INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/17

THE BAHAMAS

TAX REFORMS FOR INCREASED BUOYANCY

January 2014

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- **Technical Assistance Report** on "The Bahamas: Tax Reforms for Increased Buoyancy" was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in June 2013.

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Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

Fiscal Affairs Department

The Bahamas

Tax Reforms for Increased Buoyancy

June 2013

Selcuk Caner, Martin Grote, and Russell Krelove

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Contents Page

Tables

Figures

Boxes

PREFACE

In response to a request from State Minister Honorable Michael Halkitis of The Bahamas a technical assistance mission on tax policy visited Nassau from April 2−16, 2013. The mission comprised Selcuk Caner (head), Martin Grote, and Russell Krelove (all FAD). The mission evaluated the design aspects of the introduction of VAT and other major taxes, such as the property tax, excises trade taxes, together with an assessment of the revenue risks stemming from tax expenditures (concessions) and the untapped revenue potential from base broadening measures.

The mission met with—State Minister Honorable Michael Halkitis, John Rolle (Financial Secretary: Ministry of Finance); Simon Wilson (Deputy Financial Secretary); Ehurd Cunningham (Former Financial Secretary, Advisor); Ishmael Lightbourne (Advisor); Eugenia Cartwright (Treasurer), Mary Mitchell (Deputy Director Treasury); Robert Henry (Advisor) and technical staff in the Ministry of Finance. The mission held discussions with Charles Turner (Comptroller of Customs); David Beneby (Assistant, Comptroller of Customs); William Poitier (Customs); David Johnson (Director General, Ministry of Tourism); Harrison Thomson (Permanent Secretary, Ministry of Financial Services); Joy Jibrilu (Director of Investments, The Bahamas Investment Authority); Roger Forbes (Director of Inland Revenue); Joseph Mullings (Deputy Director, Business Licensing Department); Henk Verbrugge (IADB Consultant); Peter Deveaux Isaacs (Undersecretary, Ministry of Transportation and Aviation); Charles Albury (Undersecretary, Ministry of Transportation and Aviation); Irvin Hutchinson (Aviation Specialist, Ministry of Transportation and Aviation); Patrick McNeil (Port Consultant); and Brent Williamson (The Bahamas Port Authority). The mission exchanged views on taxation with the top management of National Insurance Board represented by Cecile Bethel (Senior Deputy Director); Phaedra Mackey-Knowles (Deputy Director, National Insurance Board); Derek Osborne (Actuary, National Insurance Board); Paul McSweeney (Managing Director of Bank of The Bahamas); Hubert Edwards (Senior Manager, Bank of The Bahamas); Edison Sumner (CEO, The Bahamas Chamber of Commerce and Employers Union); Maura Michael (CEO, Nassau Container Port); and obtained statistical information at The Bahamas National Statistics Department from Kelsey Dorsett (Director, National Statistics); Clarice Turnquest (Deputy Director, National Statistics); Leona Wilson (National Statistics). With regard to the taxation of the tourism industry and the effects of introducing VAT the mission met with Stuart Bowe (President, The Bahamas Tourism Centre) and Frank Comito (Executive Vice President, The Bahamas Tourism Centre).

The mission would like to express its gratitude for the sterling assistance provided by the authorities and wishes to single out Mr. Adrian Conliffe, for his undivided attention to the mission's information and logistical needs.

ABBREVIATIONS AND ACRONYMS

BCE	The Bahamas Customs and Excise
BIA	Bahamas Investment Authority
BLF	Business License Fee
BSD	Bahamas Dollar
CET	Common External Tariff
CRA	Central Revenue Agency
CT	Casino Tax
EPZ	Export Processing Zone
FAD	Fiscal Affairs Department
FOB	Free on Board
FTZ	Free Trade Zone
GDP	Gross Domestic Product
IMF	International Monetary Fund
MoF	Minister of Finance
PIT	Personal Income Tax
RA	Revenue Administration
SEZ	Special Economic Zone
TA	Technical Assistance
VAT	Value Added Tax
WTO	World Trade Organization

EXECUTIVE SUMMARY

The government plans to raise the revenue/GDP ratio to 21.5 percent by FY2016/17 from its current level around 17.5 percent, a 4 percentage point increase to address the rising public debt and fund much needed infrastructure projects. Revenue mobilization is expected through the introduction of VAT and other base broadening measures. In addition to introducing VAT as a source of revenue, property tax system will be reformed, excise tax rates on cigarettes will be changed from ad valorem to specific, and stamps introduced.

The Bahamas has a low tax effort due to limited tax handles and underutilization of available ones. The current issues to be addressed are: (1) Lack of buoyancy of the tax system; (2) dependence on fees and levies (94 fees) that are distortionary and cascading; (3) narrow tax bases through exemptions and concessions; (4) decline in collection efforts in property taxation; (5) over-taxation of goods relative to services; and (6) lack of adaptation to changing market conditions.

The mission welcomes the introduction of VAT together with a comprehensive liberalization of tariffs, and adjustments to the business license fee. Introducing the tax by July of 2014 will be a challenge. To reduce the risks to VAT introduction, and to ensure that the tax operates as an efficient and productive revenue source, the base should be chosen as widely as possible, the rate structure kept simple, and exemptions minimized. Thus, in particular, hotels and other tourism businesses should fall under VAT, and all room charges at hotels should be in the VAT base. Similarly, fee-based financial services, property and casualty insurance, telecommunications, and casinos should be taxed. Exemptions for food and residential utilities should be kept to a small number as they are inefficient instruments to reach their targeted beneficiaries. The mission recommends that the VAT be introduced with a single rate, although it understands that a defensible case, based on practice in the region, can be made to tax hotel accommodation at a second, lower rate.

For the successful introduction of VAT, a sufficiently high-registration threshold is needed. The level of this threshold is likely to be somewhat in excess of the current US$50,000 threshold used for the Business License Fee (BLF). In addition, the mission recommends maintaining the BLF for financial services and insurance that are not taxable, telecommunications, and for businesses below the registration threshold (the casino tax (CT) and the hotel accommodation tax should be eliminated). A good case can also be made to reform the stamp duty on residential real estate transactions when VAT is introduced, by eliminating the stamp duty and replacing it with a tax that is levied on the change (positive or negative) in value added from the property.

Real property tax collections as percent of GDP have doubled within a decade. This is despite a blanket tax exemption for Bahamians in respect of owner-occupied properties located on the Family Islands; a US$250,000 tax free threshold, and a recently introduced cap of US$50,000 on tax liabilities with its deleterious impact on distributional fairness. The property tax is based on market value, but required periodic reassessments are ignored which creates a growing sense of unfairness between assessed values for properties registered a long time ago vis-à-vis newly acquired ones. Enforcement is weak with low compliance, coverage, and collection ratios—even though recent administrative efforts seek to address the growing stock of arrears. The push for complying with the requirement of self-assessment and to increase the coverage ratio is aided by a recently introduced amnesty that also rewards compliant taxpayers. This is very positive. However, in order to achieve a higher revenue target for property taxes, significant policy adjustments in the area of rates, reduction of exemptions, the lowering of the tax-free threshold, and withdrawal of the cap on tax liabilities for high value properties would be required.

In addition to the real property taxes, a graduated stamp duty on the conveyance of immovable property is imposed at fairly steep rates. The duty's revenue importance shows sizable increases since 2002 and generates close to 1.4 percent—in some years even well above 2 percent—of GDP. Even though these transaction taxes impede the efficient functioning of markets through the lock-in effect or its encouragement of aggressive tax planning through willful understatement of transaction values, these stamp duties remain on the statute books of developed and developing countries across the world. The mission is keenly aware about current revenue needs to address the growing fiscal imbalance and, therefore, suggests that stamp duties on real estate transactions will be maintained for the foreseeable future until enhanced collections from the reformed property tax regime would afford gradual rate reductions of this transaction tax.

The authorities expressed a concern that the taxation of the informal sector is difficult and that high income earners are inclined to understate transaction values or turnover. Fuller use of the existing motor vehicle license fee could address this problem as it is relatively easy to tax visible and easily identifiable wealth in the form of a vehicle. Greater use of this instrument would not require the introduction of new legislation as the basic license fee system is sound given that the rate structure is adjusted according to the weight of the vehicle. This is a good indicator of value which can be taxed at progressively higher rates. Improving collections from the license fee system together with an increased vehicle license tax burden should be a priority from an environmental and traffic congestion perspective.

The Bahamas is characterized by a low tax effort due to resource mobilization from a tax system that ignores income as a tax base. This is already an attractive feature but there is an elaborate regime of discretionary tax expenditures available that grant tax holidays and tax concessions for basically every sector in the economy. The revenue foregone cost of import duties alone is close to 3.6 percent for the last fiscal year. This is becoming fiscally unsustainable and the mission prepared simple steps toward tax expenditure budgeting. It also provides arguments against rent seeking behavior in the tourism industry and a blueprint as to the rationalization of incentives.

As a requirement to WTO membership, the tariff rates will be lowered from their current levels. It is expected that revenue losses from tariff reduction will be compensated by VAT revenues. Reducing tariff would lower the general price level and increase trade by stimulating supply of imports. However, while tariffs are reduced, some of the non-basic exemptions from trade taxes should also be eliminated since the value of these exemptions will decline with lower tariff rates. In addition, excise taxes should be consolidated by focusing on few standard products such as cigarettes, alcoholic beverages, and petroleum products. The current exemptions of petroleum products (i.e., leaded gasoline) are inconsistent with the principles of excise taxation. All excisable goods should be under one act in order to facilitate the administration of the tax. The creation of Central Revenue Agency (CRA) is expected to improve the efficiency of tax collections as well as compliance.

Recommendations	Revenue Impact as Percent of Proj. 2011 GDP Increase (+) Decrease (-)
Chapter I: Revenue performance, tax structure, and taxation policy	
Establish a TPU to analyze revenue and tax policy development.	Neutral
Chapter II: Introducing VAT	
Introduce VAT with a single rate.	6.0 to 7.0
Tax fee-based financial services under the VAT.	
For exempt financial services, maintain the Business License tax. Consider adjusting the definition of the base to wages plus salaries plus profit.	
Tax property and casualty insurance under VAT. Consider taxing life insurance. Eliminate the Business License Tax on policies taxable under VAT.	
Tax gaming under VAT. Eliminate at least the portion of the Casinos tax that is levied as a percent of winnings.	
Tax telecommunications services under the VAT, (except possibly for the cost of basic telephone service). Maintain the Business License Fee on mobile telecommunications.	
All surcharges, gratuities, and hotel levy should be included in the base for VAT on hotel accommodation. If hotel accommodation is taxed at a lower rate, other taxable supplies by hotels should be taxed at the standard rate.	
Consider replacing the real property transfer tax on transfers between VAT non-taxpayers with a tax on the increased value-added of the property.	
Subject to further data collection and analysis, consider adopting a turnover threshold of about US$150,000. Make adequate provision for voluntary registration of businesses below the threshold.	
Preserve the Business License Tax on businesses below the VAT threshold as a simplified tax. For these businesses unify the rate structure.	
Consider as a temporary measure preserving the Business License Tax on all businesses subject to VAT (except for insurance policies that are taxed under VAT).	
Chapter III: Real property taxation	
Maintain a single-rate property tax without differentiation for property use or value	(+)
Remove the cap of US$50,000 as it benefits the high-net worth individuals without any indication that the exemption encourages activity in the construction industry.	(+)

Recommendations	Revenue Impact as Percent of Proj. 2011 GDP Increase (+) Decrease (-)
Reduce or eliminate the property tax threshold of US$250,000 and scrap the property tax exemption for Bahamians on the Family Islands as they are being provided with public services for which some payment is due.	(+)
If and when low-income residential properties deserve relief, this could be achieved by granting a tax-free amount only for properties located in suburbs commonly inhabited by low-income households.	Neutral
Limit all other exemptions to an absolute minimum.	(+)
Property tax relief for the elderly and the poor should be granted on application and be means-tested.	(+)
Alternatively, introduce 'mortgaging' of outstanding property tax liabilities.	(+)
Reduce stamp duty rates only when fiscal consolidation has been achieved.	Neutral
Replace the first-time homeowner's exemption with a generally applicable tax threshold.	(+)
Increase the vehicle licenses by 20 percent, but for distributional reasons differentiate more carefully by introducing higher rates for heavy vehicles such as SUVs.	0.1
Index the charge to keep it constant in real terms.	Neutral
Chapter IV: Tax concessions	
Consolidate the various individual concession acts into a single fiscal omnibus act.	3.6
Use tax incentives sparingly in situations where they address market failures.	
Withdraw the power to issue discretionary incentives.	
Impose a sunset clause of no more than five years.	
Influence other CARICOM member states to reduce the level of tax expenditures for tourism.	
The costs of tax concessions should be calculated by the MoF and published in a periodic tax expenditure budget.	
Withdraw all discretionary powers that grant additional concessions beyond those provided for in legislation.	
Chapter V: Excise and trade taxes	
Tax tobacco products at specific tax rates, periodically adjusted for inflation.	(+)
Tax all alcoholic beverages under the Excise Tax Act.	(+)
Establish equal excise taxation of spirits produced domestically and imports.	(+)
Limit excise exemptions and increase rates on gasoline and diesel.	(+)
Reduce the list of luxury goods subject to tax by moving taxation of some of these products under the Tariff Act.	(-)
Instead of excise on luxury goods, increase excise taxes on luxury passenger cars, yachts, and aircraft.	(+)
Reduce and consolidate tariff rates to three to five different rate bands.	-3.4
Request a long transition period in WTO negotiations in support of domestic industries, particularly in agriculture.	Neutral
Consider increasing the stamp duties on alcoholic beverages.	(+)
TOTAL	

I. Revenue Performance, Tax Structure, and Taxation Policies

A. Revenue Performance and the Analysis of Shrinking Tax Bases

1. **The Bahamian economy continues to recover from the global financial crisis, with real GDP projected to grow at about 2.5 percent in 2013/14**. Despite the growth rate, the public debt to GDP ratio is projected to continue to rise reaching 62 percent of GDP by FY 2016/17.[1] The fiscal balance is expected to be at 6.5 percent in FY 2012/13. To reverse the rising public debt levels, fiscal policy measures are required on the public expenditure side as well as revenue mobilization for new sources of funding capital expenditures.

2. **In order to finance budget deficits and reduce debt, the government of The Bahamas has developed a medium-term revenue mobilization plan**. The government plans to raise the tax/GDP ratio to 21.5 percent by FY2016/17 from its current level around 17.5 percent, a four percentage point increase. According to the plan, tax/GDP ratio will increase by about one percent each year until FY2016/17. Mobilization of tax revenues through tax base broadening is the cornerstone of the fiscal consolidation in addition to a reduction in the government's expenditures. The government plans to reach the target tax/GDP ratio by introducing a Value Added Tax (VAT), improving the property taxes, improving customs administration and increasing cigarette taxation.[2] VAT is expected to contribute about 2.2 percentage points to the target tax/GDP ratio. Property taxes will contribute an additional one percent and improvements at the customs will add another 0.5 percent. Higher excises on cigarettes and anti-smuggling measure will contribute another 0.2 percent.

3. **In addition, the current government is committed to reform the tax system and accelerate the accession process to the WTO membership**. As the VAT is introduced, tariff rates will be gradually reduced as an accession requirement. The reduction in tariff rates would result in lower prices in the economy and stimulate trade and consumption.

4. **Without a personal income tax, no corporate profits tax and a comprehensive consumption-based tax, The Bahamian tax system until now relied on a very narrow tax base**. Without these tax handles, The Bahamian tax system restricts its policy options. In addition, due to its reliance on trade taxes the tax system is susceptible to external shocks as observed in 2009. So, the government's decision to introduce a VAT system and reform the other key taxes like the property tax system would improve government tax revenues as well as the efficiency of the tax system.

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[1] IMF (2012), Article IV Consultation. The public debt-to GDP ratio increases to 76 percent when the debt of non-financial public corporations is added to the public debt.

[2] VAT is practiced in more than 140 countries around the world.

5. **One third of the tax revenues are from customs duties. Customs and excises account for 58 percent of tax revenues**. Stamp taxes (23 taxes) are about 15 percent of tax revenues while the tourist tax generates another 12 percent of tax revenues (Table 1). Property tax is responsible for about 9 percent of tax revenues. Tax revenues are mainly obtained from international trade and transactions. Taxation of trade and transactions through stamp duties and fees raises the costs in the economy and causes cascading. To mitigate the burden of high tariffs and stamp duties extensive exemptions are offered to investors which further eroded the tax base. Property tax exemptions extending as much as 20 years substantially reduce the tax base. In addition, exemptions from tariff duties distorted prices, while some industries benefitted from the concessions the other did not.

Table 1. The Bahamas: Government Tax Revenues, 2007/08–2011/12

Fiscal Year	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010_2011	2011/12
As Share of GDP										
Import and export duties	7.5	7.2	6.9	7.6	7.6	7.1	4.9	4.6	4.7	4.5
Excise tax	-	-	-	-	-	-	2.3	2.4	3.2	4.1
Property tax	0.6	0.6	0.9	0.8	1.1	0.9	1.1	1.2	1.2	1.2
Motor vehicle	0.4	0.3	0.4	0.4	0.4	0.5	0.4	0.4	0.5	0.5
Gaming tax	-	-	-	-	-	-	-	-	0.2	0.1
Tourism tax	1.4	1.6	1.5	1.5	1.4	1.4	1.2	1.2	1.8	1.8
Stamp tax	3.0	3.2	4.0	4.5	5.4	5.3	2.6	2.4	3.5	2.4
Company fees	0.4	0.4	0.3	0.3	0.4	0.4	0.3	0.3	0.3	0.3
Bank and trust company fees	0.1	0.1	0.2	0.1	0.1	0.1	0.2	0.2	0.3	0.1
Insurance Company Premium and Fees	0.0	-	-	-	0.3	0.2	0.3	0.2	0.2	-
Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fees and service charges	1.0	1.0	1.0	1.1	1.6	1.7	1.7	1.8	2.0	2.3
Total	14.3	14.4	15.2	16.4	18.3	17.7	15.0	14.7	17.7	17.3
As Share of Tax Revenues										
Import and export duties	52.1	49.9	45.4	46.5	41.3	40.3	32.6	31.5	26.3	26.2
Excise tax	-	-	-	-	-	-	15.6	16.3	18.2	23.9
Property tax	4.5	4.5	5.7	5.0	6.3	5.4	7.0	7.9	6.6	6.9
Motor vehicle	2.5	2.4	2.7	2.5	2.2	2.6	2.6	2.4	2.6	2.8
Gaming tax	-	-	-	-	-	-	-	-	1.0	0.8
Tourism tax	9.7	10.9	9.8	9.4	7.8	7.8	7.9	8.1	10.3	10.5
Stamp tax	21.0	22.3	26.4	27.4	29.4	30.2	17.4	16.3	19.6	13.8
Company fees	2.6	2.5	2.1	1.9	1.9	2.1	2.2	2.1	1.6	1.6
Bank and trust company fees	0.7	0.7	1.1	0.7	0.8	0.8	1.4	1.4	1.5	0.4
Insurance Company Premium and Fees	0.2	-	-	-	1.7	1.4	1.9	1.4	0.9	-
Other taxes	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0
Fees and service charges	6.7	6.9	6.8	6.5	8.7	9.4	11.5	12.5	11.4	13.1
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total Tax Revenues ($ million)	832.3	847.0	937.6	1,079.4	1,263.8	1,350.6	1,201.6	1,155.3	1,396.8	1,384.7
GDP Fiscal Year ($ million)	5,812.0	5,900.0	6,166.2	6,564.7	6,896.4	7,644.5	8,033.6	7,854.3	7,880.3	8,010.8

Source: Ministry of Finance, Department of Treasury and FAD staff calculations.

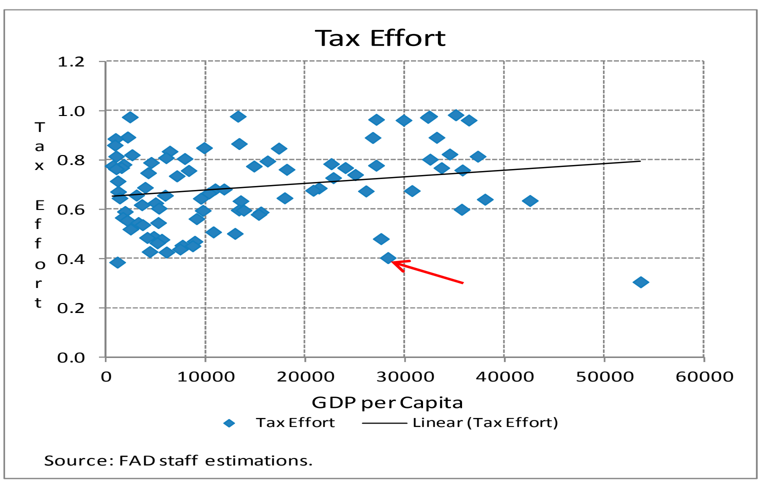
6. **In addition to improving the revenue yield to address short term financing needs of budget deficits, structural issues of the tax system also have to be resolved with major policy changes.** The key issues that have to be address in the medium term for a sound tax system can be summarized as follows: (1) The low tax effort of The Bahamas relative to countries in the same income class in utilizing its tax capacity; (2) Lack of buoyancy of the tax system. The tax system where incomes are not part of the tax base does not respond to

economic growth and rising incomes; (3) The dependence on fees and levies (94 fees) that are distortionary and cascading. Stamp duties and service charges are about 5 percent of GDP;[3] (4) Narrowing of tax bases; (5) Large number of exemptions from property taxation, tariffs and excises and, concessions to various industries eroded the tax base and tax rates have not adjusted; (6) Furthermore, the tax base eroding of concessions are accelerating; (7) The declining collection efforts in property taxation resulted in low compliance in property taxes and collections remained well below their potential level even though tax collections increased over the period of last ten years; (8) Compliance in business license fees that cascade with weak links to ability to pay has also declined; (9) Due to reliance of taxes on international trade, the tax system over-taxes goods relative to services; and (10) The tax system did not adapt to the changing market conditions. For example, the shift of tourists from hotel stay to cruise travel has eroded the potential revenues from the tourism industry.

B. Tax Capacity in The Bahamas

7. **The Bahamas ranks 19th in terms of per capita GDP in the world despite the slow growth in incomes**. However, in terms of tax effort it ranks 92nd out of 98 countries.[4] The country utilizes only 40 percent of its tax capacity.[5,6] Figure 1 compares its tax effort with other countries.

Figure 1. The Bahamas: Tax Effort (2011)



[3] There are 45 different stamp duties but 99.5 percent of the revenue is raised from stamp duties on real estate, financial transactions and alcoholic beverages.

[4] Tax effort is defined as the ratio of actual tax collections to GDP ratio relative to the tax capacity of the country.

[5] Tax capacity is defined as the maximum attainable tax/GDP ratio given the economic structure of the country.

[6] The estimated tax capacity is 39 percent for the Bahamas.

8. **Countries with a higher level of GDP per capita and public expenditure on education, as is the case in The Bahamas, are near their tax capacity and have a higher tax effort.**[7] The Bahamas is indicated with the arrow in Figure 1. Some countries such as Sweden and Denmark utilize 98 percent of their tax capacity. The low tax effort implies that there is substantial potential to raise revenues in The Bahamas. So, given the current income level there is a large potential to increase tax revenues. However, the tax capacity utilization can only improve over time with a well implemented plan that expands the tax base and removes some of the distortions thus stimulating economic growth.

C. Regional Comparison

9. **The tax-to-GDP ratio in The Bahamas is below the CARICOM average of 22 percent.** The Bahamas also have low taxes compared to the rest of the world excluding Central American countries. Many countries in the region (i.e., ECCU and CARICOM) have already introduced VAT thus providing a stable source of tax revenues. Almost all the countries in the region have taxes on income and profits. Furthermore, they have high excises on petroleum products. Table 2 tabulates the revenues as share of GDP for the countries in the region and the rest of the world. The Bahamas has the lowest tax to GDP ratio after the Central American countries.

Table 2. The Bahamas: Comparison of Revenue Yields

	Revenue[1] and Grants			Tax Revenue			Non-tax Revenue		
Country or Region	**2000–04**	**2005–07**	**2008–09**	**2000–04**	**2005–07**	**2008–09**	**2000–04**	**2005–07**	**2008–09**
The Bahamas	21.1	22.4	22.6	16.4	19.0	16.5	4.7	3.4	6.1
Antigua and Barbuda	18.7	20.8	19.5	15.5	18.0	17.9	1.9	1.2	1.1
Dominica	27.8	33.6	36.2	19.6	24.0	25.0	3.3	2.4	2.3
Grenada	23.9	25.4	23.6	18.3	18.9	18.9	2.0	1.2	1.3
St. Kitts and Nevis	26.9	32.6	31.8	19.2	23.8	22.0	6.8	6.7	7.2
Saint Lucia	25.5	25.1	26.7	21.8	23.0	23.7	2.2	1.9	1.7
St. Vincent and the Grenad	24.7	24.5	28.5	20.2	21.4	23.2	3.7	1.8	2.0
Regional aggregates[2]									
OECS/ECCU[3]	23.8	25.7	26.2	18.9	21.0	21.3	3.0	2.3	2.3
Rest of CARICOM[4]	25.1	27.1	26.7	21.4	23.6	22.3	2.0	2.1	2.7
Central America[5]	17.2	18.9	19.0	13.9	15.7	15.7	2.3	2.2	2.2
Rest of Latin America[6]	20.2	23.2	22.5	15.3	17.5	16.7	4.5	5.4	5.4
Small island states[7]	40.8	43.7	41.9	18.4	19.8	19.7	7.6	7.2	5.7
EU15[8]	29.7	30.2	29.0	27.2	27.5	26.8	2.5	2.6	2.2
Emerging Europe[9]	22.6	24.4	22.8	19.9	21.3	20.5	2.8	3.0	2.3

Sources: Asian Development Bank online database; IMF country desk data; UN-ECLAC database; Eurostat database; and authors' calculations.

Note: n.a. = Not available.

[1] General government (central or federal plus local and state) excluding social security contributions.

[2] Regional aggregates are simple averages with the exception of the OECS/ECCU and the EU15, which are weighted by GDP.

[3] Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, Saint Lucia, and St. Vincent and the Grenadines.

[4] The Bahamas, Barbados, Belize, Guyana, Jamaica, Suriname, and Trinidad and Tobago.

[5] Belize, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.

[6] Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela.

Islands, Micronesia, Palau,

Finland, France, Germany,

Poland, and Romania.

[7] Pessino and Fenochietto (2010).

10. **Revenue mobilization will also be needed elsewhere in the region to offset the likely impact from the OECS/ECCU's commitment to increased trade liberalization**. The Caribbean countries have traditionally relied on trade taxes for a large portion of their tax revenues. However, revenue from trade will decline with trade liberalization and tariff reform. External tariffs are being reduced gradually under the Caribbean Community (CARICOM) customs union, and most OECS/ECCU countries are pursuing new preferential trade arrangements, such as membership in the Free Trade Area of the Americas. As these developments continue to erode the international trade tax base, the region, similar to The Bahamas, needs to find ways to bolster revenue that rely on domestic taxation.

11. **The VAT has helped eliminate many distortionary taxes, increased the efficiency and stability of the revenue system**. This created the potential to accommodate trade liberalization—while replacing the revenue from customs duties—and offered substantial administrative advantages, thereby freeing the limited revenue administration capacity in many of the countries. The Bahamas is in the same position to make the same structural changes similar to other countries in the region.

D. The Current Tax Reform Options and Strategy

12. **The government's reform agenda includes the introduction of VAT in order to raise revenues as well as reforming other taxes such as the property taxes, business licenses and the effectiveness of investment concession (incentives)**. However, key principles should be guiding the reform effort. The reform strategy should include the following principles: (1) Keep it simple, pursue administrative feasibility, and lower collection cost; (2) Broaden the tax base by eliminating exemptions and tax preferences over a medium term; (3) Tax policy reform should reduce reliance on stamp duties and fees; (4) Tax immobile bases efficiently including, land and property, natural resources (including tourism after the hotels have been built); (5) Tax environmentally harmful activities; (6) Simplify taxation of small business and informal sector; and (7) Taxpayer consultation will enhance understanding of the system and improve tax compliance.

13. **The last IMF tax policy mission to The Bahamas was in 2002**.[8] The report provided significant recommendations on transforming the tax system from a tariff-reliant system to more buoyant system that is based on a broader tax base. Some of the recommendations in the report have been in the process of being implemented. The VAT will be introduced in 2014 as the report recommended. The report also recommended a reduction on tariffs as well as a consolidation of the tariff rates which is also in the process of being

[8] Stotsky, dos Santos, and Gorman (2002).

implemented starting July 2013.[9] The government is also pursuing a plan to reform the property tax system by updating market values and improving administration of the tax which was all recommended in the 2002 report. However, some of the measures recommended in the 2002 report remain to be implemented and this report concurs with them**.** Unimplemented recommendations of the 2002 report are readdressed in more detail in this report as they are still significant factors of an efficient tax system. These are:
(1) stopping the erosion of the tax base due to continued expansion of concessions;
(2) reduction in real estate transfer taxes as property tax revenues improve; and
(3) simplification of business license fees, and rationalization of excise taxes.

E. Improving Tax Policy Design with a Tax Policy Unit

14. **In managing tax reforms the authorities should forge a social compact with taxpayers**.[10] Governments can gain taxpayer support for policy change if they explain policy objectives for the reform initiative through carefully planned consultation processes with taxpayers, every time major tax reforms are introduced. Before the release of draft legislation, the consultation process entails the issuance of ministerial discussion papers on the reasons and design of intended tax amendments. In the interest of a predictable tax environment, policy proposals should be debated with tax practitioners, taxpayer associations, and business. The emerging consensus will have to be reflected in draft tax legislation which after announcement in the annual budget will be scrutinized by the national assembly's select committee dealing with fiscal legislation. This process could be further refined by: (1) consulting early with taxpayers and practitioners on policy changes before legislative cycle begins;[11] (2) publishing legislative drafts for greater scrutiny with a three-month comment period; (3) adopting a strategic approach to tax avoidance by addressing avoidance risks with additional provisions that entrench clarity of the law through inclusion of clear definitions,[12] practice and interpretation notes, and explanatory memorandums; and (4) when announcing changes to tax laws, explaining their reasons and compliance impact. Furthermore, by imposing new anti-avoidance measures, consider the option to negotiate publicly with taxpayers that some of the revenue gains will be returned via tax relief or improved service delivery. Adopting such an approach will enhance taxpayer morale.

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[9] Prior to current efforts to reduce the number of tariff rates, the number of tariff and excise rates was reduced from 29 to 23 in FY 2008/09 and to 17 in 2009/10.

[10] See, U.K.'s HM Treasury and Revenue and Customs, 2010. *The New Approach to Tax Policy Making: a Response to the Consultation.*

[11] However, exceptions are made in case of anti-avoidance provisions if a loophole is exploited which requires immediate closure in order to protect the revenue base (i.e., consultation on the legislation but not the policy).

[12] One should note that some countries have moved towards principles-based drafting rather than exhaustive definitions due to the difficulty in covering every possible scenario.

15. **A small group of officials in the MoF should be tasked with the formulation of tax policies.** Good tax policy design needs to be supported by the establishment of a specialized and capable tax policy unit (TPU). A TPU should deliver on four key functions which are important both during major structural reforms but also for annual smaller tax changes. They include: (1) *Revenue analysis, revenue forecasting and economic impact analysis*—is the most crucial output as the TPU needs to monitor whether the revenue outcomes are achieved. Moreover, such unit should be in cooperation with the macroeconomic division responsible for establishing collection goals for the revenue administration. (2) *General tax design*—specialist groups of tax policy analysts deal with policies relating to direct taxes and indirect taxes. In addition to the annual legislative program, the divisions would be responsible for ongoing evaluation of the effectiveness and efficiency of the tax laws, and undertake research on international trends and emerging tax design issues. (3) *International tax treaty negotiations*—international tax expertise is needed for negotiating tax treaties. It requires analysis of the effects of tax policies on inbound and outbound investments. (4) *Legal drafting*—is one of the most complex stages in tax policy design as it has to translate policy design into transparent law. The drafting language must be informed by the interpretations of a jurisdiction's tax courts.[13]

16. **Although the responsibility for revenue forecasting may rest with MoF, cooperation with the revenue agency would be beneficial in providing accurate and timely revenue forecasts**. In addition, tax expenditure reporting would require close coordination with the newly-established CRA since the taxpayer data required resides at the Inland Revenue Department and Customs. Given the small size of both corporate taxpayers and individual taxpayers micro-simulation models can be developed to analyze the distributional effects of the current tax system as well as the economic effects of tax proposals. A formal memorandum of understanding between the MoF/TPU and the CRA (or it could be part of the CRA as the second best option) should provide for the exchange of privileged taxpayer information without disclosing taxpayer identities. Further training of staff both in the MoF and CRA may be needed to develop models of revenue forecasting, tax expenditure estimates, and distributional analysis.

Data requirements and training of a successful TPU

17. **National accounts data on the income and expenditure components of GDP are essential data sources for tax policy analysis.** Hence, the TPU should establish the relationship between taxes and the macroeconomic aggregates. In addition, the TPU must obtain consistent taxpayer data from the CRA (over an extended period), which must be different than the processing data that the revenue departments have hitherto generated. At a minimum, tables and statistics on the following should be produced periodically (extracted from tax return data): Sources of income and tax by size of income for individuals; sources of

[13] Sometimes a separate parliamentary office oversees legislative drafting or undertakes it directly.

income and expenditures by industry, sales and asset size for businesses; turnover by size and industry for indirect taxes. For VAT in particular, all input purchases as well as output sales by industry and size are needed for assessing the tax gap.

F. The Role of Tax Administration

18. **Under the current system taxes, fees, and duties are collected by 31 different ministries and agencies.** This makes revenue collection efforts costly, inefficient, and may result in low compliance as each agency will have different enforcement capabilities. Such a system also makes record keeping difficult. The government is aware of this problem and is establishing a centralized revenue administration. The CRA will include the Inland Revenue Department and the revenue staff from other revenue collecting agencies. In addition, the modernization of the tax administration with new IT systems and would simplify record keeping and updating. Introduction of CRA would improve revenue yield. A centralized revenue administration is essential for the implementation of VAT as well as reforming other taxes in particular the property taxes. It is commonly agreed by the government and the private sector that reforming the tax administration is a necessary condition for the success of introduction of VAT and reform of property and business license fees. CARTAC is coordinating the efforts in reforming the tax administration. The success of implementing a tax reform depends on the structure of the tax system and the ability of the revenue administration's ability to collect the expected tax revenues.

Recommendation

- Establish a TPU to conduct revenue analysis and tax policy development.

II. Introducing the VAT

A. Background

19. **As set out in the White Paper on Tax Reform, the government intends to implement a broad tax reform package that includes the introduction of a Value Added Tax (VAT) in July 2014**. A draft law is currently being prepared. Subsequently, the authorities intend to undertake a public consultation process. On the basis of that process, a revised draft law will be prepared and presented to cabinet and to parliament. The target is to circulate draft legislation by the end of 2013.

20. **The White Paper policy proposals are broadly sound, and represent provisions that can be found in VAT laws internationally**. However, not all proposals comport with the best VAT practices, and in addition there remain a number of outstanding design issues that require further consideration. Some of these issues involve the interrelation between

VAT reform and reforms to other taxes, in particular the BLF, Stamp duties, and the CT. This chapter discusses the major issues in this regard.

21. **Introduction of VAT is a compelling option for revenue improvement**. The scope for raising more revenue by increasing rates on the current domestic taxes is limited, and the authorities are committed to reducing tariffs to effect trade liberalization in conjunction with eventual WTO membership. Given the inefficiency of its present indirect tax system and the need to raise more revenue in a sustainable fashion, the mission believes that introduction of VAT will bring The Bahamas much closer to its goals. Such a reform, if implemented correctly, should result in higher tax collections and contribute to economic development.

22. **Adopting a broad-based general consumption tax is critical for efficient revenue mobilization**. Currently, commodities are taxed overwhelmingly only at the border, while domestic sales are taxed at a much lower effective rate under the BLF. This means that only a part of the potential base is exploited—domestic sales and a vast number of services (e.g., construction, transport, and professional services) are lightly taxed. Replacing current taxes with a new VAT would be an opportunity to broaden the tax base.

23. **The BLF as a broad-based consumption tax yields little revenue**. In 2010/11, it raised about US$111 million (or 1.4 percent of GDP).[14] About half of this is raised from three sectors: banks, insurance, and telecommunications. (CT plus hotel guest tax raised a further amount equivalent to about 0.7 percent of GDP.) One reason for low BLF collections is obviously the low tax rate for most businesses. However, the scope to raise the rate without introducing significant distortion is limited, given the structure of the tax. There are, in addition, weaknesses in the administration of the BLF. Moving to a more comprehensive tax like the VAT will present an opportunity to modernize administrative procedures.

24. **The VAT avoids the tax cascading caused by the BLF**. VAT is neutral for businesses and its tax burden falls largely on consumers. Due to its crediting mechanism, taxpayers are able to recover tax paid on their inputs (purchases) by crediting it against their tax paid on outputs (sales). This happens at every stage of turnover so there is no tax cascading along the production chain. Businesses may then shift their input tax, including tax paid on imports and purchases of capital goods, to final consumers. Currently, taxpayers of services have no possibility of crediting of tax paid on their inputs—be they imported goods or other taxable services. The effective tax burden is then higher than the nominal 5 percent.

25. **VAT facilitates exports by ensuring that exports can compete in the world markets by having tax removed.** As a broad-based general consumption tax, applied both to imports and domestic sales, VAT is not regarded as an impediment to international trade.

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[14] 2010/11 data is used here, as it is the most recent year for which the mission has a detailed breakdown of collections.

In fact, it is a tax that facilitates trade across borders. With the zero-rating mechanism, it is straightforward to relieve exported goods and services from any tax paid on inputs. This issue will likely be more and more important in the future, while along with the economic growth, local business will seek sale opportunities abroad.

26. **VAT is in line with trade liberalization arrangements**. In principle, import duties are easier to administer than VAT and may generate the same or even higher revenue in small and open economies like The Bahamas. Yet, due to trade liberalization arrangements, high tariffs will no longer be feasible. VAT, even though it is likely to be largely collected on imports, is not regarded as a tariff under World Trade Organization (WTO) guidelines. Replacing tariffs with VAT is the best option to compensate for revenue loss from import duties and also to mobilize additional revenue.

27. **Introduction of VAT can be advantageous for businesses.** First, business inputs carry no tax as they may be credited against output tax. Consequently, there is a strong mutual interest in issuing and receiving invoices, i.e., charging and crediting the tax. Second, registered businesses do not face cumulative taxation (unlike under the BLF) so they do not have to be concerned about whether or not to shift hidden or cumulative taxes forward to consumers. Tax incidence is likely to fall fully on consumers. Finally, the system is transparent and does not involve excessive costs in terms of tax compliance.

B. Current Situation

28. **Indirect taxation relies mainly on taxes levied at import**. The BLF, a cascading tax on turnover, the hotel guest tax, and the CT together raise a further, smaller amount of revenue. The VAT will replace tariff collections foregone on account of trade liberalization, and to some extent to be determined, revenue from these other taxes. Planning for VAT is far along, with a draft law currently being prepared. The White Paper on tax reform laid out in some detail the main expected characteristics of the VAT, including the following:

- The standard rate would be 15 percent.
- The BLF would be eliminated, except for banks and insurance companies, which would be exempt from VAT.
- The Hotel Guest Tax would be eliminated, and hotel rooms would be brought into the VAT, at a lower, 10 percent, rate (mirroring the current guest tax rate).
- Excisable goods would be taxable under VAT, but the excise tax rates will be reduced to keep the overall burden of taxation for these goods constant.
- Other exempt goods would include: (1) food and agricultural products whose import currently benefit from duty-free status under the Tariff Act; (2) other imports that benefit from the same status and that can be justified on social grounds

(e.g., medicines); (3) health and education services; (4) social and community services; and (5) transfers and leases of land and residential buildings.

In addition, the mission was informed that the following treatments, inter alia, are under consideration:

- Casinos would be exempt, and the current CT would be retained.
- The first 800 watts per month of residential electricity and the first 500 gallons per month of residential water would be zero-rated. The minimum rental fee for telephone service and overseas calls and internet services would be exempt.
- A VAT registration threshold of US$100,000 to US$150,000.
- The BLF on telecommunications would be retained.

C. Issues

29. **Successful implementation of VAT requires a proper design of its core elements.** This section reviews briefly several of the important elements of the proposed VAT design for which the mission believes comment is necessary. For in-depth discussion, especially on treatment of specific sectors, the mission wishes to refer the reader to the references cited.[15]

Standard rate

30. **The proposed standard rate of 15 percent is comparable to those in the region** (Table 3). A 2002 IMF/FAD mission recommended this rate, and it remains broadly appropriate. Of course, a final determination of the tax rate would depend on an analysis given the desired revenue goal, decisions on the final form of the VAT base, and the measures adopted with respect to tariffs and other domestic taxes.

Lower rate for hotel accommodation

31. **Hotel accommodation is usually taxed under VAT, even in countries with a partial VAT and where no distinction is made between accommodation provided to tourists or to residents**. (An exemption of hotel accommodation for residents is difficult to rationalize or to monitor properly.) Definitional issues arise in distinguishing hotels from boarding houses, homes for the aged, etc. Some countries provide an end-use exemption for the latter forms of accommodation, but the best rule is probably a straightforward time period

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[15] For a general overview of the issues, see R. M. Bird and P.-P. Gendron, *The VAT in Developing and Transitional Countries*, New York: Cambridge University Press, 2007 and L. Ebrill and others (2001) *The Modern VAT,* IMF. For specific issues, see the references cited.

exemption stating that accommodation provided for a stretch of time in excess of, say, one month or six weeks, is exempt.

Table 3. The Bahamas: VAT in Comparator Countries and Regions

	Date of Introduction	Standard Rate (%)	Hotels Rate (%)	Threshold (US$ 000s)	Revenue (% GDP)	Revenue Productivity
Country						
Antigua and Barbuda	2007	15	12.5 1/	110	6.4	0.40
Barbados	1997	17.5	8.75	40	10.5	0.70
Dominica	2006	15	10	44	9.8	0.67
Grenada	2010	15	10 2/	44		
St. Kitts and Nevis	2010	17	10	55		
St. Lucia	2012	15	8 3/	67		
St. Vincent and Grenadines	2007	15	10	44	7.8	0.50
Regional aggregates						
OECS/ECCU		15.4			7.4	
Rest of Caricom		13.6			7.3	0.50
Central America		12.6			4.2	0.46
Rest of Latin America		16.4			6.4	0.43
Small island states		11.3			6.5	0.56
EU15		19.9				0.38
OECD		17.9				0.39

Source: Adapted from Schipke, Cebotari, and Thacker (2013); and country authorities.
[1] 12.5 percent for hotels and 10 percent on gaming.
[2] In addition, 20 percent for mobile telecoms and 7.5 percent on certain construction (temporary rate).
[3] For hotels and restaurants, until April 2013.

32. **Food and drink is invariably taxed when supplied by hotels and restaurants, the small-business exemption being used to leave small establishments outside the net**. Other tourism services provided through hotels are also generally taxed. As a general principle, a desirable characteristic of a VAT is to have a single positive rate. Single rates, applied uniformly to all goods and services, greatly facilitate compliance and administration, especially by avoiding disputes about classifications of goods and credit claims due to differential VAT rates on inputs and outputs. In addition, multiple rates can distort the market as efforts are made to package commodities and services in a way that brings more sales under the lower rate. Multiple and differentiated VAT rates have seriously impeded the functioning of a number of VATs around the world in the past.

33. **On the other hand, many countries have introduced VAT with a second, lower rate for hotels and perhaps other tourism services**.[16] Table 3 above provides an indication of rates in use in the region. A 10 percent rate, equivalent to the current hotel guest tax rate in The Bahamas, is certainly comparable to practice in these countries, as is the gap between the standard rate and the lower rate. The mission would nevertheless recommend against a

[16] It is likely that the logic of tax competition is at work to explain this result. See Schipke, Cebotari, and Thacker (2013).

second rate—among other reasons, a uniform rate would allow a lower tax rate for any given revenue requirement—however, in the current environment, doing so is defensible.

34. **If a lower rate is introduced, its negative impacts can be controlled through a number of other provisions.** First, the lower rate should be applied to the full charge for accommodation—including hotel levy, gratuities, and any surcharges added to the room rate. This is the correct treatment in most cases, and prevents a number of possible adverse incentives.[17] Second, the scope of the lower rate should be restricted to accommodation; restaurant food and other tourism services offered by the hotel should be taxed at the standard rate, to level the playing field between similar services offered by other businesses outside the hotel, which will be subject to VAT at the standard rate, and to protect revenue.[18] Finally, multiple rates complicate the administration of the tax in the case of businesses that use all-inclusive prices; for these firms, it will be necessary to review the current allocation rules to ensure their accuracy, and fairness relative to other businesses.

Domestic zero-rating

35. **Since the provision of electricity and water is undertaken by public utilities, the proposed zero-rating of limited quantities of residential sales of these items should be straightforward to administer**. The mission does not have a view on whether the preferentially treated amounts are appropriate; it does note, however, that zero-rating is a second-best measure to reduce the regressivity of the VAT; since all taxpayers will benefit, the total revenue cost of the measure will be much larger than the value of the benefit that accrues to the targeted households. If total purchases of these items were taxed, it would generate more than enough revenue to compensate targeted households through the expenditure side of the budget. For this reason, zero-rated quantities should be restricted.

Exemptions

36. **The tax base should be chosen as broadly as possible, preferably with no exemptions (and ideally with zero-rating limited to exports only)**. A broad base protects revenues and keeps compliance complexity to a minimum. Any exemptions, beyond the relatively high registration threshold (see discussion above), especially if applied to

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[17] Gratuities, which are in effect payments to workers, should be included as by definition value added equals the sum of payments to workers plus pure profits. The energy surcharge should be included in the accommodation rate, since a credit will be taken for VAT paid on purchases of energy. VAT on the hotel levy should be included in the output tax of the hotels, along with the requirement that the three tourism boards register for VAT and zero-rate the services they provide to their member hotels; this will help reduce the probability of hotels being in a frequent excess-credit position.

[18] This treatment will also contribute to help mitigate the risk that hotels will be in a frequent excess-credit position. As indicated previously, the cost of this approach is that supplies by hotels will need to be monitored to ensure they are classified at the correct rate.

intermediate products, would result in tax cascading and increase the tax burden of downstream businesses. Exemption of intermediate inputs may also induce businesses to find substitutes of their inputs and supply to themselves.

37. **However, it is common in all VATs to exempt certain types of activities.** Even though preserving the VAT chain is crucial, some sales are usually exempt. This is mainly for equity reasons (e.g., basic food items, education, and health) or due to administrative difficulties (e.g., margin-based financial services). However, in modern VATs (i.e., Australia, Canada, New Zealand, Singapore, and South Africa) more items have been included in the VAT base such as hospital and medical care, university education, postal services, and radio and television broadcasts. Taxation has administrative advantages, and there may be scope to compensate for any increase in costs by an increase in subsidies. The proposed Bahamas approach is somewhat retrograde in this respect, but the approach may reflect the current strengths of the administration and the state of feasible expenditure policy at this time. In this section, a number of selected issues in exemptions are discussed.

38. ***Food*****: In common with many other countries, it is proposed to preferentially treat basic food items**. While understandable, the argument against this approach is analogous to that for zero-rated domestic consumption above: the reduction in regressivity of the VAT comes at a very high price in terms of lost revenue, since higher-income households spend more absolutely on food.[19]

39. ***Financial Services:*** **A practical approach to taxing financial services has so far been elusive**. Consequently, the proposed approach of exempting financial services is defensible, with one important proviso: all banking services for which a fee is charged should be subject to VAT, in particular for those services provided to VAT registered taxpayers. This has been the trend as additional countries have introduced the VAT. In addition, hire-purchase agreements and financial leases should be taxed in full. This is so that an incentive is not introduced to avoid tax by leasing rather than an outright purchase of an item.

40. ***Insurance:*** **Consider bringing insurance into the VAT**. The authorities are contemplating maintaining the current BLF levied on 3 percent of the gross premium from local policies, and otherwise exempting insurance from VAT. This proposal, in general, outlines the current structure of taxes on insurance in the EU countries. This treatment is administratively complex and economically distortionary. More modern VATs have taken a different approach: insurance taken out is fully taxed, while registered businesses receive a credit for the VAT paid on insurance premiums. For the insurance company, value added is calculated as the difference between premium revenue and the sum of indemnity payouts and

[19] More generally, it has been suggested that most imports that are exempted from customs duties should be exempted from VAT. However, there is no necessary relation between the two; any VAT exemption should be justified on its own merits.

taxable purchases. This value-added can be included in the tax base by taxing insurance premiums and allowing a presumptive tax credit for the VAT imputable to payouts (plus a credit for the VAT paid on purchases). The presumptive tax credit should be treated as an output VAT collection at the level of registered businesses, while final consumers would receive the VAT along with indemnity payments without any further tax liability.[20]

41. **The VATs in Australia, New Zealand, Singapore, and South Africa have adopted variants of this approach in their VATs**, and this should be considered for The Bahamas VAT, at least for property and casualty insurance. Accompanying this, the separate BLF on insurance should be abolished. Full taxation under VAT has been shown to be feasible, simpler, and more efficient than exemption.[21]

42. ***Gaming:* In principle, spending on gambling activities should be subject to VAT in the same manner as other forms of consumption expenditures**. In The Bahamas, the argument is tempered somewhat by the fact that only nonresidents are customers; nevertheless, other types of consumption by nonresidents intend to be taxed under the VAT, and gambling should not be treated differently in this respect. Currently, gaming is taxed under the Casino Taxation Act. The CT has two components, the first is a fixed annual fee, based on the size of the casino, divided into three categories, plus an ad valorem charge that is applied to the difference between the total amount wagered and the winnings paid out, called the gross winnings. The tax rate varies by gross winnings, 10–15 percent for smaller casinos and for larger casinos, a declining variable rate between 25 percent and 5 percent (the latter rate applying to winnings in excess of US$20 million). Casinos are exempt from the BLF.

43. **There are several possibilities with the introduction of VAT**. First, casinos can be exempt, and the CT maintained. Alternatively, casinos can be brought into the VAT. The appropriate way to do this is similar to the treatment of insurance as described in the previous section—gaming as a business has several strong structural resemblances to insurance, and the approach to taxation can exploit this. The tax base would remain gross winnings, and output tax would be determined by applying the appropriate tax rate to this base. The casino would in addition take a credit for VAT paid on other purchases involved with operating the business. The net amount would represent the VAT liability. Accompanying this, the CT would be eliminated or significantly reduced. Since under the CT, the tax rate ranges up to

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[20] Cnossen (2012) has more detail, and lays out the administrative complexities and distortions involved in the approach currently being considered by the Bahamian authorities. For more discussion of the experiences in Australia and New Zealand with the taxation of insurance, see Dickson and White (2010); and Edgar (2007).

[21] As Cnossen (2012) notes, an exemption from the VAT might continue for health-related and life insurance; health insurance by analogy of other exempt health services, and because whole life insurance involves a long-term savings vehicle. If this path is chosen, consideration should be given to maintaining the BLF on insurance policies exempt from VAT.

25 percent, taxing gambling at the standard VAT rate would yield a comparable level of revenue to the CT (the analysis should be done to verify this).

44. **The mission recommends that consideration be given to bringing the casinos into the VAT net at the standard rate, as described above, and reducing or eliminating the CT**. This is the approach adopted by a number of modern VATs, including in Australia and South Africa.[22]

45. ***Real Estate:* The VAT treatment of real estate being considered by the authorities has many standard elements, but the interaction with the stamp duty on property transfers has not been adequately addressed**. The stamp duty, at rates up to 10 percent, has effects similar to a cascading turnover tax, and can introduce serious distortions into the market. Consideration should be given to an alternative approach that reduces the magnitude of these distortions in the case of property transfers between VAT nontaxpayers, while preserving a portion of the revenue collected under the stamp duty, but in a manner that is consistent with taxing value-added.[23]

46. **The proposed approach would tax the change in value of the property at the time of the transfer rather than tax the transfer value**. Under the VAT, the taxation of new properties is correctly thought of as a prepayment of VAT on the flow of housing services that the property provides. However, this prepayment approach fails to tax any subsequent changes in the value-added from the property. This can be remedied by taxing the increase (or decrease) in the value realized at the time of the transfer. This change in value should be taxed at the standard VAT rate. With this tax in place, the highly distortionary stamp duty can be eliminated (the lock-in effect of the stamp duty is reduced, since the new tax is levied on the change in value, rather the entire transaction value).

47. **The proposed tax should continue to be enforced by the registrar's office**. Sellers and buyers are not registered VAT taxpayers, and it would be burdensome to require them to register for a unique property transaction. Consequently, the easiest implementation would be to retain the stamp duty legislation (suitably modified), and continue to have the tax enforced by the property registrar's office.[24]

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[22] A description of the South African approach can be found in Schenk, A. (2008) *Gambling and Lotteries*, in R. Krever (2008). A description of the Australian approach can be found at http://www.ato.gov.au/content.aspx?ms=businesses&doc=/content/11991.htm

[23] Details of the proposal can be found in Cnossen (2010).

[24] Cnossen (2010), p. 71.

Registration threshold

48. **The role of the registration threshold is to limit the size of the taxpayer population at a minimal sacrifice of revenue**. This approach optimizes inter alia on administrative and compliance costs. Operating a broad based consumption tax can imply a large taxpayer population, many of them being small businesses with relatively small turnover and value-added. Administering many small, often noncompliant, businesses is costly and ineffective; in addition, compliance costs can represent a larger share of the total return for smaller businesses. It is very important to set the registration threshold at an appropriate, fairly high level to balance these and other considerations.

49. **The authorities are currently collecting data to analyze the likely VAT taxpayer population**. However, it is relatively clear at this point that the optimal threshold is likely to be somewhat in excess of the previously proposed level of US$50,000. The mission concurs with the authorities' current estimation that the threshold should be upwards of US$100,000, likely in the range of US$150,000. A threshold at this level will almost certainly capture businesses that account for an overwhelming percent of total turnover in The Bahamas.

50. **Especially at introduction, when administrative capacity is being built up, a high threshold that limits the number of potential registrants is desirable**. In addition, it is necessary to introduce provisions for voluntary registration, in particular for smaller businesses that export, or which sell mainly to registered businesses. By registering, these firms can take a credit for VAT paid on purchases, and their business customers can also take a credit for VAT paid on purchases from them. It may be appropriate to have tighter provisions in this regard when the tax is introduced and relax them, allowing more firms to voluntarily register, as the VAT administration matures.

Treatment of businesses below the threshold

51. **Businesses with turnover below the threshold should not be required to register**. Non-registered businesses in the VAT system are simply exempt entities. It means that they are treated like final consumers—they must still pay VAT on their taxable purchases, but are not required (nor allowed) to collect VAT on their supplies. As a result, they cannot claim credits for VAT paid on purchases and hence have to absorb the tax they pay on their purchases. Nevertheless, being exempt is advantageous to businesses that sell mainly to final consumers.

52. **It is common to levy a simplified tax on businesses below the VAT registration threshold**. The authorities have proposed to levy a flat annual fee (for example, US$100, the amount of the BLF on businesses with a turnover level below US$50,000) on all businesses below the VAT threshold. The mission recommends an alternative approach, which would raise more revenue. Specifically, it is recommended that all businesses below the threshold who are not registered should continue to pay the BLF; micro-businesses (those with turnover below say US$50,000) would continue to pay a flat annual fee, while those above

this level and below the VAT registration threshold would pay an annual tax based on turnover.

53. **The tax rate on turnover for these businesses should be unified**. There are sector-specific tax rates in the current BLF, and it would be appropriate to unify these, in the interest of simplicity.

D. Revenue Potential of VAT

54. **International experience with VAT in island countries has generally been positive**. Small economies, such as The Bahamas, tend to rely relatively more on international trade than do large ones. However, this is not an issue for VAT. VAT raises revenues efficiently by taxing the consumption base, i.e., all goods and services consumed regardless of whether they were domestically produced or imported. Just like import duties, VAT catches all imports at the border and assesses tax on them immediately, over and above duties and excises. In addition, where tourism is important, this is an addition to the base of the VAT over and above consumption by residents.

55. **VAT raises over 7 percent of GDP on average in the region.** There are small countries where VAT performance is substantially higher. Data on VAT productivity, i.e., percentage of GDP collected for each percentage point of the standard VAT rate, suggest that VAT is a good revenue raiser in the region (Table 3). On average, 1 percentage point of VAT rate collects about 0.5 percent of GDP. If this were the case in The Bahamas, a VAT with a standard rate of 15 percent would also raise in excess of 7 percent of GDP. However, actual performance would depend on many factors, including the VAT rate chosen, number of exemptions and domestic zero-rated goods, and administration capacity.[25] The authorities are currently engaged in collecting more detailed information and data that can be used to refine these estimates of the revenue potential of the VAT.

E. A Role for the Business License Tax?

56. **The BLF is an inefficient tax on consumption; as such it has no role where an efficient consumption tax—a VAT—is in place**. The authorities are considering eliminating the BLF, except for sectors that would be exempt under VAT. The mission recommends several refinements to this proposal. First, the BLF should be maintained as a sort of simple substitute tax on businesses below the VAT threshold, as discussed above. Second, the BLF could be maintained as a type of excise tax on mobile telecommunications.

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[25] This rough calculation, based on measured VAT productivities, is confirmed by preliminary estimations of the VAT tax base, based on national accounts data. Using this method, the 2002 FAD mission conservatively estimated a VAT base equal to 40 percent of GDP. A similar exercise undertaken by the Ministry of Finance estimated a somewhat larger base, equal to 45 percent of GDP. With this base, a 15 percent VAT would raise revenue equivalent to 6.8 percent of GDP.

As such, the tax rate should be reviewed to determine whether it is optimal. Third, the tax could be maintained for exempt banking services, although the base should be reconsidered; similarly the tax should be maintained on insurance policies that remain exempt from VAT. Fourth, consideration could be given to maintain the BLF on all other businesses for a temporary period after VAT introduction, perhaps at a uniform lower rate, as a type of insurance on revenue collection in the period that VAT is introduced.

57. **The appeal of mobile telecommunications' airtime excises has been growing in a number of countries**. Often mobile telephone airtime is subject to an excise calculated based on minutes of airtime usage. There are other taxes as well, including VAT, which should always apply on telecommunication services. As of early 2011, over 20 countries imposed an airtime excise.[26] Airtime ad valorem excise rates in African countries range from a low of 3 percent in Niger to a high of 18 percent in Gabon. In the region, the Dominican Republic imposes a 12 percent special telecom tax on calls and Short Messaging System usage.

58. **What an appropriate tax rate on mobile airtime would be for The Bahamas is not known; however, some guidance is available from the current BLF**. Rate-setting would have to take into account the level of pre-tax retail mobile usage rates in The Bahamas, the regulatory regime, competition, price elasticity of demand, and the current pass-through rate of the BLF on final consumer prices. A rate between 3 percent and 6 percent would appear reasonable, but more analysis is needed.

59. **The BLF could be maintained on banking services that remain outside the VAT**. Banks are currently taxed based on their gross assets; this may not be appropriate if fee-based banking services are brought into the VAT. One possibility is to tax banks based on the value added in margin-based businesses. This can be estimated as the sum of wages and salaries and pure profit in margin-based activities. This perspective has been exploited recently by the IMF in its advocacy of a "Financial Transaction Tax" on banking activities. This approach has been successfully adopted in several countries (e.g., Israel, Sri Lanka); in other countries (e.g., Denmark, France) the value added is approximated by including only the value of wages and salaries paid (i.e., to avoid the necessity of estimating pure profit).[27] Similarly, the BLF on insurance can be maintained for policies that remain exempt from VAT. For these policies, the base of the tax currently is gross premiums (the base for VAT would be premium income net of payouts), and the rate is 3 percent. This base may be appropriate; a review should be undertaken on further scope to adjust the rate.

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[26] Deloitte, 2011, *Global Mobile Tax Review 2011* (London: Deloitte LLP) http://www.gsma.com/publicpolicy/wp-content/uploads/2012/03/gsmaglobaltaxreviewnovember2011.pdf.

[27] Using the addition method as the base for levying VAT on the financial sector encounters the problem of calculating the appropriate input VAT credit for bank customers which are VAT taxpayers. For this reason, the tax rate should remain somewhat less than the standard VAT rate.

60. **BLF raised revenue equivalent to 1.4 percent of GDP in 2010/11**.[28] As noted earlier, about half of this was raised from telecommunications, banks, and insurance; this portion is recommended either to be maintained with VAT introduction, or the supplies become taxable under VAT. If, in addition, the BLF is maintained for businesses with turnover below the VAT threshold, this may preserve revenue equivalent to about 0.1 percent of GDP. Thus, a rough estimate of the potential revenue lost by eliminating BLF for all other businesses is 0.6 percent of GDP. This revenue could be preserved in a transition period during which VAT is implemented, which would provide some insurance against adverse shocks to revenue collections during the transition. Insurance of 0.6 percent of GDP may be excessive; if a determination can be made that it is in fact so, the rates of BLF can be adjusted downward when VAT is introduced. However, the BLF as a relatively broad-based tax has no legitimate long-term role in The Bahamas tax system once VAT has been introduced.

61. **The 2012 IMF Article IV mission recommended that it should be a long-term goal of the authorities to introduce a business income tax**. Adopting this recommendation could be thought of as putting in place a replacement for the BLF. This substitution would be a significant improvement in the efficiency and fairness of the tax system.

F. Stamp Duty on Financial Transactions

62. **In addition to imports and real estate transactions, stamp duties are levied on a range of bank transactions**. These raise a significant amount of money, US$88 million in 2010/11, equivalent to 1.1 percent of GDP. The major items are for mortgages (taxed at 1 percent); US$36 million; bank withdrawals, checks, and bank receipts (US$0.40 per transaction): US$14.6 million); and other bank transactions, including international bills of exchange drafts, money order, mail, and cable transfers, traveller's checks (taxed at 1.5 percent of the value): US$38 million. These duties fall on both final consumer and business transactions.

63. **Bank transaction taxes can discourage intermediation, and taxes on international financial instruments can discourage goods and capital movements**. A number of empirical studies have found that bank transactions taxes can discourage holding money in banks. For example, Kirilenko and Summers (2003) found: (1) that for each dollar raised through a bank debit tax, an amount up to 28 cents in Venezuela, up to 41 cents in Colombia, and up to 47 cents in Ecuador, was lost in disintermediation; and (2) disintermediation effects appear to intensify as the taxes remain in place, showing evidence of dynamic effects. Other studies have found similar effects.[29] On the basis of this

[28] This includes Bank and Trust Fees and Insurance levy, which at that time were outside the BLF. They have since been brought into BLF for the most part.

[29] For further information, see Fenochietto, R., E. Crivelli, and A. Pessino (2011); and Matheson (2011).

evidence, consideration should be given to reducing and eventually eliminating the most distortionary of these duties.

Recommendations

- Introduce VAT with a single rate.
- Tax fee-based financial services under the VAT.
- For exempt financial services, maintain the BLF. Consider adjusting the definition of the base to wages plus salaries plus profit.
- Tax property and casualty insurance under VAT. Consider taxing life insurance. Eliminate the BLF on policies taxable under VAT.
- Tax gaming under VAT. Eliminate at least the portion of the Casinos tax that is levied as a percent of winnings.
- Tax telecommunications services under the VAT, (except possibly for the cost of basic telephone service). Maintain the BLF on mobile telecommunications.
- All surcharges, gratuities, and hotel levies should be included in the base for VAT on hotel accommodation. If hotel accommodation is taxed at a lower rate, other taxable supplies by hotels should be taxed at the standard rate.
- Consider replacing the real property transfer tax on transfers between VAT non-taxpayers with a tax on the increased value-added of the property.
- Subject to further data collection and analysis, consider adopting a turnover threshold of about US$150,000. Make adequate provision for voluntary registration of businesses below the threshold.
- Preserve the BLF on businesses below the VAT threshold as a simplified tax. For these businesses, unify the rate structure.
- Consider as a temporary measure preserving the Business License Tax on all businesses subject to VAT (except for insurance policies that are taxed under VAT).

III. Real Property Taxation

A. Recurrent Property Taxation—Current Practice and Design

64. **Real property tax is imposed by the Real Property Tax Act on owners of immovable property in The Bahamas**. The term "owner" includes life tenants. Real estate exemptions are multiple: (1) property located in the "Family or Out Islands" owned by Bahamians; (2) unimproved property, i.e., land without buildings, owned by Bahamians; (3) land used for commercial farming; (4) property used exclusively for the purpose of religious worship; (5) school buildings, their gardens, and playing areas; (6) property owned by foreign governments used for consular purposes; and (7) property used exclusively for a charitable or public service from which no profit is derived. The basis of the tax is the market value of the property as estimated by the chief valuation officer, who in principle should make a general reassessment of market value at intervals of not more than five years. Owners must file annual information returns concerning their properties by the end of each year.

65. **The current tax rates post-November 2012 are as follows**: (1) *Residential properties* valued up to US$250,000 are exempt; (2) Properties from US$250,000 to US$500,000 are taxed at 0.75 percent; (3) Properties valued in excess of US$500,000 are taxed at 1 percent but any tax liability is capped at US$50,000 benefiting high-value real estate; (4) Vacant land valued up to US$7,000 attracts a flat fee of US$100; (5) Land values over US$7,000 are taxed at 1.5 percent; (6) *Commercial/ Rental Properties* are taxed at 1 percent on the first US$500,000 of value and the balance above that at 2 percent. "Market value" is defined as the amount the property would realize, if sold on the open market, without any encumbrances or restrictions. The Hotels Encouragement Act 1954 grants real property tax incentives for the construction of new hotels which is discussed in the chapter on concessions. Property tax collections are rising—having doubled as percent of GDP since 2002 (Table 4).

Table 4. The Bahamas: Real Property Tax Collections, 2000–11

Years	Total Property Tax Collections in US$	As Percent of GDP
2002	37,110,317	0.66
2003	37,764,528	0.65
2004	53,811,986	0.91
2005	54,270,561	0.88
2006	79,061,437	1.20
2007	72,500,021	1.05
2008	84,577,461	1.11
2009	91,732,232	1.14
2010	92,115,068	1.17
2011	95,224,954	1.21

Source: Bahamian authorities.

B. Issues—Low Coverage and Collection Ratios

66. **The Bahamian real property tax system's effectiveness has eroded through a number of design and administrative shortcomings—all comprehensively documented, in the 2011 Inter-American Development Bank study (the Kelly Report hereafter)**. The Kelly Report suggested that with innovation and improvements in the property tax's administration, property tax revenues could be doubled to 2.4 percent of GDP over the medium term. A so-called "collection-led" reform strategy is advocated that would seek to

improve the collection ratio with short-term measures such as creating a legal environment in which escalating property tax debts or arrears can be eliminated in order to enforce the law in the future. The administrative side of the real property tax is strongly supported by the IDB initiative and government's resolve to enhance property tax collections. The mission has taken note of the comprehensive multi-year strategy for the property tax system that will entail amendments to property tax legislation; implement business process re-engineering in all areas of the system to bring them up to modem standards; prepare for staff manuals on property tax administration and compliance procedures, including fiscal cadastre maintenance valuation, billing, collection and enforcement, dispute resolution and appeals, and taxpayer services; and to expand enforcement actions.[30] The issue of arrears and a low coverage ratio is evident from Table 5. Arrears increased since 2008 yearly by an average of 28.5 percent, from US$28.3 million to US$96.6 million. Alarmingly, 56.1 percent of the arrears are for properties valued US$1 million and above.

67. **In the sections that follow, the mission will focus its discussion on policy design aspects and will not address extensively matters around the coverage, collection, or valuation ratios**. Instead, the mission will address policy choices in respect of an appropriate rate structure, the extensive nature of the concession whereby all Bahamian taxpayers with property located on the Family Islands are exempt from real property tax, the graduated nature of the rate structure, and the vertical and horizontal inequities that arise from capping the absolute property tax liability, irrespective of the value of the property.

68. **The mission also took note of the real property tax amnesty program, announced in March 2013, which encourages**—(1) self-registration of owners of residential properties above the US$250,000 exemption threshold, and owners of commercial properties who have never received a property tax bill will be encouraged to register their properties which entitles them to waive all back-taxes; (2) registered property owners with payment arrears of no more than three years can become current with their tax payments and for which government will waive 50 percent of the total owed in both assessment and surcharges; (3) for property owners where accumulated arrears for more than three years exist, 100 percent of surcharges will be waived; and (4) compliant taxpayers who are current with their assessment are positively rewarded whereby government will rebate 5 percent of annual property tax assessment. These efforts are intended to clean up the real property tax register and modernize the administrative infrastructure. The mission proposes that this should be the only and last amnesty and that firm enforcement will follow hereafter.

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[30] Kelly and others (2011). The mission also held detailed discussions with Mr. Henk Verbrugge, consultant for property tax reform and, staff from the Chief Valuation Office as to fiscal cadastre challenges and the generally low compliance with provisions of the property tax. The authorities are making improved collections from the real property tax a high order priority to which the mission cannot contribute much, except to support these initiatives strongly. The material received from Mr. Verbrugge is the basis of the assessment of the state of the administrative parameters of the property tax.

Table 5. The Bahamas: Property Ownership Distribution, Collection Ratio, and Arrears

Range of values in $	Count of Entries	Percent of Ownership	Assessed Taxable Value in $	Share of Assessed Value	Billed Amount in $	Share of Billed Amount	Payments in $	Collection Ratio	Arrears in $	Share of Arrears
000 - 100,000	44,505	64.24	1,447,487,151	9.91	8,622,332	6.56	2,030,277	23.55	6,592,055	6.83
100,000 - 250,000	13,232	19.10	2,171,561,609	14.87	11,438,792	8.70	2,337,385	20.43	9,101,408	9.42
250,000 - 500,000	6,538	9.44	2,315,460,910	15.86	15,823,369	12.04	4,157,938	26.28	11,665,431	12.08
500,000 - 1,000,000	2,868	4.14	2,012,646,712	13.78	20,442,371	15.56	5,412,131	26.48	15,030,239	15.56
1,000,000 - 5,000,000	1,912	2.76	3,746,124,582	25.66	47,888,465	36.44	14,354,158	29.97	33,534,307	34.72
5,000,000 - 10,000,000	160	0.23	1,108,216,564	7.59	15,580,083	11.86	4,426,542	28.41	11,153,542	11.55
10,000,000 - 20,000,000	47	0.07	624,384,323	4.28	6,623,781	5.04	1,614,972	24.38	5,008,808	5.19
over 20,000,000	22	0.03	1,175,467,021	8.05	4,990,301	3.80	495,469	9.93	4,494,832	4.65
Totals 2013	69,284	100.00	14,601,348,872	100.00	131,409,494	100.00	34,828,872	26.50	96,580,622	100.00

Source: The Bahamian authorities; and IMF staff calculations.

C. Tax Design Aspects that Determine the Revenue Take

The revenue identity

69. **When considering property tax reforms in any country, there are five factors in the "property tax revenue identity" that inform the tax reform discussion**: (1) the tax base; (2) its valuation; (3) the tax rate; (4) coverage ratio; and (5) collection ratio. These five factors can be expressed as a useful equation[31] that always reflects the operation of a land and property tax. They can be used to quantify the revenue loss if valuation, coverage, and collection ratios are influenced by other considerations (i.e., granting exemptions):

Revenue = Legally Defined Tax Base x Tax Rate x Valuation Ratio x Coverage Ratio x Collection Ratio

70. **In this expression, the defined tax base refers to the properties identified in the law as being subject to a property or land tax and the methods to be used to determine their taxable value.** The valuation ratio is the proportion of the fully defined value that is actually assessed for tax purposes. The tax rate is simply the rate applied against the tax base expressed as a value or area (sq ft/m^2). The coverage ratio refers to the proportion of properties that should be included in the base which have actually been identified and are included in the cadastre. The collection ratio refers to the proportion of assessed taxes that are actually collected. Ideally, the coverage, valuation, and collection ratios will all be one, or 100 percent. In practice, this is almost never the case. The following example indicates how sensitive revenues respond to changes in the valuation, coverage, and collection ratios (the latter three ratios being identifiers of administrative effectiveness). Consider a case in which the legally defined base is the market value of all land and capital improvements (buildings) and the rate is set at 1 percent of that value annually. For a variety of reasons, only 80 percent of the taxable land parcels have been identified and are included on the tax rolls. Moreover, the valuations are several years old, resulting in properties being valued only at 90 percent of their current market value. The tax administration is rather effective in collections and enforcement, but only collects 85 percent of the tax liabilities due. According to the revenue identity, only 61.2 percent of the theoretical revenue will be collected (see below):

Example: Revenue = *Legally Defined Tax Base x Tax Rate (=0.01) x Coverage Ratio (=0.8) x Valuation Ratio (=0.9) x Collection Ratio (=0.85) or Revenue = Base *0.01*0.8*0.9*0.85 or just 61 percent of the theoretical revenue.*

Setting the statutory tax rate

71. **The property tax liability is calculated by multiplying the assessed value with the rate**. Given the size of the tax base, the second most important element, the tax rate,

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[31] Kelly, 2000: 39.

determines the revenue potential of a property tax. Countries use different approaches for rate-setting. There are three key considerations as to the tax rate: (1) who should determine rates; (2) should there be a single rate or differentiation; and (3) how high should rates be? Table 6 summarizes international practices for rate-setting.

Table 6. International Practices with Property Tax Rates

Practice	Rationale
Flat *ad valorem* rate	Simplest way to tax property values.
Flat specific rate	Simplest way to tax an area base.
Progressive *ad valorem* rate	Establish more fairness for the system by taxing higher valued properties at higher nominal rates.
Differential rates applied to different types of property, with non-residential property usually attracting higher rates, agricultural and residential properties benefiting from lower rates.	Usually to protect agricultural property from higher taxes, and to capture the greater tax-paying capacity of commercial and industrial land.
Different rates applied to land/site and capital improvements/structures; surcharge rate applied as penalty for sterilizing valuable/potentially productive land or a penalty for underutilization (e.g., Brazil, Senegal and Venezuela).	To encourage the development of vacant and underutilized land.
A progressive tax rate is applied to the total value of an individual's land holding (e.g., Peru).	To put higher burden on concentration in property holdings or wealth concentration.
Annual increase in tax rates to compensate for the failure to revalue properties or adjust through indexing.	To protect revenues when revaluations are delayed.

Source: USAID, 2009: 14.

72. **Property tax rates for real property are either set by central government (as is the case in The Bahamas) or locally, with often some rate range restrictions from the center**. Setting the property tax *rate* locally is crucial for accountability on local taxation decisions (while central government determines the property tax *base*) but fiscal decentralization considerations are not yet an issue in The Bahamas. Ultimately, this may become an issue for the Family Islands. It is common practice for central government to restrict rates to a statutory range to minimize inter-jurisdictional distortions.

Differentiation between flat and graduated rates

73. **Globally, governments often impose rates that are differentiated according to property class—as is the case in The Bahamas**. This could result in different rates per property class and even result in complete tax relief for some property classes. Theoretically and ignoring for a moment the overriding simplicity imperative, differentiated tax rates may be justified on a number of grounds: (1) For fairness reasons in respect of benefits received (i.e., property tax being a benefit tax, the amount of local public services may vary across property categories). For example, businesses may receive fewer public services than residential properties (i.e., schools, clinics, parks, etc.) and, hence, should attract a lower tax rate. This is rarely the case; indeed, as in most countries the opposite holds; (2) In line with efficiency considerations, properties that are least elastic in supply could carry a higher tax

burden. Normally, business investments tend to be more mobile than residential properties and, again, should be taxed more lightly than residential property. Yet, international evidence indicates the opposite, with much lower property rates for residential properties; and (3) Variable rates can be introduced to induce desired land use objectives. Alternatively, some countries in Africa—e.g., Botswana, Namibia, and South Africa—allow municipalities to apply higher rates on vacant buildable land within cities to encourage property development.

74. **Many jurisdictions specifically provide for lower property tax rates in the case of residential properties**. This is the case in countries such as Australia, Canada, India, Pakistan, and South Africa. Granting a tax-free threshold is ineffective since it benefits low and high value properties. Then again, some countries apply higher rates for commercial properties; or lower rates for selected industries and service providers such as manufacturing and tourism. Alternatively, the values of properties occupied by preferred business sectors could be under-assessed; or central government could grant other kinds of tax relief by explicitly legislating zero or low rates or tax deferrals. As indicated above, the differential or favorable tax treatment of residences is not consistent with the concept of a benefit tax and therefore does not recognize the differential use of public services.

75. **There is therefore no strong economic case for higher tax rates on commercial or industrial properties as the tax is ultimately borne by households—in an inefficient manner**. Differentially higher taxation favoring residential over commercial properties distorts land use and may lead to overinvestment in residential properties. It may also lead to the illegal use of residential properties for commercial or industrial enterprises—especially in jurisdictions where zoning laws or regulations are poorly enforced or absent. Rate differentiation complicates the design, the transparency, and the administration of a property tax. Best practice suggests that only one rate for both residential and commercial properties should apply as it would induce investment choices that are based on the best use of property. The rate differentiation and the capping of an absolute tax liability at US$50,000 has an adverse distributional impact on low- and middle-income property owners in The Bahamas, clearly illustrating that these current threshold, rate, and tax liability caps primarily benefit the high-net worth individuals (Table 7). The mission would, therefore, propose complete standardization and elimination of the caps to improve vertical equity by raising tax burdens on property valued above US$5 million.

76. **Best practice suggests that one should pursue simplicity when it comes to rate-setting in order to minimize complexity in administration and to encourage compliance**. If there is rate differentiation regarding quality, use of properties, and multiple property ownership, taxpayers will seek to artificially reclassify use or values simply to benefit from the lower rate. Hence, a single rate may be the correct approach as market valuations to a large extent already reflect differences in ability-to-pay—making discriminatory rates superfluous. In a simplified value-based or area-based system, however, differentiation may be more appropriate.

Table 7. The Bahamas: Capped Tax Liability Impairing Distributional Fairness

Property Value	Statutory Tax Rate (In percent)	Property Tax Liability Without Exempt Amount	Effective Rate	Taxable Base After Tax Threshold	Statutory Tax Rate (In percent)	Property Tax Liability After Exempt Amount	Effective Tax Rate on Market Value
2 50,000	-	-	0.00	0	-		0.00
500,000	0.75	3,750	0.75	250,000	0.75	1,875.00	0.38
1,000,000	1.00	10,000	1.00	750,000	1.00	7,500.00	0.75
5,000,000	1.00	50,000	1.00	4,750,000	1.00	47,500.00	0.95
6,000,000	1.00	50,000	0.83	5,750,000	1.00	50,000.00	0.83
10,000,000	1.00	50,000	0.50	9,750,000	1.00	50,000.00	0.50

Source: IMF staff calculations.

Level of rate

77. **Internationally, and especially in developing countries, property tax rates are mostly very low, explaining partially property taxes' low revenue importance expressed as percentage of GDP**. If The Bahamas would need to raise more revenues from the real property tax, after the administrative reforms have run their course, the target might be at the higher end of the current global revenue range of 0.6–2 percent. This goal would necessitate an increase in nominal rates. Globally, tax rates for market value-based system typically range from 0.5–2 percent.

Property tax relief for social policy or economic development objectives

78. **Political, socio-economic, and practical considerations influence many facets of a tax instrument**. These are often reflected in differentiated rates (see above), deductions, exemptions, thresholds, or tax holidays in order to accommodate economic hardship cases or to pursue some development or industrialization policy (see the mission's adverse views on the real property tax holidays for the hotel industry). In assessing whether to exempt certain properties from property tax the following key analytical questions need to be posed: (1) What cost does the exempt property impose on local (or central) government with regard to service delivery (e.g., water or sewage connections); (2) Should the property be billed by user-charging for the costs it imposes; (3) Does the property owner create public good benefits that exceed the value of tax forgiveness; and (4) Would the tax exemption provide the owner with an unfair economic advantage? Numerous and wide-ranging exemptions often lead to significant revenue loss and erosion of the property tax base. Tax base erosion then triggers rate increases if revenue neutrality is maintained. As a result, many countries then make up for suffered revenue losses by taxing businesses more heavily than residential properties. It seems that in The Bahamas, the near non-taxation of the hotel industry imposes ultimately a higher tax burden on residential and other commercial property owners.

Low-income households and pensioners and the current tax threshold

79. **There are good reasons to shield low-income owners from potential adverse impacts of the property tax**. Measures may entail forgiving property tax for those living in properties below a stated value or area threshold. The poor often live in areas with limited infrastructure and as a consequence low assessment values for their properties. An exemption would accord some rough justice to areas where tax collection costs likely exceed the revenue take anyway. An area threshold is regressive because it gives more relief to luxury homeowners in good locations than to those in modest homes and mediocre locations. Another approach, determining the tax threshold based on the number of people residing in one property, is administratively complicated and results in unfairness because a large family size does not necessarily signal an unaffordable property tax burden. For this reason, some countries have adopted a value threshold for a market-value based property tax. The appropriate value threshold must be determined carefully so as not to be too generous or too restrictive. It is evident from Table 5 that the threshold for The Bahamas is clearly excessive as it exempts more than 83.34 percent of all registered property owners on the fiscal cadastre from the real property tax. Alternatively, one could keep the system clean without any exemption, and for taxpayers unable to discharge their obligations, one could introduce tax deferment provisions (or 'mortgaging' of property tax liability)—when the property changes ownership on death or any other disposition—outstanding amounts can be collected.

Recommendations

- Maintain a single-rate property tax without differentiation for property use or value gradients.
- Remove the cap of US$50,000 as it benefits the high-net worth individuals without any indication that the exemption encourages activity in the construction industry.
- Reduce or eliminate the property tax threshold of US$250,000 and scrap the property tax exemption for Bahamians on the Family Islands as they are being provided with public services for which some payment is due.
- If and when low-income residential properties deserve relief, this could be achieved by granting a tax-free amount only for properties located in suburbs commonly inhabited by low-income households.
- Limit all other exemptions to an absolute minimum.
- Property tax relief for the elderly and the poor should be granted on application, must be reviewed annually, and be means-tested.
- Alternatively, introduce 'mortgaging' of outstanding property tax liabilities.

D. Stamp Duty on Real Estate Transactions

Current law

80. **Next to the real property tax levied on the market value of immovable property, the Stamp Duty Act provides for a graduated stamp duty (transfer duty) on the transfer or sale of immovable property**. The sale of land connected to the construction of a new dwelling house or building, whether commercial or residential, constitutes a single taxable transaction for the purpose of this act. The graduated-rate stamp duty in the absence of an income tax is taxing progressively rising values of property conveyances:

Value of Realty Transaction	*Ad Valorem* Stamp Duty Rate (In Percent)
Transactions under $20,000	4
Between $20,000 to $50,000	6
Between $50,001 to $100,000	8
Over $100,000 to $250,000	10
Over $250,000	10

81. **The buyer and seller typically share the stamp tax (unless otherwise agreed)**. They are also responsible for their individual attorney's fees (determined by The Bahamas Bar Association), which amount to an additional 2.5 percent of the gross sale price of the property. There is also a small recording fee when the title deeds are recorded at the Public Registry. Hence, transaction costs are considerable for property conveyances. Total stamp duty revenue in 2007/08 from real estate transactions reached a high of US$183.9 million or 2.41 percent of GDP vs. US$39.1 million in 2002/03 or 0.67 percent of GDP—signaling a rising revenue importance. In 2010/11, real estate transfer duties declined to US$108.3 million or 1.35 percent of GDP—and for the period FY2003–11, transfer duties revenues were on average 1.56 percent of GDP. Since FY2008, stamp duties on realty conveyances generate the lion's share of all stamp duties—on average, more than 61 percent.

Issues—transaction taxes impede efficient property markets

82. **Seen from an economic impact perspective, too-high transfer duty rates impede the proper functioning of property markets**—even though many developed and developing countries are raising significant revenues from transfer duties. Transfer taxes are assessed when the statutory title to immovable property is transferred to another party. Generally, the transfer tax is applied to the total market value of an immovable property transaction and must be paid in order to complete the title transfer. Stamp duties on the acquisition (and/or alienation) of immovable property are quite common and are often imposed even if the transfer is not the result of a sale (e.g., changing beneficial ownership of

shares in a company). Table 8 provides for a sample of countries stamp/transfer duty rates in 2010. It is evident that there is a wide variation in transfer duty rates.

83. **In traditionally Common Law countries (i.e., those with a largely British heritage), such as Australia, Canada, New Zealand, the United Kingdom, and the United States, these taxes tend to be levied as a stamp duty on the deed of sale—**usually at rates around 2 percent. In Civil Law countries (i.e., countries with a European continental heritage), such as Belgium, France, the Netherlands, Portugal, and also South Africa, stamp duties on realty transfers are usually levied at rates, often exceeding 6 percent. The stamp duty rates in The Bahamas are high and the reasons for differentiating between 4 percent and 10 percent are not that clear. In deciding on an appropriate duty rate on realty transfers, their distortive economic impact should be considered. As VAT and the real property tax reforms gain traction and raise more revenues, a gradual duty rate reduction on property conveyances should be considered as high transfer tax rates may discourage business investment or may lock in investors into immovable property, resulting in suboptimal returns. Furthermore, high transfer duty rates encourage misrepresentation of sales prices by buyers and sellers, which generally undermines tax morale. Perhaps most detrimentally, if taxpayers perceive the transfer tax to be too high, they are less likely to register the property transfer at all with an adverse impact on the coverage ratio. High rates, therefore, require effective anti-avoidance legislation.

First-time homeowners exemption

84. **On application, stamp (transfer) duty exemption for 'first-time' homeowners is granted up to a value of US$500,000 per dwelling or land for construction of a dwelling.** This tax expenditure can be exploited as there is no anti-avoidance provision against, for example, a husband and wife both applying separately for this benefit and registering the home in their names, potentially benefiting from a total relief of up to US$1 million. This relief expires at the end of June 2013. Instead of its possible renewal, raising the general tax threshold to say US$35,000—indexed periodically—and which everyone is automatically entitled to would be easier to administer and fairer.

Recommendations

- Reduce stamp duty rates as collections from a reformed recurrent real property tax compensate for resulting revenue losses—and only when fiscal consolidation has been achieved.

- Replace the first-time homeowner's exemption with a generally applicable tax threshold for all property conveyances.

Table 8. Global Transfer Duty Tax Rates: 2010

Region / Country	Transfer Tax Rates in Percent	
	Minimum	Maximum
South and Central America:		
Argentina	2.50	
Brazil	2.00	
Chile	0.00	
Costa Rica	2.30	
Peru	3.00	9.50
Venezuela	0.00	
Unweighted average	*1.63*	
North America		
Canada	2.00	
Mexico	2.00	5.00
United States	0.00	2.00
Unweighted average	*1.33*	*3.50*
Asia and Australia		
Australia	5.50	
Cambodia	4.00	
China	8.00	10.00
Indonesia	5.00	
Japan	2.50	6.00
Republic of Korea	4.60	9.40
Malaysia	1.00	3.00
Philippines	0.50	
Unweighted average	*3.89*	*7.10*
Europe		
Belgium	10.00	12.50
Cyprus	3.00	8.00
Denmark	0.60	1.50
Finland	4.00	
France	0.70	5.10
Germany	4.50	
Greece	9.00	19.00
Ireland	0.00	9.00
Italy	10.00	
Luxembourg	10.00	
Malta	5.00	
Netherlands	6.00	
Norway	2.50	
Portugal	0.80	7.30
Spain	0.00	7.00
Sweden	3.00	
Switzerland	0.00	3.30
United Kingdom	0.00	4.00
Unweighted average	*3.84*	*7.67*
Russia and Former Soviet Union		
Czech Republic	3.00	
Poland	0.00	
Romania	0.00	
Russia	18.00	
Ukraine	22.40	
Unweighted average	*8.68*	
Africa		
Burkina Faso	8.00	
Dem. Republic of Congo	3.00	
Mauritius	5.00	15.00
Mozambique	2.40	
Namibia	1.00	8.00
Niger	1.50	
South Africa	0.00	8.00
Unweighted average	*2.99*	*10.33*

Source: UN Habitat, 2011. *Land and Property Tax--A Policy Guide.*

E. Motor Vehicle Taxes

Current law and practice

85. **Currently, recurrent license fees are imposed on motor vehicle ownership**. For the period FY2009–11, the annual motor vehicle license fee (or circulation tax) contributed on average 72.4 percent of total revenues on motor vehicle ownership. Other fees and charges include the annual fee for driver licenses, motor vehicle inspection fees, license plate fee, other licenses, and franchise fees for taxis and buses. The license fee structure is graduated against the weight of a vehicle which is very common internationally—(1) The Class A vehicles (0–5,000 lbs) attract US$150/annum; (2) Class B vehicles (5,001–15,000 lbs) are taxed at US$550/annum; and (3) Class C vehicles (15,001 lbs and over) attract a license fee US$700. The vehicle license fee is sporadically adjusted, leading to modest collections. The authorities are concerned about incomplete registration records of the active vehicle population which undermines compliance and collections. Table 9 indicates the modest revenue importance for licenses, averaging for the last decade 0.29 percent of GDP.

Table 9. The Bahamas: Vehicle License Collections, Fiscal Years 2002–11

Collections in Millions $	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Motor Vehicle Licenses (MVL)	15.70	14.03	17.29	19.31	19.56	22.49	21.92	20.02	26.63	28.36
Total revenue	716.63	851.45	978.94	928.72	1,052.83	1,209.03	1,189.09	1,293.78	1,327.58	1,080.86
MVL collections as percent of total taxes	2.19	1.65	1.77	2.08	1.86	1.86	1.84	1.55	2.01	2.62
MVL collections as percent of GDP	0.27	0.24	0.28	0.29	0.28	0.29	0.27	0.25	0.34	0.35
Fiscal GDP in $ millions	5,812.00	5,900.00	6,166.20	6,564.70	6,896.40	7,644.50	8,033.60	7,854.30	7,880.30	8,010.80

Source: The Bahamian authorities; and IMF staff calculations.

Circulation taxes and taxing informality

86. **The authorities expressed a concern that taxing the informal sector is difficult and that high income earners are inclined to understate transaction values or turnover for BLF**. Equally, tax compliance with real property tax is low and arrears are mounting. If there is widespread hiding of income—and if ineffective tax administration would continue in certain areas—tax instruments should be employed that impose charges on all forms of visible wealth. Since some of the property tax bases are immobile, they constitute efficient forms of taxation. Simultaneously, property taxes are progressive and become a useful distributional tool in pursuit of horizontal or vertical equity. If properly designed, taxes on all visible forms of wealth can generate stable revenues for governments. Vehicles, albeit mobile, remain in most of the world a popular bearer of ostentatious wealth. People hide income or wealth from the tax authorities but wealth or high income is seldom concealed

when consumed. Consequently, an annual circulation tax is an effective instrument to tax incomes in economies plagued by informality or a tax system that ignores income as base.

The design of annual circulation taxes

87. **Many jurisdictions impose an annual license fee—also classified as a property tax—on the ownership of motor vehicles**. This is in addition to environmental excises and road user charges that can be reflected in the retail price of gasoline and diesel as the consumption of fuel is a good approximation for road use, environmental degradation, and congestion (a highly relevant matter in New Providence Island). It would be part of a comprehensive set of road use charges and environmental measures. It can be justified both from an environmental perspective but also as a wealth and income indicator or a taxpayer's ability-to-pay. In the European Union (EU), annual motor vehicle taxes are characterized as environmental charges. According to the tax literature, the minimum EU excise on gasoline is about the right amount for the pure road charge and green tax element in the EU.[32]

88. **The forms of motor vehicle taxation vary widely**.[33] Countries impose charges such as a circulation tax on vehicle weight (i.e., the Bahamian practice), a registration tax, a road tax hypothecated to road maintenance, motor vehicle weight taxes, passenger and fuel consumption taxes, road user charges in lieu of a toll fee, heavy good vehicle tax, tax on vehicle axles, and a weight tax on diesel vehicles.[34] Passenger vehicles are usually taxed differently than commercial vehicles. Annual ownership taxes are more common than taxes on the acquisition of motor vehicles. The annual tax on ownership may vary by the size of the motor (in cc), weight, fuel consumption, horse power, and CO_2 emissions. Acquisition taxes are mostly ad valorem levies on the purchase price. An annual ownership tax over an acquisition tax is to be preferred, because the revenue from annual taxes would be more predictable and stable. The circulation tax in The Bahamas is simple and transparent and there is an attempt to ensure some equity, as the tax is varied by weight which is a rough approximation for value—more expensive vehicles (e.g., SUVs) tend to weigh more. This suggests that the tax might vary by the weight and age of the vehicle. In Europe and the OECD member states, vehicle circulation and fuel taxes are solid revenue earners—VAT is imposed on the final duty paid retail price and on fuels—being the excise-inclusive price. Nearly an equal number of OECD member states differentiate their vehicle registration or circulation tax according to vehicles' cylinder capacity (easy to identify) but with a minimum charge, irrespective of capacity.

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[32] See D. M. Newbery, "Road User and Congestion Charges," in S. Cnossen, ed., 2005, pp.193–227.

[33] European Commission, *Taxation of Passenger Cars in the European Union,* COM (2002).

[34] OECD European Environment Agency database.

89. **Imposing more ambitious annual circulation tax on passenger vehicles would increase collections from visible wealth**. Overall, it would improve the tax system's fairness and progressivity. Only limited disaggregated data for The Bahamas' vehicle stock in terms of weight is available—that is, rough estimates from the Department of Road Traffic indicate that 85 percent of the total estimated vehicle population of 125,000 are Class A vehicles; 10 percent are Class B; and the rest are Class C. The projected revenue of US$27.2 million is close to vehicle license collections of US$28.4 million in 2011. By increasing the circulation tax rates by 20 percent, collections could easily reach 0.41 percent of GDP and with improved registration and enforcement, the revenue importance of circulation tax could attain, over the short term, 0.5 percent of GDP. To put the proposed 20 percent increase of the circulation tax in perspective: in Nassau, it costs approximately US$90 to fill up a 60-liter fuel tank of a passenger car. Hence, the increase of the recurrent vehicle license from US$150 to US$180 (20 percent increase) would be equivalent to the gas pump price of one-third of a tank filling. This is not an unaffordable amount and policymakers should, therefore, express the circulation tax as a multiple of the gas pump price of a fuel tank filling. Motorists evidence a fairly price inelastic demand for gasoline, even in a rising fuel price environment. Finally, increasing gasoline taxes together with higher circulation taxes may just provide the necessary push for motorists to switch to the proposed Unified Bus System in Nassau with the view to reducing costly congestion and rising fuel import bills.

Recommendations

- Increase the vehicle licenses by 20 percent but for distributional reasons, differentiate more carefully by introducing higher rates for heavy vehicles such as SUVs.
- Index the charge to keep it constant in real terms.

IV. TAX CONCESSIONS

A. General Fiscal Background

90. **Throughout the Caribbean Region, there is extensive use of tax incentives**. Within the CARICOM membership,[35] The Bahamas stands out as the jurisdiction without an income tax on natural and legal persons (including the taxation of capital gains).[36] This in

[35] The15 CARICOM Member States are Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, Saint Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago. Associate member states are Anguilla, Bermuda, British Virgin Islands, Cayman Islands, and Turks and Caicos Islands.

[36] Except for The Bahamas, 16 CARICOM member/associate member states impose a CIT and 15 levy the PIT.

itself constitutes a material tax concession to foreign investors that commonly attracts this tax instrument in their respective home jurisdictions. Does this mean that The Bahamas willingly consents to the export of the tourism tax base to holding companies' home countries if they manage locally hotel chains? Another policy question would be why it is still deemed necessary to widen the incentive network to other taxes such as real estate taxes, import duties, business license fees, stamp duties, and excises. In the case of The Bahamas, the combined effect of these measures erodes the tax effort as it leaves taxes to be collected from a narrow and volatile tax base which show little buoyancy as the economy and related public services expand. The next section discusses the wide range of tax incentives[37] employed in The Bahamas and their negative impact on cost-effective collections.[38]

B. Current Tax Incentive Regime

91. **Investment incentives in The Bahamas mostly include exemptions of tariffs on building materials, hotel fittings and furnishings, equipment, and approved raw materials (the Tariff Act of 2003)**. However, it is not uncommon to also exempt taxpayers from business license fees and real property taxes for periods of up to 20 years. The complete range of incentive legislation is detailed in the following acts:

- ***The Hotels Encouragement Act (1954)*** grants to hotel developers customs duty exemptions on construction plant. It is a customs duty suspensive regime on imported building supplies, equipment, furnishings, and other materials after securing prior approval. A 10-year exemption from real property tax from the date of opening applies. After the end of this period, exemption from the tax is granted for a further 10 years to the extent that it exceeds BSD 20 per bedroom. In addition, hotels can receive Crown land for no consideration. Incentives are granted for the construction of new hotels, hotel cottage colonies, and residential clubs, and for refurbishment of existing hotels. On New Providence Island incentives, are granted for new hotels, with 50 bedrooms or more in the more developed areas, and with 20 bedrooms elsewhere. In the "Family Islands", accommodation of 5 bedrooms or more qualifies for the incentives. At present, The Bahamas has no income taxes or withholding taxes on dividends and interest. If these were ever introduced, new hotels would be exempted from these taxes for 20 years from when they open. In fact, hotels have negotiated a fiscal stability clause for 20 years which internationally is commonly found in the case of extractive industries that require a much bigger initial investment than hotels.

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[37] The terms tax incentive, tax preference, tax concession, or tax expenditure are used interchangeably—all constitute fiscal support schemes extended through the tax system.

[38] The 2002 FAD report addresses the expansive concession regime in The Bahamas and proposes to rationalize the incentive regime that remains as relevant as then. Hence, evidence and arguments presented in the 2002 TA Report must be read together with the analysis of this mission and are, therefore, complementary.

- ***The Industries Encouragement Act (1970)*** provides exemptions for customs duties on equipment and intermediary inputs, business license fees, and real property taxes for a statutory period of 15 years. Income and profits taxes (if The Bahamas were to introduce such taxes) will not be charged for the same statutory period of 15 years.

- ***The Bahamas Free Trade Zone Act (1984)*** administered by The Bahamas Agricultural and Industrial Corporation grants zone companies permanent exemption from real property taxes, tariffs on goods and raw materials, stamp duties, business licenses, except consumables.[39] Free-trade zones (FTZs) have been established at Freeport on Grand Bahamas and New Providence. The Act determines privileges for a FTZ enterprise but a *designating order* may specify additional concessions. National insurance contributions remain payable in FTZs.

- ***The Export Manufacturing Industries Encouragement Act (1989)*** exempts qualifying manufacturers from customs and stamp duties (on raw materials and factory equipment) and real property tax—all for 25 years.

- ***The Agricultural Manufacturers Act (1913)*** exempts customs duties on machinery, tools, fixtures, and supplies on imports of everything needed for the construction, repair, adaptation, and running of an agricultural factory.

- ***The Hawksbill Creek Agreement Acts*** established a duty-free zone in Grand Bahamas Island with no taxation except the levying of social security contributions in support of the National Insurance Program.[40] A deep-water harbor and nearby industrial area were developed by Grand Bahamas Port Authority (GBPA) under an agreement made on August 4, 1955 with the government of The Bahamas. Under the original agreement and subsequent amendments, full commercial facilities were provided by the GBPA together with residential facilities for factory and port employees. The concessions on property taxes have been extended to 2015, while customs duties exemptions have been extended to 2054. The duty exemption applies to imports for factory construction and equipment, manufacturing supplies, and raw materials imports, and associated office supplies and materials. Taxes not subject to exemption must be levied on port authority concerns at the national rates.

- ***The Spirits and Beer Manufacture Act (1963)*** provides duty-free import of raw materials and equipment for the manufacture of spirits, beer, and wine.

- ***The Bahamas Vacation Plan and Time-Sharing Act (1999)*** exempts customs duties on construction materials.

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[39] The Bahamas Free Trade Zone Act defines "consumables" as goods for personal use, generally exported out of the zone and goods sold to passengers on vessels landing at the FTZ.

[40] The Freeport (Hawksbill Creek) harbor area incentives needs special reference as it illustrates the drawbacks of long-term contractually enforceable tax expenditures. It binds future governments—even in times when fiscal consolidation imperatives would require fair burden sharing among all taxpayers.

92. ***General Discretionary Tax Concessions* are granted under the Heads of Agreement between the Bahamas Investment Authority (BIA) with consent from the Prime Minister**. Investment priority areas are tourist resorts, up-market condominiums, timeshare and second-home development, marinas, information and data-processing services, assembly industries, high-tech services, ship registration, repair and other services, light manufacturing for export, agro-industries, food processing, marine culture, banking and other financial services, captive insurance, aircraft services, pharmaceutical manufacture, and offshore medical centers. The respective laws prohibit double dipping of tax concessions.

C. The Cost-ineffectiveness of Tax Incentives

Proliferation of tax expenditure legislation

93. **The Bahamas has promulgated at least eight stand-alone acts that provide wide-ranging tax concessions**. In addition, the BIA through the Office of the Prime Minister can grant additional discretionary concessions in so-called "Heads of Agreement" between the government and the investor. There appears to be room for rationalization of the individual tax concession laws by consolidating these into an overarching concession law with individual sector chapters or schedules. This act would have the status of a money bill and it should only be introduced, amended, and withdrawn by the minister of finance. It should contain, in lieu of discretionary powers, published objective criteria which would indicate whether an investor would qualify for a set of incentives. The soon-to-be established CRA should be solely responsible for the administration of incentives and should be empowered to withdraw tax concessions from taxpayers that transgress any of the relevant provisions or fail to meet the investment yardsticks. However, relevant line departments must assist the CRA in verifying compliance with investment criteria as the CRA is specialized to be an effective revenue agency and cannot become the guardian of an industrial or labor market policy initiative.

94. **By consolidating the individual incentive legislation, the authorities would have an opportunity to review the present system of tax expenditures**. The relevance for some of the incentives with a term of more than 50 years could be reviewed. It would enable a comparison of foregone revenues against the uncertain benefits of additional investments stemming from these long-term concessions. There is a very good chance that some of the hotel incentives are no longer needed as the sunk investments into immobile hotel assets have locked investors into The Bahamas and they should begin to make a bigger contribution to revenue collections. Generally, the long duration of tax concessions in The Bahamas are a concern as these incentives should only be available for an initial trigger period to induce investors to come in and place the investment in the hope that initial time-limited revenue losses for government will be followed by years of more buoyant revenue take on the back of an expanded tax base. Also, it is important that any initial incentive period will not be renewed after the initial start-up years as this will translate into perpetual rent seeking through lobbying for incentives in lieu of focusing on cost-effective operations.

95. **Empirical evidence suggests that a country's tax burden is not the main factor in business investment decisions**. According to a survey of firms investing internationally by the World Bank, national taxes rank number 11 among the top 20 important factors in determining their location decisions. Accessing markets, political stability, labor markets, and other operational costs are more important than taxes on location decisions of the firms (Table 10). Tax measures are poor substitutes for these key determinants of investment. In such cases, the first-best solution would be to address these underlying problems directly. For business investment decisions, the most important tax considerations are not necessarily the relative tax burdens of competing economies. It may be more relevant whether the tax system is stable, predictable, and transparent. Stable tax policy is an essential feature of a competitive tax system as frequent changes create uncertainty, dissuading potential investors from investing. Also, existing investors may refrain from expanding their businesses. For example, the high energy costs in The Bahamas should be addressed directly and not through the granting of tax exemptions to compensate for an uncompetitive power pricing structure.

Table 10. Objectives and Determinants of FDI Location

Objectives of Firms Investing Overseas 1/		Most Important Determinants of Location	
1	Improved market access	1	Access to customers
2	Reduced operating costs	2	Stable social and political environment
3	Other factors	3	Ease of doing business
4	Source of raw materials	4	Reliability and quality of infrastructure and utilities
5	Consolidated operations	5	Ability to hire technical professionals
6	Develop new product lines	6	Ability to hire management staff
7	Improved productivity	7	Level of corruption (???)
8	Develop new technologies	8	Cost of labor
9	Improved labor force access	9	Crime and safety
10	Reduce risk	10	Ability to hire skilled laborers
		11	National taxes
		12	Cost of utilities
		13	Roads
		14	Access to raw materials
		15	Availability and quality of university and technical training
		16	Available land with all services in place
		17	Local taxes
		18	Access to suppliers
		19	Labor relations and unionization
		20	Air service

Source: MIGA; Foreign Direct Investment Survey; World Bank/MIGA, January 2002.
1/ Ranked by order of importance.

96. **Tax preferences distort investment decisions and more often than not constitute a deadweight loss**. Instead, local favorable conditions in the business environment, natural resource abundance, or pristine beaches may have led to investments anyway. Consequently, foregone revenues stemming from tax expenditures could have been put to better use elsewhere such as improvement to the physical infrastructure. Tax incentives are bad in practice because frequently they are poorly implemented, cost-ineffective, and inefficient in their design, often inviting rampant abuse and corruption. Globally, there is little evidence that tax policy in respect of incentives has any significant effect on investment—the tax structure is more important.

Benefits and costs of tax incentives

97. **International experience, therefore, indicates that tax incentives create inefficiency and inequities through socially corrosive rent seeking behavior by prospective applicants**. Sparing use of tax preferences is advisable given the risk of primary revenue loss and leakage through avoidance (key drawbacks are summarized in Box 1). Granting tax preferences to new investors may undermine the competitiveness of already established companies which have been taxpayers in good standing. Tax incentives are often the quick-fix of public finance: almost everyone agrees they are not desirable, but finds them irresistible nonetheless as they seemingly indicate that the authorities are willing to absorb for the investor some of the sovereign risks or costs of an inadequate infrastructure. Ordinarily, countries offer tax incentives to attract new additional foreign direct investment by creating a competitive edge through reduced tax burdens. However, often investment incentives do not generate enough incremental investment to compensate for the loss of revenues—they only may affect location decisions.

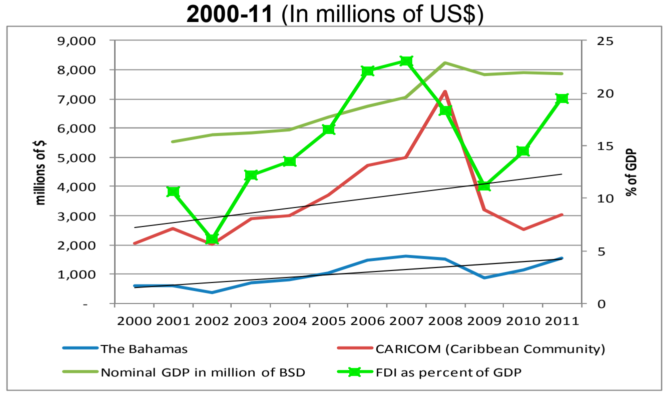
Box 1. The Ten Most Common Arguments Against Tax Incentives

1. **Revenue loss**—triggered by the existence of a deadweight loss (investment may have happened anyway) or redundancy as incentivized investment is no longer viable. In the absence of tax sparing provisions in the host country's treaty network with capital-exporting home country, the foreign tax jurisdiction preserves its taxing right (i.e., reverse foreign aid). Also, revenue losses stem from tax holiday firm displacing current taxpaying firms.
2. **Revenue leakage—**through avoidance and evasion (company churning, income shifting, interest pump, false export declarations, tailor made loopholes) secondary revenue losses are created that dwarf in most instances the direct revenue loss from the incentive.
3. **Adverse impact on tax administration—**tax administrators become incentive monitors and regulators.
4. **Economic cost of fiscal adjustment—**curtailing government expenditure through loss of tax base, or the need to increase tax burden (mostly VAT) on vulnerable or other deserving economic activities.
5. **Economic distortions—**incentivized firms may become less productive, efficient, and competitive.
6. Generally, tax expenditures impact negatively on **equity and fair tax treatment across sectors.**
7. **Lack of transparency**—in incentive adjudications gives rise to rent seeking behavior**.**
8. **Governance problems—**leading often to opaque discretions and corruption.
9. Other **fiscally more sustainable alternatives** are available (see accelerated depreciation allowances).
10. Tax incentives are mostly **too costly, merely attracting footloose investments,** without lasting employment effect.

Do concessions attract Foreign Direct Investments (FDI)?

98. **Empirical evidence suggests that tax incentives rarely have any significant effect on investments**. In the case of The Bahamas, incentives have been in place for decades and the strong FDI performance over the last decade may not necessarily be due only to the concession regime. In fact, the CARICOM region overall evidences a rising linear trend in attracting investments—and most of its member states achieve these results with an income tax system in place. For The Bahamas, over the last 11 years, FDI as a share of GDP have been an average of 15.23 percent and reveal a rising long-term trend (Figure 2). This deviates from the international evidence. For example, Klemm and Van Parys (2009) examine a panel of more than 40 countries over the period 1985–2004 and find no effect of tax incentives on economic growth and aggregate investment.[41] It is possible that the pristine marine ecology is the attraction that does not require continuous encouragement through the tax system.

Figure 2. The Bahamas: Annual Inward FDI Flows, 2000-11 (In millions of US$)



Recommendation

- Consolidate the various individual concession acts into a single fiscal omnibus act that can only be introduced, amended, or withdrawn by the minister of finance.

D. Comparison of Different Tax Incentives

An income tax does not tax loss-making firms

99. **Some tax incentives are more cost-effective than others which should inform future concession design in The Bahamas**. Appropriately designed capital allowances as part of an income tax system—such as *accelerated tax depreciation provisions*—are critical for fostering a favorable investment climate, especially since these provide a cost-effective way to grant early cash flow benefits for major investments. Generally, depreciation can be more easily afforded as it merely defers government's receipts. As an aside, an income tax regime provides start-up and loss-making firms with a tax deferral benefit through provisions that allow for the carry forward of tax losses. It is preserving cash flow for repayment of investments and government cannot tax upfront generated cash flow in situations where tax losses are suffered. In contrast, the current business licensing system together with the

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[41] Similar results emerge in a recent OECD study (OECD, 2010) according to which tax incentives do not affect investments and economic growth unless they address market failures (e.g., insufficient funds in R&D).

accompanying multiple fees and duties of the Bahamian revenue machinery ignore these fundamental cash flow dynamics of the business sector. As a consequence, taxpayers argue for even more concessions. Even though the authorities have expressed their resistance against an income tax system, even at low rates, the reality is that the current turnover based business license regime could be a deterrent to firm establishment.

Tax holidays

100. **Tax holidays are commonly not well targeted as they constitute only temporary exemptions of new investments from certain specified taxes**.[42] International experience suggests that such tax expenditure tends to attract footloose industries—such as global textile manufacturers. However, these holiday schemes have minimum backward linkages to the economy. Tax holidays for hotels with a duration of decades are unprecedented and unnecessary given that once the investment is sunk, the investor will not easily relocate. It is of least value for long-term investments (with a long gestation period). Note that for long-term investors the loss carry forward provision of depreciation allowances as an essential element of a CIT already provides a de facto tax holiday (see above). Tax holidays for start-up firms are therefore ineffective. They are particularly prone to abuse such as the manipulation of transfer pricing so as to channel profits to the untaxed affiliate—which is currently of no concern in The Bahamas. However, tax holidays granted to large investors create serious distortions between new and existing firms (probably small and local), which cannot be abolished easily. Given the unfair competitive cash flow advantage handed to large foreign investors for long periods tends to erode small firms' prospects for survival.

Free trade zone (FTZ)

101. **The local FTZ legislation is comprehensive in intent providing a complete tax holiday dispensation from all import and stamp duties, business licenses, and real property taxes for an indefinite period**. The concession is not entirely transparent as so-called designating orders can provide for additional concessions. Ideally, these zones should merely focus on the reduction of red tape with regard to customs procedures and should not grant direct tax incentives due to domestic transfer pricing concerns and tax leakage. The key objective of free zones or special economic zones is to increase exports. For that reason, most of the zones around the globe operate as ring-fenced enclaves. Zones are exempt from national import/export duties and VAT as these areas operate outside a jurisdiction's customs area. Increasingly, however, direct tax incentives are added to these zones. These translate into costly administrative challenges with revenue erosion (property taxes in the case of The Bahamas). In addition, they tend to distort the direction of investments or create complacency in extending economy-wide reforms that would benefit all investors. These incentives are deemed to be simple to administer, but the fact that no

[42] See Easson, A., and M. Zolt (2003) and Zee, H., J. Stotsky, and E. Ley (2002).

reporting on associated business activities is required allows these structures to function as powerful tax avoidance vehicles for unintended beneficiaries.

102. **Experience with export processing zones (EPZ) or FTZ from various countries indicate that zones cannot and should not be viewed as a substitute for a country's larger trade and investment reform efforts**. They are one tool in a portfolio of mechanisms commonly employed to create jobs, generate exports, and attract foreign investment, through the provision of incentives, streamlined procedures, and custom-built infrastructure. A critical determinant in configuring a zone development program is the type of zones to be promoted. Some commonly cited problems with zones are: (1) poor site locations, entailing heavy capital expenditures; (2) uncompetitive policies—reliance on tax holidays, rigid performance requirements, poor labor policies and practices, and poor zone development practices such as inappropriately designed facilities, inadequate maintenance, and promotion practices; (3) subsidized rent and other services; (4) cumbersome procedures and controls; (5) inadequate or duplication in zone administration; and (6) lack of coordination between private developers and governments in infrastructure provisions.

103. **International experience suggests for a SEZ/FTZ regime the incorporation of the following principles**: (1) Allow FTZ enterprises to locate within the same area. The development of separately fenced-off areas solely for FTZ enterprises is a less preferable, but acceptable approach; (2) Ensure that the FTZ regime is flexible, allowing a range of commercial as well as manufacturing activities. A separate commercial free zone regime is not required; (3) Promote private rather than public development of zones; and (4) Develop an appropriate legal, regulatory, and institutional framework to ensure less red tape. This will necessitate improved administrative capacities by host governments. Yet, the mission would like to stress that instead of establishing FTZs to attract FDI, a country's entire tax system should be made more attractive to all investors.

Import duty concessions

104. **Duty concessions for imports of capital or intermediary inputs, targeting new capital investments, are a standard incentive feature in The Bahamas**. They operate as a duty *suspensive and not a duty-drawback system* and are granted to registered beneficiaries of the various incentive acts (see above). They are not automatic. However, to the extent that they apply to goods that are subsequently exported, these taxes should be rebated. Note that leakage problems are higher for duty suspensive regimes than for duty-drawback schemes. Incentives for intermediate inputs into manufacturing or service businesses are not naturally targeted in this way. Generally, they tend to lead to unfair competition, relative to similar businesses not enjoying the incentive, and they are especially open to abuse through leakage into the domestic economy. Such duty concessions are most helpful for domestic producers at a current competitive disadvantage relative to international producers. Nevertheless, it would be better to address the high cost environment by reducing or withdrawing completely all tariffs on industrial or single purpose capital goods and intermediary inputs used in

manufacturing processes in lieu of special concessions that are unwieldy to administer. The introduction of VAT is being recognized by the Bahamian authority as an opportunity to afford this course and is to be welcomed. The chapter on tariff reforms will expand further on the need for low or nil tariffs for certain capital and intermediary goods.

Fiscal incentives for the tourism industry

105. The Hotels Encouragement Act focuses its attention on large international firms and this may ignore the fact that a lot of activity is generated by local smaller hotels and tour operators. By introducing discretionary incentives for foreign firms the bias towards foreign investors is perpetuated, and tax administration is unduly complicated with the risk of corruption.[43] Many tourist destinations like The Bahamas market themselves on the basis of pristine sandy beaches and coral seas or summer weather and their tourism is based on highly valued natural resources that generate economic rents. It may therefore be entirely unnecessary for governments to subsidize this industry development—the investors would have come anyway and the incentive regime then would constitute a deadweight loss. At the very least, to renew or extend tax concessions beyond the initial jumpstart period to foreign hotel operators appears to be unnecessary. For example, Mauritius is often referenced as an example how to successfully attract tourism investment by offering initially incentives in the 1980s and abolished them once the sector had gained momentum. Today, low tax rates are evenly applied across all sectors—with a standard 15 percent tax rate applied to VAT and corporate income tax.

Mitigating erosive effects of tax competition between island states

106. **In most countries, policymakers are under pressure to compete with tax incentives that can be accessed by investors in a regional grouping—the CARICOM not being an exception**. Tax competition results in a race to the bottom whereby tax rates are driven down and costly tax expenditures are granted. This erodes, especially in the case of The Bahamas, tax effort and leads to a less than efficient levels of output of public services. In order to attract business investment, officials keep taxes low and hold spending below those levels for which marginal benefits equal marginal costs. It reduces governments' ability to collect tax revenue from certain activities and thus reduces their ability to fund social programs or infrastructure. Hence, the mission cautions against participating in this relentless race to the bottom, as the granting of more tax incentives may have adverse distributional impacts. It would be, therefore, in the interest of all CARICOM member states to reduce the level of costly incentives regionally and agree, for example, on a common standard for taxing the tourism industry without exposing any individual country to unfair competition.

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[43] Corthay and Loeprick (2010:2–5).

Recommendations

- Use tax incentives sparingly and then only in situations where they address market failures or generate multiplier effects such as infrastructure development.
- Withdraw the power to issue discretionary incentives.
- Impose a sunset clause of no more than five years for all tax incentive legislation in order to analyze whether incentives are achieving the intended purpose.
- Decline requests for extending concessions granted under the Hotels Encouragement Act.
- Influence other CARICOM member states to reduce the level of tax expenditures for especially the tourism industry so that countries could reap a bigger share of the rents.

E. Tax Expenditure Reporting

The concept and measurement of tax expenditures

107. **The introduction of an annual tax expenditure budget ought to be considered as the authorities continue with granting tax incentives**. Government just as well may want to claim credit for its support to investors in the various industries. Tax expenditures,[44] being government spending through the tax system, lower tax revenues for certain categories of taxpayers (sectors, firms, or individuals) thereby deviating from the benchmark tax system. Tax expenditures may take a number of forms: exclusions, exemptions, allowances, deductions, credits, preferential tax rates, or tax deferrals. Tax holidays and free zones, for example, are tax expenditures subject to specific time periods or geographical areas. To determine whether a tax measure generates tax expenditures, it is necessary to establish the benchmark tax structure from which concessions represent a departure. Thus, to determine whether a particular tax measure generates a tax expenditure it is necessary to establish the normal tax structure from which this measure represents a departure—and that is the most difficult part of the exercise. In essence, it constitutes preferential treatment to stimulate economic activities or attain certain social objectives. These indirect income support programs should, therefore, be tabled at the same time as the annual budget and its expenditure outlays is presented to parliament—hence, its label of a tax expenditure budget.

[44] The terms tax incentive, tax preference, or tax expenditure are used interchangeably—all constitute fiscal support schemes extended through the tax system. The Belgian definition of a tax expenditure is comprehensive and could assist in designing a tax expenditure budget: “A tax expenditure is defined as a provision that lowers tax revenue; results in a deviation from the benchmark tax system; aims to encourage a specific behaviour, favouring economic, social, or cultural activities; and could be replaced by a direct spending programme,” (World Bank, 2004).

Main steps in the preparation of tax expenditure estimates

108. **Identifying and reporting tax expenditures is an intricate process that requires four steps:**

(1) *Establishing a benchmark tax system*—There is no consensus about the definition of the benchmark tax system, and countries often use different approaches. One simple method is to use as a benchmark the main legal provisions of the tax system existing at a given date, including certain deductions and exemptions that are deemed essential features of the system (e.g., VAT thresholds or property tax without tax holiday). The benchmark tax structure should represent a consistent tax treatment, and neither favor nor disadvantage similarly placed activities or taxpayers.

(2) *Identifying and estimating tax expenditures*—An inventory of tax expenditures can be defined as deviations from the established benchmark. It is good practice that such an inventory would also indicate the purpose of all tax expenditures. Inclusion of the original purpose would enable comparisons with an equivalent spending program. Thus, a simple listing of tax expenditure with their intended purposes would be a good first step of a tax expenditure budget. The best initial source for the database is tax returns filed by taxpayers.

(3) *Integrating tax expenditure reporting in budget documents*—According to best international practice of fiscal transparency and management, information about tax expenditures should be provided with the annual budget.[45] Such integration would help improving fiscal accountability.

(4) Entrench fiscal transparency in managing tax expenditures through adherance to four rules: (a) clarify roles and responsibilities so that coordination and management of tax expenditures can be centrally monitored from the ministry of finance; (b) make the cost of tax expenditures publicly available by publishing the tax expenditure as one of the key budget documents as it would improve governance, fiscal analysis, and accountability; (c) as part of the budget execution and reporting function, the tax expenditure should contain a statement of fiscal policy objectives and an assessment of their fiscal sustainability; and (d) tax expenditures should be audited for their performance.

109. **There are three principal approaches to estimate the costs of tax expenditures**. All three methods are used within the OECD member states:

(1) *Initial revenue loss (gain)* is the most commonly used method. It is defined as the amount by which tax revenue is reduced (increased) as a consequence of the introduction (abolition) of a tax expenditure. It does not account for the change from removal of one

[45] International Monetary Fund, 2007, *Code of Good Practices on Fiscal Transparency*, Article 3.1.3, http://www.imf.org/external/np/fad/trans/code.htm and OECD, 2002, *Best Practices for Budget Transparency,* http://www.oecd.org/dataoecd/33/13/1905258.pdf.

provision resulting in increased use of other provisions, or lowering tax revenue elsewhere. In addition, this method does not take into account that the removal of a tax expenditure may result in some taxpayers moving into a higher marginal tax bracket under a progressive income tax system or higher rate under the stamp duty act.

(2) The *Final revenue loss (gain)* is defined as the amount by which tax revenue is reduced (increased) as a consequence of the introduction (abolition) of a tax expenditure, taking into account the change in behavior and the effects on revenues from other taxes as a consequence of the introduction (abolition) of a tax expenditure.

(3) The *Outlay equivalence approach* estimates the equivalent amount of direct expenditures that would be required, in pre-tax dollars, to achieve the same after-tax dollar benefit if a tax expenditure were replaced by the corresponding direct expenditure program, to which the tax expenditure is associated.

Proposed steps toward tax expenditure budgeting in The Bahamas

110. The MoF is advised to prepare an annual report on tax expenditures that is published as an attachment to the Budget and which adopts the initial revenue loss approach. The various tax expenditures should be classified by tax instrument—that is, excises, stamp duties, import duties, real property tax, business license fee, and VAT (when introduced). Ideally, this tax expenditure report should be tabled together with the annual budget documentation. A recent estimate of revenue foregone from duty concession alone is equal to 21.96 percent of total collections in 2011/12 (or 3.6 percent of GDP), up from 13.2 percent of collections in 2009/10.

Recommendations

- Structure the tax expenditure inventory per Tax Concession Act—and begin to include the revenue losses from real property tax and stamp duty exemptions for first-time home purchases together with duty concessions.
- The costs of tax concessions should be calculated by the MoF and published in a periodic tax expenditure budget.
- Integrate tax expenditures into the budget process, by grouping them in functional categories to facilitate comparison with the corresponding direct budget expenditures, thereby identifying total fiscal resources allocated to each functional area.

F. Strategies for Rationalizing Existing Tax Incentives

111. **There are basically three practices that could, over time, mitigate the fiscal damage of poorly designed incentives, that should be adopted**:

(1) There should be a concerted effort in making incentives simpler and providing for a minimum of discretions—that is, ultimate withdrawal of additional concessions into the

"heads of agreements" in investment contracts or "designating orders" granted under The Bahamas Free Trade Zone Act;

(2) Regular and transparent records must be kept about take-up, including published annual lists of beneficiaries, and costs of the incentives; and

(3) Sunset provisions should be included to evaluate the effectiveness and results of investments placed in reaction to the incentive. However, the other concession agreements may have clauses that protect investors against changing fiscal regimes. It is for this reason that grandfathering of such incentive agreements may be the only option. In addition, the authorities could take the following steps: (a) Review existing tax system and ensure it conforms with international practice (i.e., broad base, low tax rates, minimum exemptions); (b) Maintain tax incentives that provide fast recovery of investments as they are most cost-effective; (c) Eliminate preferential real property tax treatment as beneficiaries are consuming infrastructural services which have to be financed from a narrower tax base; (d) Resist the renewal of any granted tax concessions because if a company could not establish itself cost-competitively in the initial concession period the chances are slim for ever achieving this benchmark; (e) Ensure that all incentives are embodied in tax codes; (f) Repeal those incentives that may be inconsistent with international agreements against harmful tax practices; (g) Eliminate all discretionary incentives that are prone to abusive rent seeking, or which are rarely used.

Recommendations

- Withdraw all discretionary powers that grant additional concessions beyond those specifically provided for in legislation.
- Maintain already granted investment incentives under an investment contract.

V. Excise and Trade taxes

A. Introduction

112. **Tariffs, excises and stamp duties on international trade are the most important sources tax revenue accounting for more than 50 percent of the total tax revenues** (Tables 11 and 12). All taxes on international trade are collected by The Bahamas Customs. Starting in FY2008/09, excisable goods are separately classified. The Bahamas has a wide range of tariff and excise rates. In addition to ad valorem rates, alcohol and some petroleum products are levied a specific amount. Revenues declined in 2009/10 to a large extent as a result of the global financial crises.

113. **Excise tax act was introduced in 2008/09**. Some items were taken from the Tariff Act and placed in the Excise Act. Now, excise tax revenues are as much as the revenues collected under the Tariff Act. This would give The Bahamas some revenue protection as the tariff rates are lowered with the expected accession to WTO membership.

Table 11. The Bahamas: Taxes on Trade 2002/03–2011/12

Fiscal Year	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
General Import Duties	421,019,197	409,252,120	412,740,705	487,909,605	507,506,816	529,713,908	379,497,051	349,532,344	354,117,822	347,913,382
Export Duties	12,224,385	13,396,228	12,615,356	14,166,523	14,011,316	14,669,539	12,738,674	13,826,914	12,860,177	15,291,158
Excise Taxes	-	-	-	-	-	-	187,170,734	188,537,338	253,718,894	331,291,179
Total Stamp Tax	95,885,605	96,388,748	112,311,656	134,615,255	143,262,477	149,786,862	15,381,513	15,136,841	16,003,730	17,656,201
Stamp Tax - Imports	95,764,551	96,300,880	111,686,493	134,523,670	143,146,602	149,740,382	15,183,692	14,984,643	15,928,074	17,556,397
Stamp Tax - Exports	-	26,072	611,976	37,899	58,767	19,110	189,833	133,667	73,026	76,530
Stamp Tax - Ship Reports	-	-	-	-	4,032	21,254	-	-	280	1,780
Stamp Duty - Exports	121,054	61,796	13,187	53,686	53,076	6,117	7,987	18,531	2,350	21,494
Customs Fees	6,420,335	6,360,155	6,483,363	7,782,812	8,138,463	8,222,237	7,301,661	5,679,991	4,576,692	4,020,671
Customs Warehouse Fees	443,321	186,697	181,484	251,820	301,333	225,093	248,718	98,977	168,267	32,096
Storage Fees	-	-	-	14,840	35,145	10,777	1,888	167,320	141,034	138,036
Customs Inspection Fees	4,857,704	1,701,812	1,676,439	827,778	809,034	663,685	558,373	539,508	665,409	726,148
Customs Inspection Fees Overtime	856,566	4,257,630	4,409,848	6,449,264	6,692,318	7,034,281	6,184,773	4,648,091	3,375,356	2,946,261
Customs Boarding Fees	23,675	8,600	51,350	63,700	40,200	14,250	28,200	7,350	3,900	10,740
Container Fees - Freeport Customs	228,389	194,765	160,872	174,052	260,033	274,151	279,709	218,705	222,715	167,251
Transportation Fees	10,680	10,650	3,370	1,360	400	-	-	40	10	140
Other Charges	2,729,793	4,542,194	3,610,889	3,767,020	2,966,671	3,110,235	3,259,294	2,816,077	6,459,631	7,468,025
Container Movement - Customs	1,121,006	1,212,386	1,373,738	1,424,348	1,473,997	1,583,211	1,460,797	1,327,546	3,578,699	5,362,828
Customs Fines & Forfeitures	265,232	258,715	223,456	345,463	349,962	297,774	429,034	255,463	260,850	242,122
Customs Wrecked Goods	3,040	444	160	-	263	221	-	-	-	75
Customs Service Charge	-	-	-	-	-	-	-	-	355	502
Other Customs Charges	792,683	864,302	901,853	571,785	499,782	240,865	349,615	227,439	374,620	170,568
Customs Bonding Tax	547,700	540,860	605,630	678,362	627,610	978,576	930,335	736,619	2,203,759	1,221,241
Wharf Dues & Port Dues	133	1,461,209	337,672	533,343	15,056	9,588	89,513	269,009	41,348	470,689
Pierage Dues	-	204,276	168,381	213,720	-	-	-	-	-	-
Grand Total	538,279,316	529,939,444	547,761,970	648,241,216	675,885,742	705,502,781	605,348,925	575,529,504	647,736,946	723,640,615

Souce: The Bahamas, Ministry of Finance, Treasury Department and FAD staff calculations.

Table 12. The Bahamas: Trade Taxes as a Share of Tax Revenues 2002/03–2011/12

Fiscal Year	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
General Import Duties	50.59	48.32	44.02	45.20	40.16	39.22	31.58	30.25	25.35	25.13
Export Duties	1.47	1.58	1.35	1.31	1.11	1.09	1.06	1.20	0.92	1.10
Excise Taxes	-	-	-	-	-	-	15.58	16.32	18.16	23.93
Stamp Tax	11.52	11.38	11.98	12.47	11.34	11.09	1.28	1.31	1.15	1.28
Stamp Tax - Imports	11.51	11.37	11.91	12.46	11.33	11.09	1.26	1.30	1.14	1.27
Stamp Tax - Exports	-	0.00	0.07	0.00	0.00	0.00	0.02	0.01	0.01	0.01
Stamp Tax - Ship Reports	-	-	-	-	0.00	0.00	-	-	0.00	0.00
Stamp Duty - Exports	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Customs Fees	0.77	0.75	0.69	0.72	0.64	0.61	0.61	0.49	0.33	0.29
Customs Warehouse Fees	0.05	0.02	0.02	0.02	0.02	0.02	0.02	0.01	0.01	0.00
Storage Fees	-	-	-	0.00	0.00	0.00	0.00	0.01	0.01	0.01
Customs Inspection Fees	0.58	0.20	0.18	0.08	0.06	0.05	0.05	0.05	0.05	0.05
Customs Inspection Fees Overtime	0.10	0.50	0.47	0.60	0.53	0.52	0.51	0.40	0.24	0.21
Customs Boarding Fees	0.00	0.00	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00
Container Fees - Freeport Customs	0.03	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.01
Transportation Fees	0.00	0.00	0.00	0.00	0.00	-	-	0.00	0.00	0.00
Other Charges	0.33	0.54	0.39	0.35	0.23	0.23	0.27	0.24	0.46	0.54
Container Movement - Customs	0.13	0.14	0.15	0.13	0.12	0.12	0.12	0.11	0.26	0.39
Customs Fines & Forfeitures	0.03	0.03	0.02	0.03	0.03	0.02	0.04	0.02	0.02	0.02
Customs Wrecked Goods	0.00	0.00	0.00	-	0.00	0.00	-	-	-	0.00
Customs Service Charge	-	-	-	-	-	-	-	-	0.00	0.00
Other Customs Charges	0.10	0.10	0.10	0.05	0.04	0.02	0.03	0.02	0.03	0.01
Customs Bonding Tax	0.07	0.06	0.06	0.06	0.05	0.07	0.08	0.06	0.16	0.09
Wharf Dues & Port Dues	0.00	0.17	0.04	0.05	0.00	0.00	0.01	0.02	0.00	0.03
Pierage Dues	-	0.02	0.02	0.02	-	-	-	-	-	-
Grand Total	64.68	62.57	58.42	60.06	53.48	52.24	50.38	49.82	46.37	52.26
Total Tax Revenues	832,252,507	847,000,720	937,592,265	1,079,360,673	1,263,829,612	1,350,588,658	1,201,547,834	1,155,319,456	1,396,751,442	1,384,662,237

Souce: The Bahamas, Ministry of Finance, Treasury Department and FAD staff calculations.

A. Excise Taxes

Current situation

114. **Excise taxes are one of most important sources of tax revenue, contributing about 24 percent of total tax revenues**. Excises raise almost as much as the customs duties. Excises apply to tobacco products, luxury items, petroleum products, motor vehicles and cameras. Alcoholic beverages are not subject to excises but taxed under stamp duties. There is no excise on beer but it is subject to tariff rates. The rates vary from 7 percent for cameras, crystals, and gasoline (in addition to a $1.06/gal. excise tax) to 220 percent for cigarette products. All together, there are 279 items subject to excise taxes. All goods subject to excises are subject to an ad valorem tax rate. Gasoline, diesel, and propane are subject to a specific rate and an ad valorem rate. Products that are easy to sell to the tourists are subject to low excise rates ranging from 7 percent to 10 percent. Table 13 summarizes the ranges of rates of aggregated excisable goods and their share in total excise revenues. Petroleum product and motor vehicle excises account for 84.5 percent of all excise revenues.

Table 13. The Bahamas: Rates and Revenues of Excisable Goods, 2011/12

	Stamp	Excise	Duty	Share of Excise Tax Revenues
Alcoholic beverages	Wine 50%, other grape 35%-60%, spirits 7% if imported, domestic spirits $10-11/proof gal.	Domestic Beer $5/gal. ($2/gal. in Freeport)	Beer $10/gal.	11.8%
Tobacco		10% on leaf tobacco, 220% on tobacco products.		0.3%
Petroleum products		45%, gasoline 7% and $1.06/gal, diesel 34.5% and $0.25/gal, aviation fuel 7%.		53.5%
Luxury goods		7% and 10%.		3.5%
Gaming equipment and video games			45% for games, 60% for equipment.	0.1%
Motor vehicles		25% to 85% most common 60%.		30.9%

Source: The Bahamas Customs and FAD staff calculations.

115. **The Bahamas has an advantage in terms of collection efficiency where all excises are collected by the Bahamas Customs**. This provides an administrative efficiency in terms of collection costs. In general, the marginal cost of collecting excise duties is considerably lower than of all other taxes, including the VAT. From an administrative point of view, excises are low-cost sources of revenue, 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. Further, the demand for 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.

116. **Excise taxes are levied to achieve several often conflicting objectives**. These include revenue-raising efficiency, externality-correction, distributional incidence, and administrative feasibility (in particular, dealing with cross-border shopping and smuggling). If properly designed, excises can serve as proxies for the cost of the damage—physical, financial, psychological—that consumers or users of excisable products impose on other people. Excises on smokers, abusive drinkers, road use, and pollution promote efficiency in the allocation of resources. It is equitable, and efficient that they should pay for these costs, ideally in the form of an amount that is equal to the marginal damage caused. It should be emphasized that duties based on externality considerations should always be raised to their appropriate level because they improve the efficient allocation of resources. Equally important, payment for external costs takes priority over considerations regarding the distribution of the excise tax burden over rich and poor or affordability.

117. **External costs caused by smoking, drinking, energy, and road use are independent of the price of the related excisable products, so that correction of externalities favors specific over ad valorem taxation**. Thus, externality-correcting excises should be expressed as a specific amount per number, volume, weight, strength, or other physical characteristic of the products. Importantly, too, specific duties tend to involve less avoidance and evasion. There are no contentious valuation issues to be dealt with and the easiest place of imposition, e.g., the factory gate or the import stage, can be chosen.

118. **Specific duties should be adjusted with the consumer price index for inflation**. Excises on items of luxury consumption 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 traditional excises, excises on luxury products should be imposed at ad valorem rates, applied to retail values to catch the full value added throughout the production-distribution chain. The main issue is whether the taxation of luxury goods is worth the cost of the administrative effort. However, in the case of motor vehicles, administrative cost is not an issue. Since excises are proxies for the external costs imposed on other people—costs which should be included in price—once the VAT is introduced, it should be imposed on the excise (and import) inclusive price of excisable products.[46]

B. Excises on Tobacco Products

119. **Excises on tobacco products are the highest at 220 percent rate**. While the rate seems to be high, it does imply that it is consistent with the objective of reducing negative externalities associated with smoking. The high ad valorem rate may result in undervaluation and smuggling. The choice between specific and ad valorem excises affects the revenue collected as well as the price and the quality of the tobacco products. Specific rates reduce

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[46] Many luxury items are purchased by tourists, especially cruise ship passengers.

relative price differences between low-priced and high-priced brands, whereas ad valorem rates increase absolute price differences. Because when an ad valorem tax is levied, tobacco excise is not differentiated according to tobacco content. Since heavy taxation of tobacco products is justified because of their negative externality, the tax structure should be based on tobacco content, not relative values. A specific tax will mitigate the negative externality of smoking while at the same time providing an incentive for producers to improve the quality of their products. As the tobacco content for cigarettes, both filtered and unfiltered, tends to be the same, averaging around 1 gram per stick, the rate for these two products should be the same.[47]

120. **Specific taxes result in lesser price competition, higher quality, diversity, and prices, and a larger number of manufacturers**.[48] Because the tax per cigarette is fixed, manufacturers can reap the benefits of investments in product differentiation with a smaller price increase (improved quality and greater diversity). In addition, specific taxes constitute a de facto minimum price and push the entire price spectrum higher by the same amount (the price of all brands will be increased by the amount of the tax); hence, there will be a lower percentage price difference between high and low quality brands, making it easier to switch to higher quality brands.

121. **The total import value of tobacco products indicate large scale smuggling in tobacco products**. While imports of alcoholic beverages were US$44 million in 2011/12, imports of tobacco products recorded at the Bahamas Customs were only US$354,000. A simple calculation indicates a significant amount of tobacco products are bypassing customs. About 5 million tourists visit annually, of which most of them come from North America, where the smoking population is about one-fourth. Assuming that the same proportion of the local population also smokes, this results in a smokers' population of about 1.3 million. Assume further that the local smokers buy a pack once a month and one-fourth of the smoker-tourists buy one pack. This implies about 1.36 million packs of cigarettes annually. At a CIF value of US$2 per pack, the declared value of imported cigarettes at customs should be around US$2.7 million. The authorities are aware of the problem. The Prime Minister indicated in his budget speech that the annual revenue loss can be as high as US$20 million. The government is initiating an excise stamp on cigarettes to reduce smuggling.

Recommendation

- Tax tobacco products at specific tax rates with periodic adjustment to retain the real value of the excise.

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[47] An argument could be made that the specific tax rate for unfiltered cigarettes should actually be higher than filtered cigarettes, as the health risks and associated costs imposed on the health care system are higher.

[48] Cnossen (2005).

C. Excise Taxes on Alcoholic Beverages

122. **Alcoholic beverages are taxes under tariffs or stamp duties not under the Excise Act**. Furthermore, different rates apply to domestically produced and imported spirits. In taxing alcoholic beverage, The Bahamas deviates from the standard practice of levying an excise tax on alcoholic beverages. However, current stamp duties on wine and spirits, and taxation of beer under the Tariff Act have all the characteristics of an excise tax. Beer is taxed at a specific rate of US$20 per gallon under the Tariff Act. Wine and sparkling wine are taxed under the Stamp Duty Act at a 50 percent duty rate.

123. **Two policy issues arise with the taxation of alcoholic beverages**. First, the taxation of different alcoholic beverages is provided under separate acts, whereas one single excise act should address this. For example, beer is taxed under the Tariff Act. Wine and spirits are taxed under the Stamp Duty Act. All taxes and duties on alcoholic beverages are collected by The Bahamas Customs and Excise and it would make it easier to administer the taxation of alcoholic beverages under one act. Second, imported and domestically produced spirits are taxed at different rates. Domestically produced spirits are taxed at a specific rate while imported alcoholic beverages are taxed at an ad valorem rate. In addition, wine and sparkling wine are also taxed at ad valorem rates. Given the plans for WTO membership, both imported and domestically produced alcoholic beverages should be equally taxed.

124. **Alcohol duties should be related to alcohol content as is the case for domestically produced alcoholic beverages in The Bahamas**. A large volume of weak drink is just as harmful as a smaller volume of strong drink.[49] An indexed specific rate rather than an ad valorem rate is preferred if the duty is to be a proxy for external costs. The application of an ad valorem rate involves contentious valuation (transfer pricing) issues at the importing and manufacturing stages.

Recommendations

- Continue taxing domestically produced alcoholic beverages using specific rates based on alcohol content by volume.
- Move beer from the Tariff Act to the Excise Act.
- Move wine and spirits from the Stamp Duty Act to the Excise Tax Act.
- Tax wine and sparkling wine by applying a specific rate based on alcohol content.
- Establish equal excise taxation of spirits produced domestically and imported.
- Adjust all specific rates periodically to maintain the real value of excise.

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[49] Cnossen (2007).

Excise taxes on petroleum products

125. **In The Bahamas, gasoline and diesel are taxed at differentiated excise rates** (Table 14). Gasoline attracts a 7 percent ad valorem excise tax plus a US$1.06/gallon specific tax. Diesel is taxed at a rate of 34.5 percent with a specific rate of US$0.25/gallon. The tax on both equalizes around a price of US$3/gallon for both fuel types. Any price below US$3/gallon favors diesel while prices over US$3 favor usage of gasoline in terms of the tax burden. Although diesel should be taxed at a more favorable rate because of its intermediate uses (which are inputs to production)—diesel-powered commercial vehicles (as well as diesel used in industrial and agricultural machinery) should also bear appropriate externality-correcting taxes.

126. **Gasoline and diesel are under-taxed**. The combined effective excise tax on gasoline and diesel is 4 percent. Furthermore, unleaded gasoline, which has more environmental negative externalities, is taxed has a much lower effective excise rate of 3.2 percent. There is a good case that can be made for increasing the excises both in gasoline and diesel. Higher motor fuel taxes (gasoline and diesel) tend to reduce vehicle use and encourage the purchase of more fuel-efficient motor vehicles. The impact would be greater on fuel use and vehicle emissions than on vehicle use and congestion.

Recommendations

- Limit excise exemptions and increase rates on gasoline and diesel.
- Index the specific excises on both gasoline and diesel.

Excise duties on luxury goods

127. **Excises are applied to about 70 products and account for about 3.5 percent of excise revenues**. The excise rates are 7 percent and 10 percent. These products are primarily goods sold to the tourists visiting The Bahamas. The products range from perfumes to linen, bags, cameras, and crystals. So, this regime is neither progressive nor revenue productive. Moreover, multiple and separate excises add to the cost of administration. If excises on luxury goods are intended to increase the tax system's overall progressivity, they should be levied on products with income elasticity of demand exceeding one. So, these will be products for which expenditure rises proportionately faster than income and their consumption much significant. Only very few products such as cars, pleasure craft, yachts, and aircraft are good candidates for higher excise taxes.

Recommendations

- Reduce the list of luxury goods subject to tax by moving taxation of some of these products under the Tariff Act.
- Instead of excise on luxury goods, increase excise taxes on luxury passenger cars, yachts, and aircraft to add progressivity to the tax system.

D. Current Trade Taxes and WTO Accession

Current situation

128. **Taxes on international trade are the largest source of income in The Bahamas.** Taxes on international trade are collected by the Bahamas Customs under the Tariff, Excise and the Stamp Duty Acts. There are 12 different tariff rates. Tariff rates range from 10 percent to maximum rate of 300 percent on live animals, fish and agricultural products, some manufactured goods such as polymers, cement, printed matter, and mattresses. Imported goods are taxed according to rates specified under three different schedules. Tariff rates in Schedule 1 are set at 300 percent. Schedule 2 specifies the rates for agricultural goods. Schedule 3 lists the rates applicable to processed food and manufactured goods. The rates vary from 25 percent for pork products to 85 percent for tomato sauce. Most products are taxed either at 30 percent, 45 percent, or 60 percent. Beer from malt is subject to a US$10 per gallon tax and a 10 percent ad valorem tax. Although a small share of the economy, The Bahamas effectively protects the agriculture and manufacturing industries.[50] However, the Tariff Act also exempts a wide range of products from customs tariffs. The exemptions which are specified in Schedule 4 are extensive. Businesses registered as light industries and which received exemptions for a period of five years can qualify for a reduced tariff rate of 10 percent. The main exempted items are listed in Box 2.

Box 2. The Bahamas: Aggregated Tariff Exemption List

Inputs and equipment used by the agricultural industry
Inputs used by fishermen including bait equipment and vessels
Aircraft parts and accessories
Collector's pieces and works of art
Educational, scientific and cultural goods
Inputs for light industries
Printing equipment and raw materials
Systems Building for Government Housing Projects
Permit under Boat Registration Act.
Promotional Articles For Touristic Purposes
Bahamian Art Work
Goods manufactured or processed in the Port Area
Items imported by The Bahamas Electricity Corporation
Motor vessels
School supplies
Medical supplies
Approved building material

Source: The Bahamas Customs, Tariff Act, Schedule 4.

[50] Agriculture and manufacturing accounted for 8.6 percent of GDP in 2012.

129. **In addition to Schedule 4, selected industries are further exempted from customs tariffs by special acts such as the Industries Encouragement Act and the Hotels Encouragement Act**. These concessions are discussed in Chapter V. Overall, while tariffs are used effectively to raise revenue, they are also used to protect and encourage certain industries. The Bahamas was able to maintain high tariff rates since it is not a member of WTO but also it has not joined the common external tariff system (CET) of CARICOM.

Issues

130. **Tariffs are a way of protecting domestic industry and The Bahamas is using them effectively while at the same time raising significant amount of revenues**. Although some rates have been reduced recently, the tariffs rates still remain high. While they protect domestic industries and support industries such as tourism in providing competitive services, they increase cost of living and doing business by raising the domestic price level. If kept at high levels, tariffs erode competitiveness of the economy.

131. **In addition to being high, tariff rates are also uneven, resulting in distortions in resource allocation in the economy**. High tariff rates would encourage investment in inefficient industries by protecting them against international competition. Protected industries will not invest in new technologies and will be less productive. Even under high protective tariffs, domestic production may not be able to supply the demand for certain goods. For example, hotel industry may have to import some foodstuffs in any case, if the domestic suppliers fall short of meeting the demand. Also, domestic suppliers may not be able to supply at the level of standards required by the tourism industry. In this case, high tariffs may unnecessarily increase the costs of an industry competing internationally.

132. **Negotiations with the WTO for accession are at their early stages**. WTO negotiations usually spread over a long period of time and certain issues will take a long time to reach an agreement. For example, negotiations regarding agriculture take the longest time as each candidate country tries to assure protection of its agricultural industry. Reducing tariffs from its current levels will require a long-transition period for the domestic production to adjust to new prices. The newly formed Ministry of Financial Services is in charge of negotiating with the WTO. The authorities should request for a long transition period allowing sufficient time for adjustment in domestic industries. The tariff rates should be reduced gradually over time.

133. **With the reduction of the tariff rates, some of the imported products should be removed from the exemption list (Schedule 4)**. As the tariff rates are lowered, the value of exemptions to the beneficiary industries will decline. This would be good opportunity to broaden the tax base of tariffs. About 35 percent of imports are exempted from tariffs. Moving exempt products from Schedule 4 to regular tariff schedule, while reducing tariff rates would mitigate the revenue losses on international trade. The choice of products to be removed from the exemption list depends on the proposed future tariff rate on the products. If

the tariff rate is going to be low, then the product can be removed immediately from the exemption list. For example, agricultural equipment may remain exempt while products used by the tourism industry can be moved out of the exemption list.

134. **The mission was informed by the authorities that the government is considering reducing the weighted average tariff rate to 10 percent from its estimated current level of about 25 percent**.[51] Estimates of the impact of tariff rate reduction from 25 percent to 10 percent are provided in Table 14 for 2011.[52] Lowering the tariffs by 15 percentage points results in a revenue loss of about US$275 million or 3.5 percent of GDP. The revenue estimate is based on aggregate import and domestic supply elasticities. For a more accurate estimation of the revenue impact of reducing the tariff rates, the revenue estimations should be done on a product group bases using price elasticities of import and domestic supply estimated for The Bahamas.[53]

Table 14. The Bahamas: Revenue Effects of Tariff Reduction, 2011

	Effect of Tariff Reduction and VAT
Tariff Rate (Current)	25%
Tariff Rate (Proposed)	10%
%Δ in Imports	24%
%Δ in Domestic Output	-4%
Δ in Tariff Revenue (million $)	-275
Net revenue increase as share of GDP	-3.5%
Notes:	
GDP (million $)	7873
Imports subject to tariff (million $)	2891
Elasticity of domestic supply	1
Elasticity of import supply	2

Source: Ministry of Finance and FAD staff calculations.

135. **Lowering tariff rates has to be synchronized with the introduction of VAT**. Since VAT will be applied to a broader base, it is expected that it should raise a sufficient amount of revenues, thereby compensating for revenue losses from tariff reductions.[54] The design of the VAT is important in raising sufficient amount of revenue to make up for the lost tariff revenues. The VAT revenues will be determined as a sum of the VAT revenues obtained by applying the appropriate VAT rate to the current level of imports plus the VAT revenue obtained from the induced import supply due to reduction of the tariff rates. However, how the VAT rate will affect imports depends on which products will be exempted from VAT.

[51] Final decisions on tariff reductions will be taken in the context of the ongoing negotiations aimed at The Bahamas' accession to the WTO.

[52] Elasticity estimates are obtained from European Economy (2010).

[53] If the elasticity estimations for The Bahamas on a product base proves to be difficult, similar estimates can be used from other countries.

[54] Assuming the VAT rate will be at least as high as the new weighted average tariff rate.

There is no reason to extend some of the exemptions from tariffs to VAT. The reasons for exemptions from tariffs are different than exemptions from VAT. For example, while tariff relief is provided to support an industry or economic activity, VAT exemptions are given to selected industries such as financial services.

Recommendations

- The current range of tariff rates should be consolidated to three to five different rate classes.
- Request a long transition period in negotiations with the WTO for domestic industries, particularly agriculture.
- Remove some products from Schedule 4 as tariff rates are reduced on these products.
- Estimate revenue impact of tariff reduction at product level if possible.
- Reduction in tariff rates should be determined accounting for the interaction with the design and rate of VAT.

E. Stamp Duty on Trade

Current law

136. **Under the Stamp Act, the only stamp duties on imports are levied on imported alcoholic beverages excluding beer**. According to the Act, wine and sparkling wine are levied a 50 percent stamp duty. Other stamp duties are on spirits with high alcohol content. The stamp duty on imported spirits is a 7 percent ad valorem duty. These stamp duties raised about US$14.6 million in 2011/12, about 0.2 percent of GDP. Stamp duties on alcoholic beverages are collected by The Bahamas Customs and Excise.

Issues

137. **In addition to imported wine and spirits, there is a stamp duty on domestically produced spirits**. Domestic production of spirits has either a US$10 or US$11 per proof gallon of alcohol. This difference in the duty structure favors domestic production of high-priced spirits. First, before accession to WTO membership, The Bahamas will be required to equalize the rates on domestic and imported spirits. Second, it would be best to move all the alcoholic beverages under the Excise Act as it is more common worldwide. Third, the stamp duty rates are low relative to taxation of alcoholic beverage elsewhere. Consolidating all alcoholic beverages and tobacco products under the Excise Act would facilitate the administration of taxation of all excisable goods.

Recommendations

- Consider increasing the stamp duties on alcoholic beverages.
- Consolidate the taxation of wines and spirits under the Excise Act.

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