



THE KINGDOM OF THE NETHERLANDS-ARUBA

TECHNICAL ASSISTANCE REPORT—TOWARDS A SUSTAINABLE TAX SYSTEM

December 2018

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Aruba

Toward a Sustainable Tax System

Geerten Michielse and Sijbren Cossen



Technical Assistance Report

October 2018

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GLOSSARY

| | |
|---------|--|
| abv | Alcohol by volume |
| AOV/AWW | Old-age, widow and orphan insurance (<i>Algemene Ouderdomsverzekering/Algemene Weduwen- en wezenverzekering</i>) |
| AVV | Aruba Exempt Company (<i>Aruba Vrijgestelde Vennootschap</i>) |
| AWG | Aruban Florin |
| AZV | General health insurance (<i>Algemene ziektekostenverzekering</i>) |
| B2B | Business to business |
| B2C | Business to consumers |
| BAVP | Tax for funding public-private projects (<i>Belasting additionele voorzieningen PPS-projecten</i>) |
| BAZV | General health care contribution (<i>Bestemmingsheffing AZV</i>) |
| BBO | Turnover tax (<i>Belasting op bedrijfsomzetten</i>) |
| BEAT | Base Erosion Anti-abuse Tax |
| BEI | Basic exempt income |
| BEPS | Base Erosion and Profit Shifting |
| CAFT | Board of Financial Supervision for Aruba (<i>College Aruba financieel toezicht</i>) |
| CARTAC | Caribbean Technical Assistance Center |
| CIT | Corporate income tax (<i>Winstbelasting</i>) |
| DIT | Dual income tax |
| EBITDA | Earnings before Interest, Tax, Depreciation, and Amortization |
| EU | European Union |
| EUR | Euro |
| FAD | Fiscal Affairs Department |
| FZC | Free-zone company |
| GCT | General consumption tax |
| GDP | Gross domestic product |
| GST | Goods and Services Tax |
| IBFD | International Bureau of Fiscal Documentation |
| IMF | International Monetary Fund |
| IPC | Imputation Payment Company |
| MNE | Multinational enterprise |
| OECD | Organization for Economic Cooperation and Development |
| PIT | Personal income tax (<i>Loon- en Inkomstenbelasting</i>) |
| SPC | Special purpose company |
| SSB | Sugar-sweetened beverages |
| SSC | Social security contributions |
| SZSN | Special Zone San Nicolas |
| USD | United States Dollar |
| VAT | Value-added tax |
| WHO | World Health Organization |
| WHT | Withholding tax |

PREFACE

In response to a request from the Prime Minister, Mrs. Evelyn Wever-Croes, and the Minister of Finance, Mrs. Xiomara Ruiz-Maduro, a technical assistance mission from the Fiscal Affairs Department (FAD) of the IMF visited Aruba in the period September 4-14, 2018. The mission comprised Mr. Geerten Michielse (FAD, Head), and Mr. Sijbren Cnossen (external expert). The mission undertook a general review of Aruba's tax system, and in consultation with the authorities, established a plan for developing tax policy options to improve its efficiency and feasibility.

The mission held discussions with both Ministers, and other senior officials of the Ministry of Finance, including Mr. Nilo Swaen, Senior Advisor, Mrs. Luenne Pieters, Director Departamento di Impuesto, Mrs. Angeline Geerman-Giel, Deputy-Director Departamento di Impuesto, Mr. Roderick Croes, Director Departamento di Aduana/Customs. The mission also met with Mrs. Amalin Flanegin, General Manager, Central Bank of Aruba; Mrs. Desiree Helder, Acting Director Centraal Bureau voor de Statistiek; and with representatives of the Aruba Tourist Agency. Finally, the mission discussed general economic developments with Mr. Manus Twisk, Secretary of the Board of Financial Supervision, representing the Netherlands. The mission is grateful for the efficient support of the Aruban authorities and their hospitality. Special thanks are due to Mrs. Bojoura Richard and Mr. Ronald van Holland, Departamento di Impuesto, for their tireless support; the mission greatly benefited from their profound knowledge of Aruba's tax system.

EXECUTIVE SUMMARY

Over the last decade, Aruba has faced three recessions resulting in a public debt of approximately 90 percent of GDP. Its current budget deficit needs to be reduced and Aruba should close a fiscal gap of 1.5-2 percent of GDP over the next two to three years to return to a sustainable path. Earlier this year, the authorities have introduced a crisis package, mainly by increasing the turnover taxes. This temporary tax measure should be replaced by a tax reform that will modernize and simplify the current system.

The new tax system should not only raise more revenue, but also shift the tax burden away from income and profits toward consumption. The current system is not well equipped to make these changes. In replacing the crisis levy, the Government sees an opportunity to streamline the current tax system, modernize it, and make it more sustainable for the future needs of Aruba.

This report provides an assessment of Aruba's tax system, provides recommendations, and suggests a general time path towards a modern tax system. Key elements of the mission's findings focus on simplification, a reduction in the multiplicity of tax instruments, and improvements in revenue productivity. The main areas that could benefit immediately from the mission's assessment are the adoption of a value-added tax and a reform of the excise taxes). Other recommendations regarding the personal income tax and profits tax serve simplification purposes.

Moving Towards a Value-Added Tax

The introduction of a value-added tax (VAT) which would replace the turnover tax (BBO), tourist levy, general health care contribution (BAZV), and crisis levies would allow Aruba to increase revenue collection from consumption. The mission recommends the introduction of a VAT designed according to best practice: a single rate, the broadest possible base with only a small number of exempt activities, and a threshold that keeps small businesses off the tax roll. Exempting goods and services should not be contemplated, except with respect to government activities, which only government can perform, publicly financed health and education services, margin-based financial services, and the occupation, lease and sale of used residential property by or to Aruban residents. This would permit a low uniform tax rate of 10 percent, which would ease implementation. The mission suggests that the threshold is set at AWG 70,000 without an option of voluntary registration below this threshold. Additional measures should be introduced to restrict refunds: e.g., a deferred payment scheme for imported capital goods and the restriction of refunds to businesses whose exports make up at least 70 percent of total sales.

Simplifying the Personal Income Tax

The personal income tax (PIT) follows a scheduler income concept, i.e., consists of and aggregates four income categories and applies a single progressive rate structure. Many countries around the world have recently introduced a dual income tax (DIT). A DIT separates the taxation of labor and capital income; the latter is subject to a single proportional tax rate (usually

the corporate tax rate). Although various variants exist, these systems typically reduce tax planning opportunities (tax arbitrage) arising from the differential taxation of various forms of capital income, and solve issues related to the allocation of income between labor and capital in proprietorships and closely-held companies.

Aruba's PIT is almost exclusively collected through a wage withholding tax. However, close to three-quarters of all taxpayers file an annual tax return claiming personal deductions and allowances, applying for joint assessment, or reporting non-employment income. A basic personal allowance of AWG 20,455 is granted to all PIT taxpayers. The mission suggests that a modernized PIT should eliminate most of the personal deductions and allowances (e.g., the interest deduction on consumer loans and the deduction for extra-ordinary expenses) and integrate those deductions and allowances in an enhanced basic personal allowance. The current rate structure (2 taxpayer categories, 14 income brackets, and 28 different tax rates) should be simplified. The mission suggests that a new rate structure should have 5 income brackets with the same number of tax rates. The lowest tax rate should preferably equal the corporate income tax rate; however, a slightly lower rate is also possible. Since the current top marginal rate (58.95 percent) is very high, the mission suggests lowering this rate to 50 percent.

Streamlining the Corporate Income tax

The standard corporate income tax (CIT) rate is 25 percent; however, the effective tax rate is substantially lower. Numerous businesses are subject to nominal tax rates varying from 2 percent to 15 percent. Aruba's CIT rate is one of the lowest in the Caribbean. Other Caribbean countries have higher standard rates but apply a myriad of tax holidays. Similar to Aruba, some countries (Bermuda and Bahamas) have recently decided to abolish their tax holidays. The mission opines that abolishing the sector-specific rate structure and reducing the standard tax rate will ultimately be more attractive for investments. Based on macro data that indicate that important economic activities (e.g. tourism) enjoy reduced CIT rates, it believes that a reduced nominal rate of 20 percent would not reduce tax revenues. However, to calibrate a further reduction, careful analysis of taxpayer's micro data is required.

Addressing Externalities Through Excise Duties

It will be difficult to increase the revenue yield of tobacco and alcohol excises but there is substantial room to increase the excises on petroleum products. The tobacco excise on cigarettes is in line with international recommendations. However, specific amounts for fine-cut smoking (roll-your-own), pipe, chewing and snuff tobacco, cigars and cigarillos should be included in the definition of tobacco. Wine should also be excised, and a new excise schedule should be drawn up for all alcoholic beverages. The fuel excises are low compared to other countries and the mission suggests substantial increases in the excises on gasoline, diesel and kerosene. Fuel oil should be made subject to excise, too. The mission also suggests that Aruba consider introducing an excise on sugar, sugar-sweetened beverages, airtime, and plastic bags.

Eliminating or Harmonizing Import Tariffs?

Closer economic integration and greater outward orientation, which promote growth, would require the elimination of trade taxes and their replacement by domestic taxes, preferably broad-based consumption taxes such as VAT, but possibly also excise taxes.

However, based on Aruba's current revenue needs and administrative capacity, the mission suggests retaining the import duties for the time being, but harmonizing the import duty tariff by moving all goods taxed higher than 12 percent to the 12 percent category and all goods taxed at positive rates lower than 6 percent to the 6 percent category, while keeping the 0 percent category as is. Finally, the mission suggests maintaining at this time the current foreign exchange commission, another import duty, since it is a stable and substantial source of revenue.

| Summary of Recommendations | |
|---|--|
| Value-added Tax | |
| When converting and integrating the various taxes on goods and services into an Aruban VAT, the authorities are advised to adopt the broadest possible base, which would permit the lowest possible uniform rate. Exempting goods and services should not be contemplated, except with respect to government activities, which only the government can perform, publicly financed health and education services, margin-based financial services, and the occupation, lease and sale of used residential property (except new property) by or to Aruban residents. | |
| The VAT base should include all goods and services, including foodstuffs, reading materials, pharmaceutical products, public utilities, petroleum products, immovable property (except if used residentially), financial services (except if margin-based), insurance (except health and life insurance), and games of chance. | |
| Impose the VAT at a uniform rate of 10 percent without any differentiation. Do not require retailers to quote the VAT separately. | |
| The new VAT should integrate the taxes in lieu of turnover tax, that is, the tourist levy, the special tax on timeshares, guesthouses and hotel rooms, the real estate transfer tax, and the tax on games of chance. The real estate transfer tax should be confined to transfers of used residential property and other property of persons and entities not registered for VAT purposes. The tax on games of chance should be retained to the extent it represents an externality-correcting excise on gambling and lottery activities. | |
| A threshold of AWG 70,000 should keep most small businesses off the tax roll. A registration option should not be available for businesses whose turnover is AWG 70,000 or less. For charitable, cultural, religious and sporting organizations that operate on a non-profit basis the registration threshold could be put at AWG 140,000. | |
| The need for refunds should be limited by introducing a deferred payment scheme for imported capital goods, by restricting refunds to persons whose sales consist for 70 percent out of exports, and by taking various administrative measures aimed at separating 'good' from 'bad' VAT payers. | |
| Personal Income Tax | |
| Consider adopting a dual income tax (DIT) under which all capital income is taxed entirely separately from labor income and taxed at the proportional rate of 15 percent. Final withholding should be used where possible. | |
| Abolish the 3-percent fixed deductible for employment-related expenses with a maximum of AWG 1,500. | |
| Eliminate the interest deduction on consumer loans and the deduction for extra-ordinary expenses. | |

| |
|---|
| Move the deduction for mortgage interest to the capital income category of the dual income tax, thus limiting the deduction to 15 percent and allow a credit against the tax on labor income if necessary. |
| Use the revenue increase from the elimination and restriction of these personal deductions to increase the basic personal allowance and restructure the tax rates. Apply the basic personal allowance and progressive rate structure only against labor income (business and employment). |
| Abolish the two tax categories and apply one single tax rate scheme for all taxpayers earning labor income. |
| Introduce a presumptive rate of return on equity for proprietorship, partnerships and closely-held companies and deem profits over and above the presumptive profits attributed to equity as labor income subject to the progressive rate schedule. |
| Corporate Income Tax |
| Introduce a reduced standard CIT rate of 20 percent and abolish all profit-based tax incentives (reduced tax rates). |
| Replace the current limitation of deductibility rule for certain cross-border payments by the introduction of a 15 percent withholding tax on potential base erosion payments. |
| Require more detailed transfer pricing documentation for companies with sizeable cross-border transactions, for instance in excess of AWG 10 million per year. |
| Excise Duties |
| Impose appropriate equivalent specific duties on tobacco products other than cigarettes based on tobacco weight or volume. |
| Introduce a comprehensive alcohol excise duty schedule applicable to domestically produced beverages as well as imports. |
| Tax denatured alcohol in full and refund the excise when incorporated in the final product. |
| Convert the import duty on sugar into an excise duty proper and increase it tenfold. |
| Convert the import duty on SSBs into an excise duty proper and also impose it on domestically bottled SSBs. |
| Convert the 57 percent import duty on fireworks into a specific excise duty equivalent to 100 percent of value on high-explosive fireworks but impose lower duties on fireworks with less explosive power. |
| Tax gaming under the proposed VAT and consider an excise duty on lottery tickets, tokens and chips. |
| Introduce a number of specific charges on the use of plastic shopping bags, plastic bottles, aluminum cans, and incandescent light bulbs to discourage their use and encourage recycling through refund mechanisms. Pay out a nominal fee for the return of aluminum cans. |
| Double the excise on sulfur-free gasoline and triple the excise on sulfur-rich gasoline; increase the diesel and kerosene excises fivefold. |
| Design motor vehicle license fees for trucks in line with laden axle weight. |
| Refine the license fees with reference to CO ₂ emissions. |
| Impose the new VAT on the dealer's margin of the sale of second-hand cars. |
| Abolish the import duties on (prepared) oysters and caviar and reduce the duty on mattresses and various other products shown in Table 10 to 12 percent. |
| Introduce a 5 percent excise duty on airtime. |
| Import Duties |
| Do not replace the trade taxes or the foreign exchange commission tax by the VAT at this time. |
| Simplify the import duty tariff by moving all goods taxed higher than 12 percent to the 12 percent category and all goods taxed at positive rates lower than 6 percent to the 6 percent category. Keep the 0 percent category as is. |

I. INTRODUCTION

1. Aruba is recovering from the global financial crisis and a recession in 2015-2016, which affected the important tourism sector. Aruba is a small open economy with high living standards; its per capita income is one of the highest in the Caribbean region. Over 85 percent of the economy depends on tourism, making Aruba vulnerable to external shocks. The temporary slowdown in tourism activity and its fiscal consolidation efforts have led to weak economic activity since mid-2015. A recovery is expected, partly thanks to possible spillover effects from US fiscal expansion, increased demands for shared-economy services, and ongoing public-private investment projects. The political and economic turmoil in Venezuela, however, has a negative impact on this recovery.

2. Aruba maintains a broad range of social safety nets. These include a universal healthcare scheme, pensions, unemployment benefits, transport subsidies, and cash transfers to low-income families and single mothers. The 2017 budget listed 1.2 percent of GDP in transfers to universal healthcare and 1.3 percent of GDP in cash transfers and various social programs.

3. Since the 2015-2016 recession, the Aruban government has pursued fiscal consolidation. However, the deficits built up in the period after the global financial crisis resulted in a public debt of 90 percent of GDP in 2018. As per an agreement between the Aruban government and the Dutch government, represented by the Board of Financial Supervision for Aruba (CAFT), fiscal targets have been set in terms of the overall fiscal balance. Depending on the estimated economic growth, a budget gap of 1.5-2 percent of GDP over the mid-term remains to be covered to meet the overall fiscal goals.

4. The Government has embarked on a reform path, including amongst others a tax reform. Mid-2018, some temporary crisis measures were introduced. The general health care contribution (BAZV) was increased by 1 percentage-point, and a new contribution for funding public-private projects (BAVP) of 1.5 percent on business turnover was introduced. The total tax on business turnover (BBO, including BAZV and BAVP) is currently 6 percent. A substitute turnover tax of 9.5 percent is levied on hotel accommodation (4.75 percent if the price includes board). The government has announced a substantial tax reform, in line with international trends by shifting taxation towards consumption and away from income and profits. In addition, simplification of the current tax system should enhance tax compliance and increase revenues.

5. Aruba's current tax system is based on an older version of the Dutch tax system and lacks a value-added tax (VAT). The tax system dates back to the 1980s or even before and is mainly based on a simplified form of the – at that time – existing Dutch tax system. Over the years it has been modified, partially driven by administrative and political ease (e.g., the introduction of various earmarked contributions based on turnover) rather than sound tax policy arguments. Furthermore, the tax system is interlaced with numerous tax incentives (mainly reduced rates).

Table 1. Aruba: Composition of Tax Revenues (in Percent of GDP)

| | 2016 | 2017 |
|---|-------------|-------------|
| Total Tax Revenue | 31.8 | 32.1 |
| Taxes on Income and Profit | 15.5 | 15.0 |
| Wage tax | 5.5 | 5.7 |
| Income tax | 0.0 | 0.2 |
| Profit tax | 5.0 | 4.1 |
| General Health Care Insurance (AZV) | 5.0 | 5.0 |
| Taxes on Goods and Services | 6.3 | 7.0 |
| Turnover Tax (BBO) | 2.0 | 2.2 |
| General Health Care Contribution (BAZV) | 2.5 | 2.8 |
| Tourist Levy, o.w. | | |
| - Aruba Tourist Agency | 1.6 | 1.8 |
| - Other | 0.2 | 0.2 |
| Excises | 3.8 | 3.9 |
| Excises on gasoline | 1.5 | 1.4 |
| Excises on tobacco | 0.2 | 0.3 |
| Excises on beer | 0.6 | 0.6 |
| Excises on liquor | 0.5 | 0.5 |
| Motor vehicle fees | 0.5 | 0.6 |
| Gambling licenses | 0.5 | 0.5 |
| Taxes on International Trade | 4.6 | 4.5 |
| Import duties | 3.5 | 3.5 |
| Foreign Exchange Tax | 1.1 | 1.0 |
| Taxes on Property | 1.3 | 1.4 |
| Land tax | 0.9 | 1.0 |
| Transfer tax | 0.4 | 0.4 |
| Not Elsewhere classified | 0.3 | 0.3 |

Source: Departamento di Impuesto, Centrale Bank Aruba.

6. With a tax-to-GDP ratio well above 30 percent, Aruban tax revenues are slightly below the average OECD levels, but higher than other Caribbean countries. The average tax-to-GDP ratio for the Caribbean countries is 22.4 percent (2016), whereas for the OECD countries the ratio is 34.4 percent (2016). Table 1. provides a breakdown of the Aruban tax revenues, including the earmarked contributions for social security that are funded through the central budget and therefore characterized as taxes. The USD 10 per foreign passenger arriving at the airport is not included in this breakdown as it accrues directly to the Aruban Tourist Agency (in 2016 this accounted for an additional AWG 20 million or 0.5 percent of GDP). The taxes on income and profit contribute close to half of total revenues, taxes on goods and services about one-fourth, and excise and import duties the remainder.

II. VALUE-ADDED TAX

7. A Value-Added Tax (VAT)—in Aruba called *Belasting over de Toegevoegde Waarde (BTW)*—should become Aruba’s most powerful tax-raising instrument and the workhorse of its revenue effort.¹ To pave the way for the VAT, this section begins by evaluating the current patchwork of taxes, duties and levies on goods and services in Aruba, the general consumption tax proposed by Willem Vermeend, and the 2018/19 measures taken by the Government. Next, the role and design criteria of a *best-practice* VAT are sketched, which are used to reflect on the broad-based consumption taxes in other Caribbean countries. Subsequently, the shortcomings of these taxes and those of the current system form the background for a discussion on the design requirements of a best-practice VAT for Aruba.

A. Current Patchwork of Taxes on Goods and Services

8. The shortcomings of the current patchwork of taxes on goods and services in Aruba are well known. They are summed up below followed by an evaluation of the proposal for a general consumption tax on services, goods continuing to be taxed at import. This proposal is found wanting. More encouraging are the recent measures by the Government, but they are *ad hoc* steps, which should be followed up by a more comprehensive reform of the indirect tax system.

Brief Survey

9. As shown in Table 2, Aruba levies three identical taxes on business turnover: (a) a 1.5 percent basic turnover tax (BBO), (b) a 3 percent turnover tax earmarked to finance the national health insurance scheme (BAZV), increased from 2 percent as of July 2018), and (c) a 1.5 percent crisis tax (BAVP), introduced in July 2018, to finance public-private projects. In 2017, the turnover taxes contributed 7 percent of total tax revenue, which was slightly over 32 percent of GDP.

10. Exemptions, also found elsewhere, apply to health, education, margin-based financial services, life and health insurance, and charitable, cultural, religious and sporting organizations. In addition – and different from what most other countries do – exemptions are provided for the supply of water and electricity and the inputs of the companies providing these utilities. Moreover, large inroads into the turnover tax base are

¹ In various countries the VAT is called Goods and Services Tax (GST) or General Consumption Tax (GCT), but in principle these taxes are all equivalent broad-based consumption taxes.

Table 2. Aruba: Turnover Taxes, Import Duties and Related Levies, 2018

| Type of tax and legislation (as amended) | Base | Exemptions | Rates |
|---|--|---|--|
| DOMESTIC TAXES | | | |
| 1. Tax on business turnover; Belasting op bedrijfsomzetten (BBO – AB 2006 no. 83) | Tax on the consideration received for the supply of goods and services. Goods include water, gas and electricity. Services are all activities against consideration other than the supply of goods. Reverse-charge rule applies to imported services and a fiscal unity concept can be used for fully related companies. | Health services, broadly defined; prescription medicines, medical aids Water, electricity Letting of dwellings, hotel rooms and apartments if tourist levy applies Transfer of real estate if transfer tax applies Publicly financed education Charitable, cultural, religious and sporting organizations if supplies do not exceed Afl. 250.000 Financial services, insurance, pension contributions Gaming if gaming tax applies Refined oil products for sale abroad Fuel for water and electricity companies Free zone companies for sales abroad | 1.5% imposed on cash basis of accounting, but option of accrual basis. The tax does not have to be shown on sale invoices. |
| 2. Earmarked health insurance tax; Bestemmingsheffing AZV (BAZV – AB 2014 no. 59) | Same | Same | 3% imposed on cash basis of accounting, but option of accrual basis. The tax has to be shown on sale invoices. |
| 3. Tax for additional provisions; Belasting additionele voorzieningen PPS-projecten (BAVP); introduced July 1, 2018 | Same | Same | 1.5% imposed on cash basis of accounting, but option of accrual basis. The tax does not have to be shown on sale invoices. |
| 4. Tourist levy; Toeristenheffing (AB 1989 no. GT 40) | Charge for hotel room or similar accommodation; tax base is 50% if charge is all-inclusive. Presumptive bases for time-sharing arrangements: Afl. 179/day for a studio; Afl. 193.95/day for one-bedroom apartment; Afl. 223.75/ for other forms of accommodation. | Residents of Aruba | 9.5% |
| 5. Special tax on time-share resorts, guest houses, and hotels; Bijzondere belasting verblijf in timeshare resorts, logementen en hotels (AB 2013, no. 43) | Specific amounts per form of accommodation | Residents of Aruba | Hotel: Afl. 5.37/night Studio: Afl. 26.85/night One-bedroom apartment: Afl. 26.85 / night Other: Afl. 44.75 / night |
| 6. Real estate transfer tax; Overdrachtsbelasting (AB 1989 no. 73) | Fair market value | Beneficial transfer of ownership (but subject to 6% BBO/BAZV/BAVP) Sale of shares in a real estate company Dwellings transferred to direct heirs or surviving spouses | 3%: value < Afl. 250.000 6%: value > Afl. 250,000 |
| 7. Stamp duty; Zegelverordening (AB 1998 no. GT 1) | Proportional or fixed amount on notarial deeds, deeds by bailiffs, excerpts from the registry of births, deaths and marriages, mortgages, exchanges, lotteries, insurance, deposits | | Various percentages or amounts; 0.2% on mortgages |
| 8. Public auction tax; Verkopingsverordening (AB 1988, no. GT 42) | Proceeds | Ships of at least 20m ³ volume | 6% |
| 9. Gaming license fee and tax; Landsverordening hazardspelen (AB 1990 no. GT 34) | License plus innings | None | License fee: Afl. 5,000/month plus 4% on innings |
| IMPORT DUTIES AND RELATED LEVIES | | | |
| 1. Import tariff; Landsverordening in- uit- en doorvoer (AB 2000 no. GT 10) | Value, unless otherwise indicated | 0% on basic foodstuffs | 12% or 6%; higher duties on luxury goods |
| 2. Foreign exchange commission; Landsverordening deviezenprovisie (AB 1990 no. GT5) | Payments by residents abroad | None | 1.3% |
| 3. Earmarked tax for Aruba Tourism Authority; Landsverordening (AB 2012 no. 29) | Specific amount per arriving airline passenger | Airline personnel | Afl. 17,90 per person |

Source: Aruban legislation and regulations.

made by various levies in lieu of turnover tax, that is, the 9.5 percent tourist levy on hotels and similar forms of accommodation (of which 80 percent is earmarked for the Aruba Tourist Agency), the special presumptively base-graduated tax on hotels, time-share resorts and guest houses, the two-tier real estate transfer tax, and the 4 percent gaming tax. Finally, some turnover-related nuisance taxes, which hardly yield any revenue, such as the public auction tax, have recently been abolished. All taxes are imposed on a cash basis, but there is the option of using the accrual basis of accounting.

11. To complete the picture, the bottom of Table 2 shows the import duties and related levies on internationally traded goods and services. A large range of import duties is levied generally at rates of 6 percent or 12 percent. Many foodstuffs, considered essential, are not subject to import duty (although they do attract turnover tax), while higher rates apply to goods generally considered forms of luxury consumption. (The higher rates are treated as progressivity-enhancing excises in this report – see below.) Further, a 1.3 percent foreign exchange commission is levied on residents transferring monies abroad, while arriving airline-passengers pay a flat USD 10, which is also earmarked for the Aruba Tourism Agency. Arriving cruise ship passengers pay a flat USD 4, which accrues to the Port Authority.

Shortcomings

12. The shortcomings of this patchwork of taxes, duties and levies are quite obvious and can be summed up as follows.

- **By taxing all transactions, turnover taxes cause tax-on-tax or cascading effects, which result in indeterminate and capricious tax-to-price ratios at the consumer level, distorting producer and consumer decisions.** Producers and distributors will integrate their activities to avoid the cascading effect. This will reduce specialization, the hallmark of economic progress. Also, the tax burden on consumers of essential goods becomes more regressive since their value tends to be added early in the production-distribution process (and hence is taxed more often) as opposed to the value of luxury items of consumption. These effects become more worrisome as the aggregated rate, now already 6 percent, increases. In short, turnover taxes do not meet basic tax design criteria relating to neutrality and equal treatment.
- **The cascading effects of turnover taxes tend to be worse if imports are not integrated in the domestic tax base.** Goods are taxed at import and when sold domestically without taking account of the import levy, while services are only taxed when supplied in the domestic market. In other words, goods are taxed more heavily than services, even though services tend to be more income-elastic items of consumption, implying that their incidence is likely to be less regressive than the incidence of taxes on goods.
- **Inherently, turnover taxes cannot be levied on the universally accepted destination principle, which holds that goods and services should be taxed in the country of**

consumption, not the country of production. This is achieved by freeing exports of tax and taxing imports on a par with domestic goods. In view of the turnover tax's unsystematic multistage character, however, it cannot be known how much tax should be refunded at the export stage to put exports on the same competitive footing in foreign markets as domestic products in those markets. By the same token, it cannot be known how much tax should be levied at the import stage to treat imports on a par with similar domestically produced goods. It is precisely for these reasons that five out of six founding member countries of the European Union (EU) substituted their turnover taxes for the VAT (at that time already levied in France) upon the formation of a customs union in 1968.

- **The 9.5 percent tourist levy is imposed on charges for accommodation.** The tax base is halved if the charge is all-inclusive (room and board), presumably because the board is already subject to non-creditable turnover taxes. A far better alternative would be to impose tax on the full charge without distinguishing between room and board as is possible under an appropriately designed VAT. Similar choice distortions arise by applying presumptive bases to time-sharing arrangements and similar forms of accommodation. Basically, presumptive amounts should primarily be used in lieu of actual charges if the verification of turnover is problematic.
- **The relationship of the turnover tax with the real estate transfer tax is murky and subject to avoidance in view of the exemptions for beneficial transfers of ownership, sales of shares in real estate companies, and the transfer of dwellings upon death to surviving spouses.** To prevent ambiguity in the application of the two taxes, the real estate tax should not interact with the general consumption tax.
- **The stamp duty and public auction tax have no place in a modern tax system as the Government has already indicated.** However, it proposes to retain the 0.2 percent stamp duty on mortgages, although the duty discourages home ownership and tends to be regressive as its incidence is on people with little wealth.
- **The proceeds of the BAZV, the tourist levy and the taxes on arrival are earmarked for specific spending purposes, which largely removes the taxes and the corresponding expenditures from annual parliamentary review.**² In other words, past arrangements determine present spending priorities, not a desirable situation. These arrangements will have to be reconsidered upon the introduction of a VAT

² The Aruba Tourist Agency receives AWG 17.90 per transient tourist, 98 percent of the tourist levy paid by timeshare tourists and 80 percent paid by all-inclusive tourists. Further, two percent of the tourist levy paid by timeshare tourists goes to the Tourism Product Enhancement Fund (TPEF), leaving 20 percent of the all-inclusive levy for the government. As a result of these arrangements, ATA collected AWG 79 million in 2017 or 1.6 percent of GDP.

B. Reform Proposal and Recent Measures

13. In 2016, a committee chaired by Willem Vermeend proposed the introduction of a general consumption tax (*uitgavenbelasting*).³ This ill-conceived tax has not been adopted, however. Instead, the Government has taken various *ad hoc* measures to boost revenue.

Vermeend Proposal: Not an Improvement

14. Upon the recommendation of a committee chaired by Willem Vermeend, the Government did draft a proposal to replace the basic turnover tax by an Aruban general consumption tax of 7 percent. Basically, goods would be taxed at import only and not in subsequent stages of production and distribution, while services would be taxed in full when supplied in the domestic market. This is hardly an improvement over the current situation as indicated by the following arguments.

- **Most of the existing distortions and administrative complexities and the inability to provide unambiguous border tax adjustments remain.**
- **To make matters worse, the proposed tax makes an untenable distinction between goods and services.** Many goods can be turned into services and vice versa: renting a car instead of buying it or the other way around. All modern broad-based consumption taxes treat goods and services alike by defining services as all performances against consideration, which are not goods. Indeed, the VAT fully integrates the taxation of services with the taxation of goods – fundamental progress over taxes that try to distinguish between the two.
- **By taxing goods at import only, domestic value added is not taxed, which introduces an unwarranted form of discrimination against services, which are taxed in full at the consumer level.** Within the goods category, the discrimination increases with the degree to which goods are in final form when imported. The economic distortions of this arrangement should not be underestimated.
- **By taxing goods at the import stage only, the incentive to under-declare the value of goods greatly increases in contrast to the situation under a truly general VAT which extends through to the retail stage.** Under a VAT, under-declaration at the import stage to avoid tax would be undone in subsequent stages of production or distribution because the input tax credit would be correspondingly smaller. Under-declaration is least likely at the retail stage, since retailers would shortchange themselves. Under-declarations complicate the application of taxes and duties at the import stage and could be an invitation to engage in collusive practices.

³ See Memorandum (2015), Ontwerp (undated) and Memorie van Toelichting (undated).

- **The proposed tax does nothing to solve the ambiguities vis-à-vis the tourist levy, the special tax on time-share resorts, guesthouses and hotels, and the real estate transfer tax.** Also, it does not deal with the issue of import duties that are higher than 6 or 12 percent.

15. It is rather surprising that the existing set of taxes favors services (only subject to turnover tax) over goods (taxed at import and by turnover tax), while the proposed general consumption tax favors goods (only taxed at import) over services (taxed in full domestically).⁴ There is no reason for this shift in the tax burden distribution. Goods and services should be treated alike; a tax-relevant distinction between them is nearly impossible to make. In short, the proposed general consumption tax is not an improvement over existing arrangements and should be rejected.

Recent Measures

16. To meet the need for more revenue, the Government announced a number of crisis measures in March 2018, which were approved by the Aruban Parliament in May following. These measures included the 1.5 percent turnover tax for Public-Private Sector projects (BAVP) mentioned above – in fact an increase in the basic turnover tax – as well as a 1 percentage point increase in the earmarked turnover tax for financing the national health scheme (BAZV). This means that the aggregated rate of the turnover taxes is now 6 percent.

17. In addition, the following specific measures relating to the taxation of goods and services have been adopted.⁵

- Renting out an asset, including residential premises other than to fellow Arubans, becomes subject to turnover tax bringing most forms of vacation accommodation into the tax base;
- The place of supply for services is the place where the entrepreneur performing the service has his domicile or residence, or a permanent place of establishment from which the service is performed. For telecommunication, radio, television and electronic services, the place of supply will be the place where the recipient of the service lives or resides;

⁴ This is also the case if a VAT is introduced while the import duties would be retained, but over time a VAT offers the opportunity to embed the import duties in its base, which a turnover tax cannot.

⁵ These measures can be found in Deloitte (2018) as amplified in a ministerial resolution of 29 June 2018. Proposed changes to other taxes include the abolition of the inheritance tax and the tax on public auctions, a reduction of deductible interest on residential mortgages from AWG 50,000 to AWG 40,000, the tax-free conversion of pension rights into taxable annuities, a reduction in the lowest income tax rate, and the application of the property transfer tax to immovable property transferred at death. The loss of purchasing power on account of the turnover tax increases has been compensated by increasing the benefits for recipients of old-age and widow and orphan pensions. Further, the AZV contribution for employees is reduced from 10.5 percent to 6.5 percent for a contribution-liable income up to AWG 30,000.

- In specified cases, the Minister of Finance may introduce a reverse-charge which shifts the liability-to-tax from the foreign supplier to the domestic recipient of services;
- The exemption for insurance companies is restricted to pension and life insurance contracts; agent services will be exempted. Under VAT, insurance would be taxed on value added, not turnover; in other words, cascading would not occur.
- The exemption for financial services will not extend to charges for keeping bank accounts or for making money transfers (except foreign exchange); the commission realized on debit and credit card transactions will be exempt. Under VAT, all fee-based financial charges are subject to VAT and the exemption applies only to margin-based services;
- Small non-incorporated businesses whose turnover is AWG 12,000 or less will henceforth be relieved from paying turnover tax, although they are obliged to charge their customers for the tax. In effect then the tax becomes indistinguishable from the amount charged for the supply itself – a rather incomprehensible measure not found elsewhere. Usual practice is to provide a straightforward small-business exemption, more generally called threshold, based on turnover, prohibiting exempt businesses to charge VAT and not allowing them to take credit for the VAT on inputs.

18. Clearly, these measures do not address the basic shortcomings of the turnover tax – fundamental distortion of consumer and producer choices. They are stopgap measures to raise revenue on short notice. Consideration should be given to a more fundamental reform of the whole set of taxes, duties and charges on goods and services, that is, a best practice general consumption tax in the form of a VAT.

C. What is a Best Practice General Consumption Tax?

19. It is time for Aruba to adopt a truly general consumption tax as other countries have done, notably Australia, Canada, New Zealand, Singapore and South Africa, but also various Caribbean countries. The VATs or GSTs of these countries should be studied by Aruba, not the out-of-date European Union (EU) VAT concept. The EU pioneered the VAT and made mistakes because it didn't fully understand the role and workings of the new tax. Newcomers learned from the mistakes and avoided them.⁶

20. To understand how a VAT should be designed, it is instructive to consider its role in the tax system.⁷ The VAT is a tax instrument primarily intended to raise revenues, predictably and efficiently. Unlike excise taxes, it should not aim to change people's behavior – i.e., relative

⁶ For an early critique of the EU VAT, see Cnossen (2004a). Of course, the EU VAT would be useful for aligning various civil law concepts with the VAT.

⁷ For more on the role and nature of a VAT and a comparison with other broad-based consumption taxes, see Cnossen (2009).

prices should remain unchanged – and, unlike import duties, it should not be used to support trade policy. It should also not be used for redistribution or to provide investment incentives like income taxes. The sole goal of a VAT should be revenue, which can be used to finance all manner of social spending, such as healthcare and education that benefit those who pay the VAT. VAT revenues will grow as its base – consumption expenditures – expands with economic development. Properly designed, a VAT is more conducive to economic growth than an income tax.

21. Specifically, a best-practice VAT has the following features.

- **Like the current turnover taxes in Aruba (at least in principle), a true VAT includes all goods and services in its base—unless specifically exempted, solely on administrative grounds.** This implies that the taxation of services is fully integrated with the taxation of goods. A best-practice VAT is also a multistage transactions tax that covers all stages of production and distribution, including the retail stage – as do the current turnover taxes. The VAT registration threshold (sometimes called the small-business exemption) is the criterion for determining whether a business firm or other entity is liable to VAT. The current turnover taxes did not have a threshold before the recent crisis measures.
- **A best-practice VAT is levied at a single, uniform rate on all domestically supplied goods and services.** Exemptions and lower-than-standard rates are frowned upon since they are ill-targeted tools to relieve the VAT burden on lower-income groups or to achieve some other ‘worthy’ purpose. An exemption or zero rate on essential foodstuffs or public utility services complicates administration without providing much relief to the poor. The income tax and particularly the government’s expenditure system are much better means to help the poor.
- **Unlike the current turnover taxes, the VAT eliminates cascading effects by granting taxable firms a full and immediate tax credit or deduction for the tax paid in respect of inputs (purchases) from other taxable firms, against their own VAT payable on sales (output).** In principle, the right to a tax credit arises at the same time that the taxable supplier has to account for the VAT on sales. As a result, no good or service anywhere within the taxable production-distribution chain has VAT attached to it and inventories are held fully free of VAT. In other words, the VAT does not enter the P&L-account of a business (unless the transaction is exempted). This neutrality feature implies that VAT does not interfere with market conditions, since relative prices between goods and services remain unaltered.
- **A VAT – economically equivalent to a retail sales tax – is collected piecemeal throughout the entire production-distribution process.** Although the retailer collects the full VAT from the consumer, he remits only the VAT relating to his own value added to the tax administration. The remaining VAT is paid to his supplier who has invoiced the retailer for the remaining VAT. This is done on the philosophy that a retailer is less likely to default on the VAT which he owes his supplier than on the corresponding retail sales tax which he

would have had to pay to the tax administration had the full tax been imposed at the retailer's level. By the way, the retailer's supplier will go through the same motion with respect to the VAT as the retailer. He will pay the VAT on his own value added to the tax administration and the remainder to his supplier, and so forth until the entire VAT paid by the consumer is accounted for.

- **Unlike the current turnover taxes, the VAT is fully destination-based.** This means that exports are zero-rated (which involves a credit or refund of prior-stage tax) in order to put exporters on the same tax footing in foreign markets as domestic suppliers in those markets. If refunds are not forthcoming or not timely the VAT becomes a tax on investment hampering economic growth. Further, imports should be taxed on a par with domestically produced goods and services. Domestic purchasers of imported goods and services should receive an immediate credit (and refund, if necessary) for the equivalent VAT levied at the import stage. This can also be achieved through a deferred payment or reverse-charge mechanism.
- **A best-practice VAT limits administrative and taxpayer discretion to a minimum.** End-use exemptions – e.g., an exemption for equipment used by fishermen – are frowned upon, as are exemptions for business inputs (including capital goods), products that are subject to another tax, or products bought by, say, government agencies. These exemptions undermine the integrity and functionality of the VAT regime. Taxable suppliers should always charge VAT when they supply goods and services, regardless of the status of the purchaser, leaving it to the purchaser to prove to the tax authorities that he is entitled to a credit or refund of the VAT.
- **The VAT is based on self-assessment.** Like the current turnover tax, this requires that taxable persons file returns and pay VAT (all on line) at their own initiative in accordance with their statutory obligations. It is important, therefore, that the VAT is easy to comply with and that it interferes as little as possible with the free functioning of business and trade. To make this possible, the VAT should be closely attuned to actual business transactions and accounting methods, which would keep the costs of complying with and enforcing the VAT as low as possible. Under a VAT based on self-assessment, the tax administration's task should be confined mainly to providing taxpayer education, monitoring late filers and late payers, and, particularly, auditing taxable persons' accounts.
- **For administrative reasons, the VAT should exclude small businesses from having to file and pay tax (which the turnover taxes do not do systematically).** Small exempt businesses tend to have less reliable books of account; their tax should be confined to the VAT on inputs for which a credit is not available. The definition of what 'small' constitutes, depends on domestic industrial structures and market conditions, among others. Although a VAT is simple to comply with – basically requiring a spike on which sales invoices can be pinned and one to take purchase invoices – full compliance control requires a cash and bank book from which a balance sheet and profit & loss account can be drawn up, so that in-

depth audits can be performed. These accounts may be difficult for small traders to maintain. Hence, these traders should be excluded from VAT, although most countries provide an option to register for small traders who wish to claim credit for input VAT (and charge VAT to their customers).

22. Below, the implications of these best-practice rules for Aruba are given hand and feet. But first the broad-based consumption taxes, mostly called VATs, in other Caribbean countries are reviewed and evaluated. The review has important lessons, not to be ignored, for Aruba regarding what to do and what not to do in designing and administering the new VAT.

D. Caribbean Experience or How Not to Design a VAT

23. Nearly all Caribbean countries have introduced a VAT (also called General Consumption Tax or Goods and Services Tax by some countries) in the past 20 years or so. Jamaica was the first country that attempted to modernize its outdated system of taxes on goods and services by adopting a General Consumption Tax in 1991, soon followed by several other countries in the region, most lately Saint Lucia in 2012. Grenada and Belize introduced and repealed a VAT in the past before settling on their current VAT version. Anguilla and Surinam are also planning to introduce a VAT.

24. As shown in Table 3, the VATs that have been implemented are anything but best-practice VATs. Presumably in view of their Anglophone tax heritage, all countries apply zero rates to basic foodstuffs, agricultural inputs, water, electricity, medicines and other items of domestic consumption. Further, these countries have non-standard exemptions for similar or other goods and services in addition to the standard exemptions found in many countries for health, education, social services, finance, insurance, and games of chance. These inroads in the VAT base necessitate a higher standard rate to collect the same amount of revenue that would have been collected in the absence of base concessions. In turn, the higher standard rate is considered too high for the tourist sector, which means that hotels, restaurants and tourism activities are taxed at a lower-than-standard rate. All of these infringements on the criteria of a best practice VAT greatly complicate the administration and compliance with the VAT.⁸

⁸ Apparently, Curaçao has introduced some VAT elements into its turnover tax by levying the tax at import but providing a credit for it in domestic stages of production and distribution or by exempting specified imports from the turnover tax.

Table 3. Caribbean Countries: Broad-based Taxes on Goods and Services, 2018

| Country (year of introduction) | Standard rate | Positive reduced rates | Base erosion | | Coverage | | Number of taxpayers (2013) | Comments |
|---------------------------------|---------------|--|---|---|---------------------------------|------------------|----------------------------|--|
| | | | Zero-rates other than on exports (not exhaustive) | Non-standard exemptions ^a (not exhaustive) | Threshold | | | |
| | | | | | National | US\$ | | |
| Antigua & Barbuda (2007) | 15 | 12.5 (hotels) | Basic food items; water, electricity for residential use; construction and sales of new residential premises; fuel | Local transport | 300,000 | 111,000 | .. | |
| Bahamas (2015) | 12 | - | Specified food items; soap, detergents; medicines; residential electricity bills at or under BSD100 and water bills at or under BSD50 | Margin-based financial services; life insurance, annuities and savings products; residential property insurance | 200,000 | 200,000 | 6,710 | 4.5% presumptive tax in lieu of VAT |
| Barbados (1997) | 17.5 | 7.5 (hotels, tourism) | Staple food items, agricultural inputs; water and sewerage; prescription drugs, veterinary services; educational or scientific literature; real estate; crude oil; imported inputs for manufacturing | Public postal services; transportation; betting and gambling | 200,000 | 100,000 | 6,000 | 22% on mobile services. No option to tax for exempt supplies |
| Belize (2006) | 12.5 | - | Specified unprocessed and processed foodstuffs, feed, seed, fertilizers, other agricultural inputs; water (other than bottled water), medicines; butane gas; educational items; stoves, refrigerators, washing machines | Locally produced fruit concentrate; accommodation in hotels, etc.; electricity up to \$150 / month; margin-based financial services; public postal services; public transport, tour operators | 75,000 | 37,300 | 4,062 | |
| Dominica (2006) | 15 | 10 (hotels, diving) | Flour, milk, rice, sugar, feed, seed, fertilizer, agricultural machinery, fishing inputs; invalid carriages; first 50 units of electricity | Bread, water, unprocessed agricultural products sold by producer; transportation; printed matter; games of chance | 250,000 | 92,500 | - | |
| Grenada (2010) | 16 | 10 | Flour, sugar, rice, milk, infant preparations; water up to 2,900 gallons, electricity up to 99 kw/hrs.; postal stamps | Unprocessed agricultural products sold by producer, fishing inputs; passenger transportation; betting and gambling | 300,000 | 111,000 | 824 | |
| Guyana (2007) | 14 | - | Specified food items, agricultural and fishing inputs; matches, soap, dental hygiene, toilet paper; educational materials; locally produced construction materials; old cars, computers, packaging materials, sewing machines | Kerosene, propane gas, gasoline, diesel; locally mined gold or diamonds | 15m | 71,800 | 2,623 | |
| Jamaica (1991) | 16.5 | 10 (tourism); 25 (airtime) | Agricultural and fishing inputs; printed materials; religious items; educational materials and equipment; electricity for residential use | Basic food items, water; prescription drugs, specified medical supplies, sanitary towels; electricity; sporting equipment; printed materials; margin-based financial services; specified construction and transportation services; postal services; colored gasoline for fishing purposes | 3m | 19,300 | 14,000 | Additional 5% advance tax on commercial imports |
| St. Kitts & Nevis (2010) | 17 | 10 (hotels, restaurants, tour operators) | Bread, sugar, flour, infant formula, oats; diapers; gasoline, kerosene, diesel; real property subject to stamp duty | Most foods (except if prepared or served as a meal), locally produced agricultural products, agricultural inputs; water, electricity; medicines, medical goods; newspapers, books; transportation; basic construction services | 150,000 96,000 (professions) | 55,500 35,500 | .. | |
| St. Lucia (2012) | 12.5 | 10 (hotels) | Eggs, pasta; water; electricity; fuel | Rice, chicken, flour, bread, milk; toilet paper, medical supplies; postal services; local transportation; agricultural and fishing inputs; betting and gambling | 400,000 | 148,000 | 1,496 | No option to tax for exempt supplies |
| St. Vincent & Grenadines (2007) | 15 | 10 | Rice, sugar, milk chicken, turkey, , wheat flour, baby food; 200 kw/month electricity, fuel; newspapers, exercise books; computers | | 300,000 | 111,000 | .. | |
| Trinidad & Tobago (1990) | 12.5 | - | Basic food items, agricultural supplies, water; hotels; medicines, inputs for pharmaceuticals; books; electric vehicles; natural gas, crude oil; industrial free zones, yachting services | Bus and taxi services; real estate brokerage; public postal services, gambling and lotteries | 500,000 | 74,200 | 20,000 | 15% transaction tax on specific financial services |

Source: Country legislation

25. The administrative burden of the Caribbean VATs is reduced by excluding small businesses from the VAT's obligations through a generous threshold, which – on average USD 100,000 – ranges from a low USD 19,300 in Jamaica to a high USD 200,000 in the Bahamas. At least two countries, Barbados and St. Lucia, seem not to permit businesses whose turnover is below the threshold to opt for registration and payment of VAT, which should reduce the number of refund claims. Refunds can also be minimized by exempting, zero-rating, or reverse-charging manufacturing inputs, particularly capital goods, at import as various countries do. In the event, no credit (and potential refund) needs to be permitted for the tax on these goods in domestic stages of production or distribution. Noteworthy is further that the Bahamas has a 4.5 percent presumptive turnover tax in lieu of VAT (payable in addition to the VAT on inputs) and that Jamaica imposes an additional 5 percent advance tax (in addition to the 16.5 percent standard rate) on commercial imports.

26. Table 4 shows the revenue yields of the various VATs in the Caribbean, along with those of the excises and the trade taxes (mainly import duties), all expressed as a percentage of GDP. Barbados collects 10.6 percent of GDP in VAT revenue (including the revenue from the higher rate on mobile services), which is a notable achievement, compared with 5.2 percent by Jamaica. The relative yield of trade taxes in the latter country is rather high, perhaps because the advance tax is booked as trade tax. Overall, VATs contribute some one-third to total tax revenue, but trade taxes – easy tax handles but highly distortionary, among others because they apply to goods only – are still important, too. This is also true with respect to the non-VAT countries, Anguilla and Aruba, in the Caribbean.

27. The last column of Table 4 shows the C-efficiencies of the various VATs.⁹ As is well known, C-efficiency is defined as actual VAT collections expressed as a percentage of total consumption expenditures divided by the standard rate. In other words, the C-efficiency of a VAT that would tax all consumption at a single rate would be one. Most Caribbean countries come nowhere near that standard, although the Bahamas does rather well with 0.80 (no doubt including the revenue from the 4.5% presumptive turnover tax, not really a VAT). This contrasts with the rather low C-efficiencies in Guyana, Jamaica, Dominica, and Trinidad & Tobago. The gap between one and the actual C-efficiency can be attributed to the VAT policy gap (exemptions, zero-rates other than on exports, lower-than-standard rates, and thresholds), and to the VAT compliance gap (the difference between actual VAT collections and the VAT that would be collected if the actual VAT would have been fully complied with). As suggested by Table 4, the VAT policy gap is large in most Caribbean countries. Reportedly, the compliance gap also needs to be narrowed.¹⁰

⁹ For more on the definition, characteristics and pitfalls of C-efficiencies, see Keen (2013).

¹⁰ For measuring the C-efficiency in developed countries, see Ueda (2017). For compliance problems in Caribbean countries, see Schlotterbeck (2017).

Table 4. Caribbean Countries: Revenues from Broad-based Taxes on Goods and Services as % of GDP, 2014

| VAT countries | Total tax | VAT | Excises | Trade taxes | C-efficiency |
|-----------------------|-----------|--------------|---------|-------------|--------------|
| Antigua & Barbuda | 16.5 | 0.9 | 6.8 | 6.0 | 0.52 |
| Bahamas | 19.2 | 7.2 | 2.3 | 7.3 | 0.80 |
| Barbados | 27.1 | 10.6 | 3.5 | 2.7 | 0.74 |
| Belize | 23.4 | 9.6 | .. | 5.5 | .. |
| Dominica | 22.1 | 9.2 | 2.6 | 4.4 | 0.66 |
| Grenada | 19.4 | 7.2 | 1.6 | 6.1 | 0.48 |
| Guyana | .. | .. | .. | .. | 0.37 |
| Jamaica | 26.1 | 5.2 | 1.9 | 9.9 | 0.47 |
| St. Kitts & Nevis | 20.4 | 6.0 | 4.5 | 3.7 | 0.67 |
| St. Lucia | 20.4 | 7.7 | 1.4 | 5.8 | 0.36 |
| St. Vincent & Grenada | .. | .. | .. | .. | 0.53 |
| Trinidad & Tobago | .. | .. | .. | .. | 0.43 |
| Regional Average | | | | | 0.54 |
| | | | | | |
| Non-VAT countries | Total tax | Turnover tax | Excises | Trade taxes | |
| Anguilla | 18.6 | 5.0 | 1.9 | 9.6 | - |
| Aruba | 31.8 | 6.3 | 3.8 | 4.6 | - |

Source: IMF, Government Finance Statistics, *Yearbook 2017*, Table 1. Data relate to 2016 for Bahamas and Jamaica, and to 2015 for Barbados. Excises include the difference between revenue from Taxes on Goods and Services, and Excises. Trade Taxes include Taxes, n.e.c, if any. Mid-2013 C-efficiencies are from Schlotterbeck (2017), Table 11. Data for Aruba are drawn from Table 1.

28. The Caribbean VATs have recently been reviewed by Schlotterbeck (2017). The author notes that the VAT has been a driving force in the modernization of tax systems and has resulted in noticeable increases in revenue, albeit tapering off in later years. In the author's opinion, VAT has not reached its full potential and sight has been lost of its revenue-efficiency generating role. Initially, Caribbean countries intended to introduce broad-based VATs with few concessions, but as illustrated by the experience in Barbados, Belize, Grenada, Guyana, St. Kitts & Nevis, and St. Lucia, amendments to the original bills punched deep holes in the potential base. In Belize and Guyana, zero-rated supplies now account for 44.2 percent and 52.5 percent, respectively, of taxable supplies. In Antigua and Barbuda, 64 percent of all sales are either zero-rated or exempt and 50 percent of imports are not subject to VAT. A study for Jamaica estimates the VAT policy gap at 5-6 percent of GDP. Schlotterbeck cites literature noting that the average VAT concessions in the Caribbean can be estimated at 2.6 percent of GDP. This is not how a VAT should be designed if it is to be the government's main revenue-raising instrument.

29. At the same time, compliance management has weakened in Caribbean countries since the introduction of VAT, as shown by deteriorating filing rates and reporting accuracy.

According to Schlotterbeck (2017), improvements to the current structure are required to turn the VATs into simple, non-distortionary, revenue-efficient taxes. Broadening the tax base is one of the main directions to take. Clearly, the experience with VAT in most Caribbean countries is not encouraging for Aruba, primarily because the body politic in these countries has not been able to show enough backbone to keep it simple. A second round of fundamental VAT reform is required. The Bahamas have been leading the way, although their VAT is still anything but a best-practice tax after the recent reform. Aruba can avoid the second round if it introduces a best practice from the start, mindful that mistakes made at the time of the VAT's introduction are very hard to undo (Keen, 2009).

E. Designing a VAT for Aruba

30. This section starts by briefly outlining the *leitmotiv* for introducing a broad-based single rate VAT in Aruba. Next, it reviews the arguments for the fullest possible inclusion of various goods and services in the base, which are often the subject of discussion elsewhere. The concluding section sums up the major desirable design characteristics of an Aruban VAT.

Leitmotiv

31. In designing its VAT, Aruba should be advised to learn from the experience of other Caribbean countries and avoid the mistakes that they made in considering the adoption of a VAT or GST. The integrity and functionality of their VATs is seriously violated by zero rates and exemptions for a large number of domestically consumed goods and services and lower-than-standard rates on hotels and tourist-related activities. While this may be understandable in countries at a much lower level of economic development, the mistakes are not acceptable for a high middle-income country like Aruba, which has other instruments, such as the income tax and the social benefit system, at its disposal to deal with changes in the tax burden distribution.

32. The following reasons, supported by empirical analysis, for avoiding exemptions are found in the tax literature.¹¹ To summarize, exemptions:

- distort input choice (exempt entities will buy products that bear a lower VAT, although not indicated by non-tax reasons);
- disincentivize investment (because investments are postponed, or second-hand equipment is purchased);

¹¹ For general references, see Ebrill et al (2001), Bird and Gendron (2007), and Schenk, Thuronyi, and Cui (2015).

- hamper outsourcing (providing, say, laundry, cleaning, food, administrative and protection services in-house is cheaper than buying them from taxable businesses);
- distort competition (because other taxable entities cannot provide similar goods or services at the same price);
- favor imports (because they enter the country free of tax, while similar domestically produced goods and services bear input VAT on purchases from exempt businesses) and discriminate against exports (because it is not possible to relieve them of tax on purchases from exempt businesses); and
- complicate input VAT allocation (if the exempt entity also supplies taxable goods and services).

33. On the basis of these arguments, the *leitmotiv* in designing Aruba's VAT should be to tax all goods and services at a single, uniform rate of 10 percent.¹² Equally, all imports should be taxed at that rate but a credit for the import VAT should be provided in domestic stages of production and distribution if eligible for it. Taxes that are now levied in lieu of turnover tax, such as the tourist levy, the real estate transfer tax and the gaming tax, should be integrated with the VAT to the extent possible. If there are grounds for taxing some goods and services differentially higher, excise duties should be employed to do so. To keep the administration of the new tax manageable, the threshold should be high enough to exclude most small businesses from having to comply with the new tax, although they would pay tax on inputs, of course, for which no credit or refund would be available on account of the exempt status of small businesses.

34. In principle, the VAT should be levied on an accrual basis of accounting; after all, the invoice is presumptive proof that registered businesses are entitled to a credit for the tax on inputs, not the cash payment.¹³ If these conditions are met, the rate of Aruba's VAT need not be higher than 10 percent (as discussed below, shortfalls from revenue targets, if any, should be made up by the excise duties), which broadly accords with the current overall effective tax rate on most goods and services. Incidentally, the revenue yield of the new VAT would be higher because the base would be broader. The new tax would also be much less distortive and simpler to administer and comply with than the current patchwork of taxes on goods and services. In other words, compliance and administrative costs (also forms of taxation!) should be lower than current costs.

¹² The majority of the countries that have adopted a general consumption tax in the last 30 years have opted for a single rate (in contrast to the multiple-rate structures that used to be common in the EU), arguing that the tax is mainly a revenue-raising instrument.

¹³ Subject to administrative approval, the cash basis of accounting might be permitted for supermarkets, which sell against cash, as is done in the Netherlands.

Foodstuffs

35. It is not advisable to exempt (let alone zero rate) essential foodstuffs since this will require a higher rate on other goods and services, which magnifies economic distortions and administrative complexities. Taxing foodstuffs uniformly also obviates the need to make a distinction between food provided on premise in hotels and restaurants, which should presumably be taxed in full and off premise food prepared at home. Moreover, there is persuasive evidence that, with some exceptions, the exemption of foodstuffs benefits the non-poor more in monetary terms.¹⁴ This is because they buy more expensive varieties of food, eat out more often and tend to throw away more food. In Aruba, high-income classes spend 43 percent more on food and nonalcoholic beverages than low-income classes.¹⁵ Accordingly, they would benefit 43 percent more in monetary terms from a zero rate or exemption. Taxing food and nonalcoholic beverages at the standard rate would raise an amount of revenue that would be much higher than would be required to compensate low income classes for the loss of purchasing power, leaving surplus revenues that can be spent for other purposes.

36. The case against exempting (or zero rating) foodstuffs has been thoroughly documented in the tax literature. In South Africa, for instance, the share of VAT savings attributable to zero-rated foodstuffs has been found to rise sharply as expenditure increases across expenditure groups. A report by the South African Katz Commission (1994, p. 117) poignantly concluded, that “providing relief to the poor through exemptions and VAT zero rating is likely to be both unsound tax policy and ineffective social policy.” This conclusion, very much applicable to Aruba, is confirmed by several VAT burden distribution studies for other developed as well as developing countries.¹⁶ It is much better to use the income tax and the social benefit system to help the poor, as Aruba has recently done when introducing the crisis package.

37. The tax reform should also be used to integrate the tourist levy and the special tax on timesharing, guesthouses and hotels into the VAT. Under the VAT, the rent of all forms of accommodation (except residential premises used by owner-occupiers or rented out to Aruban residents) would be taxed at the proposed rate of 10 percent, as would the provision of food, cleaning, administrative, and security services. The current practice of applying the tourist levy to 50 percent of all-inclusive accommodation rates because foodstuffs are subject to turnover tax should be abandoned because food would now only be subject to VAT. Of course, hotels offering all-inclusive prices for their rooms would be entitled to a credit for the tax on food purchases and other inputs, as would hotels that charge separately for food purchases and other amenities.

¹⁴ For the Netherlands, Bettendorf and Cnossen (2015) calculated that middle-income consumers benefited nearly twice as much from the lower rate on foodstuffs than lower income consumers.

¹⁵ See Table B.1. in CBS (2008).

¹⁶ For references, see Cnossen (1999, 2004) and Bird and Gendron (2007).

Public Utilities

38. Similar arguments can be brought to the fore for bringing water and electricity into the VAT base, which are exempted under the current turnover tax. Nearly all countries, in the EU¹⁷ and elsewhere, particularly if they have a modern VAT, tax these products. The exemption is understandable in countries at a low level of economic development, but not in an upper middle-income country, such as Aruba. Moreover, not taxing the services of public utilities would disproportionately benefit the rich who use large amounts of water to fill their swimming pools or large amounts of electricity to cool their premises.¹⁸ Likewise, Aruba should not contemplate an exemption for public transport, which has also been shown to exhibit a regressively distributed VAT benefit pattern, regardless of the mode of transport.¹⁹

39. In Aruba, public utility services are provided through government-owned enterprises and the prices of their products and services are administered prices. Therefore, there seems to be little reason to use the VAT to raise revenue for general purposes through public utilities. It may be thought that, after all, the surplus income of the public utilities, if any, will be transferred to the government budget anyway. This argument is wrong. Although the effects of the VAT can be exactly replicated by manipulating the price of the products, inclusion in the VAT base provides for more even-handed treatment and enables business customers to obtain credit for VAT paid on purchases of public utility services. Further, there is a presumption that government-owned enterprises will be more forthcoming in remitting the VAT that they have charged their clients to the tax administration than in transferring their surplus income, which is usually ascertained sometime after the close of the fiscal year. This process is less transparent than what a well-functioning broad-based VAT achieves.

Petroleum Products

40. Further, some countries exempt petroleum products since they are subject to an excise duty. However, the argument that applying the VAT as well is tantamount to double taxation confuses objectives and instruments. The objective of the excise is to account for the (substantial) external costs that attend the use or consumption of petroleum products. These costs should be internalized in the price; they are not different from, say, production or distribution costs. As a revenue instrument, the VAT should then be imposed on the excise-inclusive price of petroleum products so that relative prices vis-à-vis other taxable goods and services do not change. (Further, at import, the VAT should be applied to the import and excise duty inclusive price.)

¹⁷ See Annex D to the Common VAT Directive (2006).

¹⁸ Some Caribbean countries (see Table 2) provide a social exemption (tranche) for water and electricity. This concession is also found in various francophone African countries, where it has been hard to administer properly (Cnossen, 2015). Accordingly, it is not favored.

¹⁹ For evidence, see National Treasury of South Africa (2011).

Reading Materials and Cultural Services

41. Reading materials are often exempted, too, although they are income-elastic items of consumption; the rich benefit more from the exemption than the poor. Moreover, they compete with taxable forms of information dissemination. On the whole, the income elasticity of the consumption of cultural goods and services makes it difficult to justify exemptions on distributional grounds. It is also difficult to justify the exemption on externality grounds. Best practice is therefore to tax such goods and services fully, unless provided on an amateur, non-profit basis.

Immovable Property

42. Obviously, it is not possible, administratively and politically, to tax the rental value or sale of owner-occupied dwellings and, by extension, the rent of residential premises occupied by Aruban residents. For this reason, the EU countries exempt immovable property, but tax the sale of new buildings as a proxy for the VAT on the services that the buildings will render over their lifetime. In addition, there is usually an option to be taxed with regard to non-residential buildings, obviously with a credit for the tax on new buildings. By contrast, best-practice VAT countries always tax the sale and leasing of non-residential buildings, but exempt rental values, rents and sales of used residential premises. The two approaches yield the same result if, in the EU, VAT registered persons would all use the option of registration and payment of tax. This is not the case, however, and is the reason for preferring the best-practice approach, which provides for a fuller inclusion of immovable property in the VAT base because future increases in value, will also be taxed.²⁰

43. In Aruba sales of immovable property are not subject to turnover tax if the graduated real estate transfer tax applies. This involves much ambiguity; particularly since the transfer tax exempts various transactions. It would be better therefore to confine the transfer tax to transfers of immovable property between persons and entities not registered for VAT, while the VAT would apply to sales of all non-residential property by registered persons.²¹ Further, sales of building materials (exempted or zero-rated in various countries) and repair and maintenance services should always be fully taxable (subject to the registration threshold). So should social housing, although the higher tax could be compensated by a replacing subsidy. This would separate tax policy from social policy. Taxing immovable property more fully would most likely mitigate the regressive impact of the VAT, since housing is an income-elastic item of consumption.

Financial Services

44. Most countries exempt all financial services (as does the EU), whether fee- or margin-based. In contrast to fee-based financial services, margin-based services are difficult to tax under a

²⁰ For more on the taxation of immovable property taking the EU as example, see Cnossen (2011)

²¹ In the event, the exemption for the sale of shares in a company holding residential property and of the transfer of the beneficial ownership of immovable property should be withdrawn on the argument that economic ownership has been transferred; hence, tax should be levied.

tax credit method VAT, because the value of the intermediation charge (which should be taxed) is embedded in interest rates, returns, or rewards (which should not be taxed), and hence cannot be attributed to customers on a transaction-by-transaction basis – necessary if VAT-liable customers are to credit the tax against their VAT on output.

45. By contrast, fee-based services can be taxed without further ado, as is done in countries with best practice VATs, such as, for instance, Mauritius and South Africa. In the Caribbean, the Bahamas tax fee-based financial services. In line with its recent proposals, it is strongly recommended that Aruba consider taxing all explicit financial fees and commissions, too (by enumerating them in the law), and confining the exemption to margin-based services. Revenue would benefit, particularly since most financial services are fee-based and because disintermediation has made it less likely that substitution by margin-based services will occur. In due course, consideration could be given to allowing partial formula-based recovery of input VAT incurred in rendering business-to-business (B2B) margin services, which would alleviate cascading problems.²²

Property and Casualty Insurance

46. Like banking services, all insurance is exempted from VAT in EU countries, again because the taxable intermediation charge cannot be separated from the non-taxable capital contribution to the common pool. Instead, most countries subject insurance premiums to anachronistic, cascading insurance taxes or stamp duties. In New Zealand's footsteps, best-practice VAT countries, however, have pioneered a solution under which the value added of property and casualty insurance is taxed in a roundabout fashion by imposing VAT on insurance premiums (and, of course, permitting a credit for the VAT on insurance companies' taxable inputs), which is creditable by VAT-liable clients, and imputing a tax credit to indemnity payments. The VAT-liable entity receiving the payment is obliged to include in its VAT return the tax credit that is included in the indemnity payment, while an individual recipient will pay VAT on the replacement asset (or keep his capital intact).²³

47. While property and casualty insurance can thus be taxed, health and life insurance should probably remain exempt. For VAT purposes, health insurance would then be treated in the same way as other exempt health services, while life insurance – a long-term savings vehicle – would be exempted along with other financial business-to-consumer (B2C) margin-based services. Moreover, both forms of insurance are mostly taken out by individuals; hence, cascading effects are unlikely to occur. This treatment of insurance is in line with recent government measures to tax insurance premiums but improves on the measure for doing so on a value added rather than turnover basis.

²² The taxation of financial services is lucidly treated in Poddar (2003).

²³ For a full treatment of including property and casualty insurance under the VAT, see Cnossen (2013).

Lotteries and Gambling

48. Following EU practice, most countries exempt games of chance from VAT. In contrast, countries with a best-practice VAT, such as New Zealand, Singapore, and South Africa, tax most games of chance. Lotteries can be taxed on ticket sales (output), while a reverse charge can be imputed to payouts (inputs), similar to the best-practice VAT treatment of property and casualty insurance. The value added of the lottery industry would thus be taxed after providing a credit for the VAT on inputs, in addition to the VAT on payouts, against the gross tax liability. Gambling can be included in the VAT base under the margin method, where the margin is the difference between the sales of tokens and chips, on the one hand, and payouts, on the other. Again, a credit for VAT on other inputs, such as the provision of food or the awarding of (in-kind) prizes, should be allowed against the tax liability. Applying VAT implies that food and other services provided by gaming establishment do not have to be separated from the exempt payouts.²⁴ It should be noted that VAT should be applied to transactions involving games of chance, regardless of whether or not lotteries and gambling are subject to externality-correcting excises.

Government and Its Agencies

49. In the EU, public bodies are effectively exempt by considering them out-of-scope of the VAT, subject to some potentially tortuous provisos that they should be governed by public law, that they should be operated under public authority, and that their activities should not involve significant distortions of competition. Although their taxation would largely be in the nature of a pay-out and claw-back arrangement, nevertheless, the VAT on their inputs causes the same non-neutralities and complexities as occur under other exemptions: distortion of input choice, self-supply bias, unfair competition, and tax avoidance. In principle, the taxation of as many supplies by public bodies as possible promotes simplicity, accountability, transparency, and the workings of the VAT. Distortions of input and outsourcing choices are reduced and so are administrative costs because the VAT on taxable purchases does not have to be allocated between taxable and exempt supplies. Although public bodies do not pursue profit maximization, cost minimization should be their aim and this goal is promoted by applying the VAT as widely as possible.²⁵

50. Accordingly, the best advice would be to tax public bodies as Australia and New Zealand do, while Canada (a federal country with provincial GSTs) avoids the distortions by refunding the tax on inputs. However, this might be considered a bridge too far for Aruba, particularly since it presupposes reforms on the expenditure side of the budget. For the time being, therefore, Aruba should exempt the services of public bodies, unless their services can also be performed by private sector entities. In addition, various activities should be taxed as fully as possible, such as public broadcasting, public postal services, admissions to museums, parks, and

²⁴ See Schenk (2010) for a fuller treatment of the VAT on lotteries and gambling.

²⁵ See Gendron (2013).

nature reserves, the sale of licenses and permits, waste disposal, and rentals of public facilities for conferences, concerts, and sporting events.

51. In some instances, there might be arguments on what constitutes a public body. One way to avoid these arguments is to give the Minister of Finance the authority to designate the economic activities of public entities (as well as welfare organizations and public-private partnerships) as 'enterprise' activities for supplies in competition with private sector supplies, which would make them taxable. This is what Canada and South Africa do. Public utilities in these countries have to register for VAT purposes and are even deemed to supply a taxable service for grants or subsidies received from public authorities, which are taxed at the standard rate. The use of the enterprise concept bypasses the difficulty of determining whether or not supplies are made in actual or potential competition with the private sector.

Healthcare, Education, and Social Services

52. Health, education and social services are often called 'merit goods', whose consumption should not be constrained by the imposition of VAT. But even if the merit-good argument is acknowledged, full taxation (inclusive of subsidies, if any) in combination with increased subsidies could leave the total net amount of the (VAT-inclusive) charge for the service unaffected without distorting the exempt entity's input choices and outsourcing policies and without discriminating against similar taxable services provided by the private sector (which should then also be subsidized). Best-practice VATs therefore tax most of these services, albeit sometimes at a zero rate, which alleviates the distortions, except the competitive edge vis-à-vis the private sector, which may be aggravated.

53. But, as in the case of governments, the best may again be the enemy of the good. Since, in Aruba, health and education are politically sensitive areas whose taxation would be difficult to explain to the public, it probably makes sense to maintain the exemption on supplies in these sectors. Even in this context, though, various exemption-narrowing measures could be considered – e.g. regarding over-the-counter pharmaceuticals. In essence, the poor derive limited benefits from preferential VAT treatment of medical products, because most are largely unaffordable or of a low priority to them, and exemption or zero-rating would not save the poor the VAT if they can access medical services and medicines free through the public health system, as is the case in Aruba.

54. Higher-income groups benefit disproportionately from the exemption for education. The exemption, moreover, causes administrative complications when exempt institutions of higher learning are engaged in taxable activities, such as research and the sale of books, whose taxation requires the apportionment of input tax. At present, however, full taxation seems a bridge too far. Obviously, food services provided by educational (and other) establishments should be taxed, unless the turnover is below the threshold.

55. Finally, for charitable, cultural, religious and sporting organizations, best practice, as in Canada for instance, is to prescribe an exemption that is twice as large as the general threshold. For Aruba, this would be around AWG 140,000, subject to a provision that these entities cannot operate canteens with a turnover in excess of AWG 70,000.

F. Administering the VAT in Aruba

Threshold Considerations

56. The single most important measure Aruba can take to 'assist' small businesses for VAT purposes is to set a fairly high, single registration threshold. If the rule of thumb that at least 80 percent of VAT is collected from 20 percent of all businesses is correct, as it seems to be, then Aruba should be advised to have a threshold equivalent to at least AWG 70,000. According to an analysis of 13,237 BBO returns, this would account for more than 90 percent of all aggregated turnover. The high threshold is advised because there are often sharply diminishing returns to adding smaller firms in terms of additional revenue collected over and above the VAT on their taxable inputs. However, increasing the threshold further would invite businesses to split up their operations into separate taxable units, each with a turnover below the threshold.

57. A high, undifferentiated threshold implies that the VAT administration can concentrate its efforts on large taxpayers and that small businesses are not bothered by the taxman.

Although many countries permit voluntary registration for small businesses whose turnover is below the threshold, this report recommends that Aruba should not get bogged down in dealing with small businesses filing returns, requesting refunds, etc. Accordingly, exempt small businesses should not be allowed to register for VAT purposes. Threshold differentiation for services, which increases administrative complexity, is not recommended either. This applies also to presumptive taxation schemes, which yield little revenue, involve undue discretion, and are a nuisance for small businesses (which, being exempted, pay VAT on taxable inputs anyway).

58. The high threshold implies, however, that various timeshare resorts, guest houses and similar forms of accommodation would be exempted from VAT even though the rent for the accommodation is nearly pure value added (and income) in the absence of much input. This would be a revenue costly breach of the VAT-base. Accordingly, it is recommended that the special tax on vacation accommodation, expressed as a percentage of a presumptive base per kind of accommodation, should be retained for businesses/entrepreneurs which are not subject to VAT.

Refunds

59. Refunds, called excess VAT, are the Achilles heel of the VAT elsewhere. There are a number of ways, however, in which the need for refunds can be limited.

- **Aruba should not allow refunds for exempt small businesses whose turnover does not exceed AWG 70,000.** Small businesses tend to keep inadequate accounts and controlling their

compliance would be difficult therefore. Similar provisions are found in various other countries; South Africa is an example.

- **Excess VAT should not be refunded with respect to non-zero rated supplies, but should be carried forward for offset against future VAT liabilities.** Zero rated supplies occur if the claimant exports zero-rated goods and services on a continuous basis and if the zero-rated supplies account for at least 70 percent of total taxable sales in the tax period in which the zero-rated supplies occur.
- **Perhaps the most important measure to reduce refund claims is to introduce a reverse charge system for imported capital goods.** It is essential that this scheme allow a 100 percent input tax credit for any VAT reverse charged on imported capital goods. Genuine reverse charging (that is, the charge to and credit for VAT, which the importing VAT registrant both lists in the same return) would result in a zero VAT liability on imported capital goods and would largely obviate the need for subsequent refunds. Essentially, this form of reverse charging has also been implemented in the EU, but it applies to all imports, not just capital goods imports, by registered VAT-payers. Box 1 sums up the requirements of a reverse-charge system for imported capital goods, which Aruba could consider.

Box 1. Reverse Charging for Imported Capital Goods¹⁾

The following criteria are commonly used for applying reverse charging for imported capital goods:

- Importers of capital goods, broadly defined, who are registered VAT taxpayers are permitted to defer accounting for the tax liability until their next return is filed.
- In this return, the VAT applicable to those goods is reported as a VAT liability and, in the same return, the VAT input tax credit is claimed for the capital goods.
- If the importer is entitled to 100 percent input tax credit (equipment used exclusively in taxable activities), the VAT applicable to the importation, reported as a liability, will be completely offset by the corresponding input tax credit.
- The customs office is furnished with a copy of the VAT return to close their records of the importation.
- The scheme is limited to registered VAT taxpayers who import large items of capital goods in excess of, say, AWG 150,000, that are subject to the full VAT.
- Imports of capital goods by persons who are not registered VAT taxpayers, including exempt entities, are subject to VAT at the time of importation. VAT is paid, as usual, before clearance of the goods.

¹⁾ based on Harrison and Krelove (2005).

- **Another measure to reduce the refund burden of the VAT administration is to make a distinction between “certified” and “non-certified” refund claimants.** The claim of certified claimants should be honored without further ado within 30 days from the date on which the claim was filed (with interest paid on late refunds). A 60 days period would be reserved for non-certified claimants who do not have an established good compliance record or who are first-time claimers.

- **Finally, the certification of refund claims by certified public accountants, which in effect outsources part of the VAT department’s verification work is a possibility.** Presumably, large exporters would support the arrangement, because it expedites refunds. Sanctions should be imposed on accountants who knowingly certify false claims.

60. The refund issue is particularly critical with respect to the economic free zones in Aruba. In order to improve the monitoring process, it is recommended not to zero rate supplies to businesses in economic zones but, instead, the supplies of the businesses in economic zones, which is already done. This keeps intact a basic VAT principle that taxable businesses should always charge VAT, leaving it to purchasers to obtain a refund if entitled. Zero-rating supplies to economic zones could easily be abused by diverting zero-rated goods to non- taxed purposes.

G. Recommendations

61. The previous considerations on the contours of an Aruban VAT can be summarized as follows.

- **When converting and integrating the various taxes on goods and services into an Aruban VAT, the authorities are advised to adopt the broadest possible base, which would permit the lowest possible uniform rate.** Exempting goods and services should not be contemplated, except with respect to government activities, which only the government can perform, publicly financed health and education services, margin-based financial services, and the occupation, lease and sale of used residential property (except new property) by or to Aruban residents.
- **The VAT base should include all goods and services, including foodstuffs, reading materials, pharmaceutical products, public utilities, petroleum products, immovable property (except if used residentially), financial services (except if margin-based), insurance (except health and life insurance), and games of chance.**
- **Impose VAT at a uniform rate of 10 percent without any differentiation.** This is lower than the effective 13.6 percent rate of the current cumulative turnover tax if it is assumed that a product is traded twice before it reaches the consumer and that each stage adds a 10 percent margin to purchases. At the consumer level, the 10 percent rate seems to be more than the 6 percent rate. To avoid confusion, it is strongly recommended not to require retailers to quote the VAT separately on their sales unless requested to do so by businesses registered for VAT purposes.
- **The new VAT should integrate the taxes in lieu of turnover tax, that is, the tourist levy, the special tax on timeshares, guesthouses and hotel rooms, the real estate transfer tax, and the tax on games of chance.** The real estate transfer tax should be confined to transfers of used residential property and other property of persons and entities not registered for VAT purposes. The tax on games of chance should be retained to the extent it represents an externality-correcting excise on gambling and lottery activities.

- **A threshold of AWG 70,000 should keep most small businesses off the tax roll. A registration option should not be available for businesses whose turnover is AWG 70,000 or less.** For charitable, cultural, religious and sporting organizations that operate on a non-profit basis the registration threshold could be put at AWG 140,000.
- **The need for refunds should be limited by introducing a deferred payment scheme for imported capital goods, by restricting refunds to persons whose sales consist for 70 percent out of exports, and by taking various administrative measures aimed at separating 'good' from 'bad' VAT payers.**

H. Additional Issues: Revenue, Earmarking, Implementation

62. A precise estimate of potential VAT collections is difficult to make. Much depends on the structural characteristics (exemptions, level of the rate, size of the threshold) of the new tax and, perhaps more importantly, on the vigor with which tax compliance is enforced. Economic structure is also relevant. Middle-income small island economies, such as Aruba, with a large tourism sector tend to perform better since much of the VAT is collected at import and by the hotel sector. Actual VATs, including their tax base concessions, raise over 7 percent of GDP on average in the region. Statistics for 2010-2014 show that Dominica and Barbados collect more than 8 percent, while Grenada is a close runner up. Other statistics indicate that most countries collect 0.5 percent of GDP for every one percentage point of the VAT rate, again after allowing for exemptions and lower-than-standard rates, which can be quite wide ranging. If Aruba taxes all goods and services with the fewest possible exceptions, as outlined above, the mission believes that its VAT should be able to raise approximately 7 percent of GDP at a single, uniform rate of 10 percent.

63. An issue that will have to be addressed when introducing the VAT is the earmarking of 80 percent of the tourist levy for the Aruban Tourist Agency (and the 20 percent that goes to the Tourism Enhancement Fund), as well as the arriving air passenger levy whose revenues accrue to the Aruban Tourist Agency, too. Further, there is the 3 percent turnover tax, which is allocated for financing the health care system. To begin with, this mission strongly believes that fiscal control and effective allocation suffers from earmarking. Past arrangements weigh heavily on current realities. Spending priorities change with time and should be evaluated annually before the Parliament, not set in stone once and for all. Admittedly, the tie between a general consumption tax and health care serves a valuable political purpose, allowing patients to see a connection between the tax they pay and the benefits of health coverage. But abandoning explicit earmarking does not mean that the Government cannot decide every year that a specified share of the budget will be used to finance the general health scheme. The case for abandoning the earmarking of the proceeds of the tourist levy for the Aruban Tourist Agency and the arriving air passenger levy is even stronger since tourist promotion has become less urgent than it used to be now that Aruba is firmly on the tourist track and hotels are fully booked.

64. A solid implementation path is essential to the successful introduction of an Aruban VAT. The following elements should be given consideration:

- **Establish a VAT Policy Steering Committee by the end of October 2018** to lead the policy dialogue, to determine the initial policy choices regarding the base and the rate, and to submit a “while paper” to Parliament for approval by the end of November 2018. Concurrently, draft legislation and regulations, based on best practice VATs elsewhere, should be made ready for approval by the end of 2018.
- **Establish a dedicated VAT Project Management Team by the end of September 2018**, which should work closely with a CARTAC mission in October 2018 to examine the details of the administrative framework for launching the VAT, including registration (with a unique taxpayer identification number), on line filing and payment, and assessment procedures. Proper coordination with the customs authorities is essential. Instructions for potential VAT registrants and a publicity campaign should be given serious consideration.

If all of these conditions and procedures are met, it should be possible to introduce the VAT by September 1, 2019.

III. PERSONAL INCOME TAX

65. Personal income taxes are an important component of tax revenues in Aruba. The chapter begins by briefly outlining how personal income is currently taxed, before proposing a dual income tax and examining the current PIT rate and threshold structure.

A. Current Situation

66. Resident taxpayers are subject to a personal income tax (PIT) on their worldwide income. Taxable income comprises of the aggregate of income from real estate, from movable property, from business and employment, and income from annuities (Table 5). In addition to a general personal allowance of AWG 20,455 various deductions are allowed: (a) a 3 percent fixed deductible for employment income up to AWG 1,500; (b) a mortgage interest deduction up to AWG 40,000; (c) an interest deduction for consumer loans up to AWG 5,000; (d) a child allowance of AWG 750 per child (AWG 1,200 for children studying in Aruba, and AWG 5,000 for children studying abroad); (e) an old age allowance of maximum AWG 6,746; and (f) a deduction for extra-ordinary expenses for supporting relatives, health, and education – over and above 5 percent of taxable income.

Table 5. PIT Base per Income Category (2013)²⁶

| Income Category | Tax Base <i>(in million AWG)</i> |
|---|--|
| Real Estate | 16.9 |
| Movable property (dividend, interest and other) | 14.7 |
| Business and Employment | 1,844.4 |
| <i>o.w: - employment</i> | 1,805.4 |
| - <i>business</i> | 39.0 |
| Annuities | 134.6 |

Source: Departamento di Impuesto

67. Taxpayers are assessed on an individual basis but have an option to be taxed jointly. Income from real estate, movable property and from annuities, as well as the various deductions is allocated to the partner with the highest income from business and employment. The current rate schedule is divided into two categories, and 14 tax brackets with tax rates ranging from 7 percent to 58.95 percent (Table 6). The first category (slightly lower rates) covers individual taxpayers who (1) are married and whose spouse does not earn business or employment income; (2) are married and have opted for joint taxation; and (3) are unmarried and apply for child allowance. All other taxpayers are in the second category.

²⁶ This is the most recent year for which the Departamento di Impuesto has provided micro data.

Table 6. Tax Rate Schedules, 2018

| Income (in AWG) | | Rate (in percent) | |
|-----------------|-----------|-------------------|-------------------|
| <i>from</i> | <i>to</i> | <i>category 1</i> | <i>category 2</i> |
| 0 | 20,455 | 0.00 | 0.00 |
| 20,455 | 27,751 | 7.00 | 7.40 |
| 27,751 | 37,632 | 9.55 | 10.05 |
| 37,632 | 48,698 | 13.70 | 14.45 |
| 48,698 | 61,338 | 18.00 | 19.00 |
| 61,338 | 75,385 | 23.50 | 24.80 |
| 75,385 | 91,120 | 29.00 | 30.60 |
| 91,120 | 105,548 | 34.10 | 35.95 |
| 105,548 | 121,095 | 38.00 | 40.10 |
| 121,095 | 140,917 | 41.75 | 44.05 |
| 140,917 | 169,534 | 43.20 | 45.60 |
| 169,534 | 211,798 | 46.25 | 48.80 |
| 211,798 | 277,152 | 52.00 | 54.85 |
| 277,152 | 324,824 | 54.20 | 57.20 |
| 324,824 | - | 55.85 | 58.95 |

68. The Personal Income Tax (PIT) is largely collected through a wage withholding tax (“loonbelasting”). In 2013, the wage withholding tax raised AWG 237.2 million, which was credited against the assessed PIT of AWG 249.2 million. Approximately 72 percent of all registered individual taxpayers, or just over 31,000 people filed an income tax return. The high number of tax filers is explained by an option for married taxpayers to be taxed jointly and some widely applied personal deductions under the PIT.

69. A social security contribution (SSC) is due from each florin earned up to a cap of AWG 85,000. The SSC is differentiated between a contribution for the general health insurance (AZV) and an old-age pension, including a widow and orphan insurance (AOV/AWW) benefit. The contributions are split between the employer and the employees as follows:

| | Employer <i>(in percent)</i> | Employees <i>(in percent)</i> |
|---------|--|---|
| AZV | 8.9 | 1.6 |
| AOV/AWW | 10.5 | 5.0 |

The contributions by the employer are tax-exempt for personal income tax purposes and the contributions by the employees are tax deductible.

B. Analysis

Dual Income Tax (DIT)²⁷

70. As a framework for taxing individual income, a dual income tax model is recommended for Aruba. First introduced in Scandinavia in the early 1990s, the dual income tax combines a progressive tax on labor income with a lower flat rate tax on income from capital. Labor, being less mobile than capital, can absorb higher graduated rates without triggering migration of the tax base. The single rate on all capital income avoids arbitrage between different capital streams. The main features of the Nordic DIT are the following.

71. All income is separated into either capital income or labor income. Capital income includes business profits (representing the return on equity), dividends, capital gains, interest, rents and rental values. Labor income consists of wages and salaries (including the value of labor services performed by the owner in his or her business), fringe benefits, pension income and social security benefits. Royalties are taxed as labor income or as capital income (if know-how is acquired or capitalized).

72. Basically, all capital income is taxed at the proportional profit tax rate, while labor income is subject to additional, progressive personal income tax rates. To minimize tax arbitrage, the tax rate on labor income applicable to the first income bracket could be set at (approximately) the same level as the proportional capital income tax rate.

73. All costs of earning income and all allowances are deductible only from income subject to the basic or proportional tax rate. This limitation means that the tax benefit, for example, of costs that incorporate an element of individual consumption or take into account the number of dependent children, do not rise with income. The basic tax allowance of AWG 20,455 could also be transformed into a tax credit, which further strengthens the progressivity of the DIT. Some personal deductions and allowances should be eliminated altogether (see below).

74. Some countries tax capital and labor income entirely separately. Separate taxation (with allowances applied against labor income only), enables the imposition of flat final source taxes, if desired, on various forms of capital income. To achieve maximum simplification, the mission recommends that Aruba should tax capital income altogether separate from labor income.

75. The alternative, found in Norway, for example, would be to tax the two forms of income jointly at the profits tax rate (which is also the lowest rate for labor income), while net labor income is subsequently taxed at additional, progressive personal income tax rates. Joint taxation permits the application of basic allowances or tax credits against both forms of income. Furthermore, joint taxation permits the offset of negative capital income against positive labor

²⁷ This section is updated from Cnossen (2000).

income. But, as noted below, the same effect can be achieved by permitting a tax credit for capital income losses (calculated at the basic rate) against the tax on labor income.

76. Under DIT, the double taxation of distributed profits at the corporate level and the shareholder level is avoided through a full imputation system.²⁸ Alternatively but equivalently, double taxation can be avoided by exempting dividend income at the shareholder level. Under either approach, compensatory taxes guarantee that no dividends are paid out of exempt profits without having borne the profits tax, which would subsequently be creditable against the shareholder's personal income tax or constitute the final tax on distributed profits.²⁹ It should be noted that dividends received from abroad would be taxed without a credit for the underlying profits tax paid to the source jurisdiction.

77. The single taxation of capital income can be ensured through withholding or source taxes at the corporate level or at the level of other entities paying interest, royalties or other capital income. In principle, withholding or source rates should be set at the level of the capital income tax rate. Consequently, these rates could represent the final tax liability if capital income is taxed separately from labor income and no basic allowance applies. Withholding on rental income could be achieved by making internet-platforms, like for instance Airbnb or HomeAway, withholding agents, rather than using a differentiated land tax (*grundbelasting*).

78. Under the DIT, the taxable profits of proprietorships and closely-held companies, are split into a capital income component and a labor income component, and these are taxed on a current basis. The capital income component is calculated by applying a presumptive return (the sum of the nominal interest rate plus an entrepreneurial risk premium) to the book value of the gross assets of the business or to the book value of equity.³⁰ Residual profits are considered labor income. The reason for determining capital income first is that the appropriate return on labor is difficult to estimate because diligence, effort and ingenuity may diverge widely, as may the hourly wage rate relate to various kinds of labor and the number of hours worked. Moreover, if labor income were to be determined first, the marginal individual income tax rate on the profits of the self-employed and

²⁸ Under an imputation system, the net dividend is grossed up by the profits tax attributable to them. The grossed-up dividend is subsequently taxed at the personal income tax rate. Next, the tax thus calculated is credited with the profits tax with which the net dividend was grossed up. In view of the equivalence between the profits tax rate and the capital income tax rate, obviously the tax levied at the personal level is completely washed out by the profits tax attributable to the net dividend. In essence, the workings of an imputation system do not differ from a withholding tax on wages, which are subsequently taxed along with other income with a credit for previous withholding.

²⁹ The double taxation of retained profits at the corporate level in conjunction with the taxation of realized capital gains at the shareholder level is avoided in Norway by permitting shareholders to write up the basis of their shares by the retained profits net of the profits tax. The double tax on retained profits is mitigated in Finland (only 70 percent of capital gains are taxed), but fully maintained in Sweden. In view of its complexity, it is not recommended that Aruba adopt this feature of the DIT.

³⁰ Basically, the gross method (used in Norway) minimizes tax arbitrage and hence complexity because the presumptive return is applied to a base—i.e., the business's total assets—that is not influenced by the financing structure of the business. The net (equity) method (used in Finland), on the other hand, is more conducive to investment neutrality because it does not encourage debt-financed investment if the government sets the presumptive rate of return above the going interest rate.

active shareholders would exhibit a regressive incidence. Additional earnings would then be taxed at the proportional capital income tax rate instead of the progressive individual income tax rate.

79. The DIT would provide a level playing field for the taxation of capital income on Aruba and ensure a more equitable tax burden distribution. If the experience of the Nordic countries is any guide, the DIT would also increase the tax revenue from capital income.

80. A DIT would offer the following advantages compared with the current income taxes.

- First, capital income would be taxed at the same rate in whatever form or manner it arises. Accordingly, there would be no need to distinguish (and discriminate) between dividends (taxed at the profits tax rate plus a 25 percent personal income tax), interest (progressive rates, except on saving accounts that are tax exempt), rents (progressive rates), rental values (not taxed, although mortgage interest is deductible), royalties (taxed on a gross basis), and capital gains (tax exempt, unless realized on business assets).
- Second, and most importantly, labor income accruing jointly with capital income in proprietorships and closely-held companies would be taxed currently rather than (much) later in the form of a largely ineffective capital gains tax of 25 percent.³¹ Accordingly, this form of labor income would be treated on par with labor income subject to wage withholding. In other words, wage earners would not anymore be treated less favorably than professional income earners. By the same token, capital income from proprietorships would not be taxed higher than other forms of capital income.
- Third, the taxation of labor income currently sheltered in company form would obviate the need for a separate tax on the gains from a “substantial interest”. Since, gains made on the sale of owner-occupied residences would continue to be exempt, consideration might be given to dispensing with a separate capital gains tax altogether. Separate capital gains taxes are notoriously difficult to administer. Only capital gains arising in the context of a business would remain taxable.
- Fourth, all interest, including interest payable on mortgages to finance owner-occupied property, would be deductible from profits or capital income at the capital income tax rate, i.e. 15 percent. Any business loss or interest payable in excess of taxable capital income could be carried forward and offset against future capital income. Exceptionally, mortgage interest on owner-occupied property in excess of capital income could be creditable at 15 percent against the labor income tax liability.³² This tax treatment of interest would achieve equity between taxpayers with only

³¹ The profit-splitting rules of the DIT are much easier to administer than some of the tortuous and arbitrary provisions for preventing the under-taxation of the self-employed currently on the statute books in countries without a DIT. In any case, the scheme avoids most of the deferral and lock-in effects of the tax that these other countries impose on capital gains on substantial shareholdings.

³² Preferably the tax rate should be identical to the CIT rate. Currently it seems neither feasible to reduce the CIT rate to 15 percent, nor increase the PIT rate in the first bracket to 20 percent.

labor income and those with capital income. It would also nullify an important form of tax arbitrage: taking a mortgage on one's home and using the proceeds to earn lowly taxed income on other investments.

- Fifth, the DIT offers the opportunity to impose final withholding taxes on various forms of capital income (the company profits tax is a “withholding” tax on distributed and retained profits), such as interest, royalties and service fees.

Simplified Rate Structure

81. A simplified rate structure with slightly reduced rates is required to enable the passage of other tax reforms. The current rate structure comprising 2 taxpayer categories, 14 brackets, and 28 different rates ranging from 7 percent to 58.95 percent, is highly complex. The tax rates applied to the different categories of taxpayers based on their marital status are only marginally higher than the Category 1 rates. A unified tax rate applicable to all individual taxpayers on their labor income from (self-)employment would permit a simpler rate structure.

82. The elimination of various personal deductions could be used to simplify taxation through the wage withholding tax. Currently, the deduction for mortgage interest and child allowance can be claimed directly under the wage withholding tax. All other deductions can only be obtained by filing an income tax return at the end of the tax year. Currently about 75 percent of all taxpayers file such an income tax return. The requirement to file a tax return should be limited to situations in which taxpayers receive either income from two or more employment contracts, from employment abroad, or from employment not subject to wage withholding tax.

83. The revenue increase from the elimination of various personal deductions can be used either to increase the basic personal allowance or to introduce lower rates, or both. The elimination of the interest deduction on consumer loans, the fixed employment expenses, and the deduction for extra-ordinary expenses would allow for an estimated AWG 19.8 million (based on data from 2013) (Table 7).

Table 7. Revenue Loss from Personal Deductions and Allowances (2013)

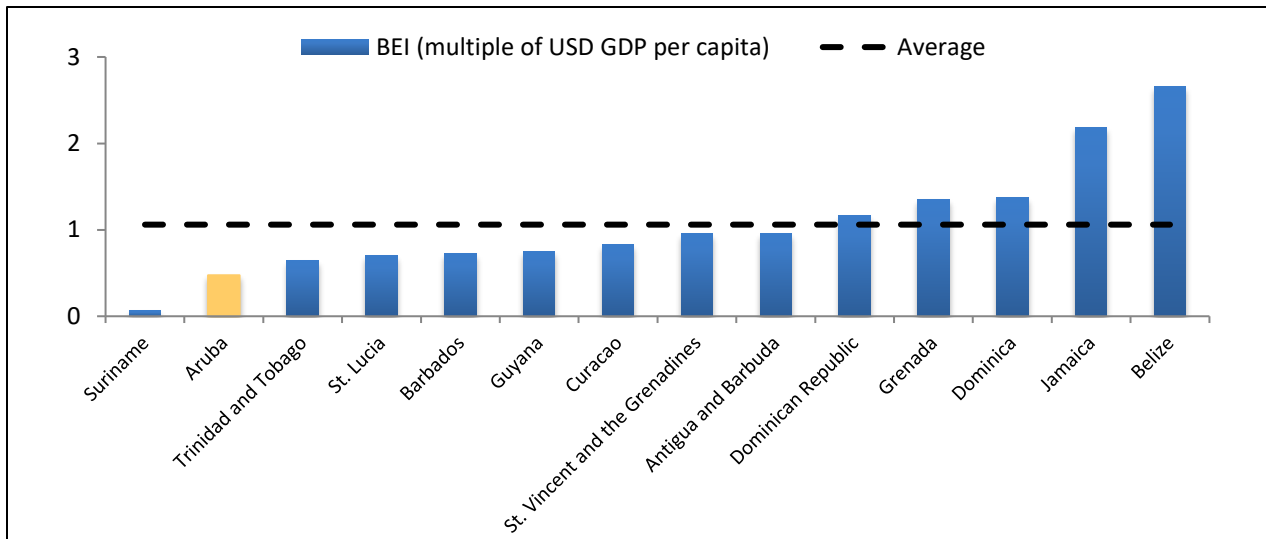
| Deduction/Allowance | Amount <i>(in million AWG)</i> | Estimated revenue loss <i>(in million AWG)</i> | <i>(in % GDP)</i> |
|---------------------------------------|--|--|-------------------|
| Mortgage interest | 110.9 | 30.4 | 0.65 |
| Consumer interest | 48.7 | 10.9 | 0.24 |
| Fixed employment expenses (3 percent) | 32.8 | 7.2 ^{1/} | 0.15 |
| Child allowance | 26.3 | 5.8 ^{1/} | 0.13 |
| Extra-ordinary expenses | 9.1 | 1.7 | 0.04 |

^{1/} Child allowance could be higher since amounts exclusively claimed under the wage withholding tax are not included.

Source: Departamento di Impuesto Aruba.

The deduction for mortgage interest could be integrated in the taxation of capital income and thus become permissible at the proportional tax rate of 15 percent. This would result in additional revenue of AWG 13.8 million. Accordingly, the combined measures would result in a revenue increase of AWG 33.6 million (0.73 percent of GDP). The authorities may wish to revisit the existence of the child allowance. Large deductions are granted for children studying abroad (up to AWG 5,000), whereas the standard allowance is AWG 750 per child. Streamlining and limiting the child allowances could be considered to further simplify the system but has presumably only a marginal revenue effect.

Figure 1. PIT Tax-Free Allowance as Multiple of Per Capita Income



Source: IMF Staff calculations

84. The estimated revenue of the elimination and restriction of some personal deductions could be used to increase the basic exempt income (BEI) and simplify the current progressive rate structure. In the mission’s proposal, the BEI is increased from AWG 20,455 to AWG 27,751 (eliminating the first income bracket). However, the BEI expressed as a multiple of per capita income is still below average compared with other Caribbean Islands (Figure 1). It is 0.47 times per capita income (AWG 24,098) and increases to 0.64.

85. Problems with splitting profits in a labor and capital income component for the self-employed and accruing jointly in closely-held corporate form is avoided for small businesses, if the tax rate on capital income, the profits tax rate, and the lowest personal income tax rate are identical. However, in the current situation a profits tax rate below 20 percent seems too much of a good thing, whereas a 20 percent step-in rate for personal income tax seems too high and would result in negative income effects for the lowest income earners. It may also stimulate the hidden economy as taxpayers consider the marginal rate too high. Alternatively, the lowest PIT rate and the proportional rate on capital could be set at 15 percent. According to Table 8, the following proposed rate structure for the labor component of the DIT would cost approximately AWG 11 million (or 0.24 percent of GDP). The problem with this rate structure is that taxpayers in the income

range up to AWG 50,000 are facing a slightly higher tax rate than their current tax rates. This regressive effect is hard to overcome without losing substantial revenue (by increasing the basic personal exemption) and maintaining a step-in rate of 15 percent. Increasing the basic personal exemption to AWG 30,000, for instance, would cost approximately AWG 10 million.

Table 8. Proposed Tax Brackets and Revenue Loss

| Labor income (AWG) | | Tax rate (%) | Revenue per bracket (AWG) ^{1/} | |
|--------------------|--------------|--------------|---|----------------|
| <i>from</i> | <i>up to</i> | | <i>new</i> | <i>current</i> |
| | 27,751 | 0 | 0 | 13,005,468 |
| 27,751 | 61,338 | 15 | 69,104,463 | 62,183,256 |
| 61,338 | 91,120 | 25 | 33,645,854 | 35,784,302 |
| 91,120 | 121,095 | 35 | 18,948,085 | 20,037,727 |
| 121,095 | 169,534 | 45 | 16,761,896 | 16,366,895 |
| 169,534 | | 50 | 30,577,990 | 33,059,113 |
| | | | 169,038,288 | 180,436,761 |

^{1/} based on 2013 revenue data received from the Departamento di Impuesto.

C. Recommendations

- Consider adopting a dual income tax (DIT) under which all capital income is taxed entirely separately from labor income at the proportional rate of 15 percent. Final withholding should be used where possible.
- Abolish the 3-percent fixed deductible for employment-related expenses with a maximum of AWG 1,500.
- Eliminate the interest deduction on consumer loans and the deduction for extra-ordinary expenses.
- Move the deduction for mortgage interest to the capital income category of the dual income tax, thus limiting the deduction to 15 percent and allow a credit against the tax on labor income if necessary.
- Use the revenue increase from the elimination and restriction of these personal deductions to increase the basic personal allowance and restructure the tax rates. Apply the basic personal allowance and progressive rate structure only against labor income (business and employment).
- Abolish the two tax categories and apply one single tax rate scheme for all taxpayers earning labor income.
- Introduce a presumptive rate of return on equity for proprietorship, partnerships and closely-held companies and deem profits over and above the presumptive profits attributed to equity as labor income subject to the progressive rate schedule.

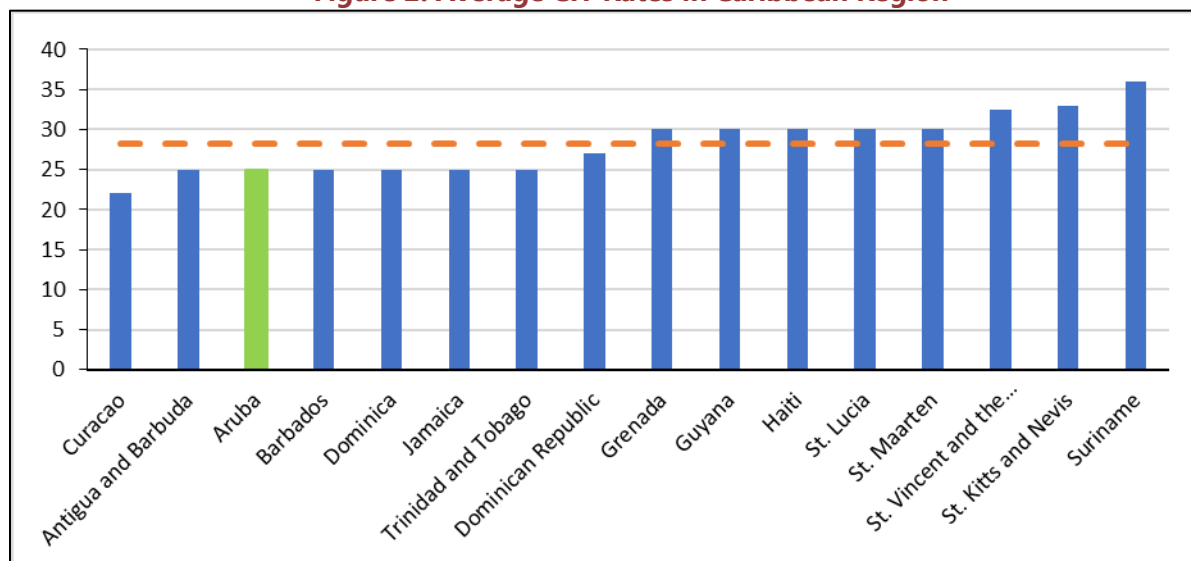
IV. CORPORATE INCOME TAX

86. Business income is subject to various tax rates in Aruba, causing base erosion, distortion, and revenue leakage. The chapter begins by briefly outlining how business income is currently taxed in Aruba, before examining the current CIT rate structure. The chapter concludes with a look at policies that Aruba can use to protect its domestic CIT base, including a summary of recent international initiatives.

A. Current Situation

87. The standard corporate income tax (CIT) (“*winstbelasting*”) rate is 25 percent. However, numerous reduced tax rates (2 percent, 10 percent, 12 percent, and 15 percent) apply under various tax incentive schemes. The standard rate is comparable to the standard CIT rates in the Caribbean (Figure 2). However, bear in mind that most countries have a large number of tax incentives, typically in the form of tax holidays. The effective CIT rates are therefore substantially lower, resulting in low CIT-revenue productivities. Aruba levies a withholding tax on dividends at a rate of 10 percent, reduced to 5 percent if distributed by publicly traded companies. If dividends are paid to resident companies that qualify for the participation exemption, dividend distribution is exempt from withholding tax. The tax base is determined in accordance with common accounting practice (“*goedkoopmansgebruik*”) whereby government ordinances and case law provide guidance and limitations. This system has been developed over the last decades and functions well.

Figure 2. Average CIT Rates in Caribbean Region



88. Aruba has introduced various tax incentives to attract investments. The main tax incentives are shown in Box 2.

Box 2. Tax Incentives

Profit-based

Free-Zone Companies (FZC) – Companies established in free zones are subject to a 2 percent CIT and an annual charge of 0.75 percent on turnover. Furthermore, exemptions apply for the dividend withholding tax, import duty tariff if goods are not entering the domestic market, and turnover tax to the extent that goods are not delivered, or services are not rendered in Aruba.

Special Zone San Nicolas (SZSN) – companies established in this zone are subject to a 15 percent CIT rate, reduced to 10 percent for hotels and activities that are 75 percent export-related, and 2 percent for reinsurance and “green” activities. Furthermore, exemptions are granted for the dividend withholding tax, turnover tax, and foreign exchange commission. A 50 percent reduction of the land tax is granted for a period of 5 years. This regime has been abolished since February 1, 2018 and is grandfathered until 2021.

Imputation Payment Companies (IPC) – This regime provided for an imputation payment representing part of the CIT paid by a local company to its nonresident shareholders, resulting in an effective tax rate on profits of 2 percent. The regime was granted for certain qualifying activities, including hotel businesses, financing, licensing, and investment activities. Since 2016 the regime has changed and replaced by a special 10 percent CIT for qualifying activities.

Special Purpose Companies (SPC) – Various different tax regimes apply to companies that are engaged in different activities. The main incentive is given to hotels that are eligible for reduced WB rates of 10 percent, 12 percent, or 15 percent depending on the revenue per available room. Profit from shipping and air transportation by companies registered in Aruba are subject to a 7 percent CIT (80 percent of profit is taxed at 2.5 percent and 20 percent at 25 percent).

Aruba Exempt Companies (*Aruba Vrijgestelde Vennootschap; AVV*) – Two regimes are applicable. The first regime exempts from CIT and dividend withholding tax companies that engage in qualifying activities, such as financing, investment activities, holding shares or participation rights, and licensing of intellectual and industrial rights. The second regime views the AVV as a transparent entity; this means that Aruba will not tax the AVV, but rather the shareholders or partners in the AVV. As they are typically nonresidents, in fact Aruba foregoes its right to tax. Most other countries, however, will treat the AVV as an entity and assume that Aruba has the taxing right. This feature creates a hybrid vehicle that can be used to facilitate international tax planning.

Cost-based

Investment Allowance – Since 2015 an investment allowance of 6 percent of the invested amount is available, if the invested amount exceeds AWG 5,000 per year, and the investment is made by a resident taxpayer. Investments in land, real estate for private use, goodwill, and animals are excluded. If the investment is annulled within 6 years, a disinvestment contribution must be included in taxable profit.

Accelerated Depreciation – Since 2010 accelerated depreciation has been introduced for assets that are used in the course of an industrial business and whose acquisition costs are above AWG 90 million. These assets may be depreciated in 10 equal annual installments.

89. Although the CIT includes a transfer pricing provision,³³ it is unclear to what extent this instrument effectively protects against tax base erosion. The CIT Law allows the tax administration to challenge prices charged for intra-group transactions. Associated parties are required to deal at arm’s length and set market-conforming transaction prices on intra-group good

³³ Article 4(2) CIT provides a general transfer pricing rule requiring related parties to deal at arm’s length. More detailed rules are contained in administrative orders.

transactions and services provision. Implementing regulations generally refer to the OECD Transfer Pricing Guidelines for documentation requirements and implementation.

90. The CIT does not include a thin capitalization rule but limits the deductibility of certain payments made to foreign parties. Interest or other payments (e.g., royalty payments or services fees) are not deductible unless the Aruban company (payer) proves that one of the following situations is applicable:

- (a) the receiving company is not associated to the payer;
- (b) the receiving company is subject to an effective tax rate of at least 15 percent; or
- (c) the shares in the receiving company are all directly or indirectly held by a company whose shares (for at least 50 percent of the number or voting rights) are listed at a qualified stock exchange.

If such payment is made and the payer cannot assert any of the circumstances above, a deduction of only 75 percent of the payment is allowed, if the payer can prove that the payment will be included in the taxable base of the recipient and be subject to tax.³⁴

B. Analysis

Multiple Rate Structure

91. The application of multiple reduced tax rates substantially reduces the revenue productivity of the CIT. Major sectors of the Aruban economy are eligible for CIT rates substantially lower than the standard 25 percent rate (see Table 9). First, the revenue raising capacity of the CIT is seriously hampered, which is shown by a CIT-productivity ratio of 0.20 percent of GDP (2016), calculated as the revenue per point of the standard rate as a percentage of GDP. Second, allocation problems and arbitrage issues occur by the application of the various rates. For example, restaurants are taxed at 25 percent whereas hotels are taxed at rates varying from 10 to 15 percent. What do restaurants have to pay when they are an integrated part of a hotel complex? Another issue is that costs can be shifted to business activities subject to the standard rate, whereas revenues are allocated to activities that are subject to the lower rates. This introduces transfer pricing issues within the domestic market.

³⁴ Article 6(3) CIT.

Table 9. Tax Position of Main Economic Activities, 2013

| Five Main Business Sectors (based on turnover) | | | | |
|--|-------------------------|---------------------------------|-------------------------|-----------------|
| Economic activity | Turnover | | Taxable profit | Tax rate |
| | <i>(in million AWG)</i> | <i>(% total turnover)</i> | <i>(in million AWG)</i> | <i>(%)</i> |
| Holding- and trustee companies | 1,338.0 | 19.5 | 108.9 | 2-10 |
| Foods, o.w.: | 619.6 | 9.0 | 9.3 | 25 |
| • retail | 324.5 | | 3.1 | |
| • wholesale | 295.1 | | 6.2 | |
| Hotels | 305.3 | 4.4 | -75.3 | 10-15 |
| Telecommunication | 288.1 | 4.2 | 48.8 | 25 |
| FZC | 265.3 | 3.9 | 24.8 | 2 |
| Five Main Business Sectors (based on tax profitability) | | | | |
| | Taxable profit | | Turnover | |
| | <i>(in million AWG)</i> | <i>(% total taxable profit)</i> | <i>(in million AWG)</i> | |
| Holding- and trustee companies | 108.9 | 30.3 | 1,338.0 | 2-10 |
| Banking | 68.6 | 19.1 | 218.8 | 25 |
| Telecommunication | 48.8 | 13.6 | 288.1 | 25 |
| FZC | 24.8 | 6.9 | 265.3 | 2 |
| Suppliers of air transportation | 24.1 | 6.7 | 155.6 | 25 |

Source: Departamento di Impuesto, Aruba

92. The differentiation of CIT rates has been a feature of the Aruba tax system for some time. Such differentiation presumes that policymakers are better-placed to pick winners than the market. However, businesses should base their investment decisions on market-determined rates of return and not on tax considerations. It is unclear that investment has increased substantially in these favored sectors beyond what would have occurred in their absence.

93. In Aruba, multiple CIT rates generate distortions and make the system prone to arbitrage, avoidance, and revenue leakage. The lower CIT rates function like a tax holiday, but are in fact permanent, distorting activity, eroding the overall tax base, and making already-profitable companies even more profitable. Even if the marginal rates of substitution of investment between sectors are low—which means that differing sectoral CIT rates may cause relatively small distortions in resource allocation between sectors—these incentives still result in a loss of tax revenue. Box 3 sets out the arguments against such profit-based tax incentives.

Box 3. Investment Incentives¹

Tax incentives that lower the cost of investment are often to be preferred over profit-based tax incentives:

Cost-based tax incentives involve specific allowances linked to investment expenses, such as accelerated depreciation schemes and special tax deductions and credits. They are targeted at lowering the cost of capital and so make a greater number of investment projects more profitable at the margin—that is, may generate investments that would not otherwise have been made.

Profit-based tax incentives generally reduce the tax rate applicable to taxable income; examples include tax holidays, preferential tax rates or income exemptions. One effect is thus to forego government revenue in order to make even more profitable investment projects that would be profitable, and hence undertaken, even without the incentive.

The difference between the two types of instruments is critical. For instance, profit-based incentives will be less effective in encouraging investment compared to incentives that reduce the capital cost if profitability is low. When profits are earned due to the presence of location-specific factors, such as natural resources, agglomerations, or local markets, profit-based incentives tend to be associated with high redundancy rates and are again ineffective in raising investment. But international considerations are important here. Profitable investments that are highly mobile across national borders—because, for instance, rents are associated with intangible assets, such as patents or trademarks, that are easy to move between jurisdictions—may be sensitive to both cost-based and profit-based tax incentives.

Tax holidays tend to favor readily mobile ('footloose') activities rather than long-term investment. By offering temporary tax relief for profitable firms, tax holidays benefit industries that start making profits soon in the holiday period. This introduces a bias towards short-term projects with low upfront investment costs, which may be those least likely to generate spillover effects on the wider economy (of the kinds described above). Such investment projects are known to "pack and go", fleeing the host country as soon as the preferential treatment is removed. For industries with significant long-term capital needs, and for which spillover benefits may be greater, tax holidays could actually discourage investment: little otherwise taxable profit might be expected during the holiday period, and, to utilize depreciation allowances, a firm might be encouraged to postpone investment until after the holiday period in order to claim full deductions for its costs (see background document).

¹ Platform for Collaboration on Tax. 2015. "Options for low income countries' effective and efficient use of tax incentives for investment". Available at: <https://www.imf.org/external/np/g20/pdf/101515.pdf>.

94. The principal objective of the CIT is to raise revenues in the most cost-effective manner rather than being used as a tool of industrial policy. The best way to achieve this objective is to have a broad tax base with a uniform and moderate-to-low rate structure. It would be preferable to consolidate all corporate income tax rates into a single unified standard rate. This would offer investors simplicity, predictability, and certainty, while limiting the opportunity for distortionary and discretionary policymaking in the system, which promotes costly rent-seeking behavior.

95. Globally, there is a clear trend towards statutory rate reductions in the mid-to upper twenty percent range: European Union economies average CIT rate of 20 percent; low-middle income economies are at 25.4 percent; upper-middle income economies average 23.0 percent; and high-income economies are at 22.6 percent. Simple calculations suggest that Aruba could attempt to consolidate the current rates at a standard rate of 15-20 percent without losing tax revenues. However, further analysis using tax return data of company profits and the tax rates they pay, is required to determine at what level to calibrate the new single CIT rate. The timing of reducing the

standard CIT rate also depends on time at which the previous incentives were grandfathered (sometime between 2021 and 2024).

Transfer Pricing

96. In general, transfer pricing rules serve two purposes. As an anti-avoidance mechanism, they protect the domestic CIT base from manipulation by multinational enterprises (MNEs) or misstatement of intra-group prices. By providing a clear and transparent framework, MNEs can operate in a climate of certainty that reasonably priced transactions will not be challenged by the tax administration.

97. Although widely recognized and accepted as the international standard to evaluate transfer prices, the arm's length principle is not without problems. The arm's length principle requires that the amount charged by one related party to another for a given product—a "controlled" transaction—must be the same as if the parties were not related—an "uncontrolled" transaction. Information asymmetries complicate its application, especially as details about transactions can be easily manipulated by related entities.³⁵ In addition, tax administrations need staff with the appropriate expertise in international tax issues and MNEs to be able to identify violations. Most countries therefore find it difficult to effectively use transfer pricing to combat base erosion. Of course, the issue is less problematic if the CIT rate is low.

Base Erosion Protection

98. In Aruba, the existing base erosion protection for certain cross-border payments is based on the arm's length approach. Cross-border interest payments made to related parties are subject to the arm's length test (Article 4 CIT), which may limit the interest rate, but not the size of the loan. Subsequently, Article 6 CIT does not allow deduction of interest, unless the payer can assert that the interest is included in the tax base of the recipient company and subject to tax. The effectiveness of this limitation rule is thus very limited and largely depends on the arm's length rule.

99. Most developed economies have introduced thin capitalization rules to prevent tax base erosion through excessive interest payments. Thin capitalization refers to the situation in which a company is financed more by debt than equity. The excessive use of debt by MNEs to take advantage of the tax deductibility of interest has led to the development of rules on debt-to-equity ratios. These rules can be especially tricky to apply when MNEs structure their financing arrangements through third party intermediaries such as banks—so-called indirect loans, e.g., back-

³⁵ MNEs' control over the specific facts of their transactions—including fundamental elements such as the assets used, risks assumed, and functions performed—has historically given them an upper hand in manipulating transfer prices based on the arm's length principle.

to-back or guarantees. More recently, many countries have modified or introduced rules that limit the deductibility of interest payments by using an earnings stripping rule.

100. The introduction of an earnings stripping rule will limit interest deductions to a maximum percentage of the tax base.³⁶ Mainly European countries have recently introduced earnings stripping type rules that cap interest deductions at 30 percent of earnings before interest, tax, depreciation, and amortization (EBITDA). Such rules allow the deduction of interest expenses up to the interest income received in the same year. In addition, any net interest expense—i.e., the excess interest expense over the interest received in the same year—is deductible up to this percentage of EBITDA. Any non-deductible net interest expenses should be carried forward.

101. Another method to curb base erosion is using withholding taxes on cross-border payments to related parties. Both debt-to-equity ratios and EBITDA rules are only aimed at limiting cross-border interest payments, whereas base erosion often involves other types of cross-border payments too. Therefore all potential base erosion payments (e.g., dividends, interest, royalties, and service fees) should be subject to a domestic withholding tax that equals the profit tax rate. For Aruba, only the Special Agreement within the Kingdom of the Netherlands (functions as a tax treaty) may restrain this approach as it reduces such withholding tax rates. Alternatively, Aruba could introduce a general—but more modest—withholding tax of 15 percent (below the standard CIT rate) and apply this to all cross-border payments.

International Issue

102. Aruba has recently decided to become a member of the Inclusive Framework (IF) and is already a signatory of important multilateral conventions/agreements to curb aggressive international tax planning. The IF is a group of over 100 countries and jurisdictions that collaborate on the implementation of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Package (Box 4). Aruba has committed itself to become a member of the IF by 2019. Aruba is a signatory of the Convention on Mutual Administrative Assistance in Tax Matters (CMAA) that allows for exchange of information outside double tax agreements, and a signatory of the Common Reporting Standard Multilateral Competent Authority Agreement (CRS-MCAA) that would allow for automatic exchange of information.

³⁶ Such rule could be extended to other payments used to erode the tax base, such as royalties, management and other service fees.

Box 4. OECD BEPS Project Outcomes

The outcomes of the BEPS project take a variety of forms. In four areas, there are **minimum standards**, the expectation being that domestic law and/or treaties will be amended to adopt them:

To counter **treaty abuse**, countries should include in treaties a “principle purposes test” provision and/or a limitation of benefits clause restricting access to treaty benefits.

On **transfer pricing documentation and country-by-country reporting**, MNEs should be required to make available general information on their activities to all countries in which they are active; more detailed transaction information specific to each country; and—for those with group turnover of more than €750 million—information on pre-tax profit and taxes paid and accrued in each jurisdiction. These data should be shared by the parent country in a manner consistent with its exchange of information agreements.

In relation to **harmful tax practices**, taxpayer rulings that raise BEPS concerns should be shared automatically. Deliberations on patent boxes led to a “nexus” principle that the preferential tax regime should only apply to taxpayers who have incurred substantial R&D expenditure in the jurisdiction.

For **dispute resolution**, countries should enact measures that ensure timely and good faith outcomes.

In some areas, guidance is captured by **amendments to core OECD reference documents** (*permanent establishment and transfer pricing*). In other areas, the outcome is guidance on a **common approach** (*hybrid mismatches, interest deductions, controlled foreign corporation rules, and mandatory disclosure of aggressive tax planning*), with an aspiration of convergence. Some recommendations, and the minimum standards in particular, will require **treaty changes**. By the end of 2016, a *multilateral instrument* was adopted that simultaneously modify signatories’ treaties.

C. Recommendations

- Introduce a reduced standard CIT rate of 20 percent and abolish all profit-based tax incentives (reduced tax rates).
- Replace the current limitation of deductibility rule for certain cross-border payments by the introduction of a 15 percent withholding tax on potential base erosion payments.
- Require more detailed transfer pricing documentation for companies with sizeable cross-border transactions, for instance in excess of AWG 10 million per year.

V. EXCISE DUTIES

103. This Chapter of the report deals with excise duties defined as all taxes and duties on smoking, drinking, sugar consumption, gambling, polluting, motoring and luxury consumption.³⁷ Each of these categories is dealt with separately following some general observations applicable to all categories. Basically, the current excise duty system is outdated.

A. Rationale of Excise Taxation

104. The major excise duties are coveted sources of revenue, in Aruba and elsewhere.

Operational costs are low, because the products are easy to identify, the volume of sales is high and the fact that there are few producers, or the products are imported simplifies collection. Research indicates that the costs of collecting excise duties are merely one-fourth of VAT collection costs per unit of revenue. Further, the demand for most excisable products tends to be price inelastic, precisely because they are addictive or indispensable. This means that the potential for distortion of economic decisions is relatively small and that tax-induced price increases do not result in proportionate decreases in consumption.

105. Apart from their revenue-raising potential, excise duties are rationalized as charges for the social (external) cost that smokers, drinkers, sweet addicts, gamblers, polluters and drivers impose on society. Smokers, sweet and gambling addicts need health care, drunk people cause accidents, polluters contribute to global warming, drivers tear up the road system and cause congestion. If properly designed, excise duties can serve as proxies for the cost of the damage – physical, financial, psychological – that consumers or users of excisable products impose on other people. It is reasonable, equitable and efficient that the perpetrators should pay for the costs (called external costs) that they impose on society, ideally in the form of an amount that is equal to the marginal damage caused. It should be emphasized that externality-correcting excise duties should always be raised to their appropriate level regardless of the need for revenue, because they improve the efficient allocation of economic resources. Equally important, payment for external costs takes precedence over considerations regarding the distribution of the excise tax burden over rich and poor or affordability. Even a poor drinker cannot be excused from the damages of an accident caused by him or her.

106. Obviously, the external costs caused by smoking, drinking, sugar consumption, gambling, polluting and driving are independent of the price of the related excisable products, so that correction of externalities favors *specific over ad valorem* taxation. In other words, externality-correcting excises should be expressed as a specific amount per number, volume, weight, strength or other physical characteristic of excisable products. An incidental but welcome effect of specific duties is that they tend to involve less avoidance and evasion than *ad valorem* duties based on value, because specific duties require only counting (e.g., cigarettes) or measuring

³⁷ For a comprehensive treatment of these excises, see Cnossen (2005).

strength (e.g., alcoholic beverages) or volume (e.g., of motor fuels). Thus, there are no contentious valuation issues to be dealt with, at the manufacturing or, not to forget, the import stage. Since the real value of specific duties is eroded by inflation, specific duties should be periodically adjusted for changes in the general price level, say annually, through discretionary powers granted to the Minister of Finance. Since external costs and by extension excise duties should be included in price, VAT should always be imposed on the excise (and import) duty inclusive price of excisable products.

107. Excises on items of luxury consumption are an exception to these considerations. They are not imposed for externality reasons but to promote progressivity in taxation. Because the demand for luxuries rises faster than income rises, an excise on them is disproportionately paid by the rich. In contrast to externality-correcting excises, excises on luxury products should be imposed at *ad valorem* rates, preferably applied to retail values to catch the full value added throughout the production-distribution chain. The central issue here is whether the taxation of luxury goods is worth the cost of the administrative effort. Generally, the answer is 'no' because the base is very small (1-2 percent of consumption expenditures), and enforcement is problematic with respect to travellers who buy luxury products abroad. Expensive passenger cars or yachts are an important exception to this observation.

B. Overview and General Observations

108. Table 10 provides an overview of externality-correcting and progressivity-enhancing excise duties in Aruba. All taxes, duties and levies are listed by tax base and tax rate whether levied on domestic products or imported. Import duties higher than the general rates of 6 percent and 12 percent are also shown. As differentially higher duties, they can also be considered excise duties although the products on which they are imposed are not necessarily produced domestically.

Generally, Table 10 indicates that various excises are not comprehensively defined, e.g., those on cigarettes and wine, or properly delineated from the import duty. As a result, the duty structures on tobacco products and alcoholic beverages lack cohesion. Further, excise duties and import duties on similar products differ one from another, obscuring the role each of these duties, on the one hand, and a general consumption tax on the other hand performs in a rational tax system. Whereas import duties are imposed to protect domestic producers, excise duties are levied for externality-correcting reasons and should be imposed at the same rate on domestic and imported products. At the import stage, therefore, a clear distinction should be made between the domestic-equivalent excise and the import duty per se. Beyond that the VAT is intended to tax all products alike and therefore should be imposed on the excise-inclusive price of domestic products and the import and excise duty inclusive price of imported products.

109. Below the rationale, base and rate structure of each of the various excisable product categories distinguished in Table 10 are dealt with in greater detail, separated into 'sin' taxes, taxes and duties on 'motoring' and in connection with climate change, and progressivity-enhancing excise duties. In addition, new excises on sugar, soft drinks, plastic bags and airtime are discussed.

Table 10. Aruba: Excise Duties and Excise-type Import Duties

| Excisable goods and services – and legislation | Tax base / type of product | Tax rates | |
|--|---|--|--|
| | | Domestic | At import |
| EXTERNALITY-CORRECTING EXCISE DUTIES | | | |
| Sin taxes | | | |
| 1. Tobacco products | | | |
| a. Cigarettes excise; Accijns op sigaretten (AB 19789 no. GT 31) | Fixed amount | AWG 6.35 / 20 cigarettes | |
| b. Other tobacco products | Value at import | | Cigarettes: 12% 57% |
| 2. Alcoholic beverages | | | |
| a. Beer excise; Accijns op bier (AB 1993 no. GT 20) | Volume | AWG 353 / hl | |
| | | | Stout beer: AWG 169 / hl Other beer: AWG 80 / hl |
| b. Wine | Volume | None | Champagne: AWG 520 / hl Other wine: AWG 400 / hl |
| c. Ciders; edible fruit on alcohol | Volume or value | None | Ciders: AWG 100/150/hl Edible fruit on alcohol: 32% |
| d. Spirits excise (Accijns op gedistilleerd; AB 1991 no. GT 27) | Volume and strength | AWG 1844 / hl of 50% alcohol | |
| | | | Spirits AWG 30 / hl of 50% Denatured alcohol: 12% |
| 3. Sugar and soft drinks | | | |
| a. Sugar | Weight | None | AWG 1.50 / 100 kg |
| b. Soft drinks | Volume | None | Mineral water: AWG 10 / hl Limonades: AWG 30 / hl |
| 4. Fireworks, gaming and plastic bags | | | |
| a. Fireworks | Value | - | 57% |
| b. Gaming license fee and tax | License fee plus turnover tax | License fee: AWG 5,000 / month plus 4% on innings | NA |
| c. Plastic bags | To be considered | | |
| Taxes on motoring and climate change | | | |
| 5. Petroleum products and motor vehicles | | | |
| a. Petroleum products excise (Accijns minerale oliën; AB 1989 no. GT 56) | Type and volume | Gasoline: AWG 61.40 / hl Diesel: AWG 38.20 / hl Kerosene: AWG 33.50 / hl | |
| b. Motor vehicle and boat tax (Motorrijtuig-en motorboot belasting; AB 1988 no. GT 23) | Annual tax differentiated by type (passenger car, truck, bus, bike), value (less than AWG 10,000, up to AWG 20,000, over AWG 20,000), weight (less than or over 2500 kg), number of seats (less than 10, 10-13, over 13), kind of propulsion gasoline, bio, hybrid); motor boats pay AWG 150. | | Up to AWG 10,000: 30% AWG 10,000 – 20,000: 40% Above AWG 50.000: 50% Motor bikes, water scooters: 40% |
| c. Special tax on hire of cars and motor bikes | Fixed amount | AWG. 96.75 per car or motorbike | NA |
| d. Car accessories | Upholstery, inner and outer tubes, mirrors, suspensions, engines, crank shafts, batteries, lamps, horns, windshield wipers, antennas, radiators, chairs, lubricants, armored vehicles | - | 22% |

| Excisable goods and services – and legislation | Tax base / type of product | Tax rates | |
|--|----------------------------|-----------|---|
| | | Domestic | At import |
| PROGRESSIVITY-ENHANCING EXCISE DUTIES | | | |
| 6. Oysters, caviar | Value | | Oysters: 22% Caviar, prepared oysters: 32% |
| 7. Various products Matrasses, wigs, canes, entertainment gadgets Whips, artificial flowers, statutes, ornaments Water heaters, generators, AC units, cooling and freezing apparatus Percussion instruments, music boxes, radio furniture and cupboards, antennas, clocks, Garden and beach parasols, tiles, safety boxes Leather and cork products Upholstery for room and furniture, carpets, felt products Boats less than 12 m; fire arms, ammunition | Value | | 22% |
| 8. Air time | To be considered | | |

Source: Landsverordening in-, uit- en doorvoer – AB 2000 no. GT 10 and beer and spirits duty legislation.

C. 'Sin' Taxes

Tobacco Products

110. Globally, tobacco excise duty levels are gradually being adjusted upwards. This is to conform with the goal of the Tobacco Convention (ratified and/or signed by most countries around the world) of achieving a total tax burden (excises and VAT) equal to 75 percent of the retail price per pack of 20 cigarettes, which is supposed to approximate the external cost of smoking and to provide a high monetary stimulus to stop or not to start smoking.³⁸ These external costs relate primarily to the expense of treating smoking-related illnesses, as well as the well-being and market earnings that are lost because of these illnesses and death. As is well known, smoking is a primary cause of lung cancer, emphysema, and chronic bronchitis, and a major cause of heart disease and stroke. Along with information failures (i.e., lack of knowledge about addiction and health risks), the external costs establish a case for government intervention through excise taxation, as well as through regulation and education. Practice suggests that in Aruba taxation should be the primary means of government intervention.

111. Tobacco taxes (excise duties and VAT) in Europe meet the 75 percent criterion, but, as shown in Table 11, most Caribbean countries come nowhere near that mark. Aruba, however, scores much better than other countries. Its tobacco excise duty of 57 percent of the retail price stands out as high compared to those levied in other Caribbean countries, which (excluding Antigua

³⁸ For a review and evaluation of tobacco excise duties in Europe, see Clossen (2007a).

and Barbuda) range from 5.2 percent in St Kitts and Nevis to 39.1 percent in St Lucia. The absolute amount of the duty in Aruba, i.e., US\$ 3.54 (plus 12 percent import duty on the excise-exclusive import value), is higher than any other duty in the region. Since excise duties are generally shifted forward into consumer prices, cigarette retail prices in Aruba are by extension also higher than the prices in most other countries. The Bahamas, Barbuda and St Lucia are exceptions.

Table 11. Excise Duties on Cigarettes in Aruba and Other Caribbean Countries, 2017

| Country | Pack of 20 cigarettes of the most common brand (in USD) | | | Type of excise | | | Tax stamps | VAT (tax-inclusive) |
|-------------------------|---|--------------|-----------------------------|----------------------|----------------------|---------------------------------|------------|---------------------|
| | Excise duty | Retail price | Excise as % of retail price | Specific/ ad valorem | Inflation adjustment | Uniform / tiered, varying rates | | |
| Aruba | 3.54 | 6.20 | 57.1 | Mixed | No | Uniform | Yes | .. |
| Antigua & Barbuda | 0.07 | 2.96 | 2.4 ^a | Ad valorem | - | Uniform | - | 13.0 |
| Bahamas | 3.00 | 8.95 | 33.5 | Specific | .. | Uniform | Yes | 7.0 |
| Barbados | 1.88 | 7.50 | 25.1 | Specific | .. | Uniform | No | 14.9 |
| Belize | 0.65 | 2.50 | 26.0 | Specific | No | Uniform | No | 11.1 |
| Dominica | 0.18 | 1.59 | 11.3 | Specific | .. | Uniform | No | 13.0 |
| Grenada | 1.01 | 3.19 | 31.8 | Ad valorem | - | Uniform | No | 13.0 |
| Guyana | 0.18 | 1.69 | 10.9 | Ad valorem | - | Uniform | No | 13.8 |
| Jamaica | 2.22 | 7.85 | 28.3 | Specific | No | Uniform | No | 14.2 |
| St. Kitts & Nevis | 0.15 | 2.96 | 5.2 ^b | Ad valorem | - | Uniform | No | 14.5 |
| St Lucia | 1.30 | 3.33 | 39.1 | Specific | .. | Uniform | No | 13.0 |
| St Vincent & Grenadines | 0.17 | 2.22 | 7.7 | Mixed | No | Uniform | No | 13.0 |
| Trinidad & Tobago | 0.57 | 3.87 | 14.7 | Specific | No | Uniform | No | 11.1 |

Source: WHO Report on the Global Tobacco Epidemic, 2017 (available on the internet)

^a Revenue Recovery Charge Act; Antigua & Barbuda do not impose excise duties on tobacco products.

^b Includes customs service charge of 1.2%.

112. On the basis of these arguments it is difficult to make a case for raising the cigarette excise further. What should be done, however, is to reform the excise duty schedule for tobacco products by incorporating separate specific amounts for fine-cut smoking (roll-your-own), pipe, chewing and snuff tobacco, cigars and cigarillos. Using the EU's definition of tobacco products for reference,³⁹ a new schedule should incorporate these distinctions keeping in mind that a thousand cigarettes contain three-fourths of a kilogram of tobacco (0.75 gram per cigarette) and assuming that cigarettes cost one-third more to produce than smoking tobacco. The current uniform 57 percent duty imposed on tax-exclusive import values is very low.

Recommendation

- Impose appropriate equivalent specific duties on tobacco products other than cigarettes based on tobacco weight or volume.

³⁹ See European Commission (2018).

Alcoholic Beverages

113. Like excise duties on tobacco products, excise duties on alcoholic beverages should be designed to account for the external costs that abusive drinkers impose on other people.

Chronic heavy drinking has harmful health effects (e.g., organ damage, birth defects) and causes (road) accidents and domestic violence. Crime can also be alcohol-related. The World Health Organization (WHO) has provided evidence that in most countries excessive consumption of alcoholic beverages is responsible for up to 10 percent of the total disease burden. Alcohol consumption and abuse in Aruba approaches or exceeds European levels. The alcohol excise can play an important role in curbing alcohol abuse. Since it is the alcohol that should be taxed, it is recommended that all duties on alcoholic beverages should be based solely and uniformly on strength.

114. Beer and spirits are the only alcoholic beverages that are subject to excise in Aruba; wine, ciders and spirits are only taxed at the import stage.

Locally produced and imported beer is taxed at AWG 353 per hectoliter, which equals almost AWG 1.76 (USD 0.99) per half liter, say, of 5 percent abv (alcohol by volume). Further, there are import duties of AWG 0.62 for half a liter of stout and AWG 0.20 for other beer. Comparative duties in the Caribbean are hard to come by, but the UK imposes slightly more than USD 0.12 on half a liter of beer and the Netherlands about USD 0.16.⁴⁰ Accordingly, the beer excise in Aruba is higher than most duties elsewhere, and there is little reason to increase it. The duty schedule, however, should have a separate duty for beer stronger than 7.5 percent abv or weaker than 5 percent abv.

115. Aruba does not levy an excise on wines but imposes an import duty of AWG 400/hl on all wines regardless of strength.

This translates into AWG 3 per bottle of 75 cl equivalent to USD 1.68. The duty in the UK is round USD 2.82 per bottle and the Dutch duty is USD 0.76. This suggests that the Aruban duty on wine is not on the low side. Again, however, the duty schedule can be improved by differentiating the rates between still and sparkling wine and by alcoholic strength. Fortified wines (sherry's and ports) should be taxed at a higher rate.

116. The excise duty on spirits is AWG 1844/hl of 50 percent pure alcohol. Accordingly, a 70 cl bottle of spirits with a strength of 40 percent is excised at a little over AWG 14.75 (USD 8.25). By comparison, in the UK the same bottle is taxed at more than USD 10, and at over USD 5 in the Netherlands (the import duty is negligible). Clearly, the Aruban spirits excise is not out of line with duties elsewhere. For the design of an alcohol duty scheme covering beer, wine and spirits, reference may be made to the European Union's classification of alcoholic beverages found in European Commission (2018).

117. Further, it is recommended to tax denatured alcohol in full with a credit (and refund) against the tax due on the finished products in which it is incorporated. Currently, a 12 percent

⁴⁰ See European Commission (2018). An exchange rate of USD 0.87 to the Euro has been used for conversion purposes. For a study on alcohol taxes in the EU, see Cnossen (2007).

import duty applies to denatured spirits sold to industrial users, such as pharmaceutical companies and manufacturers of beauty products (for example, perfumeries). Of course, denatured alcohol cannot be used for alcoholic beverages, but the risk is that the alcohol may not be denatured at all and instead redirected illicitly into alcoholic beverage production.

Recommendations

- Introduce a comprehensive alcohol excise duty schedule applicable to domestically produced beverages as well as at import.
- Tax denatured alcohol in full and refund the excise when incorporated in the final product.

Sugar and Soft Drinks

118. The rationale of an excise on sugar, soft drinks and other products containing sugar or sugar substitutes is to counter overconsumption, which is associated with obesity – a major risk factor for heart disease, type 2 diabetes, dental disease, and other health problems. The WHO recommends that free sugar intake by humans be limited to less than 10 percent of total energy intake, i.e., 12.5 teaspoons a day for a 2,000-caloric diet. Up to 28 percent of Aruban adults (20+) are affected by obesity; the rate for school children is 15 percent, quite an alarming level.

119. Aruba imposes an import duty on sugar of AWG 1.50 per 100 kg or AWG 0.015 per kg. Although the external costs of the overconsumption of sugar are not precisely known, there is a presumption that the current import duty by no means accounts for it. It is recommended therefore to increase the duty tenfold to 15 cents per kg and to convert it into an excise duty proper. Since it is unlikely that this amount would fully account for the external costs of sugar consumption further specific duties, e.g., on widely consumed sugar-sweetened beverages (SSBs) are called for. Currently SSBs, called limonades, are taxed at import at AWG 30 per hl or 30 cents per liter. Since an excise on SSBs would be an appealing revenue measure, it is suggested to convert this duty into an excise and impose it on domestically bottled as well as imported SSBs.⁴¹

120. Admittedly, there are many foodstuffs with significantly more sugar per gram than SSBs. These include items such as confectionary and other “empty-calories” junk foods. If the WHO’s health goal is taken seriously, the tax should be extended beyond SSBs. By not including substitutes (e.g., chocolates, sweets, iced sugar products) in the base, the likely impact of the excise would be more regressive, because higher-income groups spend as much or more on these products as on SSBs. Various countries (Denmark, Finland, Hungary, Mexico, Norway) have taken the base and burden distribution aspects of this to heart and have included other products high in sugar. Aruba could consider doing the same.

⁴¹ For a good study, see National Treasury of South Africa (2006).

Recommendations

- Convert the import duty on sugar into an excise duty proper and increase it tenfold.
- Convert the import duty on SSBs into an excise duty proper and also impose it on domestically bottled SSBs.

Fireworks, Gaming and Plastic Bags

121. Aruba imposes a 57 percent import duty on fireworks. The rationale of excise taxation prescribes that this duty should be converted into a specific excise duty. Further, it is suggested to differentiate the duty into three classes depending on the explosive nature of the fireworks. The duty on the most explosive type could be increased to the specific duty equivalent level of one hundred percent of its value and the duty on the other two classes at two-thirds and one-third of that level.

122. Gaming is subject to a license fee of AWG 5,000 per month and a 4 percent duty on innings. Above, it has been proposed to include gambling and lotteries in the VAT base. Lottery tickets and net innings would then be taxed at 10 percent, but gaming establishments would be able to take credit for any VAT on the provision of food or prizes, which would create a more level playing field. The VAT would not take account of the external costs of gaming, which could be done by imposing a duty on lottery tickets, tokens and chips. Ideally, this should be a specific duty but since it would be difficult to measure the base, exceptionally an ad valorem duty of 30 percent is suggested. A high specific duty is in order for slot machines, which are the crack cocaine of gamblers.

123. Several countries impose environmental levies at the manufacturer's or importer's level on plastic bags that degrade the environment when they are randomly disposed of. Some countries even ban the sale of lightweight plastic bags and tax the sale of thicker plastic bags, which can be reused. In Europe, many countries have introduced taxes and regulations that prohibit or tax the use of single-use plastic bags. Aruba should consider doing the same. To be effective, the plastic bag charge needs to be sufficiently high to influence consumer behavior. A specific duty of 10 cents per bag is suggested.⁴² This would reduce littering. Similar levies can and should be imposed on plastic bottles, incandescent light bulbs and aluminum cans. On returning plastic bottles and cans, a nominal recycling fee should be payable by the bottling or distribution companies. The introduction of an environmental levy on incandescent light bulbs promotes energy efficiency as energy-saving light bulbs last longer, require five times less electricity, and result in lower greenhouse gas emissions.

⁴² Moreover, additional regulations should be introduced that would change consumer behavior, including: (1) retailers must offer for sale reusable bags; (2) regulating the minimum thickness of allowable plastic bags; (3) full disclosure and transparency regarding the costs of plastic shopping bags; (4) regulation of the type and amount of ink that may be used for bag-printing purposes; (5) promoting a market for recycled plastic materials; (6) imposing a sufficiently high waste levy to support recycling; and (7) preventing the importation of non-qualifying bags. In addition, awareness campaigns should be ongoing to promote waste minimization and initiatives in the plastic industry that expand collector networks, which are job creators for the poor.

Recommendations

- Convert the 57 percent import duty on fireworks into a specific excise duty equivalent to 100 percent of value on high-explosive fireworks but impose lower duties on fireworks with less explosive power.
- Tax gaming under the proposed VAT and consider an excise duty on lottery tickets and tokens and chips.
- Introduce a number of specific charges on the use of plastic shopping bags, plastic bottles, aluminum cans, and incandescent light bulbs to discourage their use and encourage recycling through refund mechanisms. Pay out a nominal fee for the return of aluminum cans.

D. Taxes on Motoring and Climate Change

Preliminary

124. The Kingdom of the Netherlands stated its intention to abide by the measures agreed to at the 2015 United Nations Climate Change Conference in Paris. The resulting “Paris agreement” aims to limit the increase in global average temperature to 1.5 degrees Celsius. This implies that the focus should be on containing the consumption of fossil fuels – defined to include gasoline, diesel fuel, dual-purpose kerosene, natural gas, coal, and electricity – which are the main culprits of global warming. As in other countries, this involves the imposition or increase of excises to internalize the external cost of fossil fuel use. Aruba is the fourth biggest polluter in the world by CO₂ emissions, emitting 23.9 metric tons per capita.⁴³

125. Particularly, road users cause multiple externalities (which they should pay for) in the form of:

- global air pollution (carbon dioxide, methane, nitrous oxide), which contribute to climate change;
- local air pollution, which increases the incidence of respiratory and cardiopulmonary disease (usually half the overall incidence);
- road damage, particularly by heavy trucks;

⁴³ See GlobalPetrolPrices.com. Possibly, the high emission in Aruba is due to the presence of an oil refinery at the time that the emissions were measured. In the meantime, the refinery’s operations have been discontinued.

- congestion, which is a tax on labor estimated at around half the average wage attributable to the time spent in traffic;⁴⁴
- accident costs.

126. If these costs are properly internalized in prices, consumers and producers make better decisions regarding their use of the road network. Moreover, a properly designed road fuel and use tax system can raise substantial revenues for general budget purposes and should exhibit a progressive tax burden distribution. Aruba imposes excises and fuel levies on petroleum products as well as motor vehicle license taxes and import and on new and used vehicles. These are reviewed below.

Motor Fuel Taxation

127. Table 10 indicates that the excise duties on petroleum products in Aruba are very low compared to those levied in other upper middle-income countries, particularly the EU. These should be increased considerably if climate change is taken seriously. The excise on gasoline is merely 6 cents per liter compared with about AWG 2 in the Netherlands; the excises on diesel and kerosene are even lower. Higher motor fuel taxes (for gasoline and diesel) tend to reduce vehicle use and encourage the purchase of more fuel-efficient motor vehicles. The impact should be greater on fuel use and vehicle emissions than on vehicle use and congestion. It should be reiterated that motor fuel excises should be indexed for inflation.

128. The excise duties on gasoline should be used to encourage the take-up of ultra-low sulfur and sulfur-free versions of gasoline and diesel (not only low sulfur gas oil). In combination with appropriate regulations, in many countries this policy has resulted in the full replacement of leaded and sulfur-rich types of fuel by cleaner fuels with less environmental harm. Aruba should adopt the same policy by taxing sulfur-free fuels at half the rate of the duty on sulfur-rich fuels (if not prohibiting them outright).

129. Further, Aruba taxes diesel fuel at a much lower rate than gasoline. Presumably, this reflects the policy maker's concern about the impact of high diesel excises on the use of diesel fuel in commercial vehicles and on the cost of hotels and industrial processes. Although there is no justification for imposing *revenue-raising* excises on intermediate uses (which are inputs to production) of diesel, diesel-powered commercial vehicles (as well as diesel used in industrial and agricultural machinery) should always bear appropriate *externality-correcting* taxes, because the latter should be passed on in price if the fuel excise is to perform its economic role. Diesel-powered vehicles (and machinery) emit particulates, for example, soot, which cause health problems (respiratory ailments and cancer), particularly in urban areas. This is a strong argument for imposing an excise on fuel oil, which is not taxed now, as well.

⁴⁴ See Small (1992).

130. Although the picture is complicated, on balance a differentially lower excise duty in favor of diesel fuel is inconsistent with the relative environmental damage caused by diesel versus gasoline engine vehicles. Beyond this, the fact that diesel-powered trucks and cars are more fuel-efficient per kilometer than gasoline-powered vehicles indicate that, per liter of fuel, diesel-powered trucks and cars impose more damage to roads than gasoline-powered trucks. Thus, diesel should be taxed more heavily, not lower, than gasoline. Admittedly, diesel fuel is also used by buses, which provide transportation for the poor, but the impact of a higher excise on fares would be so small as to have a negligible effect on the costs of transportation for any individual passenger.

131. At current rates, motor fuel duties do not cover the multiple external costs of road use. It would seem appropriate, therefore, to double the gasoline excise (AWG 12 per liter of sulfur free gasoline) and triple it to AWG 20 per liter of leaded and sulfur rich gasoline. In addition, the diesel excise should be increased fivefold to about the same level. The same duty should apply to kerosene, considering that a lower duty would encourage diversion to diesel use. Table 12 indicates that resulting pump prices still would be compatible with other prices in the region.

Table 12. Energy Prices in Caribbean Countries (liter, USD)

| Country | Gasoline --Liter, USD-- | Diesel | Electricity kWh, USD |
|-------------------|----------------------------|--------|-------------------------|
| Aruba | 1.20 | 1.03 | 0.203 |
| Bahamas | 1.30 | 1.23 | .. |
| Barbados | .. | 1.57 | 0.284 |
| Belize | 1.54 | 1.41 | 0.203 |
| Dominica | 0.87 | 0.75 | .. |
| Guyana | 1.08 | 1.03 | .. |
| Jamaica | .. | 1.21 | .. |
| St Lucia | 1.13 | 1.13 | .. |
| Trinidad & Tobago | 0.59 | 0.38 | .. |
| Netherlands | 1.96 | 1.59 | 0.223 |

Source: Gasoline, diesel and electricity prices around the world, August 2018, downloaded from the internet.

132. It should be noted that the importation and distribution of petroleum product in Aruba is carried on in the form of a public utility. Hence, the argument for separating the excise from the transfer of any surplus income made above in connection with the VAT on water and electricity is also applicable to petroleum products.

Recommendation

- Double the excise on sulfur-free gasoline and triple the excise on sulfur-rich gasoline; increase the diesel and kerosene excises fivefold over a period of three years.

Motor Vehicle License Fees

133. Practically all physical wear and tear to the road surface is caused by heavy trucks. In fact, road damage costs are roughly proportional to the fourth power of the axle load. Based on this,

the Government is advised to revise the motor vehicle license system. To begin with, motor vehicle license taxes on trucks should be based on weight and raised by substantial amounts. Weights should be laden weights and axle load is a better yardstick than manufacturer's permitted gross weight. Higher diesel excises cannot alone reflect the road damage, because the additional fuel used by a heavier vehicle is by no means proportionate to the very much higher road damage that the vehicle causes.

134. But there are even weightier environmental arguments for reviewing road taxes. These taxes can and should be differentiated in ways that reflect attributes of the vehicle related to environmental friendliness (type of fuel, polluting emissions, presence of catalytic converters), passenger vs. goods transport (number of passenger seats, weight, number of axles), social considerations (exemptions for disabled people), and vehicle age. This differentiation has the potential to influence car purchasers' decisions towards vehicles meeting specific requirements as listed above and allows reflection of aspects of road use that cannot be captured by the fuel price alone.

135. Taxes are particularly useful for reducing CO₂ emissions, while regulations are more appropriate for limiting non-CO₂ emissions. Much can be learned about regulations from the 'Euro 1–6' norms, which can be imposed at import. It is recommended that Aruba should apply such regulations, as have other non-European countries. Although the norms should not be prescribed for vehicles already on the road, annual inspections can ensure that they are upheld for new vehicles.

136. In designing the new motor vehicle tax, much can be learned from Australia, Canada, the UK and Germany, all of which base their annual motor vehicle tax on CO₂ emissions. In Germany, for instance, the annual motor vehicle tax consists of a base tax and a CO₂ tax. The base tax is EUR 2 per 100 cm³ for gasoline- and EUR 9.50 per 100 cm³ for diesel-powered vehicles. The CO₂ tax is linear, at EUR 2 per g/km emitted above 95 g/km. Cars with CO₂ emissions below 95 g/km are exempt from the CO₂ tax component but not from the base tax. Similar taxes are found in Australia, Canada and the UK, which also adhere to the basic norms prescribed by the European Commission. However, the German tax is simplest. A program that would gradually tighten emission standards, as under the 'Euro 1–6' norms, would provide certainty about Government's future plans. The CO₂ reduction program for vehicles should be implemented in conjunction with gradually tightening rules for non-CO₂ emissions. It should be noted that these standards would, by implication, encourage the purchase and use of hybrid and electric cars. In other words, no special treatment would have to be prescribed for these vehicles.

Recommendations

- Design motor vehicle license fees for trucks in line with laden axle weight.
- Refine the license fees with reference to CO₂ emissions.

Motor Vehicle Import Duty and VAT

137. All new or second-hand vehicles are imported and taxed by a graduated duty based on the value of the vehicle. Expensive cars are taxed at 50 percent of value, cheaper cars at 30 percent; motorbikes and water scooters attract 40 percent duty. This seems appropriate as the value would tend to be income related and thus the tariff imparts some progressivity to the tax system. Valuation issues can be avoided by using the list prices of new and second-hand motor vehicles that foreign excise tax departments publish for imposing ad valorem purchase taxes – supported by published commercial value catalogues. VAT should be imposed on the import duty inclusive value of vehicles.

138. VAT should also be levied on the domestic sale of motor vehicles by dealers. It would be useful to consider the application of the VAT to the dealer’s margin on second-hand cars. (If second-hand cars are taxed in full, their trade will be diverted from regular channels.) Administratively the best way to achieve this is by directly taxing the trading margins. The theoretically more attractive alternative of taxing the resale in full and permitting a credit for the VAT attributable to the second-hand vehicle would be more difficult to implement.

Recommendation

- Impose the new VAT on the dealer’s margin of the sale of second-hand cars.

E. Progressivity-Enhancing Excise Duties

General Observations

139. As shown in Table 10, Aruba imposes a 22 percent excise-type import duty on oysters, 32 percent on caviar and prepared oysters and 22 percent on a fairly large range of products whose income-elasticity of demand probably is also greater than one. These products include various appliances, music instruments, leather products, upholstery and some other goods. These duties are nuisance levies, which yield very little revenue and are difficult to justify. They should be reduced to 12 percent. Oysters and caviar should be taxed at the same level as other food products, i.e., at 0 percent.

140. More generally, the mission does not recommend excises on luxury goods for the following reasons:

- An examination of household budget surveys shows that the coverage of the usual luxury products tends to be extremely narrow—hardly comprising more than 1 or 2 percent of consumption expenditures. Consequently, the effect on progressivity or revenue is insignificant;
- Higher-income groups can easily purchase various taxable luxury products abroad. Subsequently, their importation could be concealed (for example, an expensive wristwatch) or would fall within the limits of the personal exemption;

- Separate excises add to the costs of administration and compliance; the definitional refinements that are required to tax luxury items more heavily usually give rise to casuistic disputes on interpretation;
- Class-differentiated consumption patterns that are helpful in excise duty design for imparting progressivity hardly exist in Aruba for most luxury products;
- Progressivity in the tax burden distribution can be better achieved through the income tax, which is more comprehensive in coverage and more adaptable to the individual circumstances of taxpayers.

141. This is not to say, however, that excise duties and other selected product taxes cannot be used to increase the tax system’s overall progressivity. However, the requirements for effective progressivity in product taxation should be heeded. For the progressivity to be appreciable, consumption by higher-income groups must be significant. There are few products that meet these requirements, but cars, yachts and aircraft (as well as residential housing) are good candidates for differentially higher product (and property) taxes.

Airtime

142. Excise duties on airtime have become an important source of revenue-raising in several countries. Reportedly, mobile phone subscribers in Aruba number some 60,000; an estimate of average use of mobile phones in AWG per month is not available⁴⁵ For comparison purposes, the total turnover of the telecom sector in 2017 was nearly AWG 290 million, which should be netted out for network access, i.e., handset and initial connection charges. Airtime connectivity has positive rather than negative externalities and, therefore, should not be taxed at the level of tobacco products and alcoholic beverages. But this having been said a 5 percent excise duty collected at server level would be a useful revenue-raising measure.⁴⁶

Recommendations

- Abolish the import duties on (prepared) oysters and caviar and reduce the duty on mattresses and various other products shown in Table 10 to 12 percent.
- Introduce a 5 percent excise duty on airtime.

⁴⁵ For an exposition of the taxation issues and what countries do, see Deloitte (2016).

⁴⁶ See Matheson and Petit (2017), which discusses all taxes applicable to the telecommunications sector.

VI. IMPORT DUTIES

143. Aruba levies a variety of import duties, generally at rates of 6 percent and 12 percent as shown in Table 13. Many foodstuffs are taxed at 0 percent, while various excise-type products, listed in Table 4, are taxed at higher rates. Trade taxes contribute approximately 11 percent of total tax revenue or 3.5 percent of GDP and are an important source of revenue therefore. They interact with the proposed VAT and the excise duties. VAT should be imposed on all goods at import at 10 percent and excise-type import duties should be converted into excise duties proper equally applicable to domestically produced products. Two issues need to be considered: should import duties be retained and if so what should the duty schedule look like?

Table 13. Import Tariff Nomenclature

| Part | Main heading | Most common duties |
|-------|--|---|
| I | Live animals and products of the animal world | 0%; crab 6%; oysters 22% |
| II | Products of the plant world | 0%: vegetables, fruits, coffee, tea, cereals, spices; live plants and flowers 12% |
| III | Plant and animal fats and oils | 0% |
| IV | Foodstuffs, beverages, alcoholic fluids, vinegar, tobacco | 6%: foodstuffs, sugar, cacao, cereal, vegetable and fruit products; sugar, alcoholic beverages and tobacco: <i>see excise duties</i> |
| V | Mineral products | 0% |
| VI | Chemical and related products | 6%: chemical products, pharmaceuticals, fertilizers; perfumery 3%; soap, detergents, pyrotechnical products 12% (fireworks 57%); specific duties on photographic products |
| VII | Plastic, wax and rubber products | 12%; upholstery, inner and outer tubes 22% |
| VIII | Hides, skins, leather, furskins | 12%; upholstery 22% |
| IX | Wood and cork products, wicker | 12% |
| X | Paper ingredients, paper | 6%; postage stamps 12% |
| XI | Textiles and textile products | 6%: clothing; other 12%; carpets 22% |
| XII | Footwear, headgear, umbrellas, feather products, artificial flowers | 6%; hats, parasols 12%; artificial products 22% |
| XIII | Works of stone, gypsum, cement, asbestos; ceramic products | 12%; tiles 6%; mirrors, roofing and floor tiles 22% |
| XIV | Pearls, precious stones and metals | 12%; precious metal products 3% |
| XV | Metals and metal products | 12%; kitchen furnaces, tools 6% |
| XVI | Machinery, apparatus | 12% |
| XVII | Transportation equipment | 12%; passenger cars, motor bikes, boats: <i>see excise duties</i> |
| XVIII | Optical, photographic, medical equipment; clocks, musical instruments, TVs | 12% |
| XIX | Weapons and munition | 6%; hunting guns 22% |
| XX | Other goods and products | 12%; furniture for planes and cars, mattresses, party articles 22% |
| XXI | Art works and antiques | 6% |

Source: *Landsverordening in-, uit-, en doorvoer* – AB 2000 no. GT 10 as amended.

Should Import Duties Be Retained?

144. Closer economic integration and greater outward orientation, which promote growth, would require the elimination of trade taxes and their replacement by domestic taxes, preferably broad-based consumption taxes such as VATs, but possibly also excise taxes. The

case for replacing trade tax revenue by indirect tax revenue (and the many caveats to this benchmark result) for a small and competitive economy is set out in Keen and Ligthart (2001): gains in production efficiency are preserved by moving producer prices closer to world market prices, (slightly) lower consumer prices leave consumers better off, and government revenue is not reduced.⁴⁷ Whether this welfare-improving recipe has moved on to government policy menus is examined by Baunsgaard and Keen (2010) in an extensive and closely argued study based on panel data for 117 countries covering 32 years. Specifically, the authors show that past replacement has been robust with regard to high- and, to a lesser degree, middle-income countries, such as Aruba.

145. Administratively, the replacement of trade taxes by VAT implies that a rather certain, physically controlled form of tax collection, at least for goods, is being replaced by a more uncertain, accounts-controlled form, largely based on voluntary compliance (although much VAT would continue to be 'pre-collected' at the import stage). The feasibility of revenue replacement, rather than its policy desirability, is of considerable interest, particularly since Baunsgaard and Keen (2010, p. 571) find 'no strong evidence that the simple presence of a VAT has aided revenue recovery'.⁴⁸

146. Replacement feasibility is also dependent on the amount of revenue that should be raised. In Aruba replacement needs are quite significant. Presumably, excise taxes, which like import duties are also subject to physical control, can replace some of the forgone revenue, but the main replacement burden would fall on the VAT. The replacement would require a (much) higher standard VAT rate than the proposed 10 percent. Presumably, this would raise issues for the tourist sector as it has in other Caribbean countries, requiring a lower rate on accommodation and by implication a higher standard rate on other goods and services. On the basis of these arguments, Aruba should not consider the replacement of trade taxes at this time but first introduce a proper VAT.

147. The same reasoning applies to the foreign exchange commission tax, another import duty, which accounts for 3 percent of total tax revenue. Although it should be labeled an objectionable multiple exchange rate practice, its revenue importance precludes abolition at this time.

Simplifying the Current Tariff

148. Following the removal of excise-type duties from the import duty tariff proper, the tariff functions mainly as an easy tax handle. For that reason, it is proposed to simplify the tariff by lowering all duties higher than 12 percent to 12 percent and raising all duties lower than 6

⁴⁷ In sharp contrast, however, as Keen and Ligthart (2005) prove, under imperfect competition examples are easily found in which revenue replacement unambiguously reduces domestic welfare.

⁴⁸ Not surprisingly, therefore, Baunsgaard and Keen (2010, p. 568) caution 'that countries considering foregoing trade tax revenue as part of a process of trade liberalization would be well-advised to ask whether they can recover those revenues from other sources [even without relying on increased growth or other such effects]'. Baunsgaard and Keen's conclusion is supported by Ahlerup, Baskaran, and Bigsten (2015), who find that the presence of a VAT has no effect on total revenues either in the short or long run, a rather disheartening result.

percent to 6 percent. The 0 percent duties would remain unchanged. This is not an ideal solution but would create fiscal space for the new VAT to mature. *Prima facie*, revenue would not be affected.

Recommendations

- Do not replace the trade taxes or the foreign exchange commission tax by the VAT at this time.
- Simplify the import duty tariff by moving all goods taxed higher than 12 percent to the 12 percent category and all goods taxed at positive rates lower than 6 percent to the 6 percent category. Keep the 0 percent category as is.

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