed at the individual level (but are effectively taxed at the corporate level due to a lack of corporate tax deduction for dividends paid). Stocks not listed on the Jamaica exchange face personal and corporate taxation. To this point, the policy makers in the country have felt that encouraging the development of a stock exchange are more important than the potential welfare impacts of taxing all dividends on a level playing field.
4. Jamaica continues to tax interest income as income paid to individuals (or corporations) while allowing deductions for interest payment. Since the corporate and individual income tax rates are not equal, there is preferential treatment for corporate debt (the corporate tax rate at which the deduction occurs is $\frac{1}{1+\tau^d}$ while the individual income tax rate is 25 percent). This may lead to arbitrage in the system. However, this is a case where full integration of the systems at one tax rate may increase the user cost of capital.
 5. Pensions are largely untaxed in the Jamaican system. Companies can deduct some of the expense associated with pension funding and individual pensions (receipt) are largely untaxed. This represents another gap between current practice and a consumption tax. How much does this affect the positive benefits of a consumption tax? Since private pensions are still relatively small in Jamaica, this is probably not as important an issue as the issue of the more general taxation of capital.
 6. Capital gains income continues to be a source of consternation in Jamaica. Currently, capital gains are largely exempt from taxation. Companies are not forced to pay tax on retained earnings (nor are they forced to release build up via dividends). Individuals who realize capital gains do not declare these gains as income. □o reform over the past 20 years has been effective in dealing with this differential treatment. This leaves the current system very far from the consumption tax norm of taxing all capital once. It has also lead to some massive build ups of retained earnings and may have hampered growth in Jamaica (Rider, 2004).

In summary, the tax reforms of the last 20 years have moved toward the direction of a consumption tax, but in truth, the system is still a combination of consumption and income taxation. Given the level of exemptions, special treatment, and taxation of capital, Jamaica may be a good case study of a country where a pure flat tax would increase the relative cost of capital and thereby mitigate the positive implications of such a tax.

In addition, there are other impediments that get in the way of realizing a consumption tax:

1. A tax on capital gains cannot be effectively administered in Jamaica at this point. Some gains (e.g. registered shares, real property) might be reached while others (sales of assets) might not.
2. A significant amount of labor income is earned in the informal sector and not reached by the individual income tax.
 - Three of the payroll tax programs have both a contribution element and a tax element.
4. The Bauxite sector is taxed under a completely different, negotiated agreement. This tradition may be very difficult to change.
5. Services are not reached under the value added tax, so the natural transition to a consumption tax has its own holes.

Finally, we try to capture the major issues related to the transition from an income based tax system to a consumption tax in Table 1 and highlight where Jamaica sits in terms of its past reforms relative to a consumption tax. To realize the package shown in the far right column of Table 1 would require a high value added tax rate. Given that the revenue returns to a rate increase decline after a certain rate level, the necessary VAT rate may be infeasible. The importance of the relative elasticities of consumption and labor supply has not been fully explored. It may be that a pure consumption tax is infeasible in any country if we take it that a pure consumption tax system should replace virtually all income taxes.¹²

So, while Jamaica has moved toward a “pure” flat rate tax or a consumption tax, it is unlikely that it will attain a pure flat tax at any time in the near future. A bigger question is whether any country could do so or whether, as policy advisors, we should encourage that movement. Our belief is that the paradigm underlying the flat tax “revolution” is basically sound tax policy—lower rates, broader base, and reduce the complexity of the system. Meeting

¹² This is in part the criticism of Linder’s FairTax proposal, which is a national retail sales tax.

the goal of a pure consumption tax may in fact not be attainable since the economic benefits of a theoretical flat tax can not necessarily be achieved. This is due to the myriad rates and treatments under current law in any country as well as the ability to integrate the corporate and individual income tax systems.

Table 1: Flat Tax “Revolution”

How simple can it be?		
Flat tax rates on personal income, %		
Country	Rate	Year introduced
Estonia	26	1994
Lithuania	33	1994
Latvia	25	1995
Russia	13	2001
Serbia	14	2003
Ukraine	13	2004
Slovakia	19	2004
Georgia	12	2005
Romania	16	2005

Source: The Economist, 2005.

Table 2
Pre-1986 Reform Rate Structure of Jamaica's Individual Income Tax

<u>Statutory Income^a</u>	<u>Marginal Tax Rate</u>
If Income is Less Than J\$10,000	
J\$ 0 – 4,000	0
J\$ 4,001 – 10,000	.10
If Income is More than J\$10,000	
J\$ 0– 10,000	.10
10,001 – 10,000	.40
10,001 – 12,000	.45
12,001 – 14,000	.50
14,001 and over	.55

^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: Bahl, 1991.

**Table 3
Jamaica: Transition to a Flat Tax?**

Tax	Pre-1986 Reform	1986 Reform ^a	Proposed 2005 Reform	Is the reform treatment similar to the treatment under a True Flat Tax?
Individual Income Tax	<p>1. Graduated rate Structure</p> <p>2. 17 tax credits;</p> <p>3. Interest income and capital gains not taxable;</p> <p>4. Numerous deductions;</p> <p>5. Dividends not taxed for listed companies</p>	<p>1. Flat rate income tax</p> <p>2. All tax credits Abolished</p> <p>3. Interest income taxable, capital gains remain untaxed, some dividends double taxes, others single taxed</p> <p>4. Standard deduction for all taxpayers, most but not all deductions for fringe benefits abolished</p> <p>5. Dividends not taxed for listed companies</p>	<p>1. Maintain flat rate</p> <p>2. No change</p> <p>3. No change</p> <p>4. Eliminate remaining fringe benefit deductions, introduce a larger standard deduction</p> <p>5. Tax dividends for listed companies</p>	<p>1. No, integrate rate with corporate income tax</p> <p>2. OK</p> <p>3. Uneven treatment of capital is a problem. Interest and dividends Should be taxed at business level and only once. Capital gains similarly</p> <p>4. Eliminate all remaining deductions and exemptions from income; standard deduction may remain.</p> <p>5. Some dividends still taxed twice leading to potential efficiency effects.</p>
Payroll Taxes				
1. HEART	1. Earmarked payroll tax on employees	1. No change	1. Abolish the tax.	1. OK
2. Education Tax	2. General fund payroll tax on employees and employers	2. No change	2. Abolish the tax.	2. OK
Corporate Tax	1. 45 percent rate	1. Reduce rate to	1. Reduce rate to	1. OK

		individual income tax rate (thereafter changed)	individual income tax rate	
	2. Numerous targeted incentives	2. No change	2. Eliminate targeted incentives	2. OK
	3. No tax on capital gains	3. No change	3. Introduce tax on capital gains	3. OK
	4. Complicated depreciation rules	4. No change	4. Simplification of depreciation	4. Expensing of capital investment
Indirect (domestic) sales tax	1. Turnover Tax with about 100 rates 2. Separate excises on "sin" items.	1. Single rate VAT 2. No change	1. Simplify rates which had become complex; limit zero rates to exports; reduce exempt list. 2. No change	1. Eliminate corporate And individual income Tax in favor of a broad based VAT, with redistribution through expenditure scheme. Alternatively eliminate VAT if corporate and individual income tax were fully integrated, no exemptions and deductions (other than a standard level, etc.

^a Indirect tax reforms were implemented in 1990.

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