JAMAICA

USAID ASSISTANCE IN FISCAL REFORM: THE JAMAICA TAX STRUCTURE EXAMINATION PROJECT

I. PROJECT DATA

Level of Funding: $8 million

Period of Assistance: 1983-87

Types of Assistance:
1. Technical Assistance: (a) Resident Project Team, and (b) Short-term Consultants
2. Materials, Facilities and Equipment
3. Training: (Including On-the–Job, In-Country Classroom, External Degree and non-Degree, In-Country and External Special Topic Seminars)
4. Constituency Building

Areas of Assistance:
1. Tax Policy and Administration
2. Tax and General Economic Policy Analysis and Forecasting
3. Tax Information Systems
4. Institutional Development

Main Counterparts:
1. Office of the Prime Minister
2. Jamaica Revenue Board
3. Jamaica Tax Reform Commission
4. Ministry of Finance

II. THE PROJECT: BACKGROUND, PRINCIPAL RESULTS AND IMPACT

Introduction

This tax reform project covered both tax policy and tax administration comprehensively. One of the project’s unique features was the way it was organized. Its distinguishing characteristics are not fully captured by a mere listing of the types of assistance and the areas of taxation to which the assistance were directed. A brief elaboration of the more important of the distinguishing characteristics and of the types and areas of assistance is in order.

Technical assistance. Most of the project's "Key Personnel" who provided the technical leadership of the project were non-resident academic experts. They were responsible for the economic and legal analyses of each of the principal types of taxes. These component leaders led and monitored the work in their specialties, undertaking short-term visits as needed. The resident project team consisted primarily of hands-on experts with practical experience in tax administration and in training. The key members of the resident team were a Resident Chief of Party, a Customs Advisor, a VAT Administration expert, an Income Tax Administration expert and various analysts (sometimes graduate students working under the direction of the component leaders.)

The TA team worked closely with the Revenue Board to produce the design for a comprehensive tax reform with alternatives for consideration by a high-level Tax Reform Commission. The commission was made up of highly respected leaders from all the principal social, political and economic segments of the society. At that stage, the TA team became, in effect, a professional staff resource for the Commission, answering its technical questions about the implications of the submitted proposals, and evaluating the likely consequences of other possibilities put forward by Commission members.

Training. In addition to providing customary training associated with tax administration, training also took place for officials of the Revenue Board closer to the policy level, in seminar settings, both inside and outside of Jamaica. These seminars brought together tax officials and top academic experts for lively discussions and debates on such important esoterica as optimal depreciation rules.

Tax policy and administration. The Jamaican Government's initial interest in pursuing tax reform was to raise more tax revenue through improved administration and collections. However, it soon became evident that tax policy required broad reform as well, as tax policy and tax administration overlapped substantially.

Tax information. Under the project, the pick and shovel work of creating a tax information system was undertaken. This was necessary to enable system managers to monitor performance, to identify failures and to prescribe corrections, as well as to assess the reciprocal influences of the tax system and the broader economy on one another.

Constituency Building. Constituency building required frequent and good communication among USAID, the project team, the government counterparts, the Prime Minister and his Cabinet, the legislative branch, the blue ribbon Tax Reform Commission, the public at large, the public interest sectors, organized labor and the business and financial community. The goal was to make the entire community aware that a serious reform of the tax system was underway. This process afforded the community opportunities and channels to make their concerns known and to offer constructive input into the reform *before* it was cast in legislation.

A. *Background and Economic Context of the Project*

In 1982 the Jamaican economy was in a shambles. Real per capita GDP was lower than it had been 10 years earlier. The world market for bauxite and alumina, Jamaica's principal export, was deeply depressed. Foreign exchange earnings were not sufficient to pay for the imports of consumer goods and productive imports on which the economy depended (e.g., food staples and petroleum). Jamaica's international reserves were depleted and foreign debt-service was a severe drain on national resources. Business and industry were squeezed by rising costs and wilting demand, as unemployment, price inflation and currency devaluations eroded real incomes. Elements of economic policy discouraged investment and production for export.

Under these conditions, Jamaica's newly elected Prime Minister, Edward P.G. Seaga, took office. An early request to USAID was for technical assistance in designing and implementing a project to improve the performance of the Jamaican tax system.

In addition to its failure to produce sufficient revenue, elements of the tax system constituted a severe disincentive to production. Many of Jamaica's largest and strongest businesses complained that taxes were far too high. Yet the macroeconomic data showed that aggregate tax revenue fell far short of the financing requirements of the budget. The problem was that those who actually paid taxes paid at a high rate, but many with statutory tax liability paid little or nothing. Exporters were subject to a punitive *de facto* tax by the policy that required them to sell their foreign exchange earnings to the Central Bank at the official, punitive, exchange rate. Thus the need for tax reform was great. However it was also clear that the reform could not focus exclusively on raising more revenue. It would also have to address the effect of the tax structure on investment, saving, production, employment and incomes.

With substantial support from the U.S. Government, the Jamaican government established strong working relationships with the IMF and the World Bank, as well as with USAID. The three donors and the Jamaican Government forged broadly compatible conceptions of the economic policy adjustments required to give Jamaica a chance of converting a hoped-for economic spark to sustainable economic energy. This consensus embraced the basic outlines of tax reform as well. Building on this consensus, USAID and the Jamaican government designed a comprehensive tax reform project. The themes that guided the project designers were as follows: the tax system should be compatible with an export-led, private market-guided economic development thrust; it should generate sufficient revenue to finance successively larger portions of the government's budget; it should be simple to administer; and it should be fair.

The tax structure in place at the time the project began was one that had grown by piecemeal additions. There were basically three classes of taxes in Jamaican tax law: (i) income tax (on employees, on self-employed persons; and on companies); (ii) excise taxes (five separate taxes—consumption duties, retail sales tax, excise duties, customs duties and stamp duties—with separate administrations and different bases); and (iii) property and wealth taxes. Administration of the taxes was ineffective, partially because of their complexity. Numerous tax-free allowances were included in most compensation packages. Estimates of compliance rates revealed that most self-employed persons paid no tax at all. And the property values against which the property tax was assessed had not been increased in 10 years, during which time price inflation was significant.

The sections that follow present a brief review of the principal achievements and impacts in the four "Areas of Assistance" identified in Section I above. As will be seen, the project is judged to have been quite successful. Some of the recommendations that grew out of it have never been adopted, and others were diluted before being adopted. This is not a surprising outcome of a democratic political process. Nevertheless, remarkably, the general framework adopted 17 years ago in the "Green Paper" sent to the Jamaican legislature by the Prime Minister appears to have served as a continuing guide for tax reform for both of the two major political parties. In this respect, the project has produced impressively sustainable results.

B. *Outcomes and Impacts in the Project's Areas of Assistance*

(*Note: USAID commissioned an independent evaluation of the project in 1992. The evaluation was conducted by Dr. Kenneth Hubbell, Dr. Alfred Francis and Dr. Richard McHugh, and is the main source for results reported in this section.)*

1. Tax Policy and Administration

Tax Policy

USAID's evaluators concluded that, in the area of tax policy, the project had been broadly successful. Specifically, the structural reform had resulted in the tax bases being broadened, the system had been significantly simplified, rates had been lowered, and positive export incentives had been installed. Moreover, despite generally lower tax rates, the share of GDP captured through taxation had not fallen, as many skeptics had feared. In fact, the share increased from an average of 25% of GDP in the three years prior to the tax reform to 27% in the three years ending in FY 1991. Focusing more narrowly on specific taxes, the evaluation team identified the individual income tax and the system of indirect (excise) taxes as the most successful areas. Reform of the payroll tax system, the company income tax and the property tax were less successful, at least in terms of the reforms that the Tax Reform Commission had recommended.

Personal Income Tax. One of the first concrete recommendations of the Jamaican Tax Reform Commission was the adoption of a single rate of 35% of taxable income (basically all income over 7,500 Jamaican Dollars) for the personal income tax. The proposal also included the elimination of tax credits and of untaxed allowances in compensation packages. Additionally, and significantly, the proposal included withholding by financial institutions of 35% of interest income earned by depositors. The legislation that passed (in 1986) included a flat rate that was a percentage point and a half below the recommended rate, and eliminated most (though not all) tax-free allowances. The level at which personal income became taxable was increased from $7,500 to $8,480 (in Jamaican Dollars), thus liberating more of the lowest income earners from income tax liability.

<u>Company Income Tax</u>. The Tax Reform Commission recommended changes to eliminate incentives for individuals and firms to use accounting maneuvers to move income between the personal and the company income tax. Specifically, they called for a flat rate at the level of the personal income tax rate. Other elements of the proposal included streamlining of depreciation rules (by moving toward treating capital goods purchases as current-year expenses in the year of the acquisition), and the *de facto* double taxation of dividend income (i.e. taxing company profit as well as the dividends paid from after-tax profit.)

Legislation adopting company income tax reform took effect at the beginning of CY 1987. The flat rate was adopted and was set equal to the personal income tax rate. Despite these significant reforms, many of the recommendations were not adopted, in part out of concern that revenue would fall unacceptably. In fact, there was a steady decline in the revenue collected relative to companies' operating surpluses, from 13% in FY 1986 to 9% in FY 1990, and a decline in the share of total tax revenue accounted for by this tax in the same period.

Following the reform, the share of total tax revenue generated by the personal income tax initially rose from 23% in FY 1986 to 30% in FYs 1990 and 1991. Employees in the "Pay as You Earn" (PAYE) component of the personal income tax contributed slightly less after the reform, dropping from 21% to 19% over the same period. The loss (attributable largely to successive increases in the threshold below which no tax was due) was more than compensated for by the new tax on interest and dividends, which contributed 7% in FY 1987 and 8% in 1991.

<u>General Consumption Tax (GCT)</u>. The pre-reform indirect tax system was made up of a bewildering array of taxes on a variety of goods, at widely varying rates, against a variety of quantity and *ad valorem* bases. The Tax Reform Commission recommended that most of these taxes be combined in a single value added-type tax, called a General Consumption Tax (GCT), with a single rate. The indirect taxes to be bundled together into the GCT included excise duties, retail sales taxes, consumption duties and "additional" stamp duties on some imports. This tax was to be supplemented by special sumptuary excises, levied at a single rate.

Legislation adopting the GCT was eventually passed in 1991. However, in the political process, intense concern about the impact of the reform on lower-income groups, along with other pressures, resulted in many changes. In particular, the list of exempt items and items with a zero rate was extensive. Moreover, the proposal to compress the structure into three rates failed.

Despite some notable departures from the ideal GCT, the tax was quite successful. One study estimated that 86% of the larger enterprises that were required to collect the tax were enrolled. It has also been estimated that just in the first three months after the tax went into effect, collections were 10% above projections, even though the rate was set at 10% instead of the recommended 15%.

Adoption of the GCT, even in flawed form, was a noteworthy achievement. It eliminated some of the anti-saving bias of the previous tax system, provided an incentive to production for export, and eliminated some important sources of distortion in resource allocation through more even tax treatment across sectors and products.

<u>Tariffs on Imports</u>. Jamaica's tariffs were unwieldy, discriminatory, complicated and difficult to collect prior to the tax reform. Rates varied from 0% to 200%. The tariff system was not (unfortunately) an element of the project, but the Tax Reform Commission recommended that the GCT base be broadened to include import tariffs. Under the proposal, the range of rates would be narrowed to 5% from 30%. The theme of the recommendations, as with other taxes, was to broaden the base and thereby permit lower average rates. Again, through the political process, the proposals were translated into policy, though with a number of compromises. At the time of the project evaluation, it was too early to make any judgments about the overall revenue effects. Nevertheless, the maximum rate of customs and stamp duties combined was reduced from over 100% to 68%, and the number of zero-rate or exempt items was reduced by approximately two-thirds. In subsequent steps, the maximum has been further reduced.

<u>Payroll Taxes</u>. Jamaica's four payroll taxes (not including the income tax) are earmarked in the law to fund education, job training, health and a social security-like system. Compliance and collections have been erratic and unimpressive overall. The Tax Reform Commission hoped that they would be abolished, and their revenue replaced by revenue from the income tax. Nevertheless, the political situation did not permit this to happen, in part because it was considered too (politically) risky to raise the income tax rate to the level proposed by the Commission (i.e. 35%). Thus these payroll taxes had not been significantly changed from their pre-reform status by the time of the March 1992 evaluation.

<u>Property Tax</u>. Owing to stale valuations and poor administration, the property tax generated only 1% of total tax collections in 1986, whereas ten years earlier it had generated 5%. The Commission noted this and there was a consensus that reforms should be undertaken with a view to making the tax a more important contributor. Accordingly, they proposed a comprehensive revaluation of the properties along with an increase in the tax rate, to be phased in over three years. Revaluations were accomplished in 1986 and

1991, and the latter values were expected by the project evaluators (in March 1992) to be adopted by the end of 1992. Legislation to adopt the recommendations was passed in 1986. However, by 1992 only the first phase of the rate increases had been adopted. Valuations rose in 1991 to four times the 1986 level. The large tax increase implied has resulted in very slow movement to implement the new property tax system.

Tax Administration

As the Tax Reform Commission formed consensus views on tax policy, it became feasible to work on the corresponding administrative systems. It was clear from an early point, for example, that the Commission favored moving toward flat rates and reducing the number of exemptions and allowances. Thus the administration of the taxes would require significantly less effort to detect evasions aimed at bracket shifting.

The project supported technical assistance in drafting the laws to codify the new system. Jamaican and expatriate legal specialists collaborated in the process. The "Revenue Administration Act" of 1985 reconfigured the revenue services into four departments: (i) Inland Revenue (for domestic taxes other than property); (ii) Customs and Excise (for most taxes on external trade); (iii) Stamp Duty and Transfer Tax; and (iv) Land Valuation. This realignment consolidated duplicated functions and significantly simplified administration.

The new income tax laws took effect in 1986, and the GCT law was finally passed in 1991. The new laws significantly simplified administration by eliminating a plethora of low-yield and administratively complex taxes, and by consolidating administrations.

Once the laws were in place, the project focused more directly on broadening the base by getting taxpayers enrolled on the master files. Between FY 1986 and FY 1990 the number of income tax returns filed by persons not enrolled for payroll deduction (PAYE) increased approximately 60%. The number of PAYE returns showed little or no increase, due largely to the increased number of low-wage employees not subject to tax because of the increased standard deduction.

In general, the audit and compliance aspects of tax administration have turned in disappointing performances. Nevertheless, while the number of audits showed no significant post-reform increase, the revenue gains attributable to audits increased substantially, suggesting improved selection procedures and audit effectiveness.

Tax reform projects inevitably depart from the ideal. The Jamaica reform was no exception. Nevertheless, tax policy and its administration undoubtedly improved as a result of the project, and there is compelling evidence that the reform "movement" launched with the project is still vital, a tribute to the sustainability of the reform.

2. Tax and General Economic Policy Analysis and Forecasting

One distinguishing feature of the Jamaica project is that careful, academic quality research was undertaken before any specific reforms were recommended. This permitted the TA team to provide the Tax Reform Commission with credible answers to questions about the many reforms under consideration. Moreover, in order to defend a tax reform from attacks by special interests, there must be capacity within government to analyze proposals, ascertain their intended or unintended consequences and advise the policy makers accordingly. These background analyses demonstrated both the political and operational importance of careful policy analysis.

Ongoing operations of the fiscal authorities also require rigorous forecasting and analysis capability. Tax receipts in future years must be projected in order to relate them to programmed expenditures. Moreover, monitoring and evaluation of the performance of various collection offices can be significantly assisted by policy analysis units' comparison of actual and forecasted collections.

In the Jamaica case, rigorous policy analysis was performed by the consulting experts, working closely with counterparts from the Revenue Board and the Tax Reform Commission. In addition, training in analysis was provided for nine senior officials from the Revenue Board at a U.S. university. Nevertheless, acquiring the training and experience necessary for a permanent, effective policy analysis unit is a long-term process. The evaluation of the project found that this process was not completed during the project.

3. Tax Information System

The computerization of the revenue services and of a rational tax information system involved cooperation and coordination of efforts of multiple donors, and provides a good example of leveraging external assistance as observed in the project evaluation:

> The Revenue Board, recognizing the limitations and inefficiencies of the manual operating systems of the Departments, requested financial assistance from the European Economic Community (EEC) in 1981 to computerize its tax system. The EEC responded by providing a US$2.5 million grant to purchase computer hardware and technical assistance. The EEC also financed a functional design study, the recommendations of which formed the basis of a purposed (sic) Revenue Services Automation Plan (RSAP). However, it became clear that to make the plan operational, additional funding was required. USAID provided a portion of these additional monies through a US$2.64 million grant in 1986. The grant, plus matching funds from the GOJ in the amount of US$1.96 (million) funded the construction of an additional computer building (US$1 million), the purchase of three Computer Processing Units plus other ancillary hardware (US1.6 million), and software development and EDP training ($US 2 million). The GOJ's computerization program also was aided by a US $1 million loan from the World Bank.

The EDP function was centralized in a public company created by the GOJ for this purpose. This company was not constrained by the regular civil service system's salary limits, and hence was able to attract and retain a cadre of competent technicians and professionals.

Despite having been the focus of exceptional financial and technical assistance, the EDP goals of the project had not realized its huge potential to bring efficiency to the tax administration function by the time of the 1992 evaluation. Recent anecdotal evidence, however, suggests that the system has attained much improved operating effectiveness.

4. Constituency Building

Constituency building was crucial to the success of the project. Recognizing this, the Prime Minister appointed the special Tax Reform Commission. To head the commission he selected the Vice Chancellor of the University of the West Indies, one of Jamaica's most distinguished and respected citizens, and a person who was regarded as being above the partisan political fray. Having him at the head was a definite attraction to leaders of industry, commerce and finance, as well as to leaders of the trade union movement and to community action leaders.

The appointment of the Commission was well publicized and attracted reasonably little partisan political conflict. Moreover, the announcement of the project by the Prime Minister (who also served as Minister of Finance) sent a clear signal to people from the highest to the lowest echelons of the bureaucracy that the project was "owned" by the Jamaican government and held a high priority.

The effectiveness of the constituency building effort is attested to by the fact that, since the project's completion in 1991, many of the reforms that found their way into the Commission's "White Paper" report to the Prime Minister, and then into the Prime Minister's submission to Parliament, but that were not adopted in the first go round, have surfaced again and again as proposals. Some have been adopted and some have not. However, it appears that this project initiated a "tax reform movement," as the evaluators called it, and that the "movement" and its non-partisan ideology have been sustained through to the present.

III. FACTORS OF SUCCESS

While many individuals and many elements of project style contributed to the project's success, six factors are especially worthy of note.

1. USAID's Arm's Length Project Oversight. The USAID officers responsible for USAID's role, up to and including the Mission Director and USAID/Washington executives, supported the notion advanced by the Prime Minister that, except for USAID's exercise of its appropriate stewardship and contract oversight, the consultant experts were to be regarded as reporting to the Government of Jamaica. USAID's

willingness to accept this structure was key to establishing GOJ "ownership" of the project.

2. Strong Jamaican Counterparts. The GOJ had sufficiently qualified leadership in the key positions of the Revenue Board that they were competent to manage the project and its interface with the consultants.

3. Jamaican "Ownership". The GOJ felt complete "ownership" of the project because it was originated at its request, and GOJ tax officials were fully involved in the project's design, development and implementation.

4. Quality of Project Key Personnel. Many of the consulting experts were distinguished scholars whose professional standings were well known to the principal Jamaican authorities, including the Prime Minister and the Chairman of the Revenue Board. Using individuals of this caliber required approvals of numerous salary waivers at and above the Mission Director level. Approving them required wisdom and fortitude, but contributed importantly to success.

5. Other Donor Coordination. The project was well known to the other principal donors in Jamaica (the IMF and the World Bank). The high caliber of the key project consultants earned their respect and recognition. Many Jamaican counterparts reported that under this project, they felt for the first time that they were treated as professional peers by experts from international donor institutions.

6. Comprehensiveness and Attention to General Macroeconomic Adjustment. The project was comprehensive on the tax side, and was deliberately and carefully made compatible with the broader macro and structural economic goals of the GOJ.