

Exploring Caribbean Tax Structure and Harmonization Strategies

Amos C. Peters, Economic Intelligence and Policy Unit
CARICOM Secretariat, Georgetown, Guyana

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1. INTRODUCTION

The emergence of tax competition is a direct consequence of globalization and trade liberalization. The continual removal of all types of restrictions on the movement of the factors of production (land, labour and capital) as well as goods and services means that the factors are free to move to their best alternative uses within and across national boundaries. This creates a policy dilemma for the socio-economic planner who has traditionally used tax and incentive policy within his borders to alter relative prices and to cause resources to flow to a particular sector or segment of society. That planner must now do the same on the national level to prevent the movement of much needed resources to other countries. There lies the genesis of what is today called tax competition.

As the theory goes, especially within the context of the Single Market and Economy that the Caribbean Community (CARICOM)¹ is trying to establish, national governments competing against each other for tax bases and investment could progressively lower their tax rates, a phenomenon analogous to price destruction among oligopolistic firms, until the rates reach zero. This "race to the bottom" is harmful to all governments and countries since the result of this tax competition game is that all are losers.

There are two ways to achieve equilibrium in tax structure, tax rates, tax incentives and tax administration. One is through competition as was just described, and the other is through cooperation.

Cooperative behaviour among governments is analogous to the collusive behaviour among oligopolistic firms, the difference being that tax cooperation tends to be explicit and the (same) incentives to cheat may not be as strong. Under this solution, all benefit, although not necessarily equally or even proportionately. This is the primary principle behind the efforts to harmonize taxes, especially taxes on capital.

Harmonization of taxes is expected to remove the incentive of capital to move due to differences in tax rates –

1. The Member States of CARICOM are: Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.

often called the “elimination of tax arbitrage”. Capital in a harmonious world would be allocated to its best use as signalled by relative prices determined by the interaction of demand and supply. Other factors, such as various types of stability, expectations, discounted revenue or profit flows and favourable rules, will also determine the movement of capital but, to all intents and purposes, tax harmonization is intended to remove distortions to the relative price structure that will signal the direction in which capital should flow.

Similar arguments apply to other factors of production and even commodities, although with commodities sometimes the primary objective is to prevent the shifting of tax bases through cross-border trading. Tax harmonization is therefore viewed as a requirement for the smooth operation of a single market. Tax harmonization creates a similar environment across territories within which businesses and consumers can operate. One of the main benefits to the countries in the single market is revenue stability. Tax harmonization provides security to governments against potentially aggressive incentive strategies that could reduce tax revenues.

Since 1989, CARICOM has committed itself to establishing the CARICOM Single Market and Economy (CSME). The implementation of the CSME will result in the free movement of goods and services and the free movement of capital and other factors of production, as set out in the protocols, particularly Protocols II and IV, to the 1973 Treaty of Chaguaramas (see 2.). (The Treaty, as amended by the protocols, is referred to as the “Integrated Treaty of Chaguaramas”.) CARICOM has opted to pursue tax harmonization as one of the key facilitating mechanisms to enhance the functions and operation of the CSME.

The principle behind the current approach to tax harmonization in the CSME is first to reform the tax structure on a “tax by tax” basis and then to examine the tax rates. Harmonizing the tax structure really refers to the methodology of how taxes are applied across the region. Making the definitions and methodologies uniform and consistent across the region is critical to ensuring that both regional and international economic agents, be they investors or consumers, can make simple and accurate comparisons between the different territories within the Single Market. Ensuring that particular taxes are applied to the same thing or have the same tax bases is perhaps the most significant step toward tax harmony.

The “tax by tax” approach means that particular taxes are taken one at a time and reformed somewhat (but not exclusively) independently of the other taxes. The corporation tax has been the first domestic tax under consideration, and it is still under review. The next harmonization effort may be focused on the consumption tax or the value added tax.

The earliest efforts at tax harmonization began, not with the corporation tax, but with the formation of a customs union through the design and implementation of the common external tariff (CET). The operations and functions of the CET are well described in Protocol IV to the Treaty of Chaguaramas. The CET imposes maximum import duty or tariff rates on all commodities from outside the region.

The customs union also abolished export duties and duties on intra-CARICOM trade, conditional upon certain rules of origin (see Art. 17 of Protocol IV).

The Caribbean efforts at tax harmonization have largely been carried out in a partial framework, lacking the benefit of a general coherent and internally consistent framework in which to approach tax harmonization. While it is true that the Integrated Treaty of Chaguaramas does provide a foundation and limited guidelines for tax harmonization in the Single Market, this is insufficient. The Treaty is purposely limited and does not have the benefit of the Caribbean Court of Justice to interpret it and continually add to the framework through case law. This partial strategy has been possible primarily because the tax systems across the region are very similar, thereby obviating the need to pay attention to the key structural elements of the tax systems across borders. Assuming that a general framework is strictly preferred to a partial framework, however, it is the purpose of this article to outline and explore a framework for tax harmony and to recommend feasible strategies to pursue this objective.

2. THE CSME AND CARIBBEAN ECONOMIC OBJECTIVES

2.1. Background

The CARICOM Single Market and Economy (CSME) is a framework designed to further integrate the economies of the Caribbean Community. It is an instrument designed to facilitate the balanced growth and economic development of the Member States of CARICOM in the new global dispensation, which is increasingly open and competitive. The CSME has its origins in 1992, when the heads of government, as a follow-up to the Grand Anse Declaration of 1989,² agreed to transform the Common Market into the CARICOM Single Market and Economy where there would be free movement of all factors of production, namely, natural resources, capital, labour and technology, as well as free movement of goods and services across borders.

The ongoing implementation of the CSME marks the most recent effort at widening and deepening regional integration. The first major effort at Caribbean regional integration began with the short-lived West Indian Federation of 1958-1962, and this was followed by the formation of the loose trade grouping, the Caribbean Free Trade Association (CARIFTA) in 1968. In 1973, the signing of the Treaty of Chaguaramas led to the establishment of CARICOM and the Common Market.³

The transformation of the Common Market into the CSME is set out in a series of nine protocols that revise the 1973 Treaty of Chaguaramas,⁴ namely:

2. See CARICOM Secretariat, *Grand Anse Declaration* (1989).

3. See CARICOM Secretariat, *Treaty Establishing the Caribbean Community – Chaguaramas, 4 July 1973* (Georgetown: CARICOM Secretariat, 1973).

4. See e.g. CARICOM Secretariat: *Protocol Amending the Treaty Establishing the Caribbean Community – Protocol I: Amending the Treaty of Chaguaramas* (1998), *Protocol Amending the Treaty Establishing the Caribbean Community – Protocol II: Rights of Establishment, Provision of*

- institutions and organs of CARICOM;
- rights of establishment, provision of services and movement of capital;
- industrial policy;
- trade policy;
- agriculture policy;
- transportation policy;
- disadvantaged countries, regions and sectors;
- competition policy, consumer protection, dumping and subsidies; and
- dispute settlement.

The protocols are structured on two major pillars. The first involves competition by allowing goods, services and all factors of production to move freely throughout the region, thereby creating a single economic space. The second involves cooperation by harmonizing monetary and fiscal policies in order to achieve macroeconomic convergence and harmonizing tax regimes, production, and environmental standards. Protocols that address electronic commerce, government procurement, trade involving goods produced in free zones, and the free circulation of goods within the CSME are yet to be drafted and added to the nine protocols that amend the Treaty.

2.2. Key elements of the Treaty of Chaguaramas

Protocol II: Protocol II is of particular importance because it develops the policy framework for the entire Single Market. It departs from the previous regime in three major ways. It:

- removes existing restrictions on inter-regional investment;
- allows the free movement of capital as a prerequisite for monetary union; and
- treats services like goods; services are thus subject to free trade principles consistent with the new WTO dispensation.

Protocol IV and the Caribbean Court of Justice: Apart from its appellate functions, the Caribbean Court of Justice will be the final decision-making body with respect to all trade disputes. This jurisdiction of the Court is referred to as “original jurisdiction”. The Court will apply the rules of international law in interpreting and applying the Treaty of Chaguaramas. In addition to the statutes of the Treaty of Chaguaramas, the case law emanating from the Court will determine in a critical way how the CSME functions.

Protocol VII: The exposure of economies to competitive forces will inevitably lead to some dislocation and adjustment in these economies. Under Protocol VII, a development fund will be established to assist economies with the transition to a more competitive environment and to compensate them for losses due to dislocation.

2.3. Summary

The CSME creates the rules and standards for households, firms and individuals to actively compete and cooperate with one another for their mutual benefit. The CSME is expected to deliver substantial benefits to the region by increasing its growth and development prospects. Under

the CSME, it is expected that inter-regional trade of goods and services will increase, that the quality of services provided in the region will improve and, overall, that the CSME will create more opportunities for Caribbean citizens to realize their potential.

3. THE CONCEPT OF HARMONIZATION

Tax harmonization tends to mean different things to different people. Tax harmonization can refer to the pursuit of similarity of tax rates or to the standardization of methodology, definitions and administrative practices, including rules and procedures. Tax harmonization can also refer to the pursuit of similar tax structures, for example, whether the proportion of direct to indirect taxes is similar in the countries under consideration. Tax harmonization often refers to the similarity of fiscal policy, including the expenditure side. Overall, tax harmonization refers to the pursuit of uniformity, whereas tax coordination refers to a process of ensuring that tax regimes are compatible with each other.

What is meant by harmonization within CARICOM? Based on the implementation of the CET and the current Draft Protocol on the Harmonisation of Corporate Taxation, it is apparent that harmonization refers to the pursuit of similarity of tax rates and tax structures (broadly defined). The *Caribbean Trade and Investment Report 2000*⁵ defines harmonization as a concerted effort to achieve effective similarity of economic policies. Generally, the vast majority of the literature defines tax harmonization as an effort to achieve similar tax rates.

The most practical concept of tax harmonization, however, is one that encompasses elements of all the aforementioned definitions. Tax harmony has several characteristics, which are categorized below, and each of these characteristics has sub-characteristics. First, to ensure that “like” is compared with “like” across borders, critical to tax harmony are *tax administration and collection*, including rules, procedures, methodologies and definitions of concepts. If taxes are not applied in similar ways across territories, further efforts at tax harmony become futile.

The second element of tax harmony is similar *tax structures*. It is difficult to see how a region with wide variance in tax structures could progress with any harmonization effort without first resolving this problem. For example, if some countries are heavily reliant, as some are, on direct taxation while others are heavily reliant on indirect taxation, it would be extremely difficult to harmonize rates in this scenario. The first difficulty arises from the fact that some countries may have a zero tax rate (no tax rate), making the area for negotiation extremely small or non-existent. The second difficulty arises in the disparity in the relative importance of certain taxes to particular governments,

Services and Movement of Capital (1999), and *Protocol Amending the Treaty Establishing the Caribbean Community – Protocol IV: Trade Policy* (1999).

5. CARICOM Secretariat, *Caribbean Trade and Investment Report 2000: Dynamic Interface of Regionalism and Globalisation* (Kingston: Ian Randle Publishers, 2000).

virtually ensuring that the harmonization game would result in a number of losers.

The third and most debated element of tax harmony is *tax rates*. Any serious effort at tax harmonization within a single market must include some form of uniformity of tax rates. Uniformity of rates, however, can take a number of forms and does not necessarily imply that countries must define a single rate and pursue that target. Under tax rates, there are further elements, namely: (a) a uniform tax rate, (b) minimum tax rates, (c) maximum tax rates, (d) tax bands, and (e) tax competition.

These sub-elements are defined briefly here and are examined in greater detail in 11. "Uniform tax rate" refers to when countries want to pursue exactly the same tax rate. "Minimum" and "maximum tax rates" are where harmonization is achieved through the enactment of tax floors and ceilings below or above which national governments cannot tax. "Tax bands" are simply a combination of the minimum and maximum tax rates. Three of these elements, minimum and maximum tax rates and tax bands, restrict the behaviour of national governments to particular regional limits but, at the same time, allow for some discretion and variance in the rates across the countries involved. The first element, a uniform tax rate, is the most rigid constraint, allowing absolutely no discretion. In contrast, the last element, "tax competition", allows governments to freely compete for tax bases and represents the exact opposite of a uniform tax rate because there is absolutely no constraint on national governments (total discretion).

Tax harmonization has several elements, all of which are important. The next part outlines some of the elements that have been pursued in the Caribbean Community.

4. TAX HARMONIZATION EFFORTS IN CARICOM

4.1. The CET and other protocol tax issues

Protocol II states that all legal, administrative and technical barriers to the rights of establishment and the free movement of goods, services and capital must be removed. Protocol IV is even more specific on tax issues. The cornerstone of CARICOM's tax harmonization and integration effort has been the formation of a customs union through the operation and administration of a common external tariff (CET). The operation of the CET is explained in Art. 16 of Protocol IV, which gives the Council for Trade and Economic Development the responsibility for setting and administering the CET. At this time, Barbados, Belize, Grenada, Guyana, Jamaica, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago have completed Phase IV of the reduction of the CET. Meanwhile, other countries have either committed themselves to implementing Phase IV of the CET or are assessing the revenue impact of doing so.

Protocol IV also prohibits the levying of import and export duties on intra-CARICOM trade of goods of Community origin. Art. 24 of Protocol IV (on internal taxes and other fiscal charges) provides that the Member States shall not

"apply directly or indirectly to imported goods of Community origin any fiscal charges in excess of those applied directly or indirectly to like domestic goods, or otherwise apply such charges so as to protect like domestic goods". The Member States are prohibited from protectionist fiscal actions, such as applying fiscal charges to imported goods of Community origin which they do not produce at all or produce in small quantities. Art. 27 also prohibits within CARICOM the use of subsidies that would frustrate the benefits of removing restrictions. Finally, Art. 32 (on cooperation in customs administration) provides that the Member States shall cooperate with each other to ensure that various articles of the Treaty of Chaguaramas are harmoniously applied with respect to:

- effective customs systems and procedures governing the movement of goods, persons and conveyances across customs borders; and
- maximizing the effectiveness of cooperation among customs administrations and with international agencies to combat customs and other cross-border offences.

Moreover, Art. 32 also provides that the Member States should establish harmonized legislation and customs procedures. These activities would take place predominantly through the Council for Trade and Economic Development. To that end, a refined draft of the harmonized customs legislation was circulated under Savingram No. 327/1998.⁶ The 19th Meeting of the Conference of Heads of Government urged the Member States to implement the necessary legislation.⁷ To date, however, only St. Vincent and the Grenadines has implemented this legislation. Consideration is now being given to a new protocol on free circulation. This would mean that goods of extra-CARICOM origin would, upon entering the Community, be subject to only one fiscal charge applied by the destination country. This would eliminate the double taxation of transhipped goods.

4.2. Agreement for the avoidance of double taxation

The CARICOM double taxation agreement of 1994 ("Agreement among the Governments of the Member States of the Caribbean Community for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Profits or Gains and Capital Gains and for the Encouragement of Regional Trade and Investment") has hitherto been ratified by 11 Member States⁸ and is national legislation in six Member States.⁹ This agreement was drafted pursuant to Art. 49e of Protocol III,¹⁰ which clearly provides that the Member States shall conclude among themselves an agreement for the

6. A savingram is an official memorandum used by the CARICOM Secretariat to communicate with the Member States.

7. See Single Market Matrix: www.caricom.org.

8. Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

9. Antigua and Barbuda, Barbados, Belize, Guyana, Jamaica, and Trinidad and Tobago.

10. This, however, was an original element of the Treaty of Chaguaramas.

avoidance of double taxation in order to facilitate the free movement of capital within the Community. Art. 49e also requires that the Member States conclude tax treaties with third parties. These treaties are indicated in Table 1. For example, as shown in Table 1, Trinidad and Tobago has concluded tax treaties with Canada, France, Denmark, Germany, Italy, Norway, Sweden, the United Kingdom and the United States.

The CARICOM double taxation agreement is an excellent example of tax coordination within the region. The agreement applies to taxes on income, profits and capital gains, and it ensures that consumers and businesses can operate freely without restriction or penalty within the CSME. Generally, economic activity is taxed at its source or where it takes place irrespective of where the economic agent is resident.

Table 1: CARICOM – Tax treaties and related bilateral investment treaties*

Parties to treaty	Tax treaty	Bilateral investment treaty
Antigua and Barbuda – United Kingdom	x	x
Antigua and Barbuda – Switzerland	x	
Bahamas – United States	x	x
Barbados – United Kingdom	x	x
Barbados – Sweden	x	
Barbados – Canada	x	x
Barbados – Finland	x	
Barbados – United States	x	
Dominica – Germany	x	x
Grenada – United States	x	x
Guyana – United Kingdom	x	x
Guyana – Canada	x	
Jamaica – United Kingdom	x	x
Jamaica – France	x	x
Jamaica – Argentina	x	x
Jamaica – United States	x	
Jamaica – Sweden	x	
Jamaica – Norway	x	
Jamaica – Canada	x	
Jamaica – Denmark	x	
St. Kitts and Nevis – United Kingdom	x	
St. Kitts and Nevis – United States	x	
St. Lucia – United Kingdom	x	x
St. Lucia – Germany	x	x
St. Vincent and the Grenadines – United States	x	
St. Vincent and the Grenadines – Switzerland	x	
Suriname – Netherlands	x	
Trinidad and Tobago – Canada	x	x
Trinidad and Tobago – United Kingdom	x	x
Trinidad and Tobago – France	x	
Trinidad and Tobago – Sweden	x	
Trinidad and Tobago – Norway	x	
Trinidad and Tobago – Italy	x	
Trinidad and Tobago – Denmark	x	
Trinidad and Tobago – Germany	x	
Trinidad and Tobago – United States	x	

* Source: *Caribbean Trade and Investment Report 2000*, at 263 (see footnote 5).

4.3. Draft protocol on harmonizing corporate taxation

Harmonization of the corporate tax structure recently received much attention from the CARICOM Secretariat and the Caribbean Organisation of Tax Administrators. The Draft Protocol on the Harmonisation of Corporate Taxation has been completed and is under review by the Member States; it has not yet ascended to the various national legislatures.

The draft protocol contains a series of articles that harmonize the corporate tax structures in the region. The salient elements of the draft protocol are: (a) capital allowances, (b) interest, (c) losses, (d) pensions, (e) minimum corporation tax, (f) insurance premium tax, (g) mergers and division splitters, (h) disposal and acquisition of assets, (i) agreements for extra-regional financing with implications for withholding taxes, and (j) exploration and research expenses.

This effort addresses largely harmonizing the corporate tax structures and not the corporate tax rates, even though it has the flexibility to incorporate minimum tax rates once agreed by the Member States. Substantial attention is given to standardizing the depreciation system. This attempt, though incomplete, is but the first of many. Since 1995, there have been proposals to harmonize the individual income tax, corporation tax, real property tax, VAT and consumption tax. For various practical considerations, the corporation tax was the first to come under scrutiny. The draft protocol marks the culmination of a process that identified the existence of a common direct taxation system relating to corporations in the region.

4.4. Harmonizing investment incentives

Work is currently going on in the area of harmonizing investment incentives to industry, agriculture and services. This area is particularly important to foreign investment since adverse competitive tactics can severely affect the operation of the Single Market by causing decisions on business location to be made on distortionary tax and subsidy incentives. While there have been harmonization efforts in the Community since 1973,¹¹ these efforts covered only incentives to industrial enterprises.¹² The incentives relate to the provisions for relief with respect to income tax, payment of import duties, tax liability on export profits, depreciation allowances and dividend payments. The duration and magnitude of the incentives vary with the classification of the enterprise and its location. Location was important because the less developed countries were granted more favourable terms. Since that time, there have been several reviews but, until now, no development of a comprehensive strategy that includes all sectors.

Art. 49 of Protocol III provides that the Member States shall harmonize the national incentives for investments in

11. Agreement on the Harmonisation of Fiscal Incentives to Industry in the Caribbean Community Countries.

12. See Lalta, S., *Some Fundamental Issues Related to Fiscal Harmonisation in the Caribbean Community* (CARICOM Secretariat, 1987).

the industrial, agricultural and service sectors and further outlines certain provisions which any proposal must contain. First, the national incentive regimes must promote sustainable export-led industrial and service-oriented development and, second, one of the vehicles of investment promotion should be the removal of bureaucratic impediments. Finally, Art. 49 prohibits discrimination in the granting of incentives among Community nationals.

In addition, Art. 30 of Protocol IX, in reference to business conduct and competitive practices, prohibits certain types of subsidies, including tax breaks.

4.5. Social security/national insurance legislation

Although social security does not fall under fiscal matters in the Treaty of Chaguaramas, it can influence migration and labour mobility in the Single Market and must consequently be part of a tax harmonization effort. To date, harmonization and transferability of social security benefits have been written into the social security agreement that entered into force on 1 April 1997. This agreement has been signed and ratified by 12 Member States. Even the Bahamas, which is not a participant in the CSME, has signed. Suriname is yet to sign, and Dominica, St. Lucia, Suriname and the Bahamas are to enact legislation. This means that (skilled) labour is free to move without penalty, tax or otherwise.

4.6. Tax reform and policy

Ever since the structural adjustment programmes that various countries underwent either under the International Monetary Fund or by their own choice "home-grown", tax reform has become a major element of macroeconomic policy in the region. Tax reviews and reforms now occur on a regular basis within the region. Normally, tax reform efforts are not highly coordinated, but they are inadvertently leading to a harmonization or convergence of structure because of the Member States' adherence to international practices. Increased trade liberalization through the lowering of import tariffs via the CET has resulted in reduced collections of import duties. This effect, however, has been offset by increases in customs fees and consumption taxes.¹³ Barbados has introduced a VAT which has worked fairly well. Jamaica has a general sales tax, and other Caribbean nations are looking at introducing broad-based sales taxes, widening the tax net by looking at the informal sector, improving efficiency in tax collection and, in general, simplifying the tax code. Modern information technologies have been employed in processing and auditing tax returns and in tax collection and refund procedures in an effort to reduce collection costs and improve the productivity of the revenue services.¹⁴

5. TAX HARMONIZATION EFFORTS IN THE EUROPEAN UNION

Tax harmonization has a long history in the European Union. It started in 1969 with a 1% ceiling on indirect taxes on capital-raising operations, and it has continued to

make progress ever since. In 1992, for instance, a decision was taken to set a 15% minimum rate of VAT,¹⁵ and the European Commission recently decided to go on the offensive with the EU Member States that create distortions by the extensive use of tax breaks to gain leverage in the internal market. In 2001, the European Commission issued a communication to the European Council, the European Parliament and the Economic and Social Committee entitled "Tax policy in the European Union – Priorities for the years ahead".¹⁶ This communication outlines the tax policy for the European Union and the policy instruments that the Commission plans to utilize to implement this policy.

Indications are that the European Commission appears ready to reorient its tax policy away from large-scale harmonization.¹⁷ The focus this time around is less on drafting uniform tax rules and more on the practical issues and problems faced by firms and consumers operating in their internal market.

The tax policy outlined by the Commission can be described under three broad categories: EU objectives, specific tax objectives, and instruments to achieve those objectives.

5.1. EU objectives

The Lisbon European Council of March 2000 set a goal for the European Union of becoming the most competitive and dynamic knowledge-based economy in the world by 2010. This goal was confirmed at the Stockholm European Council in March 2001. It is the view of the European Commission that tax policy must be set within the context of broader EU policy objectives. Against this backdrop, European tax policy must be supportive of these and other goals of the EU region. To achieve this, the European Union must reduce the overall tax burden, striking a balance between cutting taxes and maintaining adequate levels of public services. This also means that there should be consistency of tax policy with other policy objectives, such as environmental protection, consumer protection, and energy and employment expansion. The overarching objective of regional tax policy, however, is to ensure that the internal market operates as smoothly as possible, eliminating where possible the largest obstacles to consumers and firms benefiting from the internal market. The communication of the European Commission identifies three "mutually reinforcing challenges", namely:

- stabilizing the Member States' tax revenues;
- the smooth functioning of the internal market; and
- promoting employment.

13. Williams, Ewart, *Toward A Caribbean Consensus: A Region Coping with Globalisation* (International Monetary Fund, 2000).

14. *Fiscal Covenant: Strengths, Weaknesses, Challenges* (ECLAC, 1998).

15. Smith, David, "Will Tax Harmonisation Harm Job Creation?", 2001; see www.pfizerforum.com.

16. Commission of the European Communities, "Tax policy in the European Union – Priorities for the years ahead", *Communication from the Commission to the Council, the European Parliament, and the Economic and Social Committee*, 2001.

17. "EU changes tax", *Financial Times*, 24 January 2001.

Under “the smooth functioning of the internal market”, there are four freedoms: (1) free movement of persons, (2) free movement of goods, (3) free movement of capital, and (4) freedom to provide services.

This, in essence, provides the beginning of a framework for harmonization. That is, the policy is to harmonize where necessary or where the largest barriers to an efficient market exist, but otherwise to leave matters to the discretion of the Member States.

5.2. Specific tax objectives

The European Commission has specific tax policy coordination objectives that focus on the practical problems faced by individuals and firms operating in the single market. The policies vary from tax to tax. Here, the framework is further explained because certain taxes are left within the purview of the Member States, whereas other taxes are viewed as areas for substantial coordination and harmonization. This differentiated approach is more pragmatic as it recognizes that it is not plausible to reconcile in a totally uniform fashion 15 different tax systems; thus, the approach identifies areas of cooperation, and those areas are chosen on the basis of the magnitude of the distortions that could arise from adopting a non-cooperative stance.

5.2.1. Corporate taxation

The corporation tax in the European Union is still very much within the purview of the Member States. The increased integration of economic activity and its consequences for the taxation of company profits across national borders, however, has spawned a debate on EU corporate tax reform. The European Commission and, to a certain extent, the business community support the need for greater harmonization and coordination of the corporation tax. The reasons for greater harmonization and the ways to achieve it differ, but a consensus appears to have developed around the view that it is essential to remove highly distortionary investment flows.

5.2.2. Personal income and pension taxation

The European Commission recognizes that personal income taxation and pension taxation are the responsibility of the Member States and, moreover, that coordination at the regional level is necessary to eliminate obstacles to the exercise of the four freedoms and to remove any cross-border discrimination. In the case of pensions, tax obstacles which serve as disincentives to individuals wishing to contribute to pension schemes in other EU Member States and to pension schemes providing services in other EU Member States need to be removed.

Because there is substantial provision in the EC Treaty, the Commission continues to rely on ensuring compliance with the Treaty by initiating legal action against the Member States in the European Court of Justice (ECJ).

5.2.3. Value added taxation

The Commission has adopted a legislative stance on VAT that focuses on practical issues while restraining further

harmonization. The Commission intends to focus on simplification, modernization and uniform application, and increased provision for administrative cooperation, while retaining its long-term goal of moving to an origin-based VAT system. The key here is administrative cooperation since, for most Member States, VAT is a substantial tax base and, because of this, they are reluctant to agree to proposals designed to lead toward the definitive system for fear of lost revenue. At this time, the EU Member States are not prepared to further harmonize the rates, the structure or the redistribution of tax receipts, although after 2002 there will be a review and rationalization of the rules and derogations applying to the definition of reduced VAT rates.

5.2.4. Excise taxes

Minimum tax rates on a number of commodities have existed in the internal market since 1992. The Member States, however, have highly differentiated tax rates above their minimum rates, creating serious distortions that constitute obstacles to cross-border trade in these commodities. The tax floors are themselves part of a harmonization effort to limit the movement of tax bases. In this regard, the European Commission has already proposed a directive that introduces significant revisions to the rates and structure of excise duties on tobacco, and later it will deal with other commodities such as alcoholic beverages.

5.2.5. Other taxes

There are numerous other taxes, such as taxes on vehicles, environmental taxes and energy taxes. For all these taxes, the Commission has a tailor-made approach that depends on, first and foremost, whether the current structure presents a clear and present danger to the operations and functions of the internal market and on the willingness of the Member States to accept legislative EU-wide harmonization. This approach is fragmented because it is practical, arising out of the frustrations of trying to implement a 1992 harmonization agenda wholesale. There is, however, a chord of consistency because every sub-policy is closely linked to the broad objective of making the internal market work properly.

5.3. Instruments used to achieve EU objectives

The European Commission set a new tone in its communication. The approach is no longer a hard line, centralized, all-encompassing legislative approach to pursuing a harmonization agenda. Frustrated by the last eight years, during which agreement to proposals for directives in the tax field was slow because of, for the most part, the unanimity-voting requirement in tax matters, the Commission has now adopted a “pragmatic approach”.

The Commission views its role as the guardian of the EC Treaty. This means that it has now pledged to make active use of infringement proceedings, bringing legal action against the Member States if their tax rules contravene either the EC Treaty or existing Community legislation. Traditionally, the Commission submitted regular observations to the ECJ, but rarely brought proceedings against

the Member States in the area of direct taxation. The rapid development of EC case law and tax precedent provides rich ground on which to move forward with this strategy. Of course, there are pitfalls associated with pursuing this strategy with regard to meeting harmonization objectives. This is because the ECJ rulings may be implemented in different ways by different Member States, resulting in an asymmetric and differentiated tax policy response to the same ruling – somewhat defeating the purpose. The Commission, however, is responsible for ensuring that the Member States properly implement the rulings of the ECJ. The communication states: “In short, the Commission now intends to adopt a more pro-active strategy generally in the field of tax infringements and be more ready to initiate action where it believes that Community law is being broken. It will also ensure the correct application of judgments of the ECJ.”

The Commission has also stepped up the use of non-legislative approaches or “soft legislation”. Instruments such as Commission recommendations, other guidelines and interpretative notices will be increasingly used. The principle underlying the Code of Conduct for business taxation will be extended to other areas of taxation. By their very nature, soft law approaches rely on goodwill and peer pressure and are thus inherently difficult to enforce.

Perhaps one of the more pragmatic ways of harmonizing taxation is the use of enhanced cooperation – close cooperation between subgroups of like-minded Member States. Where a group of Member States indicates a strong desire to move forward in a particular area, this would be facilitated by way of treaties. This principle was introduced by the Amsterdam Treaty and further developed by the Nice Treaty.

5.4. Tax policy in the European Union

The legal basis for EU policy is outlined in the foundation document, the EC Treaty. It is clear that tax policy is a symbol of national sovereignty and part of the policy arsenal of individual countries. As a consequence, tax policy lies primarily within the domain of the Member States. The European Union has a subsidiary role in tax policy and social security policy. It is worth noting that the objective of the European Union is not to standardize tax systems, but to make national tax systems compatible primarily with the EU objectives and, by extension, with each other. One of the numerous objectives, and the most prominent, is the establishment of a properly functioning single market, as outlined above; thus, tax harmonization and coordination are centred on removing obstacles to the free movement of goods, services and capital.

What makes the EU system somewhat different from the Caribbean Community is that there is substantial provision on tax policy in the EC Treaty.¹⁸ The EC Treaty therefore serves as a broad framework within which to harmonize, coordinate or compete on tax matters. For instance, Art. 90 of the EC Treaty prohibits tax discrimination against products that would directly or indirectly bestow privileges on national products over and above products from other Member States. In Art. 93, the EC Treaty calls for har-

monization of turnover taxes, excise duties and other forms of indirect taxes.¹⁹ Direct taxes require less harmonization, and often a minimal level of harmonization is sufficient. The EC Treaty leaves this to the discretion of the Member States, but this is conditional on national tax policy not violating the four freedoms and the rights of establishment. Community legislation on taxation has been adopted under broader provisions, such as Arts. 93 and 308 of the EC Treaty.

Although social security contributions do not directly come under tax policy, social security legislation is related, and there are regulations (EEC No. 140/71) that ensure that people moving within the Community do not pay contributions twice.

Thus far, the discussion has focused on the EC Treaty and its role and elements, but the European Union has other institutions, such as the European Council, the European Parliament and the ECJ. All of these institutions play a role in setting and implementing the tax harmonization agenda, subject, of course, to the EC Treaty. The Council is responsible for enacting the laws, and the ECJ is responsible for interpreting the EC Treaty, especially as it relates to Art. 90, and for defining the concepts in the tax directives.

6. LESSONS FROM THE EUROPEAN EXPERIENCE

Tax harmonization in the European Union is a mammoth task. In an environment with 15 relatively disparate tax systems each with its own long evolution, tax harmonization can be a difficult policy to implement. Notwithstanding the hurdles, the European Union (through the European Commission) has established a regional tax policy framework with the primary purpose of promoting the free movement of goods and services and all the factors of production within and across borders. This framework is accompanied by a set of priorities, which thereby establishes an agenda for implementation.

Perhaps the most noteworthy characteristic of the framework is that it is governed by pragmatism. The framework addresses the following questions:

- What is critical for the smooth functioning of the internal market and, by extension, what is not?
- Which policy is feasible to implement, given the current circumstances?
- What is the best method for implementing and, in some cases, enforcing policy, or by what mechanism or tool can this best be done?

The institutional structure of the European Union is fundamental to the implementation of a tax harmonization agenda. The roles of the institutions are clearly defined and, in addition, the institutions closely adhere in practice to their defined roles. This provides for frequent discus-

18. The Treaty of Chaguaramas does make provision for the harmonization of tax systems and this provides a broad framework, but it is less detailed than the EC Treaty on harmonization and other macro issues.

19. European Commission, “Tax policy in the European Union”, *Directorate-General for Taxation and the Customs Union*, 2000.

sion and coordination of tax issues. It also provides for proactive institutions, such as the Commission, to serve as guardians of the internal market and seek to promote the objectives of the internal market through the use of whatever means are available. Some of the means include the ECJ.

In the final analysis, the European experience is not wholly applicable to the Caribbean Community, but there are lessons to be drawn – not only from the tax policy itself, but also from the process of continual engagement on tax issues. The lessons that CARICOM can draw may be summarized as follows:

- (1) specific tax objectives are important;
- (2) there should be clear guidelines for a tax harmonization programme;
- (3) there should be supportive and proactive institutional arrangements;
- (4) enforcement mechanisms are necessary;
- (5) the motive for tax harmonization within a single market is efficiency;
- (6) revenue stability should be a major objective;
- (7) some degree of autonomy in setting fiscal policy will have to be forgone; and
- (8) there should be implementation arrangements that support some Member States proceeding with harmonization more rapidly than others.

The last lesson is one that builds flexibility into the adjustment process, allowing the Member States that can progress to do so without hindrance. Of course, special care must be taken to ensure that this process does not, in and in itself, cause divergence or dislocation. Moreover, given that the Member States will have varying revenue needs and preferences and different underlying economic conditions, any agreement on harmonization may need to include derogations. This type of flexibility should enhance the chances that the implementation is successful.

7. IS TAX HARMONIZATION DESIRABLE? THE ARGUMENTS FOR AND AGAINST TAX HARMONIZATION

Is tax harmonization necessary or even desirable? The literature on this issue is divided. The OECD argues that tax competition practices with respect to mobile activities can unfairly erode the tax bases of other countries and distort the location of capital and services.²⁰ These practices, the OECD argues, can further shift part of the tax burden to less mobile tax bases, such as property and consumption, and raise the administrative costs of the tax authorities and the compliance costs of taxpayers. This is essentially the general argument in support of tax harmonization. Additional arguments stem from the need to avoid a “race to the bottom” which would undermine the tax bases of competing governments. All things being equal, firms will locate in the country having the lowest tax rates and, without any effort to coordinate the setting of tax rates, the rates would be driven downward.

Baldwin and Krugman argue that all things are not necessarily equal.²¹ The economic theory on tax harmonization is based on weighty assumptions.²² Baldwin and Krugman

suggest that capital benefits from the existence of other capital or a cluster of capital already being present (hereafter referred to as “agglomeration”).

Because capital “prefers” to be adequately complemented by already existing clusters of capital, agglomeration centres can have higher tax rates, without causing capital flight, than countries without agglomeration. Agglomeration levels, however, are dependent on the extent of regional integration. If economies are loosely integrated, agglomeration becomes feasible but, if they are closely integrated, agglomeration is unnecessary.

Based on this argument regarding the benefits and allure of agglomeration, tax harmonization could result in all countries being worse off if the single tax rate is an average of the tax rates of countries with agglomeration and the tax rates of countries without agglomeration. Countries without agglomeration would have to raise their tax rates and would thus lose their tax advantage in attracting new capital and businesses that do not benefit from agglomeration.

Baldwin and Krugman, however, suggest that the benefits to tax harmonization grow with increased interconnectedness and integration.²³ This argument runs parallel to the one presented in the introduction (see 1.) that, as countries become more integrated and more competitive, the forces that encourage tax competition get stronger with the potential for having serious distortionary effects on the movement of the factors of production. This occurs because economic activities have become increasingly mobile so that countries must “tax bid” to maintain existing capital and/or attract new capital. When location decisions are tax driven, distorted capital and financial flows make it difficult to achieve fair competition for real economic activities. This, of course, results in a shift of the tax burden to labour and consumption because of the difficulty of taxing mobile activities. This further increases distortion and makes the tax base narrow and the tax system less equitable. The result is a negative effect on employment.

Smith argues that the view that tax harmonization is needed for the proper functioning of a single market is wrong.²⁴ It is true, Smith argues, that large differences in VAT between the countries of a single market will cause distorted consumption patterns, and there is also the risk that big powerful businesses would encourage countries to engage in tax bidding, thereby bidding corporate tax rates to exceptionally low levels and leaving a disincentivizing burden on the income tax rates faced by individuals.

It is important, however, to distinguish between artificial and beneficial taxation. The United States is a more integrated market than the European Union, but there are significant tax variations between the US states. The “Celtic

20. OECD, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs*, 2000.

21. Baldwin, Richard and Paul Krugman, “Agglomeration, Integration and Tax Harmonization”, CEPR Discussion Paper Series, No. 2630, 2001.

22. “Not so harmonious”, *The Economist*, 29 March 2001.

23. Baldwin and Krugman, *supra* note 21, at 33.

24. Smith, *supra* note 15.

Tiger”, Ireland, with its lower taxes did not compete away firms from Europe, but provided a haven for entrants that would otherwise not have located in the European Union at all. With each country having a particular mix or combination of factors, this argument is remarkably similar to the argument of Baldwin and Kruger. Some countries have higher tax rates associated with a known business environment, complementary factors such as a good infrastructure and ancillary services, and a skilled and qualified labour force; in contrast, other countries without sufficient complementary factors may have lower tax rates in order to establish themselves economically. It is therefore clear that, under this scenario, harmonization of tax rates would reverse economic convergence.

Moreover, assuming that public spending is inefficient, tax competition would exert downward pressure on high-tax countries to reduce taxation and consequently public spending. This reduced “tax and spend” behaviour has increased welfare effects. The integrity of these arguments is contingent on the competitiveness or lack thereof of the group of countries involved.

Razin and Yuen, using a human capital-based growth model, find that labour mobility and tax harmonization across economic groupings are critical to equalizing income levels across countries that start at different points.²⁵ Bissemer emphasizes the difficulty of moving toward a harmonized system, especially where fiscal coordination requires expansionary policies for some countries in the group and contractionary policies for others.²⁶ Indeed, the difficulty experienced by the European Union in implementing the 1992 harmonization agenda has resulted somewhat in a retreat from a more ambitious and theoretically informed approach. The Europeans now acknowledge that a reasonable degree of competition is healthy.

The debate on tax harmonization is inconclusive, but there is common ground. All sides not only acknowledge the problems accruing as a result of wide differentials in tax rates, but they also acknowledge the benefits associated with parameterized competition.

Tax harmonization and coordination should require, not that all taxes be drafted uniformly, but that tax differences among the member countries be allowed to the extent the differences do not create distortions that interfere with the smooth operation and functions of the single market and its associated benefits.

This is the policy that the European Union recently adopted. This is also the policy that CARICOM has somewhat inadvertently adopted, but needs to put into a formal arrangement with rules and procedures. The Andean Community is notably moving in this direction through its Fiscal Policy Council of the Cartagena Agreement to develop rules and guidelines on tax harmonization.

8. THE TAX STRUCTURE OF CARICOM

Notwithstanding the differences in tax burdens, in the relative dependence on direct as opposed to indirect taxation, in the size of the public sector and in the effectiveness of

the tax administrations, the tax and revenue structures of the Member States of the Caribbean Community are relatively similar.²⁷

Regarding the average tax rate, Table 2 depicts some descriptive indicators of the average tax rates in the Caribbean Community. (Data from Suriname was not readily available.)

Table 2: Average rate of taxation (total tax/GDP), 1980-1997*

	Barba- dos	Belize	Guy- ana	Ja- maica	OECS**	Trini- dad and Tobago
Mean	27.45	24.72	38.16	30.79	24.81	31.67
Median	26.75	24.98	37.79	30.94	24.80	29.08
Maximum	32.59	26.46	46.03	35.15	25.80	44.00
Minimum	23.45	22.35	31.45	25.44	23.97	24.88
Standard deviation	2.96	1.24	3.89	2.74	0.57	5.68
Skewness	0.17	-0.25	0.29	-0.22	0.24	0.96
Observation	18	18	18	13	14	18

* Source: Eastern Caribbean Central Bank (see footnote 27) and International Monetary Fund, *International Financial Statistics, 1998*.

** OECS: Organization of Eastern Caribbean States, consisting of Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

Table 2 indicates that the average tax rate over the last two decades ranged from 25% in Belize and the OECS to 38% and 32% in Guyana and Trinidad and Tobago, respectively. Using the standard deviation as an indicator of variance, Table 2 shows that the OECS and Belize have the most stable average tax rates, whereas Trinidad and Tobago and Guyana have the highest level of fluctuation in the average tax rates over the period. If the average tax rates from 1980 to 1997 are compared, the comparison shows that, with the exception of Barbados and Jamaica, the average tax rates in the region have been falling with generally wide fluctuations.

The CARICOM Member States are sometimes divided into two categories according to the CARICOM criteria of “more developed countries” (MDCs) (Barbados, Guyana, Jamaica, and Trinidad and Tobago) and “less developed countries (LDCs) (Belize and the OECS). The average tax rate in the MDCs is higher than that in the LDCs. Moreover, there is little evidence of convergence between the two categories. This seems to support somewhat the agglomeration hypothesis of Baldwin and Kruger (see 7.), although convergence is occurring within the categories.

25. Razin, Assaf and Chi-Wa Yuen, “Labour Mobility and Fiscal Co-ordination: Setting Growth Agenda for an Economic Union”, CEPR Discussion Papers, No. 1342 (1996).

26. Bissemer, Enid, “The Co-ordination of Fiscal Policy”, *COTA (Caribbean Organisation of Tax Administrators) Newsletter*, Issue 18 (July-December 1999).

27. See *The Tax Structure of the ECCB Territories*, Eastern Caribbean Central Bank, 1998; and *The Tax Structure of Barbados, Jamaica and Trinidad and Tobago*, Eastern Caribbean Central Bank, 2000.

The tax structures within the Caribbean Community are remarkably similar. The corporate tax rates range from 33% to 45% across the region, the consumption tax rates are all around 15%, and the ranges of the withholding tax and property tax rates are similar. The evidence suggests that, especially in the area of taxes on international trade, the Caribbean Community has achieved a fairly substantial level of harmonization. The greatest areas of variation are perhaps between the MDCs and LDCs, even as these groups display small intra-group variations. The personal income tax has considerable variation, not so much in the rates as in the number of marginal tax rates and the number of income tax brackets. It is widely acknowledged, however, that the variation in income tax rates has little effect on the functioning of the Single Market, conditional upon the absence of double taxation.²⁸

Fiscal incentives are granted primarily to industrial entities by the remission of duties, taxes and levies. Increasingly, however, the Member States are extending fiscal incentives to include the service sectors. Fiscal incentives are intended to attract foreign investment and encourage local investment in particular sectors of the economy. Tax

holidays are used extensively as an instrument to lure foreign firms.

The harmonization framework in CARICOM is the result of the 1974 CARICOM Agreement for the Harmonisation of Fiscal Incentives to Industry. This regime promoted investment in the manufacturing sector; over the years, however, the framework has evolved since the Member States have modified their investment regimes to include agriculture and services and to suit their particular development objectives. Table 3 summarizes the existing incentive framework within the region. Indications are that the Caribbean countries make intensive use of tax expenditure policies. The benefits and costs of these policies are hard to determine since the revenue forgone from liberal fiscal incentives is rarely measured. It may be reasonable to assume, however, that tax expenditure policies do result in significant revenue costs and distorted resource allocation.²⁹

28. The author may be contacted for detailed information on the tax structures and tax rates within CARICOM.

29. See *Caribbean Trade and Investment Report 2000*, supra note 5.

Table 3: Fiscal and non-fiscal incentives in CARICOM*

Fiscal incentive and description of policy	Countries
(1) Harmonization of fiscal incentives to industry: tax holidays and duty-free inputs for specified periods for approved firms	all except Guyana
(2) International Business Corporation Act: tax holidays and duty exemptions for foreign firms; exemptions from foreign exchange controls and levies	Antigua and Barbuda, Montserrat, Barbados
(3) Double taxation treaties: treaties to prevent the double taxation of income derived in CARICOM countries	all except St. Lucia and Antigua and Barbuda
(4) Free-trade zone: exemptions from duties for exporting firms; in Jamaica, automatic tax holidays for unlimited period; in St. Lucia, apply under Fiscal Incentives Act	Jamaica, St. Lucia, Trinidad and Tobago
(5) Export incentives not covered by (1): tax reductions, exemptions from import consumption duty; incentives vary	Jamaica, Guyana, St. Vincent and the Grenadines, Belize, Trinidad and Tobago, Barbados
(6) Hotel Aids Ordinance: tax and duty exemptions not harmonized across states	all
(7) Modernization of industry programme: approved firms receive reduction of import duties and assistance for modernization	Jamaica
(8) Investment allowance: tax deductions for expenditure on plant and machinery	Trinidad and Tobago, Barbados, Dominica, St. Vincent and the Grenadines, St. Lucia
(9) Factory construction: tax relief on operating income from leasing of factory or profits from sale of factory	Jamaica, Barbados, Dominica
(10) Bauxite and alumina industry encouragement: five to ten-year exemption from customs duty on imports and machinery	Jamaica
(11) Locational incentives: tax concessions for firms locating in designated areas	Belize, Trinidad and Tobago, Jamaica
(12) Other fiscal incentives not covered by (1): incentives for small-scale sector (St. Lucia); duty-free import of machinery (Trinidad and Tobago, Grenada)	St. Lucia, Trinidad and Tobago, Grenada, St. Vincent and the Grenadines
Non-fiscal incentive and description of policy	Countries
(13) Training of workers: special wage reduction for government-sponsored training programmes, variable across CARICOM	all
(14) Industrial estates: factory shells provided at low rental rates, variable across CARICOM	all

* Source: *Caribbean Trade and Investment Report 2000* (see footnote 5).

A 1994 review of the harmonized scheme of fiscal incentives indicated that the CARICOM Member States offered a range of non-harmonized national incentives, pointing to the fact that there has been some divergence in investment regimes.³⁰ The review further inferred that, given the sluggish development of the industrial sector in CARICOM, the incentive regimes were not as effective as originally anticipated.

9. TAX HARMONIZATION POLICY IN CARICOM

9.1. In general

The CARICOM Single Market and Economy, as established in the Integrated Treaty of Chaguaramas, provides the backdrop for any framework on tax harmonization. Efforts at tax harmonization must aim to implement and further the objectives of the Treaty. This means that countries should pursue tax harmonization, not for its own sake, but solely as an instrument to smooth the operation and function of the Single Market and Economy. This strategy allows the Member States considerable discretion in national tax policy while, at the same time, achieving a degree of harmonization that minimizes distortions in the market. Harmonization beyond this is discretionary.

Moving from the general to the specific, the CSME determines the areas of taxation in which wide differences in tax rates impede its operation and the areas of taxation which have little impact. This is a practical approach because not only does it recognize that a little tax competition is healthy, but it also recognizes the immense difficulty in implementing full-scale harmonization that severely constrains the tax policy of the Member States.

It is important to note that tax and expenditure policy is a major macroeconomic policy instrument in the Caribbean Community. Monetary policy in the Community is usually highly restrained or non-existent due to the fixed and managed float exchange rate regimes currently in effect in the region. Having established the importance of fiscal policy to the CARICOM Member States, it is extremely important to note that there already exists a substantial level of convergence of fiscal policies, tax structures, tax administration practices and, the most controversial area, tax rates.

Of course, much remains to be accomplished in the area of tax harmonization, but the foundation on which to build a viable framework is very strong. Indications are that this trend may continue since, to a large extent, some of the convergence is caused by external factors, such as the ever increasing pressure to liberalize the external sector, and depends less on taxes on international trade and more on various types of consumption taxes (including VAT) and other domestic taxes. Several countries have adopted a VAT in recent years at the standard rate of 15%. There has also been harmonization of excise taxes as part of the overall trade integration that CARICOM has pursued since 1971. These trends also suggest an expanded role for consumption and property taxes in the tax structure of the Member States. The drive to efficiency in taxes and the way they are administered also takes reforming the Member States down the same path.

This suggests that there are gains from pursuing a coordinated approach since the Community can then determine the best convergence outcome that will improve the operation of the Single Market. Moreover, since the Community has monetary union as an objective, regional coordination of fiscal policy is paramount in order to maintain a viable exchange rate among the Member States. Itam et al. corroborate this conclusion when they state that “the challenge facing the region is to agree on a co-ordinated process and timing to reach common fiscal targets across countries”.³¹

A tax harmonization framework must identify areas of cooperation and areas of tax competition. As mentioned before, these areas as well as the relative magnitude of cooperative and competitive policy are determined by the relative impediments they impose on the operation of the CSME.

Within the area of harmonization, there are various ways in which to harmonize tax systems, all of which were mentioned in 3. The most feasible and practical solution is to pursue all available routes to a harmonized tax system. Indeed, some strategies do not make much sense if pursued independently. The prevailing view in the Caribbean Community appears to be to preface the harmonization of tax rates by the harmonization of tax structures. While it is true that they are complementary, these objectives need not be pursued sequentially. The level of distortions imposed by various taxes on the CSME should determine the taxes that should be harmonized immediately and the taxes that can wait.

The tax structures can be harmonized in addition to the rules, procedures and practices that govern the administration of taxes. The most controversial by far is harmonization of the tax rates and incentive regimes because this type of harmonization is the most restrictive on national macroeconomic policy. Recognizing the importance of tax policy to national sovereignty,³² this form of harmonization must be applied in such a way that it allows the Member States leverage to manoeuvre while simultaneously achieving the objectives of the Single Market. Although not easy, this can be achieved, first, by clearly identifying the areas where wide distortion cannot be allowed to prevail and targeting those areas and, second, by implementing administrative rules and procedures through which coordinated regional policy can be set. This would occur through the Council for Finance and Planning in a manner similar to the way the common external tariff is administered by the Council for Trade and Economic Development.³³

Tax policy in the region has already been discussed at length. Here, some objectives for the future are outlined. Although it is not the intention of this article to describe

30. *Id.*

31. Itam, Samuel, Simon Cueva, Erik Lundback, Janet Stotsky, and Stephen Tokarick, “Developments and Challenges in the Caribbean Region”, IMF Occasional Paper No. 201 (2000).

32. Governments cannot conduct policy without revenue. Tax policy is an instrument of economic regulation used to influence consumption, encourage savings, promote investment and organize industry.

33. The important distinction is that the rules for CET administration are clearly set in the Integrated Treaty of Chaguaramas.

detailed tax policy objectives, it must at least identify broad objectives consistent with the establishment of the CSME and other objectives. Some of the other objectives are almost as influential as the aforementioned. For instance, revenue stability is extremely important because, even though factor mobility increases under a single market regime, governments still have their domestic constituents to cater to. They must have stable revenue sources and must implement a policy that prohibits the rapid and frequent movement of certain tax bases. Other objectives may include stabilizing the economy against the "boom and bust" cycle as well as reducing unemployment. All of these policy objectives are important and must be factored into the regional tax policy.

As mentioned earlier, the tax structures in the Community are quite similar – in many instances, even while undergoing reform; this reform is leading to further convergence. The Member States are notably trying to reduce their dependence on trade taxes and depend more heavily on domestic taxes, primarily indirect taxes. Traditionally, fiscal policy has been heavily dependent on import duties; thus, many countries are moving toward broadening the tax base. Barbados, for example, has introduced a VAT, and indications are that other Member States, particularly in the OECS, will follow that example. On the other hand, other tax issues include the rates of property taxes (which are relatively low in the Community) and the introduction of user fees for social services (such as health and education). Efficient taxes are also of major concern and, likewise, the structure is being reformed to ensure that the real tax burden approximates the nominal tax burden by making incentive regimes more transparent and systematic.

9.2. Direct taxation

9.2.1. Corporation tax

At the moment, the Community has a fairly simple corporate tax structure where the tax is calculated on the net income of an enterprise. There is very little sectoral differentiation of the corporate tax rates. Often, however, the fiscal incentive regimes distort market signals by disguising the real corporation tax burden. This occurs by the systematic granting of tax holidays and tax breaks. The Draft Protocol on the Harmonisation of Corporate Taxation attempts to harmonize the corporate tax regimes, paying particular attention to the design of the depreciation system. This is important since the allowable depreciation of physical assets for tax purposes is an important structural element in determining the cost of capital and the profitability of the investment.³⁴

The CARICOM Secretariat has already commissioned a study on the restrictions on the movement of capital and other factors. This study identifies the tax obstacles in the individual Member States for removal or reform. Indications are that the efforts to harmonize corporate taxation in the Community will have to take the conclusions of this study into account. For corporate taxation, a high degree of harmonization is necessary. This is not only for intra-regional cross-border activities, but also, importantly, for foreign direct investment since, within the Community,

this is a source of potentially harmful competition. There is, however, little difference in the location decision made by a Community firm and a foreign firm.

9.2.2. Income tax

The EU policy on income taxation is to harmonize only to the extent necessary to prevent cross-border discrimination or obstacles to the exercise of the four freedoms. This is particularly important for the avoidance of double taxation and tax evasion. The Caribbean Community, however, has a double taxation agreement that, in large part, addresses some of these issues. A few countries in the Community do not even have an income tax and, in the countries that do, the tax base is usually very narrow with ineffective high marginal rates. Consequently, the revenue yield is relatively small. This tax is perhaps best left, for the most part, to national discretion.

9.2.3. Other taxes

Other taxes, such as withholding taxes on interest income and dividends, also have implications for capital movement but, in large measure, these issues are addressed by the CARICOM double taxation agreement. There is, however, a special need for further cooperation in this area of taxation since globalization is likely to lead to strong incentives to compete in this area. While there is evidence that these taxes have come down over the decades, there appears to be a strong preference for taxing royalties.

9.3. Indirect taxation

9.3.1. Consumption tax and VAT

The Caribbean Community, faced with declining tariffs as a result of the phased reduction of the CET and the Community's commitments in connection with the WTO and the Free Trade Area of the Americas (1994), has had to reduce dependence on import duties and increase its dependence on domestic taxes, such as the consumption tax and/or VAT. Wide distortions in these types of taxes may have real effects on the movement of capital and on cross-border shopping. This implies shifting tax bases and consequently reduced revenue stability.

There is a clear case, therefore, for eliminating unfair competition. This is particularly so with regard to consumption taxes (or VAT) on individual commodities. Efficient practice dictates that these taxes be applied to a few items (usually with inelastic demand) that have negative social externalities, leaving the majority of consumer items free of tax. This is where harmonization is most critical, and perhaps a high degree of harmonization is needed, even given that the Caribbean systems are already quite harmonized. What is necessary is that complete consistency with the indirect tax system and the customs union be ensured.

The expanding importance of consumption taxes suggests that it will be more difficult to harmonize in the future. The various reform efforts have brought about some uni-

34. Tanzi, Vito and Howell Zee, "Tax Policy for Developing Countries", *Economic Issues*, No. 27 (International Monetary Fund, 2001).

formity in approach, although coordination activity needs to be strengthened. Enhanced cooperation in this area would lead to considerable improvement in the harmonization efforts.

9.3.2. Import tariffs

The common external tariff established a Caribbean Community customs union which, by definition, is the embodiment of tax harmonization. Countries are to move to the final phase of implementing the CET. The CET and its method of administration, however, are about to be reviewed because the numerous derogations by the Member States and the recent requests by some Member States to raise the CET have caused trade ministries to question some of the rules that govern it. While derogations are important to ensure flexibility in the system, constant and frequent use of them may undermine the benefits which the CET was set up to realize. Further increases in the CET add to the tax burden on the citizens of the Community.

In the European debate, many pundits who argued against harmonization efforts did so on the basis that harmonization often leads to higher tax rates and an increased tax burden. The CARICOM Member States, particularly those in the OECS, are highly open economies with moderate to high dependence on trade taxes. Progressive liberalization of trade will mean declining revenues for these territories; thus, it is imperative that the Member States reduce their heavy reliance on trade taxes in favour of a more balanced tax structure that can better cushion these small open economies from external macroeconomic shocks and trade shocks occurring from tariff reduction.

9.4. Incentives

The Caribbean Community countries use incentives, such as tax holidays, tax credits, investment allowances, investment subsidies and accelerated depreciation, to promote investment and employment creation. The Community is comprised of small economies that have fairly little bargaining power when it comes to negotiating terms and agreements with big foreign firms. Although research indicates that tax incentives are of little significance in the business decisions of enterprises, evidence – even within the Caribbean – suggests that incentives, if not harmonized, are prone to abuse. Some of the possible effects of wide variations in incentive regimes include playing country against country or exhausting tax incentives in one country and then moving to another through a nominal reorganization.

Moreover, certain types of tax incentives disguise the tax burden and undermine other revenue bases, particularly the corporation tax and duties on imports. In addition, the administration of tax incentives is often not very transparent because of the discretionary nature of the decision-making process. Frequently, approval or denial of applications for incentives is based on subjective value judgements of the granting authorities. Tax expenditure serves as an alternative to monetary subsidies which the Member States can ill afford. Expansive use of tax expenditures induces opacity in the tax system. Most of the

time, the amount of revenue forgone from the incentives is not known. This makes it extremely difficult to use a cost-benefit analysis to determine whether or not the incentives make the Community better off. Harmonization of incentive regimes is likely to result in the rationalization of tax expenditures across the region.

At this time, the CARICOM Secretariat, through a project funded by the Inter-American Development Bank, is making an effort to harmonize the investment incentives for agriculture, services and industry.

10. TAX ADMINISTRATION AND COLLECTION

Clearly, in the area of tax administration and collection, there are substantial gains to be achieved, especially within the context of the CSME where economic activities are expected to be increasingly mobile. Tax evasion and other forms of tax fraud can be significantly stifled when the tax authorities exchange information. Exchange of information, administrative cooperation and mutual assistance all contribute to improving the efficiency of existing arrangements. What could add strong support to this Community approach is a legal instrument requiring the tax authorities to assist other Member States in their efforts to capture certain tax bases – this would require the tax authorities to exchange information and cooperate in many areas of Community interest. Naturally, an institution or committee is needed to give effect to these principles and, within the Community, the Caribbean Organisation of Tax Administrators is perhaps the best suited for this role. In sum, closer cooperation and enhanced policy dialogue are critical components in implementing a harmonized tax system.

11. TAX RATES

Harmonizing tax rates is perhaps the most difficult area of tax harmonization to implement. The discussion below considers the various types of strategies to harmonize tax rates, including minimum tax rates, maximum tax rates, tax bands and uniform tax rates. These strategies differ only in the degree of freedom they offer, but even the more restrictive types can build in flexibility by allowing waivers and having other safeguards.

Minimum tax rates: Minimum tax rates are usually instituted to minimize the incidence of cross-border shopping so that the tax bases do not shift from Member State to Member State depending on the tax rate. The European Union uses tax floors for its alcohol and tobacco excise taxes. Minimum tax rates are important for maintaining revenue stability because they not only prevent the “race to the bottom” phenomenon, but also preserve minimum levels of tax revenue.

Maximum tax rates: Maximum tax rates are already in limited use at the CET level. What is more important is that there is, to a large extent, built-in flexibility that allows the Member States to occasionally request exceptions that allow them to raise the CET. This type of regime may be particularly useful with regard to taxes that affect

the movement of capital, allowing limited variation below an upper bound.

Tax bands and uniform tax rates: Tax bands and uniform tax rates are required in particular when small countries must face large foreign firms that have the ability to cause harmful competition among the countries which compete for the firm's business. Tax similarity has large benefits in this case, whereas competition can cause revenue erosion to all. The cruise ship levy is perhaps a good example of an area where tax similarity is useful.

Finally, tax competition does have its purposes since it reduces the tax burden on consumers of a single market. It reduces the ability of governments to engage in "tax and spend" type behaviour, which is generally acknowledged to have substantial distortionary macroeconomic effects. Moreover, tax competition gives governments leverage to set their own policy while maintaining their commitment to the CSME. Given that tax competition allows real discretion, it makes the tax harmonization effort easier to implement due to the flexibility that is built into the framework.

12. INSTRUMENTS TO ACHIEVE TAX OBJECTIVES

Instruments to achieve tax coordination and tax harmonization are extremely important because, without the right instruments, inertia in the process is inevitable. While the Treaty of Chaguaramas provides direction and guidance on tax issues, it does not detail, in the same way that it does for the CET, the rules and procedural elements for coordinating tax policy and administration. As it stands, the Member States can currently do almost anything outside of the CET provisions without informing a regional body and without regard to the opinions or approval of the other Member States. There is no guardian of the Treaty or the CARICOM double taxation agreement, nor is there a legal instrument that is used to further tax objectives. Moreover, the Caribbean Court of Justice is not yet in existence to interpret legal instruments and to provide a rich case law that would add to the limited body of statute law. The Treaty, however, does allocate responsibility to the Council for Finance and Planning (COFAP) to fill in the gaps. That is, the COFAP is expected to flesh out areas of the Treaty that are not detailed by providing the mechanisms or rules whereby the Member States would address these concerns.

12.1. The role of COFAP

The first concern is that there is no fiscal policy council to administer regional tax issues, i.e. a forum or platform to which the Member States would be required to report and where they could discuss issues relating to exchange of information, transparency, coordination, harmonization, etc. The COFAP is the aforementioned council since any council of this nature would comprise exactly the same representatives. At this point, there is no requirement, as there is for the CET, for the Member States to coordinate tax issues through the COFAP. It is the platform for such

coordination and, as such, it must develop the rules and procedures for administering tax harmonization and coordination within the Community.

The COFAP is responsible for economic policy coordination and is expected to promote and/or recommend, among other things:³⁵

- measures for fiscal and monetary cooperation, including mechanisms for payment arrangements; and
- measures to achieve and maintain fiscal discipline.

It is clear, therefore, that the COFAP has a clear mandate to develop measures, procedures or processes which require the Member States to inform the COFAP of any action taken to coordinate tax policy in particular and fiscal policy in general.

12.2. The Caribbean Court of Justice

The Caribbean Court of Justice is not yet in existence, but it does have a role to play in interpreting the Treaty of Chaguaramas and the supporting legislation. This ensures that the Member States keep in line with the objectives of the Single Market and that, if they deviate from the objectives, they can be held accountable to some extent. The Court will be able to fill in many of the gaps that the legal instruments do not specifically address, but this organ of the Community must be ably supported by the COFAP and other Community organs.

12.3. The CARICOM Secretariat

The CARICOM Secretariat, being the administrative and technical arm of the Community, has a substantial role to play in advancing tax harmonization objectives. These include: (a) developing guidelines on tax harmonization, (b) developing rules and mechanisms for the COFAP, (c) the usual coordination of the Member States, (d) other technical work, and (e) more notably, ensuring through a variety of means that the Member States implement what they agree on and do so in a harmonized and consistent way.

12.4. Legislation

There is an obvious need for more legislation, but legislation must never be of the type "one size fits all". It must have sufficient flexibility, allowing closely monitored waivers or derogations and safeguard mechanisms. More importantly, legislative instruments should provide for substantial and enhanced cooperative activity that encourages transparency, exchange of information and other forms of cooperation between tax authorities.

12.5. Soft legislation

Softer, non-binding or voluntary, instruments have been known to be quite effective and, indeed, soft legislation is the principle behind the Code of Conduct in the EU tax

35. See Protocol I: Amending the Treaty of Chaguaramas, supra note 4, and Caribbean Trade and Investment Report 2000, supra note 5, at 30.

package. Guidelines developed by the CARICOM Secretariat and adopted by the COFAP could be useful to the Member States when factored into their policy decisions. The voluntary nature of soft approaches is an advantage as well as a disadvantage. It is an advantage in that soft legislation tends to be broad-based and all-embracing, but a disadvantage in that soft legislation cannot ensure implementation or compliance. No guidelines currently exist, despite a fairly wide body of literature on taxation issues in the Community.

13. CONCLUSION

This article has made it clear that, while the Caribbean Community has made considerable progress with regard to tax harmonization, more needs to be done, especially to

encourage tax coordination. It is interesting to note that there is considerable similarity in both the tax structure of the Member States and the tax rates. The high level of convergence suggests that external forces play a major role in the Caribbean tax structures but, more importantly, it suggests that there is some form of coordination, some of which may even be explicit.

It is also plausible that some degree of cooperation and some degree of competition brought about this similarity. The reality then becomes that any effort to formalize a tax harmonization and coordination arrangement would be just that – the Member States agreeing to do what they already do. This does not undermine the need to do this, however, because it is important to ensure that no divergence toward practices that harm the CSME be allowed to take place. Emphasis must be on tax coordination since this is highly practical and implementation is more likely.