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# Fiscal Reform in a Modern Bahamas

Nov, 2013

# Outline

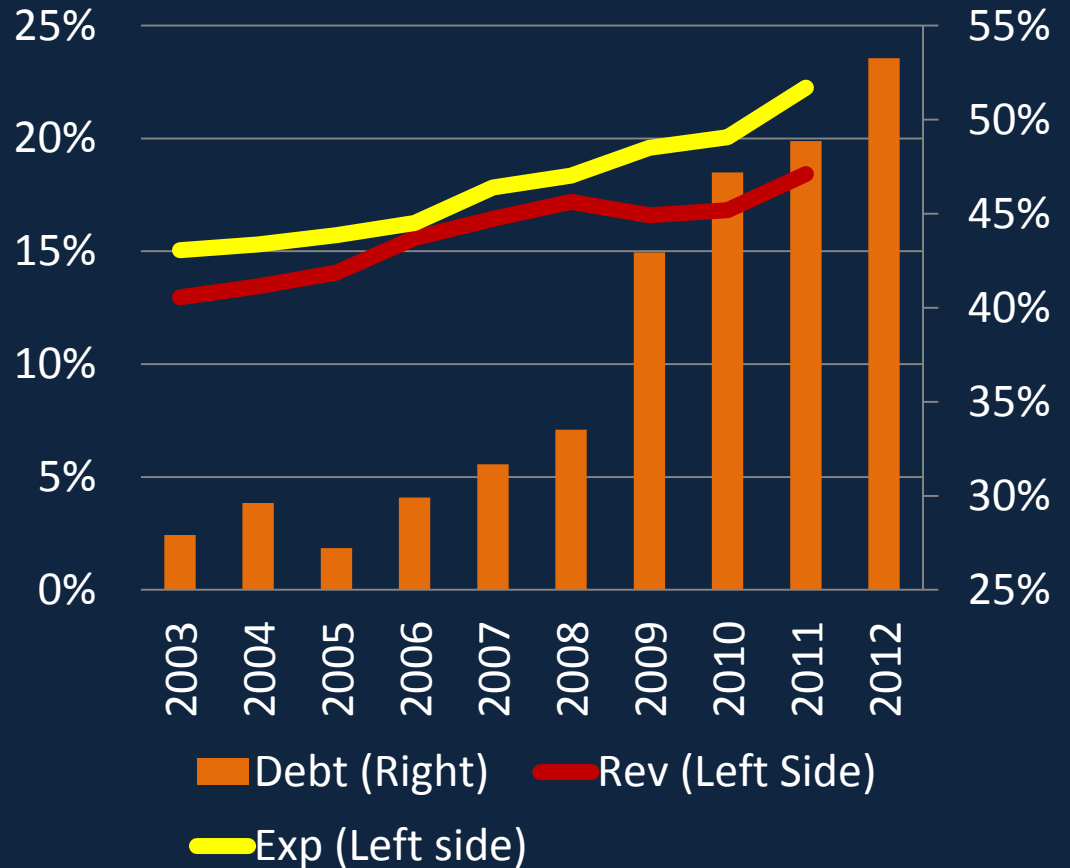
- **The broader case for fiscal and revenue reform**
- **Some comparative country analysis**
- **VAT Concepts**

# Fiscal Reality

- Growth in debt must be arrested
- This requires both revenue and expenditure measures

# Bahamas Govt. Finances and Debt (% of GDP)

Debt continues to rise because revenues have fallen behind expenditures



Ministry of Finance

# Bahamas Govt. Interest Payment Burden (% of GDP)

Rising debt shifts more resources to interest payments.  
Budgeted at \$229 million in FY2013/14



# The cost of in-action or lack of credibility

- Unchecked rise in debt
- Less capacity to borrow for emergencies
  - Increased vulnerability to shocks like hurricanes and sudden contractions in foreign economies on which we depend for tourists
- Credit downgrade and eventual loss of access to credit markets
- Outcome: much higher tax increase, larger reductions in spending, and possible reduction in public sector employment, scrutiny of the exchange rate parity

# Should Government correct with spending cuts or tax increases?

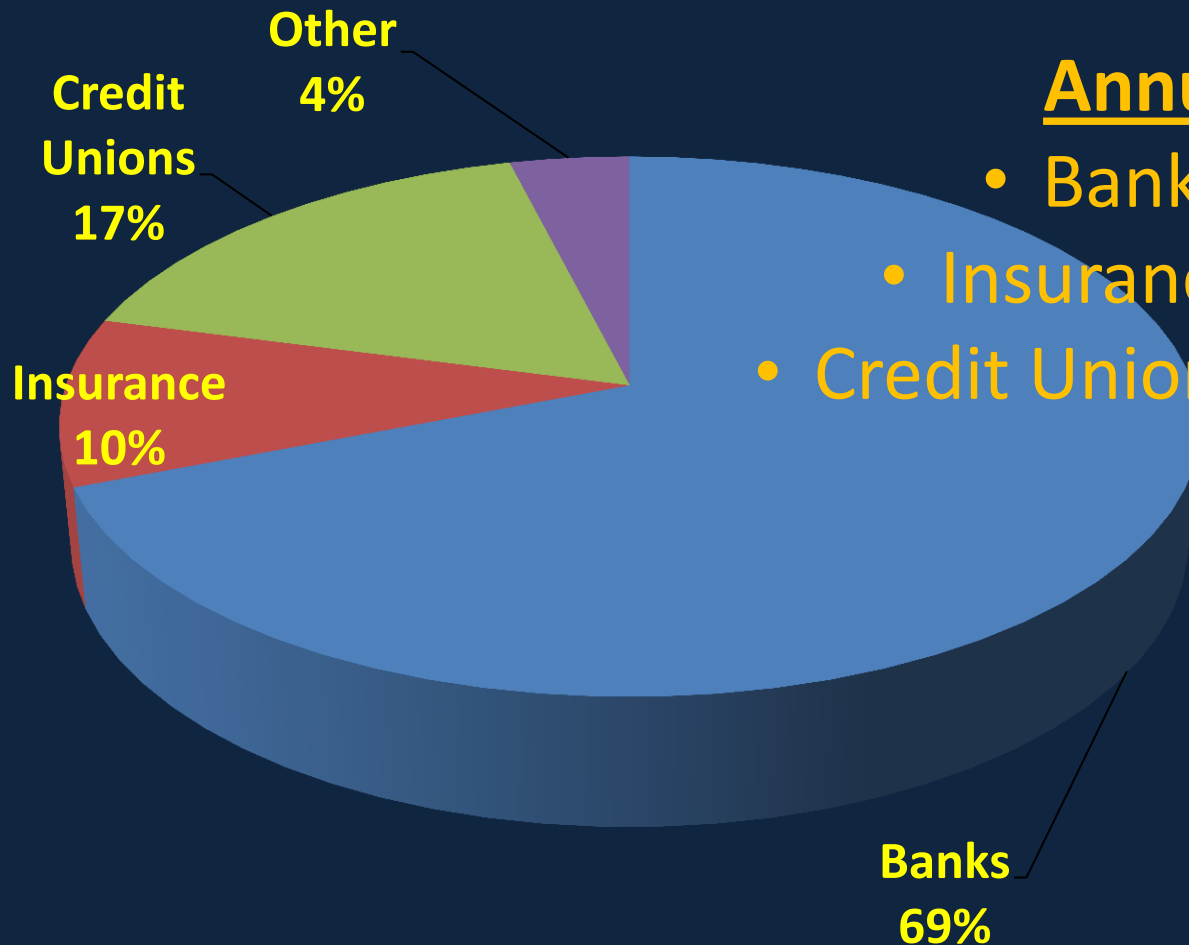
- Approach must be balanced
- Continue to address cost efficiency issues through out the public sector
- Improve revenues performance
  - A VAT as a broad base measure to share fiscal adjustment burden more equitably
  - Administrative enhancements for customs, property taxes, tobacco (excise stamp)

# Considering spending cuts

- Public investments must still be maintained
- Recurrent spending has to be tackled – but carefully
  - One third of recurrent spending is on salaries
  - More than 70 percent of salaries go to deductions for obligations to banks, credit unions and insurance companies



# *Government monthly salaried persons deductions average \$20 million*



## Annual implications

- Banks -- \$140 million
- Insurance -- \$24 million
- Credit Unions -- \$41 million

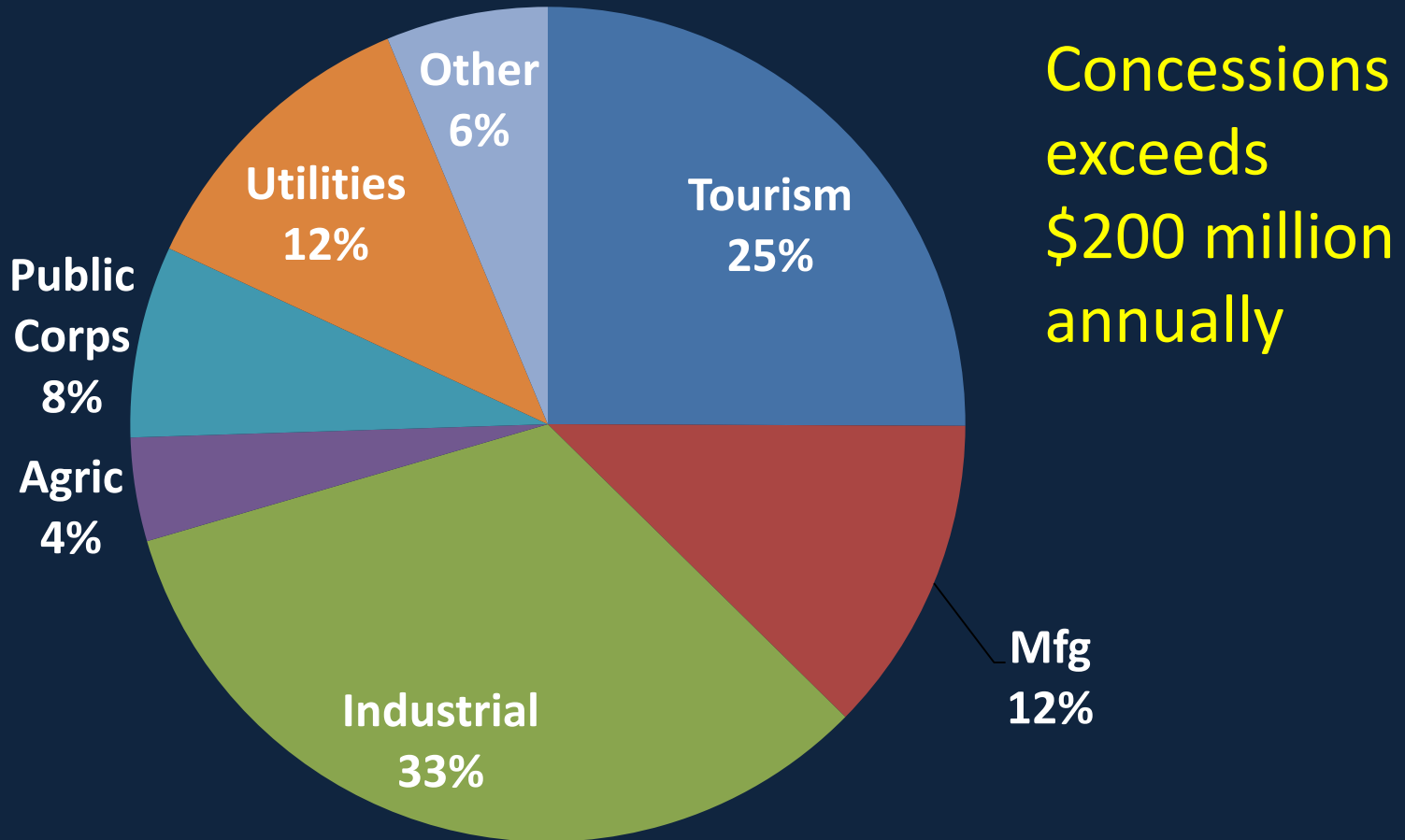
# Cutting Government Spending

- Next largest expenses is on goods and services
- These are expenditures which impact locally owned private business

# Government subsidies are significant

- More than \$200 million granted each year private sector subsidies and incentives.
- Immediate large reductions would force private sector retrenchment, and less ability in the current economic environment to attract foreign investments.

# Is it straight forward to rollback tax concessions?



# Fiscal Consolidation Strategy

## By 2017:

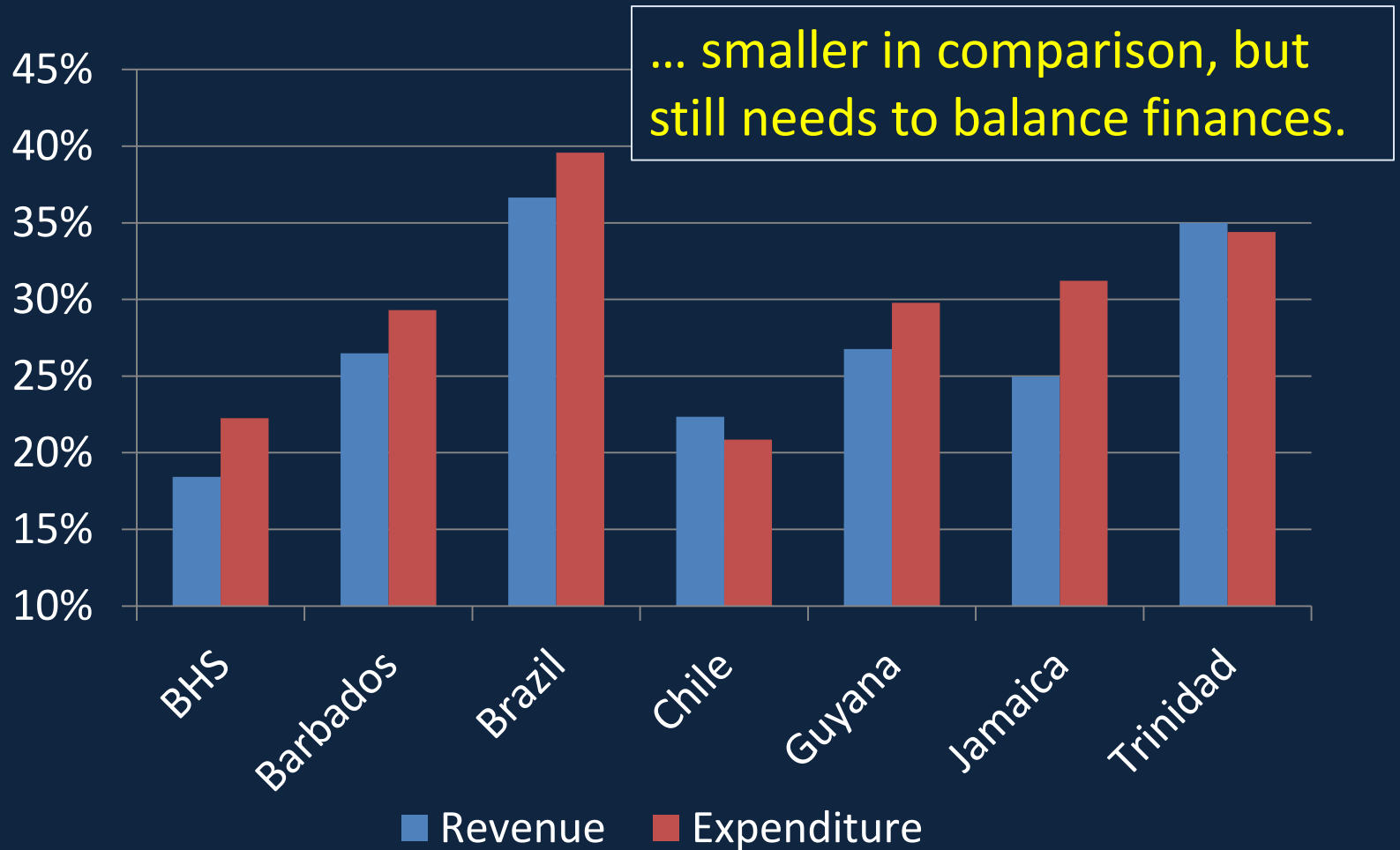
- Grow annual revenue by at least \$500 million relative to the current level of collections
  - VAT must provide at least \$200M
  - Other direct measures and reforms to give at least \$200M
  - Economic growth provides remainder
- Maintain tight control on spending. Reduce the size of government relative to the economy

# What about Growth?

- Growth is always in the equation
- Reforms which reduce fiscal uncertainty, make for more certain private investment environment
- Growth will amplify the benefits of fiscal reforms

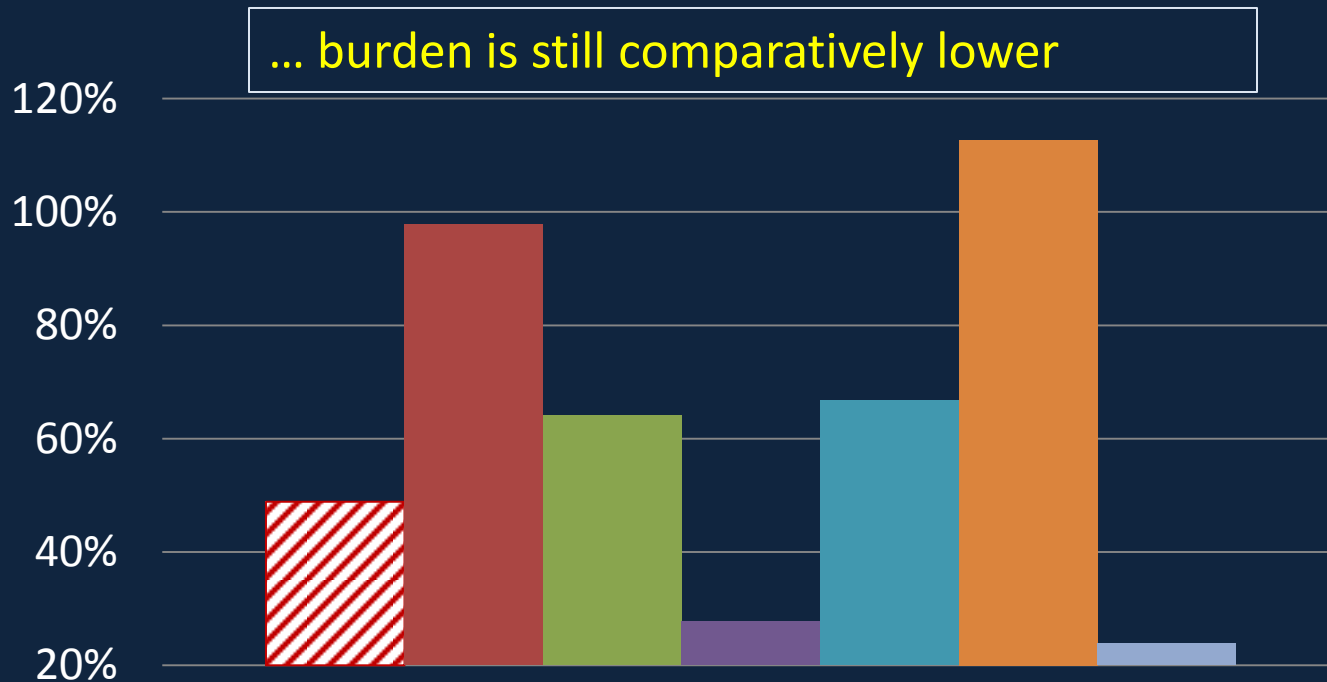
# Does the Bahamas have a spending problem?

# Government Revenue and Expenditure (% of GDP, in 2011)





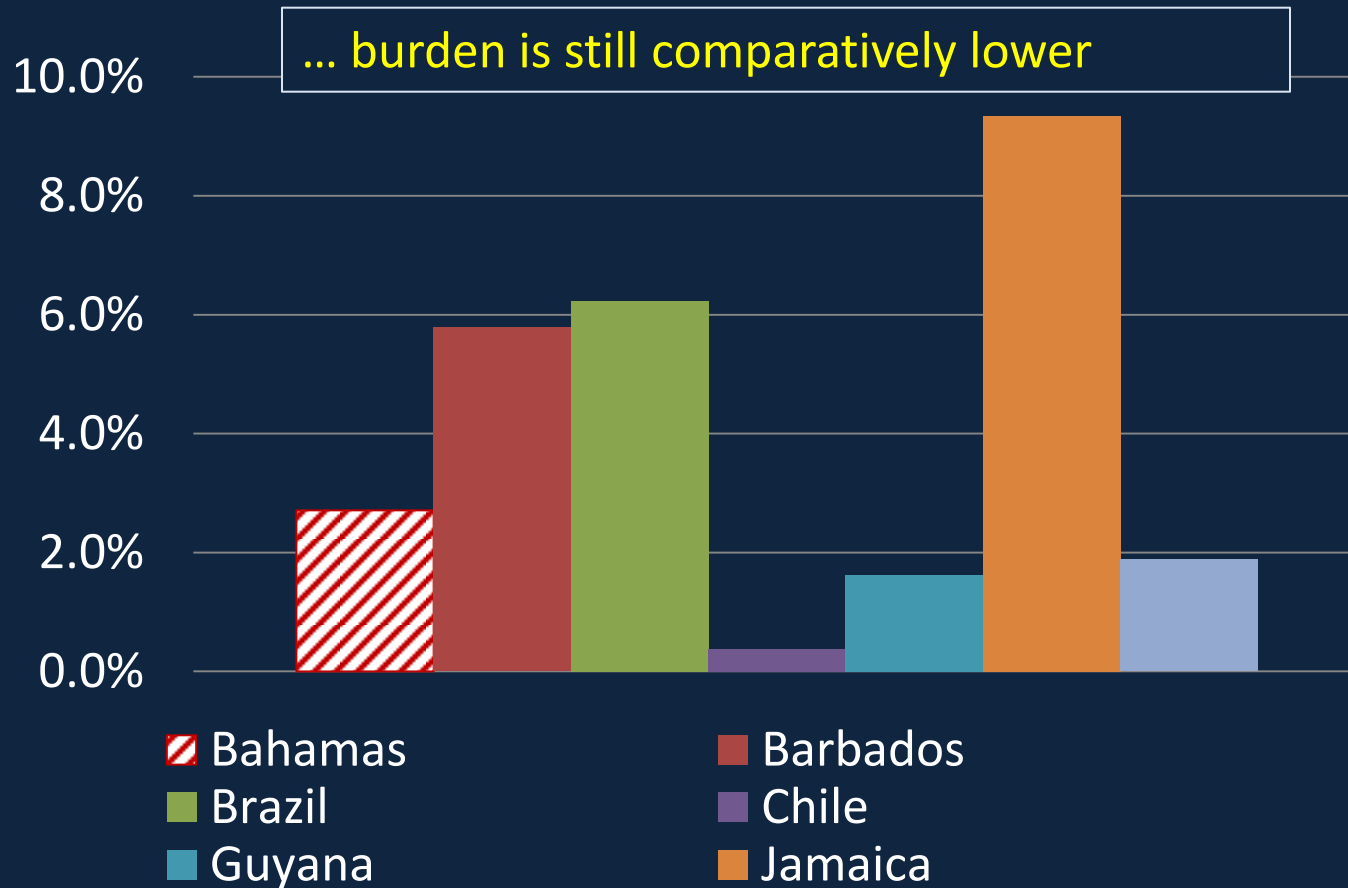
# Government Debt 2011



Bahamas  
 Brazil  
 Guyana

Barbados  
 Chile  
 Jamaica

# Interest Payments in 2011 (% of GDP)



# The Case for VAT

- Fits into program of Fiscal Consolidation
- Broadens tax base
- Increases equity, especially in burden of fiscal adjustment
- Superior to sales taxes in collections and enforcement efficiency

# Approach to VAT is one of rebalancing--**Plus**

- **A replacement tax** (not entirely new revenue)
  - July 1 2014: Lower the average rates of customs duties and excise taxes
  - Impose the 15% VAT on these goods
- **Impose VAT on a range of services**
  - New revenues from services will offset any reduced customs revenue
- **PLUS....** generate additional net revenue

# Frequent Comments Questions

- VAT will disadvantage business that cannot claim credits
- The underground economy will flourish
- Individuals will shop abroad to avoid paying at cash register
- A sales tax would be better
- The culture of tax compliance is weak
- Bahamian business are not accustomed to keeping good records

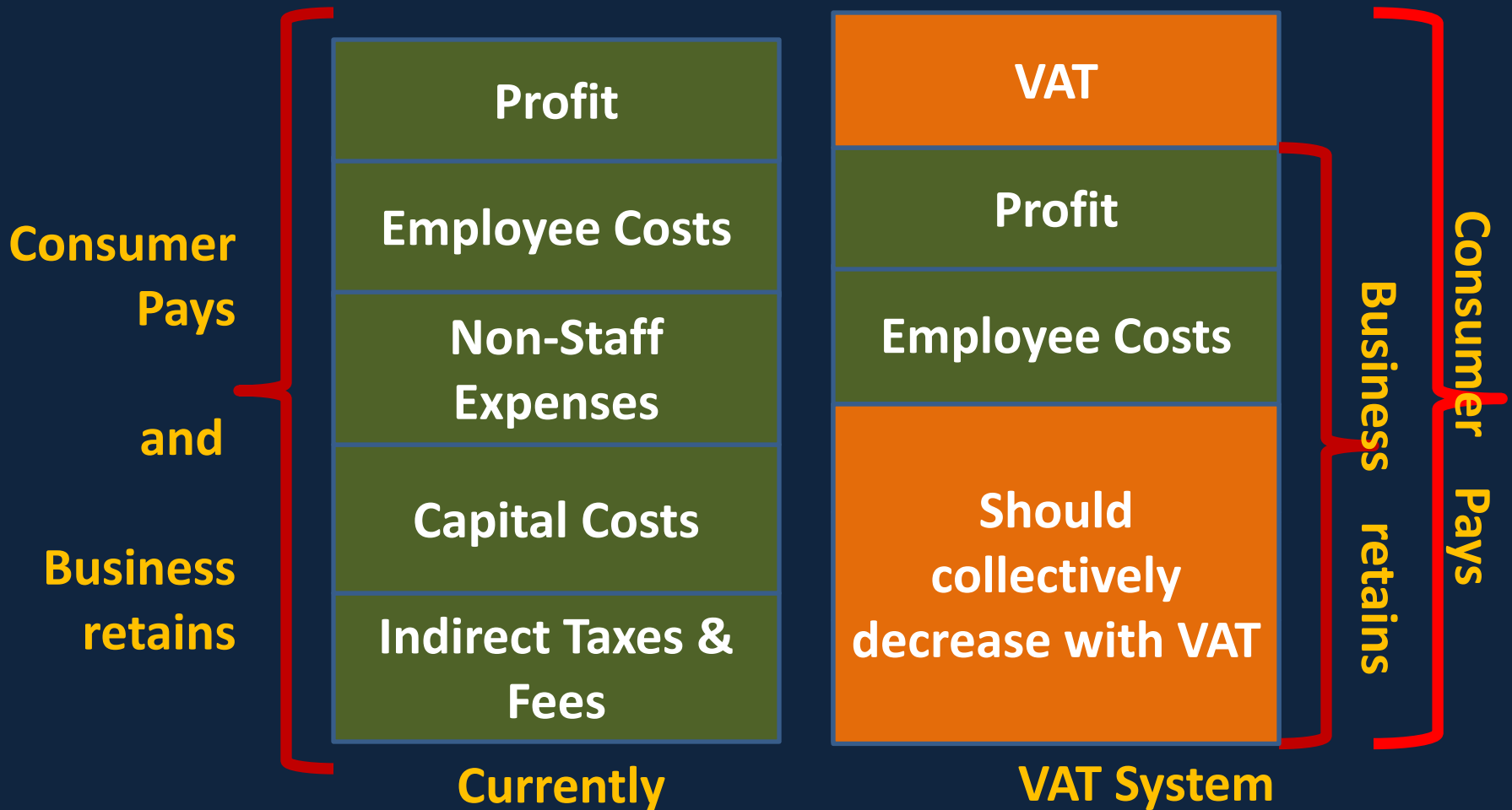
**Does it matter whether the focus is  
on VAT registrants or non-registrants?**

**How does this affect business and  
consumers?**

# The Going Concern

- Revenue/cashflow stream is adequate to cover all expenses and amortization of capital costs
- Revenue, broadly, is selling price multiplied by sales volume
- End customer is source of all revenue. Price paid by consumer reflects all costs and taxes absorbed by business.

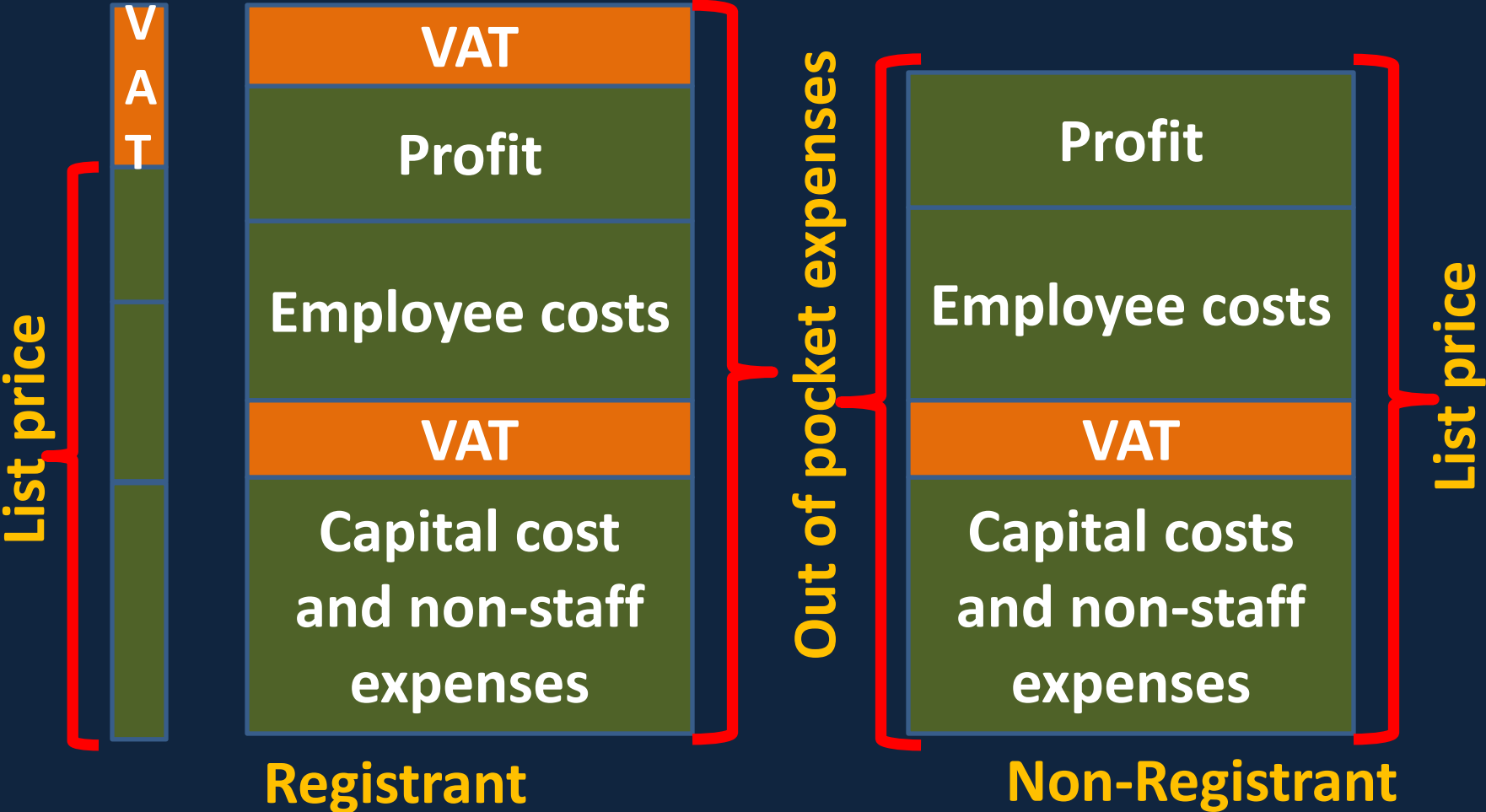
# What the consumer pays





# Registrants vs Non-Registrants

## Incidence of VAT



# Why Not A Sales Tax?

- The experience is same for end consumer
- Sales taxes are cascading
- Weaker self enforcement mechanism
- No ability to secure any portion of tax before final stages
- Incentive for evasion increases as tax rate exceeds 10 percent

# Why not use a lower rate of VAT?

- Fiscal reform is being driven by size of the correction.

# Why not other taxes: income, corporate

- Reforms would have to be net positive for investments, growth and employment; and occur in equitable fashion across the economic landscape
- Will require reform of incentives frameworks for large FDI, which commonly rule out tax on profits
- Must fit into broader strategy to build external competitiveness and reduce other costs of doing business (like productivity, and skills deficiency)
- Would require redesign of approach to residential tourism (if equity in personal taxes is achieved)
- Would have to address equity in treatment of international services sector and Freeport licensees

# Analyzing the Economic Impact of VAT (forthcoming)

- Employs a macro-economic model calibrated to match behavior of Bahamian economy (2000-2011)
- Simulates the hypothetical impact of VAT
- Framework allows multifaceted inferences, *inter alia*, about revenue impact, economic growth, deficits, inflation and poverty

# Expected Growth

- VAT will encourage private expenditure switching into investments
  - Raises medium and long-range growth potential and reduces structural unemployment
- Over a decade the economy has potential to be at least 10 percent larger than in the absence of reforms.

# Expected Impact on Inflation

- VAT has initial domestic price impact which will dissipate quickly
- The fiscal reform package would lead to reduced price pressures
- After 5 years the price level would be comparatively lower overall, than in the absence of reforms.
  - Lower budget deficits reduce the pressures on inflation

# Conclusions

- Important to deliver on as broad a fiscal reform as possible
- VAT is an important part of the fiscal reform agenda
- Government is also focused on broader reforms to revenue administration, and public sector expenditure
- Growth, employment and private sector interests will fare better



# Comments/Questions

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