TURKS AND CAICOS ISLANDS GOVERNMENT

CURRENT AND POTENTIAL REVENUE SOURCES: AN ASSESSMENT

Contents

Abbreviations

CARTAC	Caribbean Region Technical Assistance Program
CET	Common External Tariff
CT	Corporation (Profits) Tax
DTAs	Double Taxation Agreements
ECCB	Eastern Caribbean Central Bank
GDP	Gross Domestic Product
GST	General Sales Tax
IMF	International Monetary Fund
NI	National Insurance
NIB	National Insurance Board
NHIB	National Health Insurance Board
ODTs	Overseas Dependent Territories
PIT	Personal Income Tax
PORC	Producer-owned Reinsurance Company
RCU	Revenue Control Unit
TIEAs	Tax Information Exchange Agreements
TCI	Turks and Caicos islands
TCIG	Government of the Turks and Caicos islands
VAT	Value-added Tax

Executive Summary

This Report describes and assesses the various options available to the Government for a revenue strategy to meet the needs of the medium term. The serious economic crisis that the economy now faces has arisen from a complex of three major shocks: global developments, hurricane damage and self-inflicted wounds from mal-administration. The agenda to deal with this crisis is multi-facetted –short term expenditure cuts, medium term improvements in public economic management and parallel medium term efforts to establish a more efficient revenue system. This present Report deals with the last of these matters.

TCI is frequently presented as a "low tax" environment. In fact the ratio of total taxes and fees collected in recent years to the country's GDP has for some time been above the average among Caribbean tax jurisdictions. This is in spite of the complete absence of all the mainstream taxes: corporate income tax, personal income tax, property taxes and a broad-based sales or VAT. In their absence, public revenues have been raised from an unconventional package of taxes and fees and especially from high rates of import duties, stamp duties, high fees on work and residency permits and sector specific indirect taxes mainly on hotels and restaurants. The central question for this Report is whether this is the best way to raise any given amount of revenue for the future.

The Present Revenue System

This system has largely evolved on an *ad hoc* basis over many years. Technical proposal for reform (e.g. by IMF/CARTAC) have been made but were never accepted. Instead public expenditures consistently ran ahead of both budgets and revenues even in good economic times and the economy failed to build reasonable levels of reserves. The system is now dominated by revenues from import duties, stamp duties on land transfers, sector-specific indirect taxes notably the accommodation and gaming taxes, and specialised fees and charges notably those for work permits and permanent residency certificates. In 2008/09 10 revenue items under these various heads together accounted for almost 88% of all recurrent revenue. However, only five of those items are true taxes: the others are fees and charges. Notwithstanding its somewhat unconventional nature, this structure has proved able to deliver relatively strong revenue growth with a marked acceleration in the boom years from 2003-04 onwards. From a peak of $200 million in 2007/08, total revenues then declined slightly in 2008/09 before the major collapse of revenues that will bring the current financial year total to something around $150 -160 million.

A major structural feature of revenue performance in the past two decades has been the growth in the *relative* importance of the main "domestic taxes" (stamp duties on land and the accommodation tax). Between the mid-1990s and 2008/09 these revenues more than doubled their *share* of total recurrent revenues to 40% by the end of that period.

The Size of the Tax Effort

A CARICOM study of July 2004 showed that TCI was positioned well above the average (median) level of the tax effort seen across the 17 comparator countries. Six of the 17 comparators produced a higher tax effort than did TCI but eleven produced a weaker effort. On the basis of these comparisons it was definitely ***not*** possible to classify TCI as a low tax environment. More recent statistical evidence compiled for this present study confirms that TCI was still generating a reasonably strong tax and revenue performance at least through 2007 – at around 25% of GDP. This evidence enhances the conclusion that TCI is *not* and has *not* been a particularly low tax environment.

A closer look at the evidence for two of TCI's main economic areas namely tourism and financial services indicates the following. As regards *tourism*, the major cost-raising taxes and charges impacting the sector are relatively common across the various Caribbean jurisdictions. The TCI seems to have made itself higher cost than most of its competitors in terms of the rates of *accommodation* and *departure taxes* that are currently levied. But it more than makes up for this in terms of its presently zero rates of corporation tax, its low charges for business licences, the absence of a VAT, and the absence of high excise duties on luxury consumption goods including alcohol and tobacco. TCI's high rates of import duties might be expected to be a competitive disadvantage but the present very generous exemptions substantially mitigate this disadvantage In the case of *financial services*, It is very clear that even after the September 2009 increases in charges, TCI has the scope to raise its licensing fees quite a lot more before it is likely to lose its competitive advantage *vis a vis* the comparator jurisdictions.

The Assessment of Individual Taxes

Section 4 of this Report defines and explains *seven* criteria against which the quality of any tax might be judged. Six of these are standard textbook criteria that are widely applied in international analysis of tax systems. The seventh is more specific to the circumstances of small island economies such as TCI. These are:

1. Horizontal Equity
2. Vertical Equity
3. Breadth (or otherwise) of Tax Base
4. Efficiency/ Cost of Administration and Collection
5. Economic Efficiency
6. Reliability (of revenue stream) versus Volatility, and
7. Feasibility and Appropriateness in a Small Economy

Each of TCI's main *existing* taxes and fees was assessed against these seven criteria using a four point scoring scale (where 4 is a "very good tax" and 1 is "a very poor tax"). The results of this assessment indicated the following:

- The present revenue system contains ***four*** main items that achieve average scores of "3" which indicates a "good tax". This means that these taxes should probably play some role in any reformed tax system. These are the import duty, the accommodation tax, the Corporate Tax (CT) on Communications, and the various gaming taxes.

- There are two taxes/ charges that overall are poor ways to raise revenue. These are the stamp duty on land transfers and the charges for work permits and Permanent Residence Certificates (PRCs). Both of these score pretty badly on all the criteria other than #7 - sensitivity to the special problems of small economies.

The same exercise was then applied to a set of five possible *new taxes* – the mainstream taxes that TCI presently lacks namely the personal income tax, corporation tax, VAT (or general sales tax), property taxes and excises. The results led to the following conclusions.

- Stakeholder concerns about both the personal and corporate income tax were largely confirmed by the numerical evidence: both were assessed as "relatively poor taxes" in the TCI context

- Both the VAT (or general sales tax) scored much better and in fact achieved scores comparable to the "relatively good" taxes of the present system

- The property tax produced scores somewhat in the middle of these two other outcomes.

Options for a Reformed Tax Structure – the Short-Term

On the basis of the analysis conducted for this Report a number of options for possible short-term adoption have been adduced and are defended in the main body of the Report. The five priorities listed below could be expected to reduce the *economic efficiency* burden of the existing taxes and also lower the *administrative costs* of collection. The changes could be introduced in a manner that was largely revenue neutral. Alternatively, in a few cases they could be made in such a way as to increase total revenue without imposing an unreasonable extra burden on the prospects for the economy going forward. Many of the changes could be actioned quickly with impacts on revenues and efficiency expected within one year.

Priority 1: Improving the import duty system
it is major priority that in respect of this single most important tax there should be a process of (i) tariff reduction (ii) simplification and (iii) elimination of all or most exemptions. However, there are at least four different routes to giving effect to these three elements of the reform. These are:

i. Refine the present tariff for reasons of international compatibility but retain some differentiation of tariff rates ensuring that these are more obviously justified by the need to support some processing and other activities in the islands. The rates for most products would be significantly lowered.

ii. Refine the existing tariff system for reasons of international compatibility but commit to a very limited set of different tariff rates – ideally one common *ad valorem* rate for almost all but a few exempt products. This option would explicitly ***eliminate*** the policy freedom to manipulate particular tariffs to favour certain local industries, but would also greatly simply tariff administration and reduce the potential for mistakes.

iii. The same as option (ii) but with the add-on of *specific* additional rates of *excise duty* levied on various luxury consumption items. This would have the advantage of allowing the new customs tariff to be set at a relatively low level and thereafter be predictable for an extended period of time. Also by being applied on both imported and domestically produced goods such as beer and rum this approach would result in a modest but welcome broadening of the tax base.

iv. Eliminate all customs duties in the short term and replace these by a standard first-stage sales tax or VAT. This option would be worth pursuing only if TCI decided eventually to adopt some form of the general sales tax (GST) or value-added tax (VAT) (see the options for the medium-term that follow).

Priority 2: Revamp the present system of Stamp Duties on land transfers.
Although the stamp duty is a very poor tax from most points of view, it has also been the second most important sources of revenue. So it is *impossible* for purely practical reasons to

recommend its early abolition or even a radical short-term reduction in the rate of the tax. Further, no one knows for sure whether the condominium model of development that was the mainstay of TCI's property development through 2008 is dead or merely temporarily damaged. The consensus view seems to expect a slow recovery of the model over a period of 4- 5 years. In this case nothing much will be lost by taking a few risks in the direction of eliminating some of the most egregious failings of the tax in the short term. The two alternative options for reform that follow are framed in that spirit.

i. Enact an early small increase in the rate of stamp duty on land transfers. But allow for this tax to be paid *either* fully as an up-front charge (as now) *or* via a smaller up-front charge followed by annual payments phased over the next 6 years. The government would not seek to direct developers (and purchasers) about which of the two payment options they should chose. At the same time the government to the extent that a phased payment was selected would have a more assured ongoing source of *annual revenue* than is now the case. If a one-off up-front payment was chosen by some developers the government would explicitly put equivalent amounts of that revenue on reserve so that it could be managed, in effect in the same manner as a phased payment.

ii. This would be the same as the first option except that the TCIG would not offer developers (or purchasers) the option to pay the full amount of the stamp-duty as a one-off up-front payment. All transactions would be subject to phased payments over a 6 year period. This has several advantages over Option 1. Above all it would provide the TCIG with an ongoing annual source of revenue on all land/property transfers and it would not need to set up its own internal system of reserves in order to stabilise this source. But it would of course sacrifice short-term revenue.

Priority 3: Introduce an explicit system of Excise Duties

With a much simpler system of import tariffs in place (as proposed above) TCI could use an additional system of excise duties distinct from the import tariff. Such a system would enable the government to levy additional taxes (mainly on a *specific* basis) on a limited set of luxury items. The rates of duty could be adjusted on a fairly regular (possibly annual) basis in line with inflation. The goods in question would mainly be ones where there was (i) some social or environmental motivation for wishing to discourage consumption and (ii) a low elasticity of demand so that even quite high rates of tax and some reduction of consumption would still leave the Treasury with worthwhile levels of revenue. The main body of the Report identifies some of the obvious candidates for this new tax.

Priority 4: Re-design of the quasi-tax on Work Permits

The Work Permit "fee" is a very poor tax. In particular it is very distortionary being a tax on specialised types of labour that are by definition required to contribute to the country's economy in ways that cannot otherwise be accommodated. In addition, almost all the negative comments about this "tax" relate to the bureaucratic inefficiencies, delays, excessive agency charges and occasional corruption associated with the process of obtaining work permits. There are far fewer complaints about the *level* of the fees as such. These bureaucratic problems certainly need to be resolved but are well beyond the scope of our own terms of reference. So the recommendation that follows is only partial in its scope.

The recommendation here is to more explicitly recognise that the work permit fee is really a *tax on labour* and to manage and collect it as such. This can be done by eliminating the work permit *fee* altogether. Instead the Immigration Department would be required only to manage the issuing of work permits (i) using criteria about eligibility that can hopefully be clearly defined and (ii) with bureaucratic performance standards that could (hopefully) eliminate the delays and alleged corruption associated with the past. Thereafter, the revenue element associated with work permits would be assigned to the National Insurance Board (NIB). The difference from now would be that the NIB would require an additional PAYE deduction from the earnings of all persons holding work permits. The multiple rates for work permits associated with many different occupations would be eliminated and charges would be related only to levels of earnings.

Priority 5: Rationalising the System of Fees and Charges
For a small country, TCI maintains an incredibly large number of fees and charges. Most of these have some justification and collectively they provide significant sums of revenue which cannot be readily dispensed with. The recommendations here are of two types:

i. Review and raise some existing charges but eliminate others completely. Most fees and charges are seriously out-of date having not been adjusted for many years. In addition there seems to be a general willingness on the part of stakeholders to pay more for many of the component items provided that such increases are accompanied by greater efficiency. The sample cases that were reviewed suggest that there is likely to be a justified case for adjustments of fees and charges by some 200-300% depending on item. The main body of the Report list the items for which an increase may be possible as well as those where elimination of charges seems possible.

ii. Rationalise collection methods. The fees and charges are collected by a wide variety of agencies using a variety of different methods. There is an obvious potential to reduce this complexity and so the cost both to the payer and to the collection agencies. One obvious way forward that is recommended for more detailed study is increasing use of E-Payments whenever this methodology is technically and financially feasible. A proper feasibility and cost assessment would be called for before this reform could go ahead.

A Reformed Tax Structure – Medium and Longer Term Options

The analysis and assessment carried out for this Report has also elicited *two* main suggestions for the medium term that need considerably more work before they can be adopted. These would further enhance the efficiency of the system and provide for a more assured stream of revenues and generally lower rates of tax on the traditionally taxed elements of the system. These additional recommendations in brief are as follows:

Priority 6: Commit to some form of Broader Sales Tax or VAT
There are two main arguments in favour of this further development. First, TCI already has a number of other sales-type taxes imposed on important sectors such as hotels, restaurants and banking. But these taxes are not integrated either in their design or in their collection with the customs duty. Hence there is a significant amount of double jeopardy (“cascading” in technical terms). This introduces an arbitrary element in the taxation of some important activities which can create unintended disincentives. Second, the efforts to supplement the customs tariff with *ad hoc* taxes such as the accommodation and restaurant taxes are crude attempts to extend indirect taxation to more areas of the economy: to broaden the tax base. But this effort largely fails since it still misses a significant part of the total economy. The result is that the taxed components bear a higher rate of tax and a higher burden of tax than is strictly necessary. The three major sectors of taxed activity namely Hotels & Restaurants; Financial Service and Real estate together account for only 52.3% of total GDP. A tax such as VAT could potentially extend indirect taxation to important sectors such as Construction (18% of GDP); Transport and Communication (9%); Utilities such as Electricity and Water

(4%); Wholesale and Retail Trade (4.5%);Manufacturing and Mining (3%) and other Business services (3%).

The recommendation here is that TCI should move in time to adopt a general VAT system of taxation albeit with generous exemptions that would address the concerns about administering this tax in smaller enterprises. There are at least three different ways to do this which are described and explained in the main body of the Report. At the simplest level the new system would merely be a marginal extension of the present arrangements for customs duty.

Priority 7: Commit to an evaluation of the potential for a broader annual tax on land and residential property.
The recommendation here is to use the short-term reform of the stamp duty on property (see above) to assess the practicality of a more mainstream annual property tax. In the next 12 - 18 months, it is recommended that a detailed but open-minded investigation be started into the feasibility of a broader property tax system for TCI. This investigation could be sub-divided into (i) an assessment of whether land *per se* could be a viable object of a new annual tax; (ii) the assessment of the feasibility of, and a design for a system of *residential* property taxation and (iii) a parallel assessments of the case for a system of *commercial* property taxation. These three components need not sink or swim together – they should be considered on their own merits. However, there is a general message to keep rates of property tax low and to not introduce any such new tax during ongoing periods of serious depression of the property market when the "urban blight" tendencies are already likely to be a threat independently of the existence of property taxation.

Implications for Total Revenues

A package of revenue measures such as those proposed for the short-term would have the potential to close the revenue gap of some $50 million that has emerged in the past 12 months. The revenue measures in combination also seem likely to have an overall positive impact on economic performance and therefore to be a factor that can help to ease the GDP of TCI back towards the levels achieved in 2007 and 2008. But even if this recovery does not happen as quickly as we would like it to, the measures proposed will create a sounder revenue system, some short-term gains in revenue and a platform for more broad-based revenue collection in the medium term. If in the event there is a rapid recovery towards the 2007/08 levels of economic activity then the new revenue measures have the potential to create a cushion of excess revenue to help pay-off TCI's debts and to build a reserve cushion against future down-turns.

Tax Administration

Aside from the issues of the design of an appropriate tax system, TCI faces major issues connected with the administration of taxes. There is currently a multiplicity of budget agencies collecting revenues in addition to specialised departments such as Customs. This leads to a plethora of problems which have recently become clearer from the initial *Revenue Management Review* conducted by the Revenue Control Unit (RCU) in November 2009. This has identified a variety of failings including poor record-keeping leading to the serious under-collection of some revenues, a tendency in some units to allow large arrears to accumulate, the incorrect assessment of some taxes etc. The RCU has already set in motion actions to eliminate the more egregious of these failures. .

1. Introduction

This Report describes and assesses the various options available to the Government of the Turks and Caicos islands (TCIG) for a revenue strategy to meet the financing needs of a viable public service in the medium term. That strategy must also be consistent with the TCI retaining its competitiveness in the markets in which it operates. The Report is based on a period of intensive consultations with a very wide spectrum of commercial, government and financial sector stakeholders in the islands in the period from November 24th to December 3rd 2009. A verbal report on preliminary findings was presented to HE the Governor and his advisory team on December 2nd and their comments have been factored into the present draft.

The need for the study that has produced the Report arises from the several major shocks that together have disrupted normal commercial activities on the islands and severely damaged the viability of the public finances. First, the global financial crisis has had a serious effect on one of the islands' main industries, the tourism and leisure market. US visitors in particular have declined in numbers at the same time as many American condominium and other property investors have needed either to reverse out from earlier investments or delay possible new investments. There is now a very large backlog of unsold units. Second, tropical storm 'Hannah' and hurricane 'Ike' within a space of two weeks in 2008 damaged a great deal of physical infrastructure but also further reduced the financial capacity of the country to respond to the declines associated with the global crisis. Third, a self inflicted wound came from the irresponsible and, uncontrolled spending of the previous government – partly supported by the unsustainable property boom through 2007. This left a legacy of large public debts, a poorly disciplined spending culture and a much deteriorated system of governance and public financial management in general.

TCI now confronts the classic problem of a small economy faced with much diminished revenues and with almost no instruments to mitigate this problem other than that of radically cutting its public expenditures. Since TCI uses the US dollar as its currency, it cannot adjust its exchange rate or "print money" in order to reduce the pain of expenditure reduction. Nor as an Overseas Dependent Territory of the UK, does it have access to the concessional medium term financing from the IMF that is available to other Caribbean jurisdictions.

The agenda to deal with this very serious situation is multi-facetted. It involves a *short term* effort that is already well underway to radically reduce immediate levels of public expenditures to bring these into line with available revenues. It includes a similarly *short-term* effort to tighten up on the collection of revenues and to make sure that those taxes and fees that are already in place are indeed collected in full. In the *medium term* it must involve a major functional review and then a reform of the civil service in order to "right-size" this for the needs of the islands, and an associated improvement in the quality of governance and integrity provided by the islands' public services more generally. In the *longer term* it requires a policy that will systematically build reserves in good times in order to have some cushion to deal with any future downturns.

The exercise reported on here is merely one part of the structural response to the larger problem. Its objective is to propose a sounder public revenue system for the *medium term.* It is intended first to assess the feasible level of total tax and non-tax revenues that might be collected to finance the public services. Second, it sets out to identify various options for most efficiently raising such total revenues (the definitions of "efficiency being provided later in the report). It is not a primary purpose of the present exercise to propose immediate new sources that can address the short term budget financing crisis that the authorities now face.

Furthermore, as our interlocutors in Providenciales and Grand Turk repeatedly pointed out there is no case for raising additional revenues if (a) the collection of existing taxes and fees is poorly carried our and (b) there continues to be serious waste on the expenditure side of the budget. The present report does give some attention to point (a) which is a vital part of the short-term measures now being taken but less to point (b) which is a central concern of those who are managing current expenditure budgets.

A final introductory point is to emphasise an important paradox. This is that the TCI is frequently presented by TCInvest and its other promoters as a “low tax” environment. In fact the ratio of total taxes and fees collected in recent years to the country’s GDP has for some time been around 25%. This positions TCI at or above the average (median) level among Caribbean tax jurisdictions. The paradox is explained by the complete absence of the four mainstream taxes namely corporate income tax, personal income tax, property taxes and a broad-based sales or VAT. The public revenues that have been raised come instead from a relatively unconventional package of taxes and fees and especially from high rates of import duties, stamp duties, high fees on work and residency permits and sector specific indirect taxes mainly on hotels and restaurants. One of the questions posed below (and to those stakeholders consulted in recent weeks) is whether this is the best way to raise any given amount of revenue.

The Report is presented in eight further sections. Section 2 briefly describes the present TCI system of revenue collection and examines how this has performed in terms of total revenue delivery, and the stability of those revenues over the past two decades. Section 3 looks at the total revenue collections of TCI against the performance of a number of comparator jurisdictions in both the Caribbean region and more broadly. Section 4 suggests SEVEN criteria that might be used to assess the suitability of any individual tax or set of taxes. It then goes on to assesses (i) TCI’s present configuration of taxes and charges and (ii) possible new taxes against these seven criteria. Sections 5 and 6 then use the conclusions of this analysis to identify some leading options for adjusting the present tax system either by adjusting the application of the existing taxes or by introducing certain new taxes. Section 7 presents some broad numerical indications of the likely revenue yields that could be associated with these different options. Section 8 briefly examines some of the issues involved in improving the effective collection of whatever taxes and charges are in force. Section 9 provides an overview and possible time frame and strategy for adopting the recommendations that emerge from the analysis.

2. The Present Revenue System

The present revenue system of TCI seems to have largely evolved on an *ad hoc* basis over many years. Box 1 below provides a quick overview of what it now comprises. There is little evidence of any earlier strategic analysis that has underpinned that system. Instead, the more recent budget speeches of various Ministers of Finance seem to have adjusted rates of taxes and charges in a largely non-strategic manner as the immediate needs of revenue dictated[1]. In some very real sense inflated expenditures – encouraged in the years to 2008

[1] So, for example in financial year 2007/08 the out-turn was a recurrent deficit of $35.7m against a budget that had anticipated a small surplus. By that stage Government reserves have been exhausted and unpaid creditors were also building up. The Minister’s response in his 2008 budget speech included the announcement of several tax hikes and new *ad hoc* charges including an increase in the airport departure tax from $30 to $40; a rise in the accommodation tax up from 10% to 15%; a new 2.5% customs processing fee on exempt imports; and a new a 50% tax on charges for wired money transfers. Note: these proposals were not adopted during 2007/08. In the 3 years prior to 2007/08,

by buoyant conditions in the economy's property market - drove the need for enlarged revenues. But these inflated expenditures also called for additional borrowing capacity and land sales in order to sustain the public finances. In his 2007 budget speech the Minister did acknowledge the need to widen the tax base and he also undertook to review the proposals from an in-depth IMF/CARTAC study written in 2003[2]. But these proposals were never accepted. Nor were suggestions to adopt a Medium Term Financing framework to ensure reasonable coherence and sustainability - as between recurrent revenues, current expenditures, new capital programmes, the sales of Crown lands and borrowing - ever adopted.

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budget outcomes had invariably proven to be worse than budgeted with the result that either *ad hoc* tax changes were needed and/or the build up of budgetary reserves was lower (typically zero) than anticipated at the start of the year.

[2] John King, Paulo dos Santos et al, *Turks and Caicos Islands, Reform of Tax Policy and Administration. IMF* Fiscal Affairs Department, July 2003.

Box 1: An Overview of the Present System of Taxes and tax-like Charges

Import Duties. These are the most important source of tax revenue. They are administered using a complex multi-rate system with some high rates and numerous exemptions provided for various developmental and other purposes. Since 2007/08 there has also been a 2.5% customs processing fee on exempt imports.

Personal Income Tax (PIT*).* There is no PIT but all employers are required to collect National Insurance Contributions from employees at rates ranging from 4.025% to 4.6% and also pay similar amounts from their own resources to give a total ranging from 6.85 to 8%. Lower rates are applied to temporary workers. The NI system also extends in principle to the self-employed.

National Health Insurance. This is a tax in all but name. As in the NI system, contributions under the new National Health Insurance Plan (NHIP) are deducted on a PAYE system from the pay of employees. Others can also contribute directly to the NHI Board that runs the scheme. The deductions began amid much controversy in December 2009 and will be used in a dedicated manner to fund mainly the costs of two new public-private hospitals on the islands.

Corporate Income Tax (CT). There is no general CT but a form of CT is paid by Cable and Wireless – the main telephone services provider - in the shape of the “Communication Tax” .This is levied on profits in excess of 17.5% of the company’s net assets in TCI.

Hotel and Restaurant Taxes. These taxes are levied on hotel accommodation (15% since 2008), meals and beverages in restaurants at a rate which is currently 11%.

Stamp Duties are levied on three main tax bases namely (i) sales/transfer of land for monetary purposes (ii) vehicle rentals and (iii) bank cheques and loans. In revenue terms the stamp duties on land transfers are by far and away the most important element (see also Table 1). The main rate is 9.75% but lower rates are used to favour development in the less developed islands such as Grand Turk

Airport Departure Tax and Security Charges. These taxes and charges (the airport departure tax has been $40 since 2008) are levied on all adult passengers leaving the islands.

Banking and Insurance Licenses. These are charged at differential rates (e.g. for domestic versus overseas banking licenses and for domestic versus captive insures) with both initial and annual renewal charges being levied. The rates of charge are set to a large extent to preserve TCI’s attractiveness as an offshore financial centre and are currently very low. The tax is administered by the Financial Services Commission that retains a part of the proceeds to run its own operation.

Business Registration Charges. Charges are differentiated by the five types of companies which can be incorporated under the 1981 Companies Ordinance: Ordinary Resident companies, Exempt companies (International Business Companies), Foreign Companies, Limited Liability companies, and Hybrid companies. Incorporation fees are typically modest (and so highly competitive with other jurisdictions) ranging for Ordinary Resident companies from $275 to $2,000 depending on capitalisation. The annual filing fees are also low at some $250.

Work and Permanent Residency Permits. Work permits for foreign skilled workers to be employed by a local company are obtained by the employer, who needs to post a 'repatriation bond' and who will have to demonstrate that no local employee was available for the job. They can be granted for 5 years. Work permits for unskilled workers are naturally harder to obtain. The charge to the employer is typically $2,000 annually but there is significant variation depending on occupation with more than 100 different occupational rates currently in place.

Double Taxation. Mainly because TCI currently has no mainstream taxes other than customs duties and stamp duty, it has not entered into any Double Tax treaties with other countries.

As a consequence of this largely unplanned process the recurrent revenue base of the economy has now come to rely on an extremely unconventional cocktail of taxes and charges. Specifically, this system is now dominated by revenues from import duties, stamp duties on land and property transfers, sector-specific indirect taxes notably the accommodation and gaming taxes, and specialised fees and charges notably those for work permits and permanent residency certificates. The actual dollar amounts for the revenues collected in the last full year for which we have data namely 2008/09 are shown in Table 1.

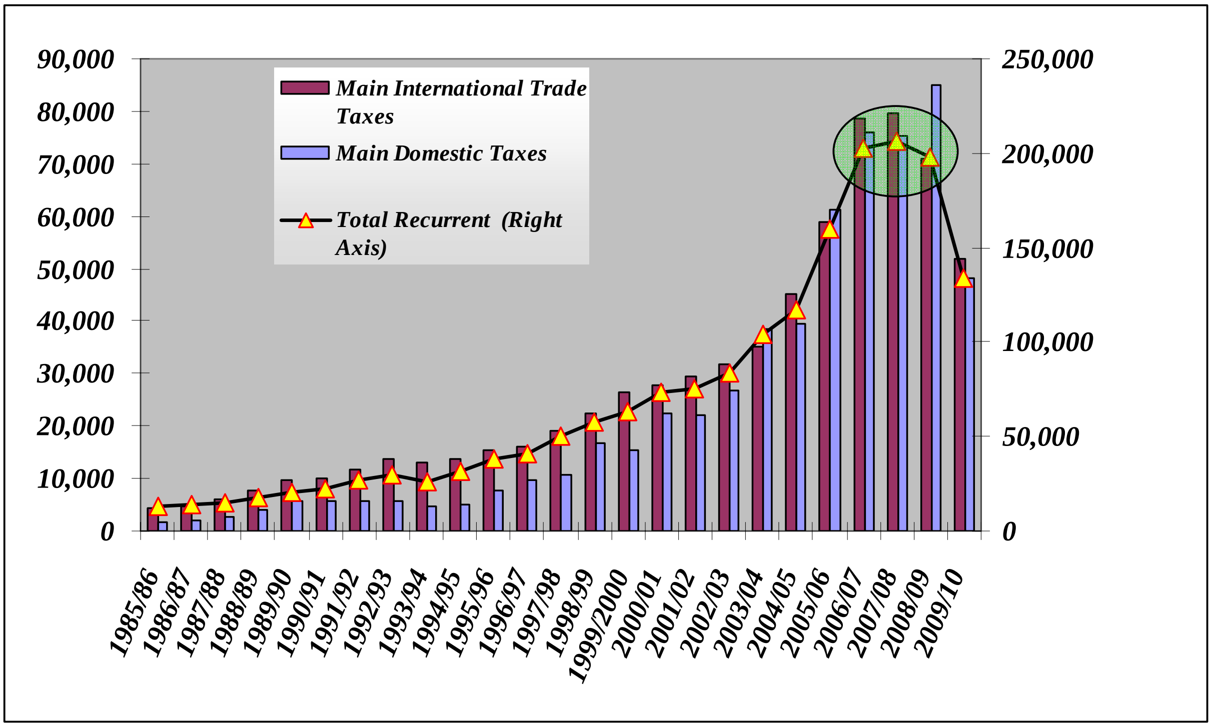
Table 1: The Ten Main Recurrent Revenues in 2008/09

Budget Code	Revenue Source	Amounts Collected ($ million)	Share of Total Recurrent Revenues	Tax or Fee
15004	Import Duties	70.82	35.82%	Tax
12002	Stamp Duties on Land Transactions	44.10	22.31%	Tax
11001	Accommodation Tax	19.75	9.99%	Tax
16035	Work Permits and Permanent Residency Certificates	18.25	9.23%	Fee
11005	Communications Tax	4.99	2.52%	Tax
18001	Cargo Dues	3.96	2.00%	Fee
13007	Telecommunications License	3.04	1.54%	Fee
11008	Gaming Machine Tax	2.79	1.41%	Tax
16056	Financial Services Commission Net Revenue	2.69	1.36%	Fee
13006	Business License Renewal	2.68	1.36%	Fee
	Total Recurrent Revenue	**197.72**	**87.54%**	

It can be seen that in 2008/09 these 10 revenue items together accounted for almost 88% of all recurrent revenue. However, only five of those items are true taxes: the others are fees and charges. The structure has been broadly like this for at least the past 5-6 years.

However, notwithstanding its somewhat unconventional nature, this structure, over a sustained period until 2009, does not seem to have been a hindrance to relatively strong revenue growth. This is confirmed by the time series data summarised in Figure 1 below which trace total recurrent revenues between 1985/86 and 2009/10 (see the right hand axis)[3]. This graphic shows a strong growth throughout the whole period but with a marked acceleration in the boom years from 2003-04 onwards. It can be seen that by 2007/08 total revenues had expanded to a total in excess of $200 million. A modest decline was then experienced in 2008/09 before the major collapse of revenues that seems likely to bring the current financial year total to something around $150 -160 million (for the moment the 2009/10 figure is obviously preliminary).

Figure 1: Recurrent Revenues – 1985/86 to 2009/10



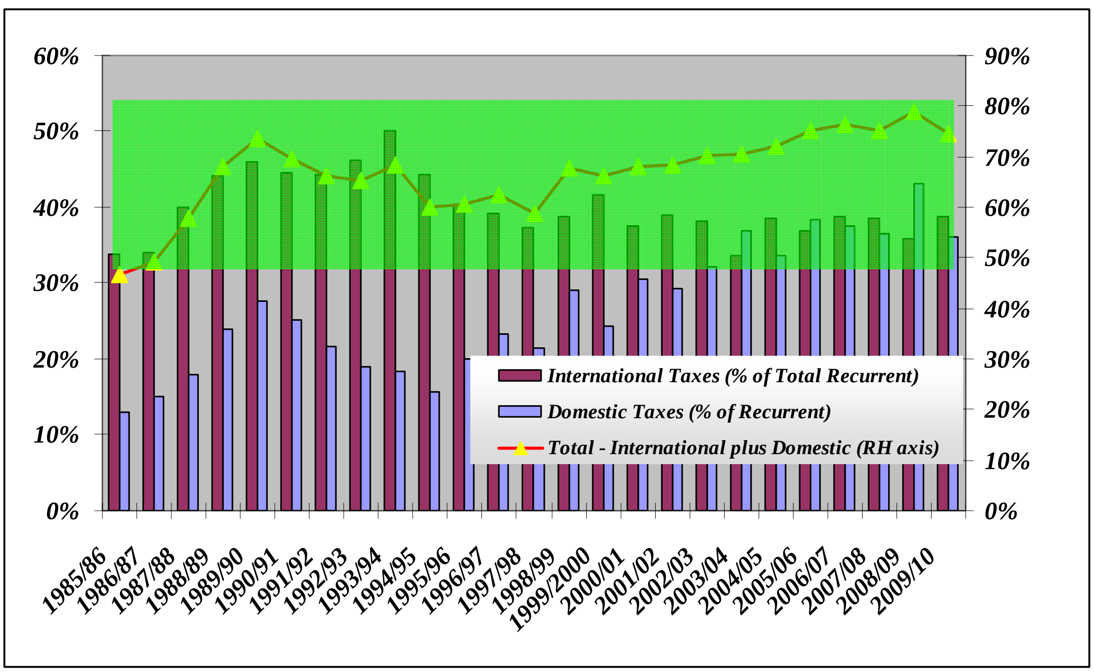
Significantly for this present study, any judgements about whether the existing system of taxes and charges can soon restore total revenues back to the circa $200 million level from their currently hugely reduced level is problematic in the extreme. Such a judgement hinges on whether or not the economic circumstances of the three year period 2006/09 (as ringed in the figure) when revenues were hovering around $200 million will return. This judgement relates in particular to the likely future of the condominium model of property development in the islands. If such a return seems likely then the pre-existing revenue system – eccentric as this may be – could be one leading option for the future. If on the other hand such a return is adjudged to be unlikely – as several commentators in the islands think it is - then some

[3] The data trace the top five items from Table 1 plus export duties and the airport departure tax and classify these as follows. "International Trade taxes" are import duties, export duties and the airport departure tax. "Domestic taxes" are the stamp duties, the accommodation tax and the communications tax. The main source is TCI, Statistical Department, Department of Economic Planning and Statistics, *Report on Government Finance Statistics*, 2005, 2006 and 2007 editions. The preliminary numbers for 2009/10 are based on Ministry of Finance data through end-August 2009 which are then pro-rated to estimate a total for the full year.

significant changes in the revenue balance would be called for unless public services were to be run permanently at a much reduced level.

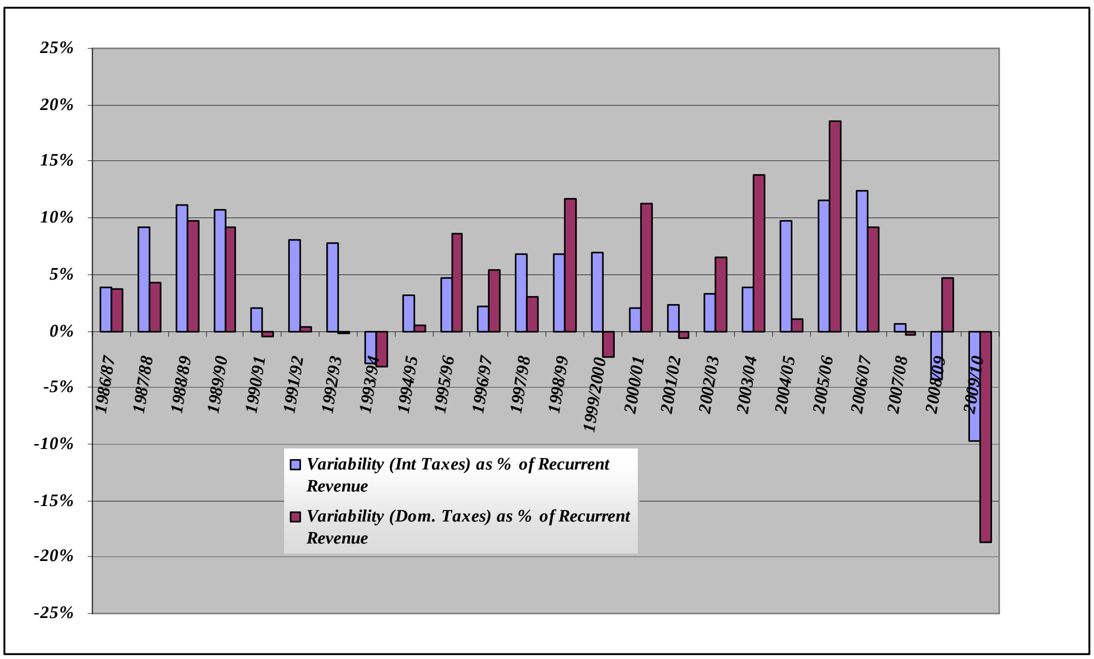
In order to throw further light on this matter, Figure 2 indicates the *shares* of the main international and the main domestic taxes (as defined in footnote 3 above) and their volatility over time relative to total recurrent revenues. Two main insights emerge from this. First, the right-hand axis confirms that the dependence of the system on these two main categories of taxes and charges rose significantly (to over 80% of the total) by 2008/09 before the collapse in the financial year 2009/10. The 80% dependence compares with only about 50-60% in earlier years with the change over time indicated also by the shaded area in Figure 2. Second, and even more significant has been the growth in the *relative* importance of the main "domestic taxes" (stamp duties on land and the accommodation tax). These are shown as the blue (lighter) shaded areas against the left hand axis of Figure 2. Between the mid-1990s and 2008/09 these revenues more than doubled their share of total recurrent revenues from 20% in 1995 to 40% by the end of that period. In other words the country's tax revenues became ever more dependent on tourist stays and on a particular form of property development – the condominium model - that generated the bulk of the stamp duty revenues.   So the nation's budgetary situation is in serious trouble if, as some local commentators argue, the condominium model is dead or chronically damaged.

Figure 2: The Revenue Record 1985 to 2010 (% ages of Total Recurrent Revenue)



A third and similarly important insight emerges from Figure 3 below that shows the year-on-year changes in the revenues generated by the two main classes of taxes. These data are shown as percentages of the total tax take of the previous year and so they give a rough indication of the uncertainties that the authorities would have faced in their revenue forecasting in each of those years. It is readily apparent that there was considerable year-by-year variability in the receipts from each of the two categories of tax: an amount of variation equivalent to 12% of total recurrent revenue in some years. Until 2009/10 the largest annual changes were in the upward direction and so the authorities had the benefit of seeing large *increases* in the revenues available to them. But there was also a high degree of collinearity in the tax take received from the two sources. This is very evident in the boom years but also in the two main years that saw a revenue decline – 1993/94 (a modest decline) but then again in 2009/10 where based on preliminary numbers through August 2009, the decline has been dramatic. A reasonable conclusion is that these two standard IMF revenue categories[4] of "import trade taxes "and "domestic taxes" are not as distinct as their names might suggest. On the contrary both are highly susceptible in the TCI context to the ups and downs of global economic forces. In other words the present system provides little or no diversification to insulate total revenues from the periodic swings of the global economy.

Figure 3: Year-on-Year Changes in Revenue (% of total Revenues of preceding year)



3. The Size of the Tax Effort in TCI

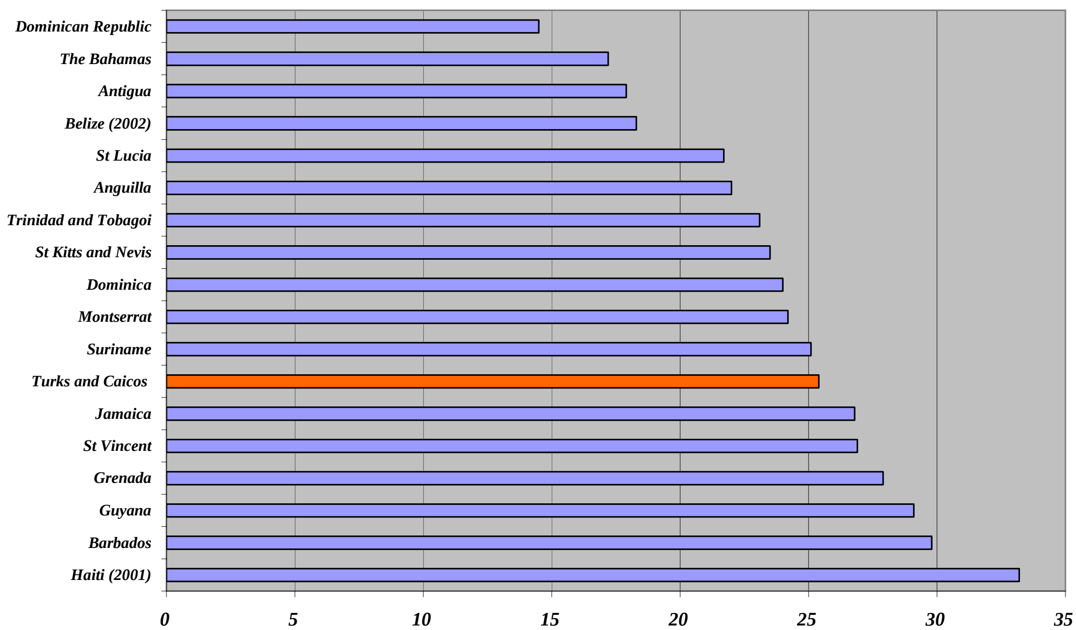
Figure 1 above presented some data on the total tax effort in TCI measured in $US. But in order to assess how large this is in relation to comparator jurisdictions it is also helpful to look at total tax and fee revenues as a percentage of each country's GDP. A CARICOM study of July 2004 conducted this comparative analysis for TCI and a set of 17 other economies in the region[5]. Although this study is somewhat out-of date (being based on 2003

[4] From the standard IMF, *Government Finance Statistics* (GFS)

[5] Paulo dos Santos and Laurel Bain, *Survey of the Caribbean Tax Systems*, CARICOM, July 2004

data) it us useful to begin there. The CARICOM data on *tax revenues* as a percentage of GDP are shown in Figure 4 below. They show that TCI - with a tax take at that date equal to 25.4% of GDP - was positioned well above the average (median) level of the tax effort seen across the comparator countries. Six of the 17 comparators produced a higher tax effort than did TCI but eleven performed worse in this respect. On the basis of these comparisons it was definitely ***not*** possible to classify TCI as a low tax environment.

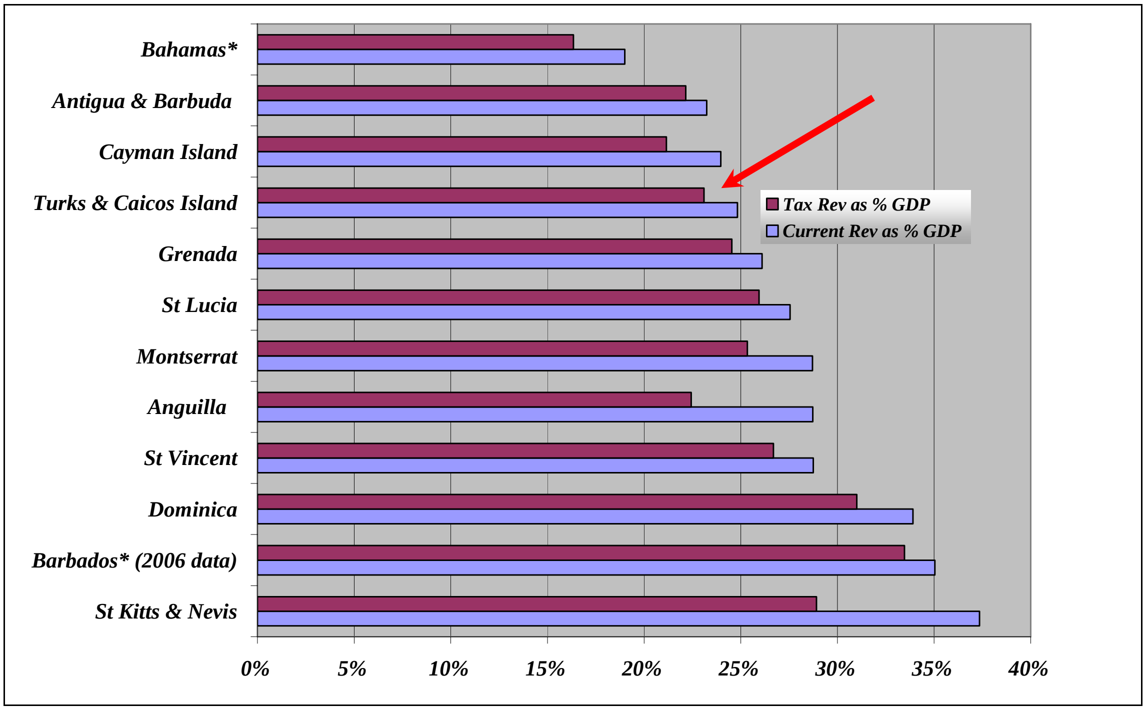
Figure 4: Tax Revenues in 2003 (percentages of GDP) ***Source: CARICOM, July 2004.***



For most countries one could generate an up-date of these comparisons by consulting the IMF's *International Finance Statistics* (IFS) or *Government Finance Statistics* GFS data bases for the countries included in the comparison. Unfortunately having reviewed the most recent IFS data it transpires that only a few of the countries listed in Figure 4 provide the requisite data to the IMF. So an additional source (albeit for a slightly different sample of countries) was found in the data sets provided by the Eastern Caribbean Central Bank (ECCB)[6]. This source was supplemented, for countries not having available data from either the IFS or the ECCB sources (including TCI), by consulting national source data sources. The resulting second set of comparisons – now for 2007 – are shown in Figure 5 below which contains data on both *tax revenues* and *total recurrent revenues* for each country. The countries are ranked in order of their total *recurrent revenues* as a %age of GDP.

[6] Source: Eastern Caribbean Central Bank, *Annual Economic and Financial Review 2008.*

Figure 5: Tax Revenues and Recurrent Revenues in 2007 (percentages of GDP)



This second comparison shows the TCI in a somewhat less favourable light. It is now ranked only 9th among the 12 countries shown in Figure 5 in terms of its total recurrent revenue effort and 7th in terms if its tax effort. However, its total revenue effort (taxes plus fees and charges) in that year still delivered some 25% of GDP to the Treasury. This compares reasonably well with all the other jurisdictions with the exception of St Kitts, Barbados and Dominica which by 2007 had achieved a most impressive increase over its own 2003 number[7] as reported by the earlier CARICOM study in Figure 4.

Given the possible slight differences of definition across the various different sources used to construct Figure 5 we should not make too much of relatively small percentage differences in the size of the tax efforts that are shown there. The important point from that figure is the confirmation that TCI was indeed still generating a reasonably strong tax revenue performance at least through 2007 – at around 25% of GDP. Once again we can conclude that TCI has *not* been a particularly low tax environment.

Comparisons in TCI Niche Areas

The evidence available to us while preparing this Report indicates that TCI's reasonably strong ***overall*** revenue performance as illustrated above has not prevented it from retaining a high level of tax-regime competitiveness *vis a vis* the main competing jurisdictions in the region and beyond. This has been achieved by largely eschewing the use of direct taxes such as the personal income tax (PIT) and the corporate profits tax (CT). [8] In this respect,

[7] Dominica had extensive help in this period from DFID and other donors, across a broad range of public financial management issues including assistance on its revenue effort.

[8] albeit with the partial exceptions to this as shown in Box 1 for both PIT and CT.

TCI has followed a pattern which is also seen in most of the six overseas dependent territories of the UK. The recent assessment of these jurisdictions authored by Michael Foot at the request of the UK Chancellor of the Exchequer[9], categorises the tax stance of these territories in the following terms: *"the Crown Dependencies and Overseas Territories were distinguished within the developed world by differentiating themselves from the international consensus, sometimes through tax rates but more often through the absence or near absence of certain forms of taxation. The tax regimes in most of the Overseas Territories have not evolved beyond the imposition of specific transaction and consumption taxes: they operate a range of customs duties on imports, on which they are heavily reliant for revenue. With the exception of Gibraltar, the Overseas Territories have not introduced income taxes, corporation taxes, or value added tax (VAT) or goods and services tax (GST)."* (pg 34).

The next few paragraphs examine this feature of the revenue system of TCI in terms of its likely effect on the competitiveness of two of the key sectors of its economy namely off-shore finance and tourism. The purpose is to define the constraints on possible revenue reforms that are dictated by the need to retain a good level of competitiveness.

Off-Shore Financial Services

TCI has for many years provided a range of financial services including banking, the provision of an off-shore base for specialised insurance services and especially the so-called PORCs (producer owned reinsurance companies), and also for trusts and corporate structures including a large number of exempt companies. As an IMF report on this matter noted in January 2005, few statistics are available to measure the size and performance of this financial sector [10] and even the recent Foot Report seems to have missed some important dimensions of that industry in TCI However, in purely numerical terms the sector is dominated by TCI's niche position in PORCs (producer-owned reinsurance companies) of which there are now 4,300 – most of which have a US parent base, and by the registration of a large number of Exempt (International Business) companies of which there are currently no fewer than 10,786- almost twice the number of ordinary resident companies.

TCI's low (direct) tax regime certainly provides one important part of the basis for the location of these and other offshore financial activities in the islands. This fact needs to be kept carefully in mind when considering any possible extension to the present range of taxes.

For the moment however, the country generates budget revenues from this sector largely from the licensing fees that are charged and it is the competitiveness of these charges which plays the more critical role in defining the relative attractiveness of the islands. The charges are levied and collected by the licensing authority namely the Financial Services Commission (FSC)[11]. A comparative assessment of these licensing charges was conducted early in 2009 by the FSC with the two main low-tax jurisdictions in the region (The Bahamas and the Cayman Islands) being chosen as the comparators. The results are shown in table 2 below.

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[9] Michael Foot, *Final report of the independent Review of British offshore financial centres*, UK Government, London, October 2009

[10] IMF, Turks and Caicos: *Assessment of the Supervision and Regulation of the Financial Sector – Review of Financial Sector Regulation and Supervision*, Washington DC, January 2005

[11] The FSC as a Statutory Body is now able to retain a part of these charges to fund its own operations.

Table 2: License Fees for Financial Services Companies - 2008

Annual Fees	**Bermuda**	**Bahamas**	**Cayman Islands**	**TCI**	**TCI**
				Pre-September 2009	***Newrates from September 2009***
Bank License	$ 16,500 to $ 220,000	$ 15,000 to $2,500,000	$ 48,780 to $ 609,756	$ 12,500 to $ 22,500	$17,500 to $ 40,000
Insurance License	$ 971 to $210,000	$ 5,000 to $ 20,000	$ 9,146 to $48,780	$ 2,000 to $2,500	$ 2,000 to $3,750
Company Registration	$ 585 to $31,120	$ 350 to $1,000	$ 556 to $1,640	$100 to $300	$150 to $ 350

It is very clear from this comparison that even after the September 2009 increases in charges, TCI has the scope to raise its licensing fees quite a lot more before it is likely to lose its competitive advantage *vis a vis* the two comparator jurisdictions (see also Section 6 where the issue of the appropriate fees and charges is discussed more generally).

Several of the stakeholders consulted while preparing this report argued that there is also considerable scope, *with the right policies*, to increase the size and importance of the offshore financial activities within the overall TCI economy. The necessary conditions for this would include (i) an update of much of the underlying legislation to ensure a high level of compliance with current OECD standards and (ii) a streamlining of present work permit arrangements (but not necessarily lower charges for these) to ensure the ready availability of the additional skilled legal and financial specialists. This potential was argued by some to include greater scope for using the offshore company registration model for which TCI is already attractive as evidenced by the 10,000 or more exempt companies already registered in the islands. This could be realised, for example, by linking the promotion of such a model more explicitly to the islands' property development and the possible relocation of senior and wealthy business owners from the USA, Canada and elsewhere. However, we note that the OECD still promotes the principle that countries should not introduce or should scrap beneficial/discriminatory ring-fenced tax arrangements that are designed to attract/steal business based purely on low or zero tax[12]. In the light of this it may be better for TCI to consider the implications and benefits of a pro-active strategy to establish a comprehensive network of double taxation agreements, starting perhaps with Canada.

[12] See OECD, *Harmful Tax Competition: An Emerging Global Issue*. 1998. This analysis led in June 2000 to the OECD publishing a blacklist of tax havens based on three main criteria, one of which was the existence of ring-fenced tax regimes. Although published in 1998 we understand that that initiative is still current. The current emphasis is now on signing tax information exchange agreements (TIEAs), However, we understand that the OECD still promotes the principle enunciated in the main text above.

The Foot Report noted that TCI along with most of the other ODTs has not made any use of double taxation agreements (DTAs) as a means to attract offshore companies to the islands. However, it may not be too late to solicit some of this business by, for example establishing ring-fenced corporate tax regimes at low or even zero tax rates for companies from a few target countries such as Canada. This would call for some limited extension to the current list of TCI's taxes but, done properly, this could enhance rather than diminish the competitiveness of the islands for this particular type of activity.

Tourism

A November 2006 study on tourism in the Caribbean region by PA Consultants for the Caribbean Hotels Association[13] provided comparative data on the aspects of tax regimes that affected the tourist sector in 15 different countries. Although the analysis of the various tax regimes in these countries was relatively complex and so is not easily summarised, the tabular comparisons provided in the report enable us to make the following statements about the tax system in these 15 countries in comparison with TCI[14].

- *Accommodation Tax.* All 15 countries operate an accommodation tax or a general sales tax (as in the case of Jamaica) that has the equivalent effect on tourists. The rates of tax varied from a low of 7% (St Kitts and St Vincent) to a high of 23% (Dominican Republic) with Jamaica (15%) and Bahamas (12%) also levying quite high rates.[15] *Comment:* TCI' current rate of 11% i

- *Departure Taxes.* All 15 countries apply a departure tax and one country also applies an arrivals tax. The lowest rate is $10 per passenger (Suriname) but rates go as high as $30 (Haiti) and $25 (Jamaica)[16].

- *Property Taxes.* At least 12[17] of the 15 countries apply either a once-for-all or an annual property tax. In many of these cases the tax is levied on an annual basis using either annual rental value, capital vale or size of land area as the basis for charges which in some cases were progressive. For example, St Lucia levies 5% of assessed annual rental value on domestic properties and 0.25% of the market value on commercial properties. The Bahamas levies 0.5% per annum on the first $50,000 of assessed value, 1.0% on the next $50,000 of assessed value and 1.5% per

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[13] PA Consulting Group, *Taxation & Operating Costs for the Caribbean Hotel Sector. A preliminary comparative study and recommendations relating to tax levels, incentive structures, and costs affecting tourism enterprises in CARIFORUM countries*, Report prepared for prepared for the Caribbean Hotel Association, November 2006

[14] The fifteen countries are Antigua, Barbados, The Bahamas, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St Kitts and Nevis, St Lucia, St Vincent, Suriname, Trinidad and Tobago

[15] See Table 1 in Section 6.1 of the report.

[16] See Table 2

[17] For the other three countries the report indicated "data not found" which may still mean that a tax was in place.

annum on assessed values in excess of $100,000.[18] *COMMENT:* With no annual property tax TCI seems highly tax-competitive in this area but the high up-front Stamp Duty on property transactions will dent this competitiveness to some degree.

- *Value-Added Tax.* At least ten of the fifteen countries levied a VAT or General Consumption tax at the data of the study (2005). Since then at least two others namely Antigua and St Vincent have introduced such as tax[19]. *COMMENT:* With no VAT or GCT, the TCI is very competitive in this area.

- *Corporate Income Tax*. Only one of the 15 countries namely The Bahamas did ***not*** levy a general Corporation Tax.[20] *COMMENT:* With no general Corporate Income tax the TCI is very competitive in this area.

- *Duties on Imports.* All but one of the fifteen counties applied the CARICOM Common External Tariff or something like it with rates on tourist-relevant items ranging from zero to 25-30% (but higher in Antigua and the Bahamas). But in addition most of the countries applied additional charges to imported goods. For example, 8 of the 15 countries applied some sort of additional charge or surcharge on at least some imports; 5 applied a stamp duty on some imports; 12 applied either VAT or a general consumption tax and others applied various excises and other levies. *COMMENT:* TCI suffers from high average rates of customs duty (somewhat higher on average than in the CARICOM CET) but mitigates this disadvantage (i) by offering very substantial exemptions to many tourism related importers and (ii) by not levying the various additional charges seen in many other Caribbean jurisdictions.

The balance of these various competitive advantages and disadvantages to TCI in terms of tax cannot be readily summarised in simple numerical terms. However, the overall picture is one in which the major cost-raising taxes and charges (impacting either the tourist directly or the supplier of tourism services such as hotels, restaurants and condominium owners) are relatively common across the various Caribbean jurisdictions and TCI. The TCI seems to have made itself higher cost than most of its competitors in terms of the rates of *accommodation* and *departure taxes* that are currently levied. But it more than makes up for this in terms of its presently zero rates of corporation tax, its low charges for business licences, the absence of a VAT, and the absence of high excise duties on luxury consumption goods including alcohol and tobacco. TCI's high rates of import duties would be expected to be a competitive disadvantage but the present very generous exemptions mitigate this disadvantage especially as they are enjoyed in particular by the developers of the tourism sites. The high 9.75% up-front rate of *stamp duty*, at least in Providenciales is difficult to read as an influence on TCI's overall tax competitiveness. Interlocutors from the local realty industry with whom we met while preparing this assessment were somewhat unclear and divided about whether or not this was indeed a handicap to their efforts to attract new buyers and developers: recognising that the other jurisdictions maintain generally lower up-front charges but also impose annual property tax levies in lieu.

A relatively secure conclusion is that most countries of the Caribbean region have introduced tax disincentives to the tourism sector similar to, but on the whole rather more damaging

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[18] See Table 3

[19] See Table 4

[20] See Table 5.

than those seen in TCI. In the words of the PA Consultants study …"*High taxation of inputs through import duties and other indirect charges are affecting the hotel industry within the CARIFORUM countries. These taxes are reducing margins and also increasing the overall price of the hotel product…... Incentives in the hotel sector in the CARIFORUM region are for capital inputs only. The present import regime of the CET has significant operating costs for both the hotel sector and the government. This tax is a clear challenge for the hotel sector. Taxes directed at the tourist such as departure tax and hotel accommodation tax while easy to administer, are a nuisance factor to the visitors, and appear to be price gouging when they become too visible or too high." ….*In this general context it would seem that TCI does have some room for a careful redesign of some parts of its existing tax structure without imposing a major competitive disadvantage on its tourism sector. The later discussion identifies some possible components of this redesign.

4. Criteria for Assessing Individual Taxes

There are a number of well defined criteria that are routinely used to assess the suitability of particular taxes. This present Section first defines ***six*** main criteria which find a presence in the textbooks but then adds a seventh criteria to reflect the particular issues that arise in very small economies such as that of TCI. The criteria themselves are defined below with a little more explanatory detail being provided in Annex 1.

The Criteria

The six main textbook criteria are as follows:

1. ***Horizontal Equity.*** This is the principle that a tax is "good" if people in similar circumstances (e.g. with the same levels of income or the same accumulation of wealth) pay broadly the same amounts to tax. A system is horizontally *inequitable* if persons with similar income levels pay substantially different amounts of tax. This principle is rarely capable of being achieved fully in the real world. In any tax system some people perhaps through dishonesty or by being able to afford a good accountant will be more able than others to avoid some of the tax for which they are strictly liable. But this is a problem of administration rather than design. To the greatest extent possible the *design* of a tax system should wherever possible seek to be equitable across persons of similar means. The point is illustrated graphically in Figure A in Annex 2.

2. ***Vertical Equity.*** This is the parallel principle that a tax is good if has elements of "progressiveness". In other words persons who are relatively better off (in terms of income or wealth) should pay a somewhat higher proportion of their income in tax than poorer persons. The principle derives in turn from the relatively non-controversial proposition that people generally are subject to a diminishing marginal utility of income and consumption. In other words, one extra dollar in the hands of a poorer person will normally convey greater utility than that same dollar in the hands of a richer person. In general it is much easier to make direct taxes progressive than it is to introduce a progressive element into an indirect tax. So this principle taken on its own is often seen as an argument in favour of direct taxation. However, as we shall see below some of the other criteria point in a different direction. The point is illustrated graphically in Figure B in Annex 2.

3. ***Tax Base – Breadth and Inclusiveness.*** This is the idea that a tax with a broad base that encompasses a large proportion of the income, consumption or wealth that is being taxed is preferable to a tax which impacts only a narrow part of the potential base. The logic here is quite simple: the broader the tax base the lower can be the rates of tax that need to be applied to generate any given amount of revenue. The point is illustrated graphically in Figure C in Annex 2.

4. ***Efficiency of Administration and Collection.*** All taxes need to be collected and some taxes are obviously easier and cheaper to collect than others. The simplest tax to collect would be something like a poll tax (everyone pays a specified dollar amount of tax irrespective of their situation). But this example quickly shows that the administratively easy taxes may also fall foul of the other criteria that we have articulated above. So it is not the case that a tax can be chosen solely on the basis of the ease and costs of collection. But by the same token, taxes that seem desirable on other grounds should always be designed with at least one eye one administrative efficiency. One way to do this is to avoid too many different tax rates with differentiated conditions for any given tax.

5. ***Economic Efficiency.*** Every tax will impose some burden on the individuals or the productive sectors that pay the tax. Further these burdens will invariably cause some changes of behaviour that are adverse for productive activity (for example a tax on wages is likely to discourage some workers from providing as much labour effort; a tax on consumption is likely to discourage the consumption of the taxed items). These burdens and the resulting changes of behaviour are typically complex to analyse and not least because the taxes can often be "shifted" to a person or company other than the ones responsible for actually paying the tax. In TCI, for example, it is likely that tourist visitors pay a major part of the accommodation tax charged to hoteliers and that purchasers of condominiums pay a large part of the stamp duty charged to developers. The idea of economic efficiency is to try to choose taxes that ***minimise*** the total burden and the resulting reduction in activity levels that can invariably be expected to result from a tax. Two examples to illustrate this point are shown in Figures E and F in Annex 2.

6. ***Reliability versus Volatility*** This sixth criteria uses the idea that other things being equal, one tax is superior to another if the revenue it can deliver to the Treasury is relatively more stable from one year to the next. Public finance planning works best when there is a reasonably reliable and stable supply of revenue from one year to the next. 2009/10 in TCI has revealed the huge problems that arise when that stability is lost. In most cases one would expect to find some degree of association between the breadth of the tax base and the stability of the tax revenues that it can generate. The stamp duty on land in TCI is an example of a relatively narrow tax base that has demonstrated a high degree of *instability*.

These six standard criteria are relatively non-controversial and not least because they do not point to a unique set of the "most desirable" taxes in any jurisdiction. A tax that performs well against one criterion may do badly on some of the others. So judgements and trade-offs are needed to turn the list of criteria into a parallel list of the "preferred taxes" in any given country.

The consultations held in Providenciales and Grand Turk while preparing this Report produced several cogent reasons for also factoring in the very special circumstances of small economies[21]. This has led to the introduction of a seventh criteria for assessing the suitability of any individual tax. Although this could be presented as a sub-component of criteria #4 above, it is sufficiently distinct for us to present it as an additional criterion in its own right.

7. ***Feasibility and Appropriateness in a Small Economy.*** There are two main aspects to this final criterion. The first is the high fixed costs of setting up the administration of some potential new taxes and the difficulty in small economies of spreading these costs over enough tax payers to justify the incurring of that cost. The second relates to the practical difficulties of privacy and tax enforcement in a small and relatively close community where there is naturally some reluctance to divulge too much financial information to tax officers who in many cases may also be relatives, friends or close acquaintances. We were advised several times not to rely too much on any tax the effective collection of which might encounter difficulties because of such reluctance. Obviously this advice cannot be adhered to fully since all taxes do require some divulgence of some financial information. The point is rather that some taxes are more or less onerous from this point of view than others.

Assessing TCI's present Tax System

The next step in the analysis is to assess the performance of TCI's present system of taxes and revenue charges against the seven criteria just listed. Since there is such a high concentration of total revenues on just six items (see Table 1 above), this assessment focuses only on those six items. It could if necessary be extended to embrace other tax components. In order to permit some comparison of the various taxes against the seven criteria, a simple scoring system has been adopted. This involves assigning an equal weight to each of the seven criteria and scoring each tax against each criterion according to the following four point scale:

4 = a "very good" tax when judged against the criterion

3 = a "good" tax

2= a "relatively poor" tax

1 = a "very poor" tax

The results are presented in Table 3 below.

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[21] We were also referred to some relevant published papers on this matter. They include Anne Sibert, *"Undersized: Could Greenland be the new Iceland? Should it be?* www/voxeu.org, 10th August 2009. Easterly and Rebelo in a 1993 paper explain why small economies tend to rely less on relatively efficient income taxes and more on relatively inefficient indirect taxes. See, William Easterly and Sergio Rebelo, "Fiscal Policy and Economic Growth: an Empirical Investigation", *Journal of Monetary Economics*, 32, pgs. 417-57, 1993. In another 1993 paper Farrugia noted of small economies like TCI that .."Many necessary decisions and actions can be modified, adjusted and sometimes totally neutralised by personal interventions and community pressures. In extreme cases, close personal and family connections lead to nepotism and corruption" See Charles Farrugia, "The Special Working Environment of Senior Administrators in Small States," *World Development*, 21 pgs 221-26, 1993. Willem Buiter and Anne Sibert have applied similar logic to try to explain Iceland's inherent vulnerability to banking crisis. See, The Collapse of Iceland's banks: the predictable end of a non-viable business model", www/voxeu.org. October 30th 2008.

Table 3: An Assessment of the Existing Revenue System

	Horizontal Equity	*Vertical Equity*	*Breadth of Tax Base*	*Stability/Volatility*	*Administrative Efficiency/ Costs of Collection*	*Economic Efficiency*	*Sensitivity to Small Islands Problems*	**Totals**
Import Duty	3	2.5	4	3	3	2.5	2	**20**
Stamp Duty on Land and Property Transfers	3	2	1	1	2	1	4	**15**
Accommodation Tax	3	3	2	2	3	2	4	**21**
Work Permits and PRCs	1	1	1	2	3	1	4	**13**
CT/Communication Tax	2	2	1	4	4	4	4	**21**
Gaming Taxes	2	2	3	3	3	4	3	**20**

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There is inevitably a degree of subjectivity in assigning scores in the manner of Table 3. However, while some of the individual scores as shown above might vary marginally if assigned by some other analyst, it is unlikely that that *relative positioning* (or rankings) of the total scores would be much changed.

The following important conclusions follow.

- The present TCI revenue system contains ***four*** main items that achieve average scores of “good”. This means that these taxes should probably to play some role in any reformed tax system. These are the import duty, the accommodation tax, the corporation tax on the main communications company, and the various gaming taxes. This is not to say that these taxes should all be administered in exactly the same way as now but they should probably have some ongoing role.

- There are two taxes/ charges that overall seem like poor ways to raise revenue for the government coffers. These are the stamp duty on land transfers and the charges for work permits and Permanent Residence Certificates (PRCs). Both of these score pretty badly on all the criteria other than #7 - sensitivity to the special problems of small economies. On this latter criteria they do well because they clearly impose themselves mainly on the non-belonger population and in a manner that makes them reasonably easy to administer[22]. So it would only be by increasing the weight attached to this last criterion that these taxes would start to look good overall.

Assessing Potential New Taxes

The same scoring exercise is now repeated for a small selection of possible new taxes that have been suggested by other commentators such as the IMF and the recent Foot Report and, or appear as a part of the tax apparatus of competitive economies. The results of that scoring exercise is presented in Table 4 below.

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[22] The score of “2” assigned to the costs of collection for stamp duty reflects the unfortunate reality that substantial under-collection of this tax has been the norm in recent years.

Table 4: An Assessment of Potential New Taxes

	Horizontal Equity	*Vertical Equity*	*Breadth of Tax Base*	*Stability/ Volatility*	*Administrative Efficiency/ Costs of Collection*	*Economic Efficiency*	*Sensitivity to Small Islands Problems*	**Totals**
Personal Income Tax	3	4	3	3	1	2	1	**17**
General CT	3	3	3	3	1	2	1	**16**
Property Tax	3	3	3	3	2	3	2	**19**
Value-Added Tax	4	3	4	3	1	4	2	**21**
Excises on Selected Items	2	4	2	3	3	3	3	**20**

This second scoring table is particular helpful because it provides a coherent analytical basis for incorporating many of the *qualitative* comments provided by various stakeholders at the consultation meetings that preceded the drafting of this Report. Those stakeholders were almost unanimously nervous about the introduction of either of the main direct taxes namely the Personal Income tax and the general Corporation tax (although some did support the extension of the present Communication tax (a type of CT) to rather more of the islands' utility companies). We can see from table 4 that this resistance to these two direct taxes does not stem necessarily from the quality of these two taxes in terms of the *first four* of our seven criteria. On the contrary, these taxes score quite well on these four criteria. They do poorly overall only because of their poor scores on the last three of those criteria including the costs of collection and the sensitivity to the small economy issues. These were the points mainly stressed by our interlocutors.

The initial conclusion from this analysis is that the PIT and the CT should not figure too prominently in suggestions for the future shape of the tax system. This fits also with the evidence from many of the comparator jurisdictions that we have reviewed and also with the findings of the recent Foot Report. Most of the comparator jurisdictions considered earlier do not have an explicit PIT but many of them – like TCI – have some form of PAYE (pay-as-you earn) system for collecting national insurance, health or pension contributions. Several do have a system of CT which is broader than the narrow TCI arrangement of the so-called Communications tax. However, Foot summarising the Deloitte's study on tax that accompanies his own report notes the following: ….*"Deloitte concluded that the Crown Dependencies' industry bases were sufficiently diverse that they had the potential to raise worthwhile levels of revenue from a CT system more aligned with international 'best practice' than the regimes currently in place. By contrast, some of the Overseas Territories' focus on a narrower financial sector niche suggested that the introduction of a broad-based CT would offer less scope for a significant tax take." (pg 34).* While a broader corporation tax for TCI should not be ruled out completely, these arguments, the views of stakeholders and the findings of our own numerical assessment indicate that it is not as strong a candidate as some other possible new taxes.

Overall

The two tabular assessments presented in this Section of the Report provide a very clear steer about (i) what is wrong with the present TCI tax structure and also (ii) the broad directions in which we may look to find potential new sources of revenue. In the next two sections we turn more explicitly to the main options for reform based on these initial assessments.

5. Leading Options for a Reformed Tax Structure – Short-Term

In moving to this stage of the analysis it is useful to articulate two important points of departure. First, even if there is a strong reform of the TCI civil service in the next few years, the country will remain small and it is unlikely that it will have the capacity to manage highly complex administrative tasks. This suggests that any new taxes that might be considered should be capable of being relatively easily administered and at low cost. Second, the previous revenue system has not failed comprehensively and so we should try to build on the good elements and beware of throwing away elements of that system unnecessarily.

The discussion that follows is subdivided into two parts namely (1) in this present Section, we assess the short–term reforms requiring relatively limited design and organisational change and so capable of being implemented within a 3 -12 month time frame and (2) in Section 6, we assess the possible additional Medium and Longer Term reforms requiring more analysis and a design and implementation time frame of 1 to 3 years.

The short-term options

Priority 1: Improving the import duty system

Table 3 above confirms that the TCI import duty is the only one of the main taxes that has a broad tax base. It is important in looking ahead that opportunities are taken to broaden the overall tax base of the islands if possible. But however that is done, it is immediately clear that the customs tariff must be the foundation for that objective of the reform agenda. Although the customs tariff has shown itself capable of generating over $ 70 million of revenue annually (and even in 2009/10 its revenue yield is standing up much better than that of most other tax sources) it has three major defects:

- The nominal rates of duty on many key goods are far too high
- The structure and differentiation of duty rates is very complex and anomalous (for example coffee is charged a much higher duty than tea and roofing materials are charged at twice the rate of gutter pipes) and this leads to unnecessary administrative difficulties and cost, to unintended disadvantages to some productive activities, and to avoidable incentives for corrupt classification
- The very large duty exemptions that have been adjudged necessary to offset the high duties and to favour certain types of development have been administered increasingly in a manner that has “given away” a large part of the potential tax without any real evidence of any proportionate economic benefit for the economy being achieved.

So it is major priority that in respect of this single most important tax there should be a process of (i) tariff reduction (ii) simplification and (iii) elimination of all or most exemptions. Let us consider each of the three defects in turn.

Exemptions : The government has already moved rapidly to analyse and assess the system of duty exemptions and some reform of this aspect of the present system seems likely to proceed in the near future. Data from the TCIG’s own assessment of the revenue losses associated with exemptions is reproduced below as Table 5.

Table 5: Import Duty Exemptions in 2008/09

	Amount ($ US)		
	Value of Eligible imports	**Duty Collected on these Imports**	**Loss of Revenue**
Section 69 – Customs Ordinance	**52,016,008**	**120,742**	**14,953,559**
Section 70 – Customs Ordinance	**91,287,354**	**4,171,471**	**21,990,608**
Encouragement of Development Ordinance (CAP 185)	**74,854,085**	**4,420,071**	**20,872,664**
Total	**218,157,447**	**8,712,284**	**57,816,831**

It can be seen that of total imports in 2008/09 of some $549 million[23], some $218.2 million had some claim to duty exemptions under various ordinances. The revenue actually conceded under those ordinances amounted to no less that $ 57.8 million as against the total import duty revenues actually collected as shown earlier in Table 1 of $70 .82 million[24]. If this revenue loss had instead been spread as a reduction of duty rates across all imports it would have permitted an average 10.5 percentage point reduction of the average nominal tariff..

The policy recommendation thus far to deal with this huge and unnecessary leakage is to amend sections 69 and 70 of the Customs Ordinance to remove many exemptions and to significantly strengthen both the design and the monitoring of the conditions against any exemptions that remain. This present Report supports that package of recommendations but with the added presumption that almost all exemptions should be eliminated. [25]

[23] Data are from the Customs Department

[24] Significantly, a sampling of the exemption cases indicates that 20% of the exemptions related to the importation of motor vehicles. Vehicles are classified as high value items subject to a duty rate of between 25-45%. So a discount of 50% will have caused significant losses of revenue to government on this one item alone.

[25] One of the respondents to our consultation process noted the following very important point about exemptions*…." another rather curious progression for those with duty concessions is that virtually all their purchases are made overseas and brought in at low or no duty. Local businesses suffer as a result; the building supply companies do not have the level of sales they may have planned for; the air-conditioning contractors make no profit by sale of equipment but have to exist on the labour*

The Height of the Tariff:
There is a strong argument that the need for the duty exemptions derives in large part from the unreasonably high rates of tariff applied on many goods – bearing in mind that almost all consumption goods, raw materials and intermediate goods and capital goods used in TCI need to be imported. Active consideration should be given to a radical *reduction* in nominal tariff rates.

It is further suggested that the detailed work for this be carried out as a part of the in-depth study of the tariff structure to which the government has already committed[26]. As even the simple calculations in the previous sub-section has indicated it seems possible to reduce the typical tariff by up to 10 percentage points if there is a parallel willingness to eliminate most exemptions. This reduction would represent a very significant percentage fall in the costs of importing most consumer good (including processed foods) and capital goods (including machinery and commercial vehicles) even if applied in a crude pro-rate fashion to the existing tariff rates which are summarised at their most aggregated level in Table 6 below.

Table 6: Existing Rates of Import Duty (summary categories only)

- Live Animals, Meat, Fruit and Vegetables – Duty Free
- Lumber/Plywood – 10.25%
- Prepared Foodstuffs – 25%
- Vehicles – 25%/45%
- Manufactured Goods – 30%
- Alcohol - $9.00/$32.60 USD per gallon
- Tobacco - $32.60 per pound

At the present time the TCI tariff unlike the common external tariff of CARICOM does not distinguish explicitly between (i) products that may need some protective tariff because they are capable of being produced domestically and (ii) all other tariffs. In the TCI case the tariff has been established purely for revenue purposes[27]. Nonetheless that tariff contains a bewildering range of different rates across different products that may have had some logic at some point but now seems merely to be a maze of complexity that is hard to defend. One result - via the "law of unintended consequences" - is the unintentional undermining of the commercial prospects of some processing activities (e.g. bakeries) which are otherwise viable in TCI. Similarly, since many smaller businesses have been less able to gain access to the exemptions it has the further unintended consequence of discriminating against some smaller businesses who need to pay the full nominal tariffs on their set-up equipment and their ongoing raw material requirements.

component alone; the car dealers lose sales; the furniture and appliance companies lose sales. The development of a long term stable revenue base is absolutely linked to the development of locally based businesses (emphasis added) who are in many ways the collectors of the taxes".

[26] Terms of Reference have already been drafted and considered.

[27] The one possible exception to this is the tariff treatment of lobster, conche and other fish products

Going forward there are a number of options that ought to be considered (not least by the consultants who will be engaged to deliver the detailed tariff study for which outline Terms of Reference are already drafted).

- Option 1. Develop a refinement of the present tariff to make it more internationally compliant but retain a multiplicity of different tariff rates applied to different parts of the tariff. Such multiplicity in this case must be more scientifically grounded than in the present tariff to recognise more explicitly the need to provide some support via the tariff to some processing and other activities in the islands[28] . Additionally, the rates for most products would be significantly lower than at present.

- Option 2. Extend the existing tariff system to be more internationally compliant as with option 1 but commit to a very limited set of different tariff rates – ideally one common *ad valorem* rate for all products other than unprocessed food and a very few other zero rated items such as medicines and processed baby food. This option would have the same basic advantages as Option 1 but (i) would explicitly ***not*** provide any policy freedom to manipulate particular tariffs to favour certain local industries and (ii) by working with only a very small number of rates would greatly simply tariff administration and reduce the potential for both mistakes and corruption.

- Option 3. This would be the same as Option 2 but with the add-on of *specific* additional rates of *excise duty* levied on various luxury consumption items. This would have the advantage of allowing the new customs tariff to be set and thereafter be predictable for an extended period of time. The excisable commodities would to the greatest extent possible be consumer goods where the cost-raising effect of the excise would not spill over to increase the production costs of TCI businesses. Target products for these excises would be the familiar ones of cigarettes and tobacco; beer, wines and spirits; fuel oils; and luxury private motor vehicles (defined either by price or by engine capacity). The levying of these duties as specific duties would also open the way for the rates of duty to be reviewed on a regular annual basis (as is the case in the UK and elsewhere) without the subsequent changes disturbing the stability of the new customs tariff. Also by being applied on both imported and domestically produced goods such as beer and rum this would result in a modest but welcome broadening of the tax base.

- Option 4. Eliminate all customs duties in the short term and replace these by a standard first-stage sales tax or VAT. This option would be worth pursuing only if TCI decided eventually (see the options for the medium-term that follow) to adopt some form of the general sales tax (GST) or value-added tax (VAT). In the short-term this option should provide identical results – and similar revenues - to those arising from options 2 or 3 above. But it would in addition seed the idea that any eventual adoption of a GST or a VAT would, in an import-dependent economy such as TCI be an extension of the much more familiar import duty. Indeed if the eventual registration of businesses for, say the VAT involved a very high threshold below which businesses were exempt, the VAT and the customs duty tax bases

[28] The present TCI tariff as established 1991 is a truncated version of the internationally recognised Harmonised Commodity Description and Coding Systems (HS) adopted by Customs Administrations throughout the world. It is expected that under any of the options listed above that the structure will itself be extended to be more fully compliant with the international Harmonised System.

would be quite similar. However, any businesses that did register for VAT (e.g. larger hotels and restaurants) would be able to claim rebates on the duties paid on their purchases of imports as an offset to the VAT charged on their own sales.[29]

Since there is a forthcoming specialist study on the customs tariff already planned (with results expected quite early in 2010) it is better at this stage to leave all four options above in play. However, there would be merit, for the reasons of simplicity stressed earlier, to pursue Option 1 only if very clear reasons can be found in favour of the high level of differentiation between tariff rates that we now see. Such reasons are not apparent to the author of this present Report.

Priority 2: Revamp the present system of Stamp Duties on land transfers.

As the analysis around Table 3 above has made clear, the stamp duty on land transfers is a thoroughly poor tax on most counts that are considered in that table[30]. It involves a relatively small tax base (it applies only to land that happens to change hands in any given year). For that reason the revenues it generates are extremely volatile and dependent in particular on the buoyancy or otherwise of the domestic property market. In 2009/10 as the property market has collapsed, the stamp duty revenues have dropped disastrously (in the worse months so far revenues have been only about $ 0.5 million per months as against an average close to $ 4 million per month in 2008/09). Furthermore, as the experiences with the Land Registry[31] indicate, the stamp duty has not been an easy tax to collect especially in the small island context. The tax also scores poorly in terms of *economic efficiency* considerations. It places a very high up-front cost on developers at the very point in their business planning when their cash flows are most under stress – a point where capital construction costs, the draw down (and interest payments) on loans are both high and revenue flows are non-existent. In periods when property prices are rising and expected to rise by the 25% or more per annum seen after 2004, these cash-flow consideration may be thought to be relatively unimportant. But in the current market climate of falling realty prices, reduced availability of credit and the higher cost of credit in many cases, the 9.75% up-front tax has to be a huge disincentive to prospective purchasers. [32]

The reform dilemma here is twofold. First, the stamp duty is a very poor tax from most points of view but it also happens to be the second most important sources of revenue (at least through 2008/09). So it is *impossible* for purely practical reasons to recommend its early abolition or even a radical short-term reduction in the rate of the tax. Second, no one know for sure whether the condominium model of development that was the mainstay of TCI's property development through 2008 is dead or merely temporarily damaged. The various

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[29] This assumes the most common credit-invoice basis for levying the VAT.

30 The exceptions are that the stamp duty tax scores quite well in terms of both horizontal and vertical equity considerations and very well in terms of its sensitivity to the small island problems – it can be presented as taxing foreigners and does not therefore raise too many criticisms from belongers and other longer term residents.

[31] The Land Registry is responsible for assessing land transactions and collecting stamp duty according to rules laid down in the Stamp Duty Ordinance and Registered Land Ordinance.

[32] It is recognised of course that in a falling property market the current 9.75% tax is likely to be absorbed in part at least by the developers rather than by the ultimate purchaser (of a condominium unit). But in that case the margins of the developers are squeezed in a manner that must surely deter some further development. In the absence of the tax the developer would b able to offer similar discounts if he or she chose but not also pay over 9.75% to the government.

realtors who were consulted in the course of preparing this Report were somewhat divided on this matter but most came down in favour of a slow recovery of the model over a period of 4- 5 years. If this assessment is indeed correct then that period will, in any case, be a period of sluggish revenues for that particular tax. Nothing much will be lost by taking a few risks in the direction of eliminating some of the most egregious failings of the tax. The options below are framed in that spirit.

Option 1: This would involve an early small increase in the rate of stamp duty on land transfers –. But this tax from that point could ***also*** be paid via an , , up-front charge followed by annual payments of % in each of a specified number of subsequent years. The additional *total* payments associated with the decision to spread payments over a six year period would merely compensate the government for the delays in receiving revenue associated with such a decision. The government would not seek to direct developers (and purchasers) about which of the two payment options they should chose. But to the extent that they had the right to select a phased payment then some of the economic efficiency problems described above would be reduced. At the same time the government to the extent that a phased payment was selected would have a more assured ongoing source of *annual revenue* than is now the case. If on the other hand, where a one-off up-front payment was chosen by some developers the government would explicitly put equivalent amounts of that revenue on reserve[33] so that it could be managed, in effect in the same manner as a phased payment.

Option 2: This would be the same as Option 1 except that the TCIG would not offer developers (or purchasers) the option to pay the full amount of the stamp-duty as a one-off up-front payment. All transactions would be subject to phased payments over a six year period. This has two advantages over Option 1. First it would provide the TCIG with an ongoing annual source of revenue on all land/property transfers and it would not need to set up its own internal system of reserving some payments in order to stabilise this source. Although it would be good to offer a choice, just having a system of phased payments would be simpler to administer, and better for TCIG's budgeting. Second, it would avoid potentially complicated problems (and the need for clear rules) about assessing the tax payable on properties sold *before* the end of the six year period of phased payments. Its disadvantage is that it would deny to government some of the larger revenues that would be associated with payments by developers who preferred a one-off up-front payment (this is small or a larger problem depending on whether one takes the ultra pessimistic or less pessimistic view of the future for the TCI property market).

Issues common to both options

- Whichever of these two options is chosen or even if the *status quo* is retained, this part of the system needs a radical improvement in the assessment and collection of this tax. The Land Registry has failed to do a good job in recent years and will need a major shake up if the tax – however designed - is not to fail for reasons of poor administration. This point should be addressed as a matter of some urgency, even if taxes are not reformed.

- Some of our interlocutors noted also that the stamp duty tax may be more benign if it could be levied formally on the seller of the land/property rather than the buyer. This would enable the buyer to present a loan/mortgage request to his or her bank inclusive of the duty which the seller would then add to the sale price.

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[33] Clearly this could only happen once the intense cash flow problems for the budget are resolved.

Priority 3: Introduce an explicit system of Excise Duties

This suggestion follows naturally from the earlier discussion of Import Duties and so does not call for much additional explanation. With a much simpler system of import tariffs in place (based on *ad valorem* rates that could be held constant for several years), TCI would need an additional system of excise duties distinct from the import tariff.

Such a system would enable the government to levy additional taxes (mainly on a *specific* basis) on a limited set of luxury items. The rates of duty could be adjusted on a fairly regular (possibly annual) basis in line with inflation. The goods in question would mainly be ones where there was (i) some social or environmental motivation for wishing to discourage consumption (examples would be improved public health with a tax on cigarettes and reduced CO_2 emissions with a tax on high fuel-consumption cars) and (ii) a low elasticity of demand so that even quite high rates of tax and some reduction of consumption would still leave the Treasury with worthwhile levels of revenue. [34]

It is suggested that the excise be applied in the first instance mainly on those products that are already subject to customs tariffs namely

- Beers, wines, spirits and other fermented beverages –these are presently taxed on the basis of gallons.
- Tobaccos, cigarettes and cigars – presently taxed on the basis of pound weight.
- Fuel oils – currently taxed on the basis of gallons
- Larger engine cars – presently cars are taxed on an *ad valorem* basis but with a differentiation according to engine size.

Since the items in question are already dealt with by the Customs Department the new excise duties could fairly easily be accommodated without any significant changes of organisation. The major additional element would be the gradual need to extend the excises to any *domestic production* of the items in question. In the first instance this would probably be restricted to the local manufacture of beer and spirits such as rum. In addition, the regular hikes in excise duty rates would impose additional work burdens on the department.

The major improvements would be (a) a cleaner and simpler customs tariff where most rates were levied on an *ad valorem* basis and so were capable of being held constant for extended periods of time to give greater certainty to domestic industries and (b) a new excise element in the tax system where rates could be more easily adjusted on a regular basis and the "sin" element of the tax structure could be isolated from the rest.

[34] Ministers of Finance around the world routinely exploit the "sin" taxes while always asserting their opposition to sin. As a former UK Chancellor Nigel Lawson recently stated it …" *I and my predecessors and successors as Chancellors of the Exchequer in this country (and in many of our counterparts in Europe) have used high sounding arguments to justify raising substantial revenues from tobacco taxation, always taking care not to pitch the duty so high that too many people actually give up smoking, causing the tax yield to actually diminish. In the same way if people like to feel that they are helping to save the planet by paying a carbon tax, they should not be deprived of the opportunity to do so"* , *An Appeal to Reason, Ch 8.,* Duckworth Overlook, London, 2009

Priority 4: Re-design of the quasi-tax on Work Permits

In most countries this item would not figure prominently in any discussion about tax reform. It appears here only because the revenue associated with work permits currently represents the fourth largest source of revenue for the government: almost 10% of total recurrent receipts in 2008/09. Further, although the work permit item is strictly a "fee" and *not* a tax, the high rate of charge clearly exceeds the administrative costs involved in providing work permits. So there is a tax-like element involved in the amounts that are currently charged.

The analysis around Table 3 above clearly indicates that the Work Permit "fee" is a very poor tax – it had the lowest score of any of the six tax items assessed in Table 3. In particular it is very distortionary being a tax on specialised types of labour that are by definition required to contribute to the country's economy in ways that cannot otherwise be accommodated. This distortion would only be acceptable in economic efficiency terms if there was a much better developed education and training system in TCI that could routinely offer employers an alternative to the "foreign" recruit for specialised key jobs. The work permit fee scores well as a tax only because (a) it is quite easy to collect and (b) because it speaks to the sensitivities of the small economy problem by being imposed entirely on a foreigner group with little direct impact on the sensitivities of the belonger or permanent resident populations[35].

In addressing this difficult issue it is important to emphasise that almost all the comments on work permits received during our consultations related to the bureaucratic inefficiencies, delays, excessive agency charges and occasional corruption associated with the process of obtaining work permits. There were far fewer complaints about the *level* of the fees as such: several stakeholders suggested that the fee might even be increased. These bureaucratic problems certainly need to be resolved but are well beyond the scope of our own terms of reference. ***So what follows relates only to one narrow part of the problem as stakeholders currently experience it in their commercial activities.***

The suggestion here is to more explicitly recognise that the work permit fee is really a *tax on labour* and to manage and collect it as such. This could most easily be done by eliminating the work permit *fee* altogether. Instead the Immigration Department would be required only to manage the issuing of work permits (i) using criteria about eligibility that can hopefully be clearly defined and (ii) with bureaucratic performance standards that would quickly eliminate the delays and alleged corruption associated with the past. If this were to be done the perceived need for (and problems with) agents who arrange work permits on behalf of others would also likely disappear.

The revenue element associated with work permits would thereafter be assigned to the National Insurance Board (NIB). As soon as a work permit was issued by the Immigration Department, information would be transmitted to NIB to issue an NI number and NI card in parallel with the issue of the work permit. As we understand it this is in any case an existing condition of the law. The difference now would be that the NIB would require an additional PAYE deduction from the earnings of all persons holding work permits. There are several advantages with this proposed new system:

- The NIB is an established revenue collection agency and the Immigration Department is not. So a major TCI tax would be assigned to an agency that is better geared to collect and account for revenues

[35] Although belongers and permanent residents are also inconvenienced if they need to recruit foreign workers for their own businesses

- The present work permit fee is charged at differential rates on different professions (e.g. teachers pay much less than accountants) with currently more than 100 different rates defined only on the name of the profession: there is no differentiation within professions – e.g. junior versus senior accountants. So the present differentiation of charges is merely a crude attempt to establish a progressive and so fairer system of charges. But this could be done much better (and so in a much fairer way) if the tax payment was linked explicitly to the dollar value of earnings. This can obviously be done relatively easily once the payment is linked to the NI system that needs, in any case to maintain records on the earnings of each registered employee or self-employed person.

- Notwithstanding the differentiation built into the existing design it is understood that there are also exemptions that to-date have been administered by the Immigration Department. It is far from clear that these serve any useful purpose. So these too could be eliminated at the same time as the responsibility for collection shifts to NIB...

The main potential difficulty with the proposal which would need to be assessed in greater depth would be that NIB would need to maintain a separate accounting record of those deductions made for purposes of work permit fees and remit these funds periodically to the Ministry of Finance. It seems unlikely that this would be a major practical impediment to the new system although it would involve some initial set-up costs.

A second issue is that the present revenue budget codes do not differentiate work permits fees from the charges for permanent residency certificates (PRCs). Since PRCs involve only a one-off payment there is much less of a case for transferring their administration to the NIB. So as a practical matter the reform would need an early separation of the two elements into two different budget codes for monitoring purposes.

Priority 5: Rationalising the System of Fees and Charges

For a small country, TCI maintains an incredibly large number of fees and charges mainly on businesses but also in part on private persons. Most of these fees and charges have some justification and collectively they provide significant sums of revenue which cannot be readily dispensed with. Some fees and charges in common with the work permit fee have tax–like qualities in the sense that they are significantly higher than they need to be merely to cover the administrative costs of collection. A few have mainly nuisance value and could probably be scrapped. The system as a whole would benefit from a rationalisation which could include *inter alia* (i) the increase of some fees and charges to catch up with inflation (ii) some consolidating of two or more charges in order to reduce the cost and time-burden involved both in paying and collecting the charges (iii) new collection arrangements for some fees and charges including a streamlined system of E-payment for many of them – and especially those imposed on businesses. This present Report offers merely some initial suggestions for this task of rationalisation.

Table 6 below lists the main fees and charges that were either collected in 2008/09 or budgeted in 2009/10. It is the full list of revenue codes less those that involve explicit taxes and sales items (e.g. sales of stamps and books). The table provides an initial classification of each item according to whether it is more likely to be collected from a business organisation or from a private person/family: some items are collected from both. The Table also shows the actual revenue collected under each code in 2008/09 and the percentage that this represented of total recurrent revenue in that same year. Two of the items – the FSC revenue and the Airport Authority revenues – are fees and charges that are now collected and consolidated in single statutory authorities.

Table 6: The Main Budgetary Fees and Charges in 2008/09

Budget Code	Revenue Item	Business (B) or Private (P)	2008/09 Actual Revenue Collected	% of Total Recurrent	Increased rates to be considered	Electronic - E-collection to be explored
16035	Work Permits and Residency Fees	B and P	18,252,272	9.231%	See earlier Comments	
18001	Cargo dues	B	3,964,226	2.005%	YES	
13007	Telecommunications licence	B	3,036,323	1.536%	YES	
16056	Financial Service Commission Net Revenue	B	2,694,846	1.363%	YES	Yes
13006	Business Licence Renewal	B	2,681,166	1.356%	YES	Yes
13021	Vehicle Licence	B and P	1,992,818	1.008%	YES	Yes
11011	Port Security Fees	B	1,724,254	0.872%	YES	
16026	PDA application fees	B	1,634,160	0.826%	?	
11015	Airport Authority Net Revenue	B	1,500,000	0.759%	?	
16034	Work Permits Repatriation Program	B and P	1,359,315	0.687%	YES	
18030	Visas	B and P	1,105,585	0.559%	YES	Yes
16020	Medical fees and charges	P	1,083,150	0.548%	?	
16018	Labour Clearance Fees	B and P	607,820	0.307%	YES	
16014	Fines and forfeitures	B and P	448,289	0.227%		
13022	Drivers Licence	B and P	444,256	0.225%	YES	Yes
16029	Registration fees	P	418,618	0.212%	YES	Yes
16024	Naturalisation Fees	P	309,694	0.157%	YES	
16032	Survey fees	B	289,371	0.146%	YES	Yes
13009	Fishing licence	P	286,895	0.145%	YES	Yes
16008	Berthing fees	B and P	275,388	0.139%	YES	Yes
13005	Business Licence Application	B	239,241	0.121%	YES	Yes
16041	Fees for Official Search, Inspection and copy of Register	B and P	190,205	0.096%	YES	
18029	Travel Documents	B and P	122,975	0.062%	?	

16010	Court and Office fees	B and P	121,445	0.061%	YES	
13019	Gaming Location Licence	P	115,000	0.058%	YES	
13015	Liquor licences	B	114,260	0.058%	YES	
16023	National Parks Fees	P	64,165	0.032%	?	
16043	School Fees	P	45,961	0.023%	?	
18027	Ship Registration and Tonnage	B	32,210	0.016%	YES	
16011	Dental fees	P	29,560	0.015%	?	
13011	Gun Licences	P	27,300	0.014%	YES	Yes
13017	Sand and Quarry Licences	B	17,641	0.009%	YES	
16039	Hotel Inspection Fees	B	10,272	0.005%	YES	
16031	Salt Cay Boat Fees	B and P	7,483	0.004%	YES	
16047	Administration Fees/Business License	B	6,587	0.003%	YES	Yes
18023	Sale of Customs Forms and Tariffs	B and P	5,692	0.003%	Part of Customs Review	
16016	ID Card Fees	P	3,895	0.002%		Yes
13020	Casino Certificates	B	3,450	0.002%		
16007	Audit fees	B	2,700	0.001%		
13010	Casino Permits	B	1,350	0.001%		
16012	Examination fees	P	1,078	0.001%		
16038	Tender Document Fees	B	736	0.000%		
16040	Time Sharing Fees	B	25	0.000%		
13008	Casino licences	B	-	0.000%		
16036	Filming Permits	B	-	0.000%		Yes
16044	Scientific Research Permit	B	-	0.000%		
16048	Fire Certification Fees	B and P	-	0.000%		
16049	Customs Service Charge	B and P	-	0.000%		
16051	Coastal Infrastructure Fees	B	-	0.000%		
16053	Storage Fees	B and P	-	0.000%		
16055	Migrant Processing Fee	B and P	-	0.000%		
	TOTAL		197,723,378	22.896%		

It is noted that if it were decided to reduce administrative costs by eliminating all the smaller revenue items, then 15 of the items that actually delivered some revenue in 2008/09 could be eliminated if a cut off point below one quarter of one percent of total revenue were used (< 0.25%).[36] But at this stage it seems preferable to look at these and the other items one by one to assess first if there is a scope for significantly increasing the rates charged.

Selective Increases in Fees and Charges

The very limited sample assessment of the individual charging systems that has been possible while conducting the work for this Report suggests three things

(i) most fees and charges are seriously out-of date having not been adjusted for inflation or higher administration costs for many years in some cases

(ii) there is no systematic review process for these fees and charges, and

(iii) there is a general willingness on the part of stakeholders to pay more for many of the listed items provided that such increases are accompanied by a much more streamlined service and less wasted time in multiple queues

In the cases of those fees and charges that have been looked at there is a pretty clear case for increases in:

- Most of the licensing charges managed by the Financial Services Commission (when the recent increases were approved the FSC was encouraged to return after one year to request additional increases).

- Registration fees for births, marriages and deaths. Increases of up to 400% have already been suggested in the recent Revenue Management Review.

- Land survey fees. These have not been adjusted for 25 years and so a significant percentage increase is called for.

- Naturalisation and Registration Fees. The Immigration Department claims that of all the British Overseas Territories, Turks and Caicos have the lowest fees in placed for these services. Since no adjustments have been made for some 20 years a doubling or tripling of the fees would not be unreasonable.

- Visas. The Immigration Department has submitted a proposal to increases these fees.

- Work Permit fees and Permanent Residency Certificates. A case for increases has already been prepared and submitted by the Immigration Department. This proposal needs to considered alongside the earlier idea for a more fundamental shake up of the work permit system.

These sample cases suggest that there is likely to be a justified systemic case for adjustments of fees and charges by some 200-300% depending on item. The items in Table

[36] At least one of the items introduced for the first time in the 2009/10 budget will be a significant source of revenue. This is the Customs Service Charge. So our cutting agenda as discussed in the text ignores all the zero items in Table 6.

6 where this possibility should be more systematically examined are listed in the penultimate column. Even abstracting from the large work permit fees, it seems likely that reform in this area could yield a gain in revenue of at least $15 million.

Rationalising Collection

The fees and charges listed in table 6 are collected by a wide variety of agencies using a variety of different methods. It is commonly necessary for a person paying the fee or charge to visit two or more offices to obtain their license or service. There is an obvious potential to reduce this complexity and so the cost both to the payer and to the collection agencies. It has been beyond the time and resources of our own exercise to look at this matter in any detail. But one obvious way forward which we recommend for more detailed study is to adopt an increasing use of E-Payments whenever this methodology is technically (many cases) and financially (some cases) feasible.

This approach is more likely to be technically feasible where there is no detailed technical assessment involved in deciding whether or not the license should be granted or the service provided. So, for example, it would be more likely to be feasible with the allocation of car registration licenses and visa than with the issue of driver permits – though renewals of the latter should be possible using E-methods. The final column of Table 6 provides an initial listing of those fees and charges that could be candidates for being collected using E-methods.

The great advantage of following this route to reform would be to enable a possible consolidation of a number of the fee and revenue collection services in one or more specialised units equipped with the necessary IT equipment, software and data-bases. A proper feasibility and cost assessment would be called for before this reform could go ahead. However, it would be well worth starting such studies as soon as is practicable since the potential efficiency savings on a recurrent basis would be considerable.

Overall

The outline reforms described under the five headings discussed in this current Section of the Report could collectively simplify TCI's present tax system. They could be expected to reduce the *economic efficiency* burden of the existing taxes on which the government currently relies and also to lower the *administrative costs* of collection. The changes could be introduced in a manner that was largely revenue neutral. But in some cases such as the work permit fees and other fees and charges they could be set in such a way as to increase total revenue without imposing an unreasonable extra burden on the prospects for the economy going forward. Many of the changes could be actioned quite quickly with some impacts in revenues and efficiency to be expected within one year.

6. A Reformed Tax Structure – Medium and Longer Term Options

In addition to the ideas raised in Section 5 there are a number of other ideas for reform of the TCI tax system that have been under debate in the islands for several years. These ideas emerged in particular from the major review of the system conducted in 2003 by the IMF with inputs from specialist tax experts from CARTAC – the IMF-supported technical assistance service for the Caribbean region. The ideas from that review were considered by the Ministry of Finance in subsequent years but were never actioned – mainly perhaps because revenues seemed so buoyant in the years following the submission of the IMF-CARTAC recommendations. In this Section we re-consider mainly the ideas put forward in 2003 but with certain elaborations to reflect issues of concern raised during he consultation process that supported the preparation of this current Report. It is stressed that the recommendations presented in this current section will all need significantly more assessment and detailed design if there are eventually to be actioned. But they are serious ideas that should be given more consideration than was the case after 2003.

Priority 6: Commit to some form of Broader Sales Tax or VAT for the Medium Term

The International Experience with VAT

As was noted in earlier discussion, the major single defect of the present TCI tax system is its very narrow base. With the exception of the import duty all the major taxes fall on only a restricted group of the population or on a restricted part of a potentially broader tax base (e.g. land). The experience of the past two decades including in many jurisdictions similar to TCI has been to adopt a broad based sales-type tax with the VAT being the commonly preferred option. The VAT has been the most successful tax in terms of new uptake in the C20th and C21st centuries. It was first introduced in France in 1948 but is now in use in some 140 countries worldwide, including CARICOM countries such as Jamaica, Barbados, Trinidad and Tobago, Dominica, Belize, St. Vincent, Antigua and Barbuda and Grenada. In the case of Grenada the tax was introduced in 1986 and was then withdrawn because of difficulties of implementation. But the tax was subsequently re-designed to be much simpler to operate and was reintroduced, apparently successfully in 2007. A longer list of comparable small-economy jurisdictions that now use a VAT is shown in Table 7 below. It is noted that significant number of these small economy jurisdictions also have National Insurance or National Health contributions systems similar to those in TCI. Most also levy some form of Corporation tax.

Table 7: Countries similar to TCI who have a VAT

Country	***Standard Rate of VAT***	***Personal Income Tax***	***Corporate Income Tax***
Antigua	15.0%	No	0.3
Belize	10.0%	No	1.75% to 25%
Comoros	10.0%	No	35.0%
Costa Rica	13.0%	No	30.0%
Dominica	15.0%	No	30.0%
Dominican Republic	12.0%	Pension deduction from salaries	25.0%
El Salvador	13.0%	Health and Soc Sec deductions	25.0%
Grenada	15.0%	Social Security Deductions	30.0%
Guyana	16.0%	Social Security Deductions	35.0%
Haiti	10.0%	Social Security Deductions	30.0%
Honduras	12.0%	Pension and Soc Sec Deductions	25.0%
Jamaica	16.5%	Various Social Deductions	33.0%
Mauritius	15.0%	Social Security Deductions	15.0%
Netherland Antilles	5.0%	No	?
Nicaragua	15.0%	Social Security Deductions	30.0%
Panama	5.0%	Social Security Deductions	30.0%
Samoa	12.5% and 15%	National Provident Fund Deduction	27.0%

St Vincent	15.0%	Social Security Deductions	35.0%
Suriname	10.0%	Labour Tax Deducted	36.0%
Tonga	15.0%	PIT	15-30%
Trinidad and Tobago	15.0%	Social Security Deductions	25.0%
Vanuatu	12.5%	Social Security Deductions	NO
West Bank and Gaza	14.5% and 16%	PIT	15.0%

Issues:

The difference between VAT and sales tax is that the sale tax (as in many US states[37]) is only applied at a *single stage* (most often at the retail stage) whereas VAT can in principle be applied at various different stages of production. In an import-dependent economy such as TCI the first and most important tax stage for a VAT would be the point of importation: Recognising this several of the interlocutors during our consultation process noted that *"import duty works effectively as a form of VAT that is incorporated into the price of almost everything imported into the islands"*. This is quite true and maybe the implication is that an import duty is all that TCI needs.

However, this conclusion would miss two important points. First, TCI already has a number of other sales-type taxes imposed on important sectors such as hotels (the accommodation tax), restaurants (the restaurant levy) and banking (the money transfer levy). But these taxes are not integrated either in their design or in their collection with the customs duty. Hence there is a significant amount of double jeopardy ("cascading" in technical terms) where the restaurant for example needs to pay import duties on most of their supplies and are then taxed further on their sales of rooms. There is no provision in the present design of the system for the hotel, restaurant or bank obtaining any offset (credit) for the indirect taxes (e.g. customs duties) already paid at an earlier stage of the value chain. This introduces an arbitrary element in the taxation of some important activities which can create unintended disincentives to some economic activities.

Second, the efforts to supplement the customs tariff with *ad hoc* taxes such as the accommodation and restaurant taxes are in truth crude attempts to extend indirect taxation to more areas of the economy: to broaden the tax base. But this effort largely fails since it still misses a significant part of the total economy. The result is that the taxed components bear a higher rate of tax and a higher burden of tax than is strictly necessary. For example, if we scrutinise the sectoral composition of GDP in 2007 – the last year for which we have data – we note the following. The three major sectors of activity namely Hotels & Restaurants; Financial Service and Real estate together account for 52.3% of total GDP. But this means *that other sectors represent almost half of the economy.* Since most major taxes have been designed to extract revenue from the three dominant sectors – albeit with varying degrees of success – all the rest of economic activity is paying taxes only (i) via import duties and (ii) via the various taxes and charges levied on their activities. This begs the question of whether this is a rational arrangement for the medium term or whether a broader-based indirect tax such as a VAT would not provide a better solution.

[37] It is significant that it is at the *State* level in the USA that the sales tax is mostly seen. It is used in only a limited way in the tax structures of *Central* governments – at this level of government the VAT is indisputably more common.

A tax of the VAT type could potentially extend indirect taxation to important sectors such as Construction (18% of GDP); Transport and Communication (9%); Utilities such as Electricity and Water (4%); Wholesale and Retail Trade (4.5%); Manufacturing and Mining (3%) and Business services other than real estate (3%). Participants in those sectors will argue (i) that they already pay high taxes via the customs tariff and business licenses etc and (ii) that the VAT would be too difficult to collect from them. But the first of these points can be addressed by noting that the height of the customs tariff should in any case be reduced well before any VAT was introduced (see Section 5 above) and also that under a VAT system, taxes paid on imports at the first stage of the value chain would be rebated as a credit against any VAT taxes levied at a later stage. The second point is more substantial and will need to be addressed with great care in the design of any system that was considered for TCI.

However, several points about the design of a possible VAT can be stressed here. First, all of the larger enterprises in each of those sectors (the large utilities in electric power and water, the airlines in the transport sector, the large $ million plus units in the retail sector) would all maintain records that with only modest adaptation could be used to enable them to administer a VAT system. Similarly existing taxpayers such as hotels and larger restaurants would not find the administration of a VAT significantly more onerous than the present accommodation and restaurant taxes (if it were decided to absorb these existing taxes into a VAT system[38]). Many of these enterprises might indeed support a VAT system if it provided them with a reliable system of credit rebates on any import duties they had previously paid. Smaller enterprises in any country definitely do struggle with the record-keeping requirements of the VAT and so it is absolutely essential to absolve such enterprises (below a certain threshold of turnover) from any involvement in the VAT. They would not be required to charge VAT on their sales to customers (an advantage to them over larger firms) but nor would they be able to claim any credits from any VAT taxes charged to them on their own purchases of inputs (a disadvantage to them). In the early stages of operating a VAT it would be highly desirable to apply a very high threshold for VAT registration so that the tax was enforced only on relatively large enterprises.

Recommendation:

These general considerations can be combined with the strong score for the VAT in Table 3 above to make a recommendation similar to that presented in the 2003 IMF-CARTAC study. This is that TCI should move in time to adopt a general VAT system of taxation albeit with generous exemptions that would address the concerns about administering this tax in smaller enterprises. There are at least three different ways to do this.

- Option 1. Design the VAT to enable it to become an eventual *full replacement* of the customs duty as well as other indirect taxes such as the accommodation tax, the restaurant tax, the airport departure tax, the money transfer tax and the possibly also (as suggested by IMF-CARTAC) some direct taxes such as the Communication tax also.

- Option 2. Introduce a VAT with limited scope leaving in place a number of the other existing indirect taxes such as the accommodation tax, the restaurant tax, the airport departure tax and also all the existing *direct taxes* such as the Communications Tax with a possible view to extending their scope at a later stage. Several of our interlocutors suggested that a tax similar to the communications tax might eventually

[38] This is not strictly necessary.

be extended to other large near monopolies such as those providing electric power and water.

- Option 3. In recognition of the potential administrative difficulties of a VAT, commit instead to the introduction a more limited General Sales Tax (GST) to gradually embrace sectors that presently avoid indirect taxation other than the customs duty.

Given the very short time period committed to this present study it was not possible to assess and test the pros and cons of these three competing options in any detail. But at this preliminary stage it is noted that option 3 though administratively easier than the other two would not deliver the same benefits to the economy. Option 1 would give the TCI a very simple tax system that could eliminate the multiple points of collection of existing taxes, as well as most of the unintended negative incentives associated with the cascading of taxes. It could be built upon the administration of the exiting Customs Department as the first and largest collection point for the new tax with a strengthened Customs eventually absorbing the existing work of several other collection agencies and so morphing into a broader and unified Revenue Authority.

Priority 7: Commit to an evaluation of the potential for a broader annual tax on land and residential property.

The serious weaknesses of the existing stamp duty on land transfers were discussed earlier. Because of the very narrow base of the existing tax the revenues it generates are extremely volatile and dependent in particular on the buoyancy or otherwise of the domestic property market. In 2009/10 as the property market has collapsed, the stamp duty revenues have dropped by more than 70%. Proposals for short term reform were presented in Section 5 above. If accepted, these would have the effective of introducing an element of annual payment on a few properties only instead of the single up-front stamp duty charge. It was noted also that even this modest reform would only work if there were to be a radical improvement in the present system of assessing and collecting the stamp duty tax in the Land Registry.

The next 12 -18 months after this first reform could be treated as a pilot period to assess the feasibility of collecting the annualised charge on land transfers. In this same period, it is recommended that a detailed but open-minded investigation be started into the feasibility of a broader property tax system for TCI. This investigation could be sub-divided into (i) an assessment of whether land *per se* could be a viable object of a new annual tax; (ii) the assessment of the feasibility of, and a design for a system of *residential* property taxation and (iii) a parallel assessments of the case for a system of *commercial* property taxation. These three components need not sink or swim together – they should be considered on their own merits.

A land tax

The most simplified approach here is a tax that is levied on land at a rate of so much per acre. Different plots of land would be subdivided according to their likely use or commercial value. So, for example any buildings already in existence or capable of being built on each tract of land could be regarded as creating different levels of land-value in a very simplified manner – e.g. rural uses versus urban uses, housing development versus commercial development versus land with only limited development potential etc). The inherent difficulty of this approach in the TCI is that the majority of land is *not* agricultural and therefore there is little value for much land unless and until it is the subject to some development. But if it is development that gives the land "value" then perhaps it makes more sense to tax the properties rather than the land *per se.*

Residential property

Notwithstanding some affection for the present once-for-all and up-front stamp duty, several of the realtors and other stakeholders consulted while preparing this Report did recognise that an annual tax on residential property is a relatively common and well accepted element of the tax systems of most countries around the world. Properly administered and at low rates there is no obvious reason why this would represent anything like a fatal assault on the viability of the long term property market in the islands. There is also no denying the proposition that the accumulated stock of residential property in TCI represents an extremely substantial asset – with an extremely high rateable value - and it seems unreasonable that no recurring tax at all is levied on this multi billion dollar asset. The introduction of a small annual property tax could be accompanied by a significant reduction in the existing rates of stamp duty so that the net effect up-front could be quite small. Many owners and prospective buyers would also by the date of any introduction have seen some reduction in their costs associated with the reduced import duties proposed earlier.

Simplicity could be built into any ongoing system of taxation by using periodic valuations (updated perhaps every five years) according to well-defined principles and coupled with the application of low annual percentage rates of tax. Valuations would preferably be applied to a small number (no more than 8) *valuation bands* (as with the UK Council tax) rather than to every single point on the valuation scale. So appeals against valuation would relate only to the band in which a property was located rather than to an absolute dollar value. An initial task would be to complete and then maintain a data-base of all residential properties on the islands with valuations, by band, established for each. Thereafter, the design of any residential tax could establish first the broad total revenue target that the tax sought to raise. Given the orders of magnitude of TCI's present tax collection efforts (see Table 1 above) an amount of around $20-40 million would be a worthwhile addition to (or a partial substitution for) the stamp duty if the costs of collection could be shown to be commensurate. Thereafter tax rates and exemptions could be set to both achieve the target revenue and to allocate the overall burden of the new tax in as fair a manner as possible. Issues of resident versus non-resident property ownership; of the conditions for full exemption; and of the treatment of foreign owned houses kept vacant for long periods could all be addressed at this stage.

Commercial Property

The case for the taxation of commercial property in TCI is less compelling. This is because such a tax would largely be a tax on the businesses using the premises and these businesses can probably be taxed more efficiently using a combination of improved business licence charges (see above) and a new VAT. However, the compiling of an inventory of commercial property is an exercise that should be undertaken for other reasons. That work could then be combined with an investigation of the possibility and desirability of introducing a tax on commercial property. In this case, any such tax should probably be levied on the annual "use-value" (or rateable value) of each property with the total of these values across all properties being regarded as the tax base for this particular tax.

There are two major objections to property taxes that are commonly voiced and that were repeated during our own consultations. The first is that the administrative practicalities would be too onerous – a point that Table 3 above partly recognises with a low score of only "2" against that particular criterion for judging a tax. That point is answered here in an entirely pragmatic manner. If the 12-18 month period of piloting a limited annual taxation via the reformed stamp duty fails then a broader property tax is also unlikely to be successful. If on the other hand that piloting exercise is reasonably successful then the in-depth work on the broader property tax might be brought to a conclusion and such a tax considered. The second objection is that a residential property tax imposed at too high a level in a jurisdiction such as that in TCI can easily lead to some form of “urban blight”. Many homes are owned by remote owners and it is argued that the marginal utility of second homes and particularly retiree-owned homes may be quite low. If that is the case, and a property tax had the effect of raising the effective economic rental cost (including the new tax) to a high proportion of disposable income, then such a tax might precipitate a wave of selling and some near abandoned residential communities of the type already seen in Southern Florida and parts of Spain. The messages here are clear. Keep rates of property tax low and do not introduce any such new tax during periods of serious depression of the property market when the “urban blight” tendencies are already likely to be a threat independently of the existence of property taxation.

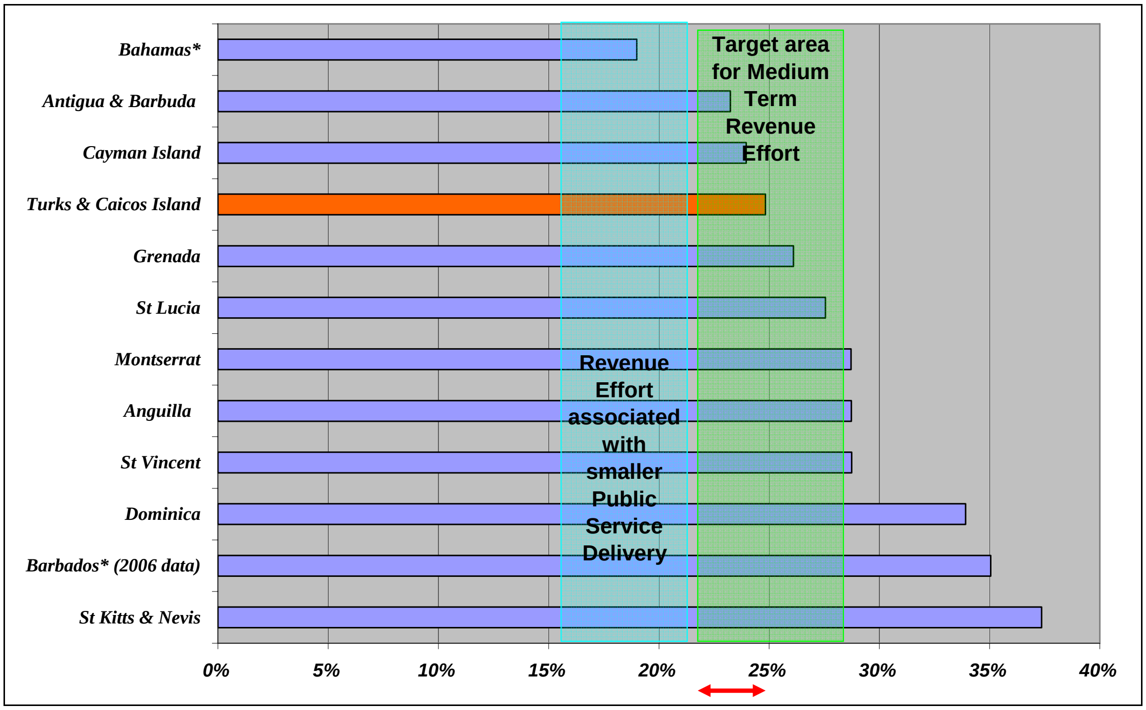
7. The Numerical Implications

The Terms of Reference for this assignment included the requirements (i) to determine the achievable and sustainable tax capacity of the TCI and (ii) to identify the gap between the current revenue yield and the sustainable tax capacity. In this present section we examine both of these questions and also comment on how the various reform ideas sketched above may impact on total revenue collections.

Tax Capacity

The comparative data already presented above gives a pretty good idea about the level of tax collections that are possible in a jurisdiction such as that in TCI. For this purpose we can rely in particular on the more-recent 2007 comparative data that were presented in Figure 5 above and that are repeated below – but only for the total recurrent revenue totals - as Figure 6

Figure 6: Total Recurrent Revenues (% of GDP)



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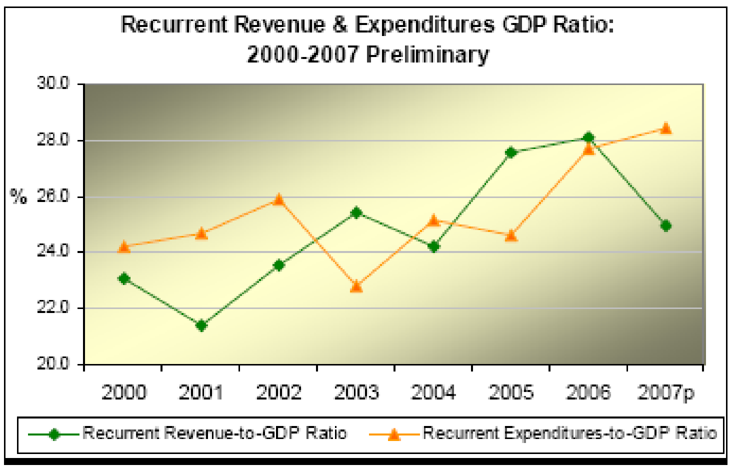
Until the full force of the recession and the other external shocks hit TCI in 2008, the country seemed quite capable of achieving total recurrent revenues at the level of circa 25% of GDP as shown in Figure 7. Given that the 2007 level of GDP totalled \$ 828.6 million – the last year for which we have firm official data – this translated into an annual dollar revenue total of just over \$ 200 million. These two figures – 25% of GDP and \$200 million - represent a reasonable estimate of the country's revenue capacity in normal times. This is confirmed by the time series data from the official TCI National Accounts data.[39] Even though the years prior to 2007 saw rapid rises in government revenues they also saw rapid GDP growth as well. The official TCI data show the revenue ratio to be consistently at or above 24% of GDP for most of the previous five years before 2008. See Figure 7 which is taken directly from the 2007-08 National Accounts Report.

Based on this evidence, targets for revenue generation in the medium term once the economy returns to something like "normal" conditions could quite reasonably be set in the range between about 22% and 28% of GDP[40]. This target range is indicated by the green

[39] TCI Statistical Office, *National Accounts Statistics, 2007*, Grand Turk, November 2008.

[40] The only attempt to estimate GDP for years after 2007 of which we are aware is that of the journalist John Hartley. Using a variety of assumptions many of which he admits are quite heroic, he projects the 2010 level of GDP as being 42% lower than that of 2007. In fact Mr Hartley works his forecast using GDP in "basic prices" which in 2007 totalled \$ 707.6 million - a significantly lower figure than the GDP at "market prices" data as quoted above. His 42% reduction applied to either the 2007/08 or the 2008/09 actual budget revenues would yield an expected revenue total in 2009/10 of \$ 116 million. On this basis the out-turn that so far in 2009/10 seems likely of circa \$150 million would shaded area in Figure 5. It can be seen that this target area spans the range of the revenue efforts seen not only in TCI in 2007 but also in most of the comparator jurisdictions in the Caribbean region that are represented in Figure 6. It is anticipated that the efforts that have already been made in relation to the improved management of public expenditures will deliver some efficiency savings in the years ahead. So even with a revenue effort equal to only 22% of

Figure 7: The Revenue: GDP Ratio 2000-2007.



GDP – lower than in 2007 – it is likely that the TCIG would be able to provide public service delivery at about the same level as in the pre-crisis past. At the higher end of that target range it ought to be possible to deliver either an expended volume of public services, or to build reserves at a faster rate than in the past, or a bit of both. It is of course a political decision to determine how much larger – if at all- the public sector might become. But provided that there is no ambition to go beyond the range indicated in Figure 6, it should be possible for an improved revenue system to deliver the resources that are needed to fund a modest expansion and also to much needed reserves.

The Revenue Gap

The 2009/10 gap between actual recurrent revenues and the taxable capacity of the country seems likely to be in the region of $50 million. However, based on the evidence from Figures 6 and 7 and also from the unofficial GDP estimates produced by John Hartley, this gap is wholly attributable to the collapse of the country's GDP (see also footnote #37). There has been a collapse of GDP that has *caused* a large revenue gap. But, surprisingly perhaps, revenue seems to have held up as a ratio of GDP! *There is no evidence from the statistics themselves- even from the alarming GDP forecast of Hartley - that there is a revenue problem additional to that induced by the large fall in GDP in 2009 and 2010*.

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represent a significant *increase* in the ratio of revenue to GDP over the 2007 figure. See John Hartley, *"Forecasting the 2010/11 TCI Economy (For Policy Wonks)"* in, October 2009.

It was this fact the encouraged many of the persons consulted while preparing this Report to argue that there is nothing inherently wrong with TCI's present tax system. However, this is a somewhat dangerous conclusion since the truth is that we simply do not know when "normality" in terms of something like the 2007 level of GDP will return and whether this new situation will be broadly the same as in the pre-2009 era.

The main factor explaining the present high level of uncertainty about the future is the very substantial uncertainly about the future prospects of the TCI condominium model which was the major element behind the massive property boom and the rapid GDP growth of the years prior to 2008. Even the more optimistic of the realtors and others consulted while preparing this Report expected there to be 3 to 4 years of relatively flat performance before anything like a full recovery to the 2007 levels. The more pessimistic commentators have declared that the condominium model is basically dead!

Faced with this high level of uncertainty it would not be prudent to base the medium term revenue strategy on a tax system in which the recovery of revenues from the property markets – and especially from the stamp duty – played a critical role. Instead the suggestions for reform made in the previous sections of this Report have (i) suggested reduced rates of tax where possible in order to provide help the economy *in general* and not only to those sectors linked narrowly to real estate and tourism and (ii) to also find more ways to broaden the tax base to move the medium term burden of taxation somewhat away from the real estate sector. This strategy has involved an approach which recognises explicitly that the short-term revenues from the stamp duty on land transfers will in any case be lower than in the past. So little need be lost by advocating lower rates for this tax and a somewhat different annualised approach to its collection.

8. Tax Administration

It is not a primary purpose of this study to examine the issues of tax administration (assessment, collection, audit, control etc.) in any detail. However, there are a number of critical issues regarding administration that have a bearing on the reform agenda detailed above. The purpose of this present Section is to bring these various issues together in one place.

The obvious starting point is the comment that at present TCI has only one dedicated and specialised revenue assessment and collection agency namely the Customs Department. Fortunately this department already collects the country's major tax namely the import duty. With the organisational and technical improvements that are already well under way, the Customs Department will remain as the mainstay of revenue collection in the islands and should also be capable of absorbing other tax collection assignments in the future: examples are the collection of the new dedicated excise tax if that is introduced and a major role in VAT administration if that tax is also introduced at a later stage. There are now in addition two organisations that have responsibilities that are equivalent to tax collection namely the National Insurance Board and the National Health Insurance Board. Both these boards collect revenues via PAYE-deductions to fund their respective operations. Then finally there are a number of state-run statutory bodies that both collect specific taxes and also retain a part of the proceeds to cover the costs of their own operations. The main examples are the Financial Services Commission and the Airports Authority.

In addition to these more specialised units, there is a long list of budget organisations that have been assigned various responsibilities in revenue collection under the broad controlling oversight of the Revenue Control Unit (RCU) that is based in the Ministry of Finance. A listing of these various organisational units as they appear in the 2009/10 Budget Estimates is shown in Table 9 below. The percentages in column 2 indicate the share of total revenues expected to be collected by each unit in 2009/10.

Table 9: Who Collects the Revenue?

	Shares in 2009/10
Customs Department	38.98%
Revenue Control Unit	16.88%
Land Registry	8.63%
Immigration Board	6.11%
Immigration Board	4.46%
Ministry of Trade, Tourism	3.44%
Financial Services Corporation	2.74%
Gaming Inspectorate	2.60%
Ministry of Housing, Agriculture, Works and Telecoms	2.40%
Civil Aviation Department	2.23%
Port Administration	1.96%
Road Safety	1.47%
Port Administration	1.38%
Ministry of Natural Resources etc	0.96%
Immigration Department	0.78%
Water Undertaking	0.64%
Tertiary and Further Education	0.57%
Myrtle Rigby Clinic	0.48%
Immigration Department	0.46%
Judiciary	0.41%
Primary Health Care	0.39%
Department of Environmental and Coastal Resources	0.33%
Labour Department	0.20%
Registrar General's Office	0.19%
Registrar General's Office	0.18%
Physical Planning Department	0.18%
Physical Planning Department	0.18%
Labour Department	0.17%
Grand Turk Hospital	0.16%
Education Department Zone 1	0.15%
Post Office	0.07%
Post Office	0.06%
Maritime Department	0.02%
Dental Department	0.02%
Survey and mapping Department	0.02%
Philatelic Bureau	0.02%

Police General	0.02%
Public Health	0.02%
Audit Department	0.01%
Printing Office	0.01%
Printing Office	0.01%
EMS Finance Administration	0.01%
Philatelic Bureau	0.01%

The very substantial spreading of the burden of revenue collection indicated in Table 8 has in the past lead to a plethora of problems which have recently become clearer from the initial Revenue Management Review conducted by the RCU in November 2009. This review has identified a variety of failings including poor record-keeping leading to the serious under-collection of some revenues, a tendency in some units to allow large arrears to accumulate, the incorrect assessment of some taxes etc. The RCU has already set in motion actions to eliminate the more egregious of these failures.

The resolution of the problems that the RCU has identified relates only in part to the excessive proliferation of collection units. However, some rationalisation and consolidation of the revenue administration process is clearly called for. Our own analysis above has indicated the following suggestions and priorities in this area.

- Whichever of the two options for the reform of the present *stamp duty* is chosen or even if the *status quo* is retained, this part of the system of tax administration needs a radical improvement. The Land Registration Unit has shown itself unable to maintain the records needed to administer this important tax properly and its performance regarding both tax assessment (especially its inadequate liaison with the Valuation Department) and collection has been deficient. Going forward the stamp duty will remain a very important tax and the pilot proposed for the next 12-18 months to test the feasibility of a more general property tax will be a critical ingredient for the medium term revenue position. So it is a major priority to install appropriate skills in the Land Registry and then to intensify the monitoring and control that must overlay the day-to-day running of that department.

- The introduction of an explicit system of *excise duties* has been recommended above to replace the present taxation of the items in question via relatively high rates of import duty. Given the existing competencies in the Customs Department this need not create any major organisational problems However, a major additional element of work would be the need to extend the excises to any *domestic production* of the items in question. This together with any enabling legislation needs to be thought through in terms of the detail in the near future.

- It is also recommended above that the revenue collection associated with the issue of work permits should be re-assigned from the Immigration Department to the National Insurance Board (NIB). The proposals is that as soon as a work permit is issued by the Immigration Department, information would be transmitted to NIB to issue an NI number and NI card in parallel with the issue of the work permit. The rationale for this change is that the NIB is an established revenue collection agency and the Immigration Department is not. So a major TCI tax would be assigned to an agency that is better geared to collect and account for revenues. There are practical issues here for the NIB (unfortunately no meeting with NIB was arranged duding this assignment) and these issues relate principally to the additional record keeping for the work permit "tax" that would be called for. The practicality of this should be assessed by the NIB and Min Fin in the near future. A small sub-issue is the need to establish separate budget codes for Work Permits and for Permanent Residency Certificates

- As regards Fees and Charges, there is a considerable potential to (i) raise the rates of charge on some items and (ii) to wholly eliminate other items where – even after an increase – the revenue yield is likely to be very small compared to the efforts of collection. All revenue units identified in Table 9 above should be asked - unless they have recently done it - to undertake a review of their present scales of charges and to propose and justify new levels of charges. This can include suggestions from them of charges that might be eliminated

- Also as regards Fees and Charges, it should be possible to rationalise the collection of several of these and, at the same time save a great deal of wasted time on the part of the payees, by moving towards an E-based system of payment. Table 6 above identifies some of the revenue heads for which such an approach might be feasible. But the first step is a feasibility study and thereafter the installation of appropriate arrangements In the Revenue Control Unit or some other appropriate unit with the necessary IT equipment, software and data-bases.

- In addition the very practical department-by-department reforms recommended in the November 2009 RCU Revenue Review should be actioned in full and as soon as possible.

In addition to these specific ideas related to the immediate reform agenda, attention should soon turn to the more fundamental and longer term re-organisation of revenue collection that was trailed in the 2003 IMF/CARTAC study. This anticipated the gradual transfer of more and more respsonsibity for collecting the non-Customs duty revenues to a strengthened Revenue Control Unit. At the same time, the functional competencies of the RCU would need to be strengthened to ensure that it can deal adequately with taxpayer registration, support and advisory services to taxpayers; the collection/cashier function; the processing of returns and arrears; audit, objections and gradually improved IT support to all those functions and to the tax payer.

At a later stage once both the RCU and Customs have undergone their own organisational strengthening, it may be appropriate to consider a combining of the two agencies to establish a Unified Revenue Authority. This would be a new Executive Agency having a degree of separation from government. The various sub- departments within this Authority would then be responsible for both the collection and the control/oversight of revenue functions as well as for the liaison with the taxpayers and public information campaigns to keep the general public well-informed about both revenue strategies and specific issues.

9. Key Points and Strategy

This Report has sought to provide a comprehensive diagnostic assessment of the present TCI tax system and to comment as objectively as possible on the "fitness for purpose" of that system for the future financing of public sector activity in the islands. Objectivity has been sought in part by basing the main recommendations for a partially new system on some principled criteria that can help to differentiate "good" from "poor" taxes. The more familiar of such criteria have also been supplemented by also factoring in considerations that capture the special problems of very small economies such as that of TCI. The analytical work has also been undertaken by a lead author and a small supporting team none of whom have any personal stake in any commercial activity in the islands.

The assessment has been undertaken in the context of the worst collapse in levels of economic activity and government revenues in the country's modern history. For this reason a serious effort has been made to locate the specific problems of 2009/10 in the longer term context of public revenue management going back to the mid-1980s.The crisis in public finance which is now being experienced has forced an urgent re-think about many aspects of the conduct of public financial policy – the formulation of a revenue strategy is one important component in that process but by no means the only one. But it is important not to allow the crisis to drive the reform agenda to the neglect of the needs of more "normal" periods.

The Report has established that there has been very little if any serious strategic attention to this matter in the recent past. Although various ideas from IMF-CARTAC and others have long been on the table, the persistence of the economic boom and the high revenues generated by this have weakened any imperative that may otherwise have been present to question or reform the established system. The findings and recommendations of this present Report – as with the earlier studies - are also likely to encounter a degree of instinctive resistance. This may be associated with the reluctance of some stakeholders to admit that the very benign conditions experienced through 2008 may have gone away for good or, at least for several years. Neither they nor the authors of this Report truly know what the next few years will bring and above all whether the development model that worked well prior to 2008 will really function again in anything like the same manner. This has called for a set of new ideas about taxation (i) that can be of potential assistance to a wide range of economic activities and not merely to the established areas that have done so well in the past and (ii) that can deal with the inherent uncertainty of the present situation by delivering a revised system that will be more robust than the present system to future shocks.

END OF THE MAIN TEXT

Annex 1: Persons and Organisations Consulted

Gordon Wetherell	Governor
Mark Capes	Chief Executive, Governors Office
Brian Titley	Senior Economic Adviser, Governor's Office
Ben Boddy	Governors Office
Delton Jones	Permanent Secretary, Ministry of Finance
Henry Saunders	Revenue Control Unit, Ministry of Finance
Katherine Forbes	Chief Economist, Ministry of Finance
Shirlen Forbes	Statistician, Ministry of Finance
Ian Lang	Adviser, Ministry of Finance
Terry Selver	Customs Department, Ministry of Finance
Geoff Thorne	Customs Department, Ministry of Finance
Keith Sargent	Planning Adviser
Ole Kragh	Adviser, Ministry of Finance
Kevin Higgins	Head, Financial Services Commission
Conrad Higgs	CEO, TCInvest
John Smith	CEO, Airport Authority and Advisory Council
Paul Fletcher	Finance Director, Providenciales Water Company
Derek Taylor	Former Chief Minister
Washington Missick	Former Chief Minister
Joseph Connolly	PriceWaterhouse Coopers and Advisory Council
Carlos Simmons QC	President Bar Association and Consultative Forum
Mr. Kit Fennimore	Chamber of Commerce
Erwin Jones	Chamber of Commerce
Anton J.B, Faessler	TCI Bankers Association
Doug Cochrane	CEO Scotia Bank
Sherma Hercules	FCIB
Audley Higgs	FCIB
Bonnie L. Voyanovich	Royal Bank of Canada
Brian Trowbridge	Bank and Trust Ltd.
Rochelle Thompson	International Banking Group
Allan.Eden-Hutchison	Honarary Jamaican Consul and Eden International Ltd.
Wilbur C. Caley	British American Insurance Co. Ltd.
Katherine Brown	Coralie Properties and TCI Real Estate Association
Bernadette Hunt	Turks and Caicos Property Ltd.
Nina Siegenhaler	Sotheby's International Realty
Caesar Campbell	Hotel Association

Samuel Forbes	Principal Community College
Silvie Wigglesworth	Principal British West Indies College
Dave Edwards	British West Indies College
Clive Stanbrook QC	IGA – Retail/ Tourism Working Group
Robert Brace	IGA - Retail
David Hartshorn	Project Tech
Barrie Cooke	Regent Grand
Lou Patane	Highlands Estates Project
Stan Hartling	Hartling Group
Michel Neutelings	Milo Resorts Ltd
Mark Durliat	Grace Bay Resorts
Rob Ayers	Wymara Resort
Floyd Seymour	Century 21 and politician
Titus H. de Boer	German Consul
Josephine O' Connolly	Tropical Auto Rentals
Kenrick Walters	Businessman
John Phillips	Claymore Asset Management
Ron Burchill	Chair Small Business Association
Richard Savory	Savory and Company - Attorneys
Guy Chapman	Savory and Company - Attorneys
Conrad Griffiths QC	Misick & Stanbrook-Attorneys
Sarah Knight	Misick & Stanbrook-Attorneys
Tim O'Sullivan	Miller, Simons. O Sullivan - Attorneys
Bernd G. Wolf	TWA . Marcelin Wolf - Attorneys
John Hartley	Businessman and Journalist
Norman Saunders	Saunders & Co.
Kevin Coupland	Saunders & Co.
Jeffrey E. Lee	Lee and Astwood, Architects