

CARICOM Tax Harmonization: Implications of the Effects on Investment for Regional Integration^Ψ

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CONTENTS

| | Page |
|--|-------------|
| GLOSSARY OF ACRONYMS AND ABBREVIATIONS | iv |
| EXECUTIVE SUMMARY | 1 |
| 1. INTRODUCTION | 2 |
| 2. BACKGROUND | 5 |
| 2.1 Investment in CARICOM and the CSME | 5 |
| 2.2 Objectives of Tax Harmonization – Investments | 10 |
| 2.3 Taxation of Investments | 14 |
| 3. INTEGRATION EXPERIENCES – TAXES AND INVESTMENT ... | 19 |
| 3.1 The European Union Experience | 19 |
| 3.2 The Andean Community (Latin American Experience) | 23 |
| 4. EXPECTATIONS FOR AND EFFECTS ON INVESTMENTS | 28 |
| 5. RECOMMENDATIONS | 35 |
| 6. CONCLUSION | 38 |

| | |
|-------------------------|----|
| REFERENCES | 39 |
|-------------------------|----|

APPENDIX

| | |
|---|----|
| A. International Organizations | 45 |
|---|----|

FIGURES

| | |
|---|----|
| 2.1.1 FDI Inflows of Selected CARICOM Countries, US\$ Million: 1992 – 2001 | 7 |
| 4.1.1 FDI Inflows to Barbados and Bahamas, US\$ Million: 1992 – 2001 | 32 |

TABLES

| | |
|--|----|
| 2.1.1 FDI Inflows for Selected Caribbean Countries (US\$ Million): 1992 – 2001 | 6 |
| 2.1.2 Forms of Capital Inflows within OECS (%): 1995, 1997 and 1998 | 9 |
| 3.1.1 Simulation Results for FDI and Corporate Tax Ratio for EU Countries; (percent of annual GDP: 1990 – 1997 average) | 23 |
| 3.2.1 VAT Rates as at 2001 and World Exports in US\$ million for 1999 – 2001 ... | 24 |
| 3.2.2 CAN FDI Inflows (US\$ billion): 1985 – 2002 | 27 |
| 4.1.1 Change in OECS FDI Inflows, 1996 – 1999 | 29 |
| 4.1.2 Average Rate of Taxation (Total Tax/GDP Ratio): 1980 – 1997 | 29 |
| 4.1.3 Tariff Reduction Schedule for CARICOM Member States | 31 |
| 4.1.4 Tax Buoyancy in Selected CARICOM Countries | 33 |

GLOSSARY OF ACRONYMS AND ABBREVIATIONS

| | |
|---------|---|
| CAN | Comunidad Andina / Andean Community |
| CARICOM | Caribbean Community |
| CET | Common External Tariff |
| COFAP | Council for Finance and Planning |
| COTED | Council for Trade and Economic Development |
| COTA | Caribbean Organization of Tax Administrators |
| CSME | CARICOM Single Market and Economy |
| ECCB | Eastern Caribbean Central Bank |
| ECLAC | Economic Commission for Latin America and the Caribbean |
| EEC | European Economic Community or Common Market |
| EIPU | Economic Intelligence and Policy Unit |
| EMU | European Monetary Union |
| EU | European Union |
| FTAA | Free Trade Areas of the Americas |
| IMF | International Monetary Fund |
| LDCs | Lesser Developed Countries |
| MDCs | More Developed Countries |
| OAS | Organization of American States |
| OECD | Organization for Economic Co-operation and Development |
| OECS | Organization of Eastern Caribbean States |
| UNCTAD | United Nations Conference on Trade and Development |
| VAT | Value Added Tax |

EXECUTIVE SUMMARY

The current aim of CARICOM is to develop policies that encourage regional integration and transformation to the CSME. On the agenda to support the integration process is the full introduction of a tax harmonization framework. The harmful effects of tax competition have been the main stimuli for wanting to harmonize taxes. Tax structures and rates are important determinants for foreign and local businesses and consumers in deciding where to conduct investment operations. Decreasing tax rates results in a rise in income and revenues to existing tax payers, which enhances the ability for trade and investment within the CSME as shown from the experience of the EU. Latin American economies have shown that liberalization, deregulation – especially in the capital market – and the implementation of a CET induces FDI to that region. The investment levels in CARICOM should expect mixed results from tax harmonization, based on current tax rates and elasticity of Member States.

1. INTRODUCTION

Since the formation of the Caribbean Community and Common Market (CARICOM) in 1973¹ by the Treaty of Chaguaramas, the region has been faced with many changes, ranging from those political to those structural and administrative. Some of these changes have been aimed at integrating the Caribbean into a stronger and more cohesive body, the CARICOM Single Market and Economy (CSME), which may be more capable of combating the numerous challenges from globalization. With this in mind, the harmonization of economic policies is being pursued to smooth the process of transformation to the CSME.

The harmonization agenda that will be discussed emanates from what the Heads of government of CARICOM describes as “the emergence of tax competition” (CARICOM Secretariat 2002, p. 8)². As a result of tax competition, CARICOM has recognized that the formation of a coordinated tax structure within the region is one of the key elements “to enhanc[ing] the functions and operations of the CSME”³. Hence, the need exists for the creation of a tax harmonization framework⁴. A tax harmonization framework will also be vital to the achievement of macroeconomic convergence within the CSME (CARICOM Secretariat 2002; and Bourne 1994).

¹ For a list of CARICOM Member States and Associate Members and other international organization members see Appendix A. For further information on the Treaty and protocols governing the agreements see Müllerleille (1996); CARICOM Secretariat (1973); and CARICOM Secretariat (2001c).

² See presentation done by the EIPU of the CARICOM Secretariat. “Exploring Caribbean Tax Structure and Harmonization Strategies”, CARICOM Secretariat, Guyana, 2002. Tax competition is described further in the study, along with how the lowering of tax rates is used to compete for investment.

³ Ibid 9.

⁴ Tax harmonization, for the purposes of a definition, will be used throughout this research to mean a concerted effort to achieving similar tax structures and/or similar tax rates; or the process of adjusting the tax structures based on compatibility with regional objectives. See Cano 1986; CARICOM Secretariat 2002; and European Commission 2000.

Macroeconomic convergence, based on a harmonizing tax regime, will be governed (not exclusively) by Protocol IV; namely Trade Policy; a revision of the 1973 Treaty of Chaguaramas⁵. The convergence or harmonization of macroeconomic policy is critical in order to avoid the conflicts that arise from the objectives of individual national policies. Harmonization is also vital because it creates a scenario portraying economic stability within the integration process. For example, suppose there is a change in the real exchange rate between two Member States. This fluctuation will create a repercussion in the trade flows and the investment operations of - not just the affected Member States - the entire Members Countries of CARICOM. Hence, the harmonization of macroeconomic policies enhances the objectives of CARICOM and supports the efforts of the integration process.

A harmonizing tax regime is being built on the basis of the “formation of a customs union” implemented through a Common External Tariff (CET) and administered by the Council for Trade and Economic Development, COTED (Eastern Caribbean Central Bank 1997; and CARICOM Secretariat 2002)⁶. This research is designed to examine one of the areas for transformation from the Common Market to the CSME, namely the introduction of a tax harmonization framework. However, specific attention will be placed on the effects of a harmonized tax structure on investment in CARICOM and how this further affects the endeavors to integrate regionally. Also, this study is informed from the empirical findings of other studies and draws from the integration experiences in the Caribbean, Europe and South America.

⁵ See also CARICOM Secretariat. ‘Chapter Five: Trade Policy’. Revised Treaty of Chaguaramas Establishing the Caribbean Community Including the CARICOM Single Market and Economy. Georgetown, Guyana; CARICOM Secretariat, 2001.

⁶ Ibid Part Two: Article 83.

This is a working paper and its contents are as such, section two will provide a background on investment in CARICOM and CSME, the objectives of harmonizing taxes and a background on the taxation of investment. Subsequently, section three will highlight two major elements to the research. These elements include the experience of the European Union (EU) and the experience of the Latin American Community. Section four discusses expected consequences for investment in the Organization of Eastern Caribbean States (OECS) and other Member States. For instance, based on analysis from the preceding section, the paper explores the anticipated trend for investment in Member States. The penultimate section will seek to address the problems identified with the expectations from tax harmonization and investment by suggesting solutions and ideas for consideration. The last section concludes the paper and delves into the effects on regional integration.

2. BACKGROUND

2.1 Investments in CARICOM and the CSME

Investment in any economy is an important aspect for growth and development. Investment can be used as a tool to stimulate other trading activities within and outside the region by the fact that cross-border investors and local investors have a vested interest in the region. Investment therefore creates links between CARICOM Member Countries and the world markets. However, the need exists for us to establish what is referred to as investment and the kind of investment climate that CARICOM portrays. Also, the dependence of Member States on trade and investment from business entities and individual investors requires consideration.

Investment represents property or another possession acquired for future financial return or benefit, such as laying out money or capital in an enterprise with the expectation of profit. More specifically, foreign direct investment (FDI) refers to the “contribution originating abroad belonging to foreign individuals or companies to the capital of a company in freely convertible foreign exchange or in physical tangible goods, such as industrial plants, new and reconditioned machinery ... equipment, replacements, parts and pieces, raw materials and intermediate products”⁷. According to the Caribbean Trade and Investment (CTI) Report 2000, a study conducted by Mathew Stamp PLC on the attractiveness of investment locations shows that various CARICOM economies received similar ranking to those in industrialized Asian economies⁸.

However, the actual volume of investment flows to Member States is much lower than those obtained in Asian countries (CARICOM Secretariat 2000a). For example, in

⁷ See the available website http://www.sice.oas.org/cp_bits/english99/andean.asp

⁸ See CARICOM Secretariat 2000a.

1998 FDI inflows directed to Asia amounted to approximately US\$85 billion while Caribbean countries and Latin America received a total of US\$72 billion (approximately US\$1.6 billion were concentrated within CARICOM - see Table 2.1.1). Girvan (1973) and United Nations ECLAC (1999) explain that the low volumes of FDI accounted for within the Caribbean may be due to the small size of those economies.

Table 2.1.1 ~ FDI Inflows for Selected Caribbean Countries (US\$ million): 1992-2001

| Country | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|----------------------------|------|------|------|------|------|------|------|------|------|-----------------|
| The Bahamas | 7 | 27 | 23 | 107 | 88 | 210 | 147 | 149 | 250 | 101 |
| Barbados | 14 | 9 | 13 | 12 | 13 | 15 | 16 | 17 | 19 | 18 ^a |
| Belize | 18 | 9 | 15 | 21 | 17 | 12 | 18 | 56 | 28 | 34 ^a |
| Guyana | 146 | 70 | 107 | 74 | 92 | 52 | 47 | 48 | 67 | 56 ^a |
| Haiti | - | - | - | - | 4 | 4 | 11 | 30 | 13 | 3 ^a |
| Jamaica | 142 | 78 | 130 | 147 | 184 | 203 | 369 | 524 | 471 | 722 |
| OECS^b | 136 | 127 | 161 | 186 | 113 | 182 | 232 | 257 | - | - |
| Trinidad and Tobago | 178 | 379 | 516 | 299 | 356 | 1000 | 732 | 643 | 662 | 835 |
| CARICOM | 495 | 699 | 965 | 846 | 834 | 1686 | 1571 | 1626 | - | - |

Source: UNCTAD World Investment Report 2002 and the CARICOM Secretariat Caribbean Trade and Investment Report 2000

^a Estimates

- Information was unavailable

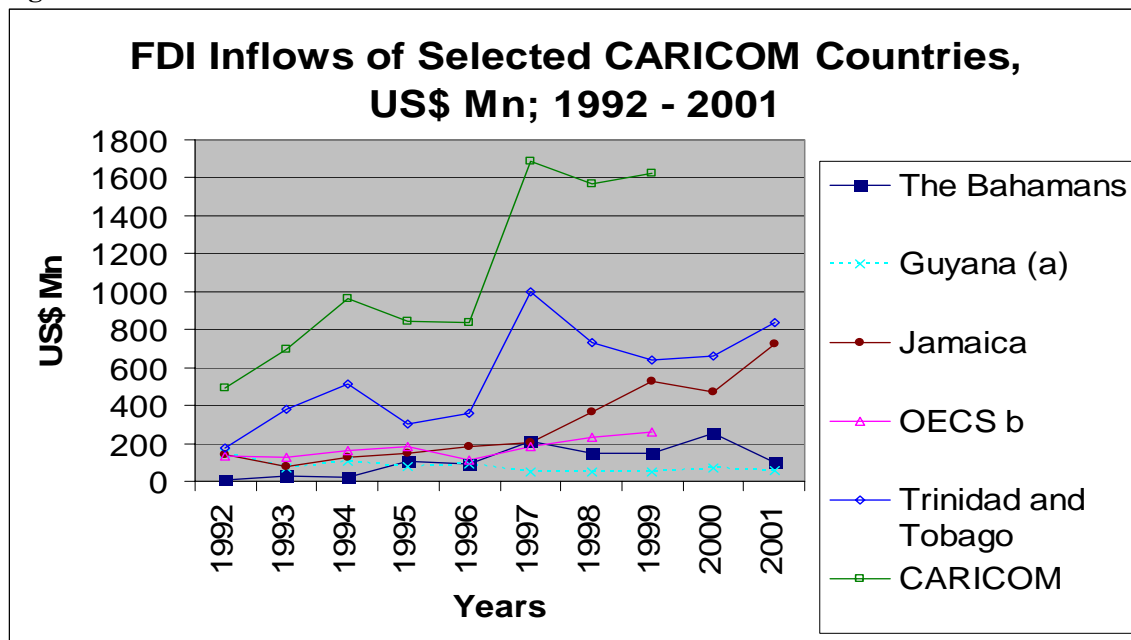
^b Excluding Montserrat

Note: Information on Suriname missing due to lack of available data

Figure 2.1.1 shows that the performance of the OECS Member States in attracting investment from 1992 to 1999 has been commendable. Despite falls in FDI inflows in

1993 and 1996⁹ by US\$9 million and US\$73 million respectively, the Member States of the Eastern Caribbean Central Bank (ECCB) area consistently raise their volume of capital inflows, producing an increasing trend over the past eight years – for the tabled period. Figure 2.1.1 also highlights the other major players within the Member States, Trinidad and Tobago and Jamaica.

Figure 2.1.1



Source: Based on Data from Table 2.1.1

Investments in Trinidad and Tobago concentrate large percentages of its equity capital inflows dedicated to natural gas facilities and the production of crude oil¹⁰. This fact has contributed to Trinidad and Tobago maintaining little over sixty two percent (62%) of total FDI acquired by CARICOM between 1992 and 1999 – a more than three hundred percent (300%) increase in inflows from 1996 to 1997 helped to stimulate this dominance. On the other hand, Jamaica which has seen marginally larger increases between 1998 and 2001, received US\$1.777 billion in inflows between 1992 and 1999

⁹ Most Member States experienced losses in 1993 except for Trinidad and Tobago and the Bahamas that showed FDI figures that more than doubled that of the previous year.

¹⁰ See CARICOM Secretariat (2000a).

out of a total US\$8.722 billion received by CARICOM; representing approximately twenty percent (20%) of the total investment to the region. From observation we realize that Trinidad and Tobago and Jamaica account for in excess of eighty two percent (82%) of total capital inflows into the CARICOM region.

The main forms of FDI identified within the Caribbean Community are earnings that have been reinvested, loans issued within a company and equity capital¹¹. The investment climate within CARICOM may be more understood from studying the level or rate of reinvestment that occurs. Examining the rate of reinvestment will emphasize the investor's level of satisfaction with the business environment of the Community. Reinvestment can also be used to reflect the "effectiveness of the investment promotion authorities" and hence, the prospects for future investment possibilities¹². Generally CARICOM has performed satisfactorily - during the 1990's - in increasing the volume of FDI coming to its shores yearly, but how well has it done to encourage capital to remain in productive profit bearing economic activities?

The CTI Report 2000 demonstrates that the rate of reinvestment varies among countries especially those endowed with natural resources - such as petroleum and gas, gold mining and forestry - namely Trinidad and Tobago, Belize and Guyana¹³. The percentage of investment earnings reinvested into Trinidad and Tobago was generally higher during the 1990's. Belize however, maintained relatively high percentages of capital inflows in the form of equity capital¹⁴. Between 1992 and 1999 the poor performance of Guyana in attracting reinvestments was based on the premise that FDI

¹¹ Ibid 209

¹² Ibid 209

¹³ Ibid 209

¹⁴ Ibid 210

were directed into lengthy development projects that provided little compensations¹⁵. The smaller islands that comprise the OECS recorded varied rates of reinvestment during the 1990's.

An observation from Table 2.1.2 illustrates that Saint Lucia had seventy six percent of FDI reinvested in 1995. Dominica and Montserrat managed to record the largest rates of reinvestment within the eastern Caribbean basin for 1997 and 1998 with rates of 39.5 and 73.4 percent for the former and 74.9 percent in both years for Montserrat (see Table 2.1.2).

Table 2.1.2 ~ Forms of capital inflows within OECS (%): 1995, 1997 and 1998

| Country | New Equity | | | Reinvestment | | | Land Sites | | |
|--------------------------------|------------|------|------|--------------|------|------|------------|------|------|
| | 1995 | 1997 | 1998 | 1995 | 1997 | 1998 | 1995 | 1997 | 1998 |
| Antigua and Barbuda | 7.4 | 22.9 | 52.8 | 15.8 | 17.8 | 6.3 | 11.0 | 43.2 | 9.7 |
| Dominica | 69.4 | 51.5 | 13.7 | 10.4 | 39.5 | 73.4 | 1.9 | 20 | 92 |
| Grenada | 24.4 | 44.3 | - | 17.5 | 21.0 | 17.6 | 47.9 | 28.7 | 21.0 |
| Montserrat | 0.6 | - | - | 22.0 | 74.9 | 74.9 | 77.4 | 25.1 | 25.1 |
| St. Kitts and Nevis | 10.5 | 30.5 | 56.0 | 25.6 | 26.1 | 18.1 | 61.6 | 42.3 | 25.9 |
| St. Lucia | 0.1 | 2.0 | 0.3 | 76.0 | 24.8 | 18.7 | 12.4 | 5.0 | 3.7 |
| St. Vincent and the Grenadines | - | - | - | 24.1 | 14.2 | 26.5 | 15.0 | 12.4 | 13.1 |

Source: ECCB, see website www.eccb-centralbank.org
 - Means Nil

The ECCB reports indicates that a significant proportion of inflows to the ECCB area originate from other CARICOM countries¹⁶. These rates of reinvestment should be an indication of the level of confidence that investors have in committing funds to

¹⁵ Ibid 209

¹⁶ Data provided from the ECCB web site www.eccb-centralbank.org and from the statistical unit of CARICOM Secretariat in Guyana.

Member States. The CTI Report 2000 indicates however that “the form of FDI in the OECS countries seemed to reflect a strategy of hedging against risks and a preference for committing loans, rather than equity” (CARICOM Secretariat 2000a, p. 211). Other major sources of FDI into Member States have been identified from the European Union, North America, South Africa and eastern Asia (UNCTAD 1999). Investments from Asian countries were mainly concentrated on labour-intensive garments industries that were located in export-oriented free zone areas¹⁷.

In short, investment can be considered a vehicle by which CARICOM can stimulate trade and provide increased opportunity for labour and in effect create a better and stronger regionally integrated body.

2.2 Objectives of Tax Harmonization - Investments

The European Commission (2000) state that taxation is essential as it is with revenue from taxes that governments conduct policy frameworks. Taxation is an instrument of economic regulation that can be used to influence consumption, encourage savings or shape the way entities conduct business (European Commission 2000). The establishment of tax harmonization in the Caribbean began with the introduction and implementation of a CET as previously mentioned. The policies of the CET include:

- The imposition of import duty or tariff rates on non-regional commodities and
- the abolition of duties levied on intra CARICOM trade conditioned on certain rules of origin¹⁸.

Some of the objectives of constructing a harmonized tax structure include

¹⁷ See United Nations Conference on Trade and Development (1999) for more details.

¹⁸ See CARICOM Secretariat (2002); and CARICOM Secretariat (1999).

- i the ensured improvements in the incentive structure in the region,
- ii the benefit of reducing distortions imposed by existing tax systems on the private sector, in particular the elimination of tax competition and
- iii the increase in revenue mobilization to correct for imbalances of an imperfect market.¹⁹

However, the main concern for wanting to develop a tax harmonization framework was due to the harmful effects of tax competition (Gropp and Kostial 2001; and CARICOM Secretariat 2002). Tax competition among countries originate from

1. the eagerness of countries to attract investment and trading partners and from
2. the increase in capital mobility that which has resulted from the integration policies that have encouraged the free movement of all factors of production²⁰.

As Gropp and Kostial (2001) expounds, if the domestic tax burden of one country is relatively higher than another, then “the tax base may shift to countries with a less burdensome tax regime” resulting in an outflow of FDI (p 3). Consequently, there exists the need to “mak [e] the region ... more competitive with other countries and regions of the world ... while reducing the tendency for individual CARICOM states to compete with each other” (Osbourne 1990, p 9). In effect a harmonized tax structure would persuade investors to seek alternative reasons – other than tax structures and/or frameworks - for choosing to invest or develop trade relations within particular Member

¹⁹ CARICOM Secretariat. Convening of a Two Day Seminar/Workshop on Tax Harmonization and the CARICOM Double Taxation Agreement. Trinidad and Tobago: CARICOM Secretariat, October 2001.

²⁰ European Commission (2000); and Gropp and Kostial (2001)

States. Therefore harmonization reduces the tendency for competition amongst Member States²¹ and provides equal opportunity amongst those States.

The EIPU reports that tax harmonization is a major requirement for the CSME to ‘operate smoothly’ (CARICOM Secretariat 2002). Furthermore by the development of a tax harmonization framework, revenue stability may be ascertained due to the fact that similar environments are created from “which businesses and consumers can operate” (2002, p 9). Importantly, stability in any economic atmosphere demonstrates an increased potential for growth, which is essential for entities seeking to invest (especially in the financial market) in a country²². Hence according to Cano (1986), tax harmonization should reduce or eliminate the inequalities “that arise due to differences in internal taxation”²³.

For instance, based on the CTI Report 2000 (see Table 2.1.1) FDI inflows to Guyana have been fluctuating and remain to be extremely low (CARICOM Secretariat 2000). The report has revealed that over the last decade FDI inflows into Guyana have exhibited a downward trend moving from a high of US\$146 million in 1992 to a low of US\$47 million in 1998 (see Table 2.1.1). One reason for this trend may be due to the frequently unstable economic climate within the country, founded by sporadic political and racial outbreaks. Another reason might be due to the lack of returns on investment as previously discussed. Tax harmonization can provide a better prospect for Guyana in such instances (given an improvement in social and political conflicts), as intra and inter

²¹ Usually done by way of the ‘race to the bottom’. See for more details on the subject Wibbels and Arce (2003)

²² See CARICOM Secretariat (2000a).

²³ Hugo González Cano. Tax Harmonization in Economic Integration Processes. Washington, D.C.: Organization of American States, 1986

regional investors will find that trade and investment within CARICOM produces the same incentives across the borders.

‘The Agreement for the Avoidance of Double Taxation’²⁴ expressed by the CARICOM Secretariat (2002) is another significant aspect when examining the objectives of tax harmonization. This agreement among CARICOM Member State governments helps to ensure the free movement of capital within CARICOM²⁵ (CARICOM Secretariat 2002). The DTA encourages increased investment within the CSME since it allows consumers and businesses to conduct trading operations unhindered by tariff or non-tariff barriers; hence equivalent conditions are created for local and foreign traders. Article 49e of Protocol III in which the DTA is contained also highlights the fact that Member States should conclude double taxation agreements with third parties through the directives of the Council for Finance and Planning, COFAP²⁶. The DTA applies to taxes on capital, profits and incomes and ensures that tax is deductible from the source of the economic activity (CARICOM Secretariat 2002). Eliminating double taxation within the CSME implies a reduction in taxes on consumers and businesses and further implies an increase in income levels and revenues. A rise in income and revenues enhances the ability for trade and investment within the CSME by (a) encouraging investors to reinvest because it is more profitable and by (b) the region becoming more attractive to the world market.

²⁴ Called CARICOM Double Taxation Agreement (CDTA or just DTA).

²⁵ See Article 49e of Protocol III – Protocol Amending the Treaty Establishing the Caribbean Community; and CARICOM Secretariat (2001c).

²⁶ See Article 49e of Protocol III; and CARICOM Secretariat (2001c)

2.3 Taxation of Investments

Investors generally want to know and understand the tax regime and the manner in which taxes are assessed and paid. Hence, investors usually pay particular attention to the tax rate in a country, complexity of calculating tax returns and they often compare tax arrangements with countries they are familiar (CARICOM Secretariat 2000a). Therefore, an investor will be attracted to invest in a particular market that exhibits equality, efficiency, stability and harmonization. This section will seek to outline some of the elements for tax harmonization discussed by the Caribbean Organization for Tax Administrators (COTA) with emphasis placed on investment incentives and attracting investment.

Below is a concise description of the elements for corporate tax harmonization identified by COTA at their General Assembly and Technical Conference held in Trinidad and Tobago in August 1996. Also incorporated is the draft of a seminar on tax harmonization and DTA.

ARTICLE 1 – Capital Allowances²⁷

The depreciation of some capital assets in a business is designed to reduce the taxation profits of the business and hence reduce its tax liability. Since depreciation provisions are not deductible under taxation practices, capital allowances are provided instead. These allowances are calculated on the estimated useful life of the asset and are usually computed annually for tax purposes. Harmonizing such allowances across CARICOM

²⁷ CARICOM Secretariat. “Harmonization of Corporation Tax Structure among CARICOM Member State. Proposed Articles.” Convening of a Two Day Seminar /Workshop on Tax Harmonization and the CARICOM Double Taxation Agreement (CDTA). Port-of-Spain; CARICOM Secretariat, October 2001.

provides a less complicated means of calculation for businesses and enhances the regional integration process.

ARTICLE 2 – Interest

According to the seminar on tax harmonization and DTA in Trinidad and Tobago “in calculating the chargeable or assessable income of a person for the basis or income year, there shall be allowed as a deduction interest paid or payable on lowlands for the acquisition of capital provided that such capital is used in/for the production of chargeable or assessable income and provide further that where the interest is not paid within two years with respect to arms lengths transactions and one year with respect to non-arms length transactions , the interest shall be added back in the year deduction was taken”²⁸. Article 2 encompasses three ideas:

1. interest expense on ‘Fixed Capital’ – not a deductible expense for taxation purposes.
2. interest expense on ‘Circulating Capital’ – relates to the use of capital employed in the production of income and is a deductible expense.
3. interest expense on ‘Investment Capital’
 - A. interest on capital for a dual purpose, that is, funds required or used for the daily operations of the business – not deductible
 - B. interest in respect of loan funds for economic development deemed for the production of income – deductible²⁹.

²⁸ CARICOM Secretariat. “Harmonization of Corporation Tax Structure among CARICOM Member State. Proposed Articles – Attachment III.” Convening of a Two Day Seminar /Workshop on Tax Harmonization and the CARICOM Double Taxation Agreement (CDTA). Port-of-Spain; CARICOM Secretariat, October 2001.

²⁹ Ibid 8.

ARTICLE 3 – Losses

There is an allowable deduction with respect to losses incurred on the chargeable income from persons who carry on a trade, profession or vocation for the income year³⁰. An allowable deduction also exists for the treatment of losses arising from business activities and for losses carried forward.

ARTICLE 4 – Pensions

Pension schemes in CARICOM provide future incomes to persons and businesses and are therefore essential to the harmonization exercise with regards to direct taxation and an individual's investment options.

ARTICLE 5 – Insurance Premium Tax

It is common for insurance companies within the CARICOM region to record annual losses; however most companies have been able to create substantial wealth in the form of capital invested and real estate development³¹. “In some Caribbean States governments have been able to circumvent the no-tax liability position by the imposition of a tax on gross premiums collected ... [where] tax ranges between three and five percent.”³²

ARTICLE 6 – Minimum Corporation Tax

Due to competition small CARICOM Member States have had low levels of investment and have been forced to examine tax rates and structures in order to attract investors. However, the introduction and implementation of a ceiling or floor on corporate taxes throughout the region from examination is not feasible³³. Hence, CARICOM Member

³⁰ Ibid 9

³¹ CARICOM Secretariat. “Harmonization of Corporate Taxation – Attachment I”. Fourteenth general Assembly and Technical Conference of the Caribbean Organization of Tax Administrators. Port-of-Spain; CARICOM Secretariat, August 1996.

³² Ibid 6

³³ Ibid 5

Countries may adopt individual rates on the gross receipts of a company for each year of income. Trinidad and Tobago, for instance, has adopted a ‘Presumptive Taxation’ calculated at a low rate of turnover to ensure minimum revenue collection.

ARTICLE 7 – Mergers and Splitters Division

This article ensures that given changes to the underlying ownership of a company and where conditions obtain which are consistent with tax avoidance or where the nature of the business has changed, any losses incurred at the time of the change shall not carry forward³⁴.

ARTICLE 8 – Disposal and Acquisition of Assets

The ‘Disposal and Acquisition of Assets’ implies that where following the merger, reconstruction or amalgamation of a company if assets are not acquired by arms length, then the assets have been disposed of or acquired at market value. However if the assets were not disposed of or acquired at arms length, the written down value shall be used.

ARTICLE 9 – Agreements for Extra-Regional Financing with Implications for Withholding Taxes

Studies by Caribbean Tax Administrators have shown that in some Caribbean countries the surplus of liquid cash in the banking sector has associated with it high cost of utilization, which implies that these funds are inaccessible³⁵. As such alternative funds from outside the region have to be sought. The proposed article highlights that where a person makes an interest payment to financial institutions outside of CARICOM they are liable to pay withholding tax (rate not exceeding 20%)³⁶.

³⁴ Ibid 9

³⁵ Ibid 6

³⁶ CARICOM Secretariat. “Harmonization of Corporation Tax Structure among CARICOM Member State. Proposed Articles – Attachment III.” Convening of a Two Day Seminar /Workshop on Tax Harmonization

ARTICLE 10 – Exploration and Research Expenses

The important aspect of this article demonstrates that taxation would not qualify where exploration and research expenses are incurred. This is because the expenses were not incurred in the production of the income but rather before the production of the income. Hence such expenditures will be treated as revenue expenses and would qualify as a deduction in computing the profits of the business when established³⁷.

The Harmonization of Investment Policy in the Caribbean Community is important as it indicates the direction CARICOM intends to take with regards to harmonization tax policies.

and the CARICOM Double Taxation Agreement (CDTA). Port-of-Spain; CARICOM Secretariat, October 2001.

³⁷ CARICOM Secretariat. “Harmonization of Corporate Taxation – Attachment I”. Fourteenth general Assembly and Technical Conference of the Caribbean Organization of Tax Administrators. Port-of-Spain; CARICOM Secretariat, August 1996.

3. INTEGRATION EXPERIENCES - TAXES AND INVESTMENTS

‘Integration Experiences’ explores the integration process of the European and the Andean Community and examines some of the salient tax harmonization issues that define their efforts to harmonize economic policies. The importance of this section will manifest into section 5 where the experiences of the European Union and Andean Community will highlight future expectations in our study of the integration process in CARICOM. The European and Latin American communities were studied because their process of integration depicts similar objectives to that of CARICOM. This will be shown especially in the tax regimes implemented. The European Union experience will be looked at first.

3.1 The European Union Experience

In 1957 six European countries signed the treaty of Rome. The signing of the treaty established the European Economic Community (EEC) or Common Market that sought to abolish tariffs and trade restrictions between member countries. Further integration developed with the Maastricht Treaty of 1991, the result of which was the transformation of the EEC to the EU (for a current list of EU members see Appendix A). The Treaty of Maastricht promoted closer economic and political union through the establishment of a European currency and central bank, and the harmonization of defense, foreign, social and economic policies.

“In recent years, the contribution of tax policy to [the EU] Community objectives has increasingly been linked to the development of Internal Market, to EMU and to closer

economic integration”³⁸. The main concern of the implementation of the EU tax policy objectives is the harmful effects of tax competition, which is becoming inevitable as EU Member States compete for a greater level of international trade and investment with multinational and intra regional corporations. The European Commission believes that harmonizing tax policies must support the “broader EU policy objectives” (European Commission 2000). Regional tax policies should ensure, as with tax harmonization in CARICOM, “that the internal market operates as smoothly as possible, eliminating ... obstacles to consumers and firms benefiting from internal market[s]” (CARICOM Secretariat 2002, p. 25; and European Commission 2000).

Tax harmonization in the EU started with indirect taxation by the harmonization of the Value Added Tax, VAT³⁹ (CARICOM Secretariat 2002; and European Commission 2000). Recently the European Commission decided to put pressure on EU Member States that extensively used tax breaks to favourably influence their internal markets. This ensures the reduction of discriminatory investment incentive policies within the EU that produce distortions in the integration process.

A press release by the European Commission on June 3 2003 states that it has accepted the decision by the European Council for developing three measures to tackle tax competition with regards to investment⁴⁰. The package, which was proposed in October 1997, contains Council Directives “to ensure effective taxation of interest income from cross-border investment savings that is paid to individuals within the EU; a

³⁸ Commission of the European Communities. Tax Policy in the European Union – Priorities for the Years Ahead. Brussels; Commission of the European Communities, 2001. Referred to as the Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee or as COM (2001) 260 Final.

³⁹ For a detailed discussion of the types of taxes within the EU see European Commission (2000).

⁴⁰ See article written by the European Commission ‘Taxation: Commission welcomes adoption of package to curb harmful tax competition’. Brussels, 2003. Press release and report is available at <http://europa.eu.int/rapid/start/> and http://europa.eu.int/comm/taxation_customs/taxation/law/primarolo.htm

Code of Conduct for business taxation; and ... to eliminate withholding taxes on payments on interest and royalties made between associated companies of different [EU] Member States”⁴¹. The three measures are important because the restructured tax systems are more employment friendly and the measures reduce tax revenue losses⁴². What will the effect be on investment from these measures to tackle tax competition? When one examines, for example, the measure aimed at reducing distortions in interest and royalty payments between associated EU Member State companies, it is expected that the Directive should have the effect of reducing problems created in cross-border trading by (1) decreasing the cash flow losses to business and (2) eliminating instances of double taxation. The Directive is to come into force on January 1 2004 and will improve investment along with transnational and regional trade relations within the EU⁴³.

Like CARICOM, the EU does not specifically intend to standardize the existing tax systems of all EU Member States, but rather to make national tax systems congruent with EU objectives. However, the non-standardization of tax systems must ensure that tax systems contribute to a higher efficiency in the factors of production markets, namely in the capital, labour, goods and services markets. The Commission of the European Communities supports this view in stating that tax cuts should be focused on areas where “they have beneficial supply side effects and they be accompanied by reforms to benefit systems in order to increase growth and employment”⁴⁴. A tax system that contributes to higher levels of efficiency produces an increase in the propensity to earn revenues or profits. This is advantageous because the rise in efficiency and earnings inadvertently

⁴¹ Ibid 1. See article from press release for a detailed explanation of the three measures.

⁴² See Wibbels and Arce (2003) for a discussion on tax burden shifting from companies to labour which is beyond the scope of this paper.

⁴³ See Table 3.1.2.

⁴⁴ COM (2001) 260 Final

creates a positive outlook to exiting and potential foreign investors and also to local consumers and businesses. EU members have on the other hand, experienced mixed results from the efforts to harmonize taxes.

A simulation exercise by Gropp and Kostial (2001) was studied. The aim of the exercise was “to assess the impact of harmonizing corporate tax rates” by simulating “FDI flows and revenues for all EU countries, assuming that they harmonized their rates at the EU-wide mean rate [of thirty-five percent] from 1990 onward”⁴⁵ (see Table 3.1.1). The results of the simulation indicate that countries with high tax rates would hope to gain more from harmonizing. Germany moved from -1.12 percent to -0.13 percent, a gain of approximately 1 percent on Gross Domestic Product (GDP) revenue, by reducing its tax rate from 47 percent to 35 percent. This means that Germany expects to improve its net FDI flows by gaining an increase in FDI inflows. Also Italy, which has the smallest revenue elasticity rate in the EU, but the largest corporate tax rate, gained 0.44 percent of GDP in revenue a year on net FDI flows. Conversely, further analysis shows that the country with the smallest tax rates, Ireland (10%), would be the biggest loser based on the simulated harmonization exercise. Ireland is expected to lose approximately 2.44 percent of its GDP revenue annually. It is also important to note that Ireland has the largest revenue elasticity rate in the EU.

In short, the fervent efforts of the EU to introduce harmonizing tax measures is due to the reason that EU governments want to compete in the new global economy, in order to attract foreign and intra EU investments. The progress of the Andean Community also bears similar characteristics in its efforts to harmonize economic policies and will be discussed below.

⁴⁵ See Gropp and Kostial (2001, p.6)

**Table 3.1.1 ~ Simulation Results for FDI Flows and Corporate Tax Ratio for EU Countries:
(percent of annual GDP, 1990 - 1997 average)**

| Countries | Net FDI Flows | | | Revenue Elasticity | Corporate Tax Ratio | | Actual Rate |
|-----------------------|---------------|-------------------------------|----------|--------------------|---------------------|-------------------------------|-------------|
| | Actual | Simulated after Harmonization | Δ | | Actual | Simulated after Harmonization | |
| Austria | 0.09 | -0.17 | -0.26 | 1.59 | 1.60 | 1.49 | 32 |
| Denmark | -0.17 | -0.44 | -0.27 | 1.41 | 1.88 | 2.39 | 36 |
| Finland | -1.12 | -0.25 | +0.87 | 1.53 | 2.08 | 2.26 | 33 |
| France | -0.60 | -0.32 | +0.28 | 1.52 | 1.85 | 1.91 | 34 |
| Germany | -1.12 | -0.13 | +0.99 | 1.43 | 1.45 | 2.15 | 47 |
| Ireland | 1.79 | -0.65 | -2.44 | 1.80 | 2.64 | 1.69 | 10 |
| Italy | -0.31 | 0.13 | +0.44 | 1.02 | 3.92 | 5.21 | 51 |
| Netherlands | -2.35 | -1.59 | +0.76 | 1.42 | 3.62 | 3.68 | 35 |
| Portugal* | 1.26 | - | - | - | 2.59 | - | 40 |
| Spain | 0.96 | -0.07 | -1.03 | 1.46 | 2.23 | 2.23 | 35 |
| Sweden | -0.52 | -1.00 | -0.48 | 1.48 | 2.41 | 2.33 | 30 |
| United Kingdom | -0.47 | -0.65 | -0.18 | 1.33 | 3.15 | 3.29 | 33 |

Source: World Bank; OECD; IMF staff estimates; and Gropp and Kostial (2001).

Δ Change in net FDI flows based on actual and simulated results

* Portugal not included in simulation

3.2 The Andean Community (Latin American Experience)

Previously called the Andean Group/Pact, the Andean Community⁴⁶ (CAN) with a combined population of over 110 million and an annual GDP of US\$281 billion since the 1990s, began with the signing of the Cartagena Agreement in 1969. The original intentions of the Andean Pact were to consider the implementation of a customs union similar to that in the European Union, and a free trade area (FTA). However, over the last three decades, changes to democratic governance and developments in investment and trade liberalization have prompted the transformation of CAN from a closed regional economy based on the import substitution model for development, to one focused on outward-looking integration and open regionalism⁴⁷.

⁴⁶ See Appendix A for a list of institutions and Member States that make up the Andean Community

⁴⁷ See website http://www.americasnet.net/trade_integration/ and <http://www.comunidadandina.org/> for "Integration"

The idea for outward-looking integration policies was expressed at the Eleventh Andean Presidential Council meeting held in Cartagena Colombia on May 27 1999. The meeting assumed a commitment to establish the Andean Common Market by the year 2005, by creating the conditions for the unimpeded movement of goods, services, capital and people in CAN⁴⁸. The smooth operation of the Andean Common Market – as with the CSME discussed above – will rely to a large degree on the success of tax harmonization as well as the ability to attract investment. Tax harmonization will seek to (1) eliminate double taxation and (2) harmonize indirect taxes, particularly the VAT (see Table 3.2.1). The Advisory Council of Treasury Ministers administers these two agendas along with the Presidents of the Member States Central Banks and Economic Planning Officers (Decisions 330 and 338 of the Cartagena Agreement)⁴⁹.

Table 3.2.1 ~ VAT Rates as at 2001 and World Exports in US\$ million for 1999 – 2001.

| Country | VAT (%) | World Exports | | |
|------------------|---------|---------------|-------|-------|
| | | 1999 | 2000 | 2001 |
| Bolivia | 14.95 | 1402 | 1457 | 1322 |
| Colombia | 16 | 11550 | 13126 | 12318 |
| Ecuador | 12 | 4207 | 4822 | 4455 |
| Peru | 18 | 5983 | 6794 | 6854 |
| Venezuela | 16.5 | 20076 | 31400 | 27089 |

Source: CAN website www.comunidadandina.org

Like CARICOM, there exists an agreement for the avoidance of double taxation in CAN (Decision 40 of the Cartagena Agreement). However, DTA is not been enforced and its model is not been followed by CAN Member States. The elimination of sub-

⁴⁸ See website <http://www.comunidadandina.org/ingles/market/market.htm> for “Tax Aspects”

⁴⁹ See website <http://www.comunidadandina.org/ingles/politics/>

regional export subsidies has so far been adopted by CAN⁵⁰. In regard to indirect taxes, Table 3.2.1 illustrates that there exist similar VAT rates within CAN as all rates are between twelve and eighteen percent inclusive. Noticeable also is the percentage sharing of world exports that Venezuela and Colombia maintained in CAN; approximately 74% of all world exports in CAN for the period 1999 – 2001.

Decision 330 and Decision 338 of the Cartagena Agreement prohibit tax subsidies such as exemptions and refunds or deferrals resulting from export activities. In the case of exports the ‘Country of Destination’⁵¹ principle will take effect and indirect taxes are liable in the country where the goods are consumed.

The Heads of State of the five CAN Member Countries issued in December 1989 the Galapagos Declaration, which provided a new strategy for the Andean Member States. They designed, in particular, a mechanism for the creation of CET, bilateral agreements that strengthen trade between the countries in the sub-region and internationally, and the harmonization of economic policies⁵². Venezuela, Ecuador and Colombia implemented a CET on February 1 1995; the tariff structure of Bolivia was already within the specified rates⁵³; and Peru had earlier withdrawn from the sub-regional commitments, citing fundamental differences in economic liberalization policies and unfair competition from CAN Member States such as Venezuela and Colombia but later rejoined in June 1995. The CAN Member States also signed agreements that provided guarantees to international investment⁵⁴.

⁵⁰ Ibid 1

⁵¹ See Cano (1986)

⁵² See website http://www.americasnet.net/trade_integration/ for “Andean Community”

⁵³ Ibid 3. Rates were 0%, 5%, 10%, 15% and 20%.

⁵⁴ Ibid 3.

A Common Market for capital means the deregulation of individual and business entities investment options and operations, to correct for distortions in competition. Investment operations to include (a) the free movement of people's capital, (b) sub-regional access to commercial credit, (c) the purchasing of bonds and securities on the stock markets of CAN Member Countries, (d) opening of accounts in CAN Member Countries, and (e) transfers from trade in services⁵⁵. Hence, CAN rules encourage new technologies by eliminating barriers to entry for investment; granting foreign capital the same treatment as national investments. Decisions 291 and 292 reflect the provisions in the Cartagena Agreement for investment⁵⁶. Multinational enterprises under Decision 292 enjoy national treatment to the right to (1) transfer dividends for distribution abroad in freely convertible currency, (2) transfer capital abroad, (3) matters relating to taxes such as tax equality in regard to domestic taxes, provisions for the avoidance of double taxation and (4) the right to open branches in CAN Members States⁵⁷.

The combined effects of harmonizing taxes and capital liberalization have developed great optimism within the CAN Member States. This is because the free movement of capital and an increase in FDI offer to CAN economies new technologies, the opening up of new export markets and increased technical skills to stimulate growth and development. The energy, oil and mining sectors play a pivotal role in the economies of the CAN Member States. This role was evident from the fact that during 1991 – 1997 the amount of FDI that entered CAN doubled twice⁵⁸ (see Table 3.2.2).

⁵⁵ See website <http://www.comunidadandina.org/ingles/market/market.htm> for “Common Market”

⁵⁶ Decision 291 of the Cartagena Agreement – ‘Regime for the Common Treatment of Foreign Capital and Trademarks, Patents, Licensing Agreements and Royalties’, contains the definition for FDI and classification of investors; and Decision 292 regulates the case of Andean multinational enterprises.

⁵⁷ See website www.comunidadandina.org/politics/

⁵⁸ See CAN website for the Secretary General's speech “FDI in the Andean Community 1990 – 1997” (October 20 1998). <http://www.comunidadandina.org>

Table 3.2.2 ~ CAN FDI Inflows, US\$ billion; 1985 – 2002

| | 1985 – 1995 (Average) | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|------------|--------------------------|-------------|--------------|--------------|-------------|-------------|-------------|-------------|
| Bolivia | 0.01 | 0.47 | 0.73 | 0.950 | 1.01 | 0.73 | 0.66 | 0.61 |
| Colombia | 0.4 | 3.11 | 5.56 | 2.83 | 1.47 | 2.28 | 2.33 | 1.95 |
| Ecuador | 0.2 | 0.50 | 0.72 | 0.87 | 0.65 | 0.72 | 1.33 | 1.33 |
| Peru | 0.6 | 3.47 | 2.14 | 1.64 | 1.94 | 0.66 | 1.06 | 1.94 |
| Venezuela | 0.5 | 2.18 | 5.54 | 4.50 | 3.29 | 4.47 | 3.44 | 1.39 |
| CAN | 1.71 | 9.74 | 14.69 | 10.79 | 8.36 | 8.85 | 8.83 | 7.23 |

Source: UNCTAD, World Investment Report 2000 and CAN website <http://www.comunidadandina.org>

The main contributors were the EU area, MERCOSUR Member Countries⁵⁹, East Asia – namely Japan – and the United States. Venezuela and Colombia were the major recipients of inflows with a little less than two third of the total FDI to the Community⁶⁰. Gil (2001) explains that Venezuelan and Colombian economies were better able to expand because they increased their level of privatization, successfully implemented the CET and made more use of the FTA that CAN created. In other words, Venezuela and Colombia had tax structures that exhibited less discrimination in external and internal taxes, and increased the liberalization of their goods and capital markets. Table 3.2.1 demonstrated that not only are they the largest producer in CAN but that they maintain similar tax rates; Venezuela and Colombia has VAT rates of 16.5% and 16% respectively.

In summary, the success of CAN Member States required these states concentrating on the operations of an open market, the establishment of a CET and implementing similar VAT rates. These elements along with the prospect of a larger market space through regional integration have aided CAN Member Countries

⁵⁹ For further details on MERCUSOR see Appendix A and website www.americasnet.net for topic “trade and integration”.

⁶⁰ See website <http://lanic.utexas.edu/> for Julio Cesar Gil. Ed 62. “The FTAA, A Step Further in the Consolidation of the Andean Community.” *The FTAA: Opportunities and Risks* (2001).

tremendously and the introduction of a Free Trade Area of the Americas (FTAA) will only extend current investment advancements and further the integration of CAN.

4. EXPECTATIONS FOR AND EFFECTS ON INVESTMENT IN CARICOM

Some of the many challenges that CARICOM and the CSME experience include the ability to achieve sustained income growth for their economies by raising investment rates, becoming more competitive in world markets given the small size of their economies and importantly, succeeding with objectives to integrate into a Common Market. This section will attempt to establish future investment trends to be expected based on past and ongoing regional integration efforts being pursued in CARICOM, the EU and CAN. The ideas in this section will focus on the effects of tax harmonization on future investment decisions and earnings. The effect on investment will further help to highlight whether CARICOM and the CSME will benefit from having a coordinated tax structure and rate.

As Table 2.1.1 and Figure 2.1.1 showed, the OECS have been experiencing increasing trends in the volume of FDI inflows to the region. However, FDI has been increasing at a decreasing rate. Examining the periods for which continuing increases existed for the OECS (1996 – 1999), the rates by which FDI increased are as follows in Table 4.1.1 below;

Table 4.1.1 ~ Change in OECS FDI inflows, 1996 – 1999

| | 1996 – 1997 | 1997 – 1998 | 1998 – 1999 |
|----------------|--------------------|--------------------|--------------------|
| Change* | +US\$69M | +US\$50M | +US\$25M |
| | = +61.06% | = +27.47% | = +10.78% |

Source: Based on Data from Table 3.1.1

* Change is calculated from the value at end of first year minus value at end of second year of the specified period.

On the other hand, this information alone will not suffice to make a decision as to whether or not investments will ultimately begin to decrease. However, Table 4.1.1 can be used to establish a base for understanding the possible future development of FDI in OECS. In addition, consider the descriptive indicators of the average tax rates in CARICOM (see Table 4.1.2). Observing the average tax rates we realize that the OECS, only second to Belize, has one of the lowest average tax rates amongst CARICOM Member States.

Table 4.1.2 ~ Average Rate of Taxation (Total Tax/GDP ratio): 1980 - 1997

| | Barbados | Belize | Guyana | Jamaica | OECS | Trinidad and Tobago |
|---------------------------|----------|---------|---------|---------|---------|---------------------|
| Mean | 27.4500 | 24.7202 | 38.1556 | 30.7863 | 24.8086 | 31.6695 |
| Median | 26.7457 | 24.9828 | 37.7885 | 30.9448 | 24.7998 | 29.0783 |
| Maximum | 32.5905 | 26.4609 | 46.0315 | 35.1452 | 25.7966 | 44.0005 |
| Minimum | 23.4506 | 22.3525 | 31.4453 | 25.4363 | 23.9727 | 24.8811 |
| Standard deviation | 2.9650 | 1.2397 | 3.8854 | 2.7442 | 0.5687 | 5.6777 |
| Skewness | 0.1743 | -0.2530 | 0.02867 | -0.219 | 0.2445 | 0.9606 |
| Observations | 18 | 18 | 18 | 13 | 14 | 18 |

Source: ECCB, IMF Staff estimates, CARICOM Secretariat (2002)

In making a comparison to the simulation exercise that was done by Gropp and Kostial (2001) for EU Member States, it should be expected that if tax harmonization is to be implemented then the effect it will have on the OECS and other CARICOM Member Countries would depend on

1. the tax rate to be introduced and
2. the price or income elasticity of the items that the tax will affect.

One reason for the importance of considering the EU simulation exercise comes from the Fourteenth General Assembly of COTA held in Trinidad and Tobago on August 1996. The conclusion of the Assembly identified corporate taxation as the primary area of taxation that was likely to impact on the establishment and operations of the CSME. Harmonizing corporate taxes reflect homogeneity of practices in business tax policies. Corporate tax harmonization also provides for entrepreneurs who conduct businesses in more than one CARICOM Member State one methodology in reviewing business operations⁶¹.

Tax Rate - If the tax rate is set for a higher value than the OECS average, for instance 30% (see Table 4.1.3), then it is highly possible, based on macroeconomic theory and the experience of the EU, that the OECS will expect a fall in GDP revenues due to a decrease in net FDI flows.

Table 4.1.3 ~ Tariff Reduction Schedule for CARICOM Member States

| Period of Application | Period Allowed to Effect Implementation | Rate Structure (%) | |
|--------------------------|--|--------------------|-------------------|
| | | MDC ⁶² | LDC ⁶³ |
| 1 Jan 1993 – 31 Dec 1994 | 1 Jan 1993 to 30 June 1993 | 5-30/35 | 0-5 to 0/35 |

⁶¹ CARICOM Secretariat. "Harmonization of Corporate Taxation". Fourteenth General Assembly and Technical Conference of the Caribbean Organization of Tax Administrators. Port-au-Spain, Trinidad: CARICOM Secretariat, August 1996.

⁶² MDCs here refer to the more developed countries of CARICOM and include Barbados, Guyana, Jamaica, and Trinidad and Tobago; the opposite being less developed countries (LDCs).

⁶³ Belize and the ECCB area

| | | | |
|--------------------------|----------------------------|---------|-------------|
| 1 Jan 1995 – 31 Dec 1996 | 1 Jan 1995 to 30 June 1995 | 5-25/30 | 0-5 to 5/30 |
| 1 Jan 1997 – 31 Dec 1997 | 1 Jan 1997 to 30 June 1997 | 5-20/25 | 0-5 to 0/25 |
| 1 Jan 1998 onwards | 1 Jan 1998 to 30 June 1998 | 5-20 | 0-5 to 20 |

Source: CARICOM Secretariat (2001b)

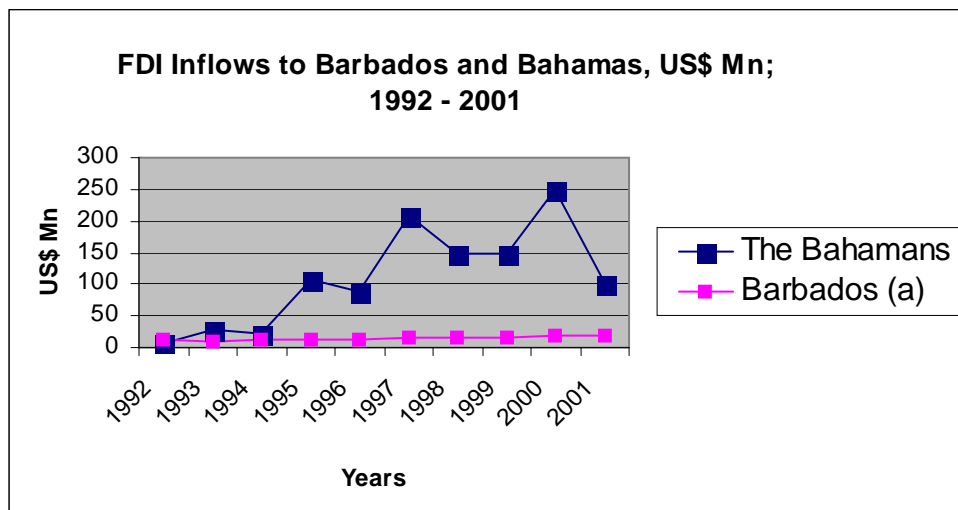
This decrease in flow balances resulted from an increase in the average tax rate (from 24.5 – 30 percent) of the OECS. Hence, an increased tax rate causes an increase in ‘capital flight’ and a decrease in earnings for business entities thus creating a reduction in the ability of industries to expand. A decline in revenue perpetuates lower savings and results in a reduced level of reinvestment because other investment options and location become more viable. Assuming ‘ceteris paribus’ the converse is also true, that is, if the tax rate was set below the average rate then we would expect an increase in net FDI flows as a percentage to GDP to the ECCB area. Moreover, these observations and analysis would hold for other CARICOM countries.

Like Venezuela and Colombia in CAN, or the Netherlands and the United Kingdom in the EU, Jamaica and Trinidad and Tobago are the main recipients of investments in CARICOM. However, Trinidad and Tobago has the highest level of fluctuation with regards to the average tax rates – being more than 5 standard deviations away from the mean. This may imply that a better-structured tax system may result in Trinidad and Tobago becoming a stronger economic force in CARICOM and the upcoming CSME. Examining Belize, a decrease in the tax rate – all things being equal – would suggest that Belize becomes the least affected Member State receiving just moderate reductions in government revenues; especially since the standard deviation value of Belize is just over one indicating that Belize has one of the most stable average rates of taxation. FDI inflows into Belize would rise as lower rates imply that Belize is more attractive to both intra and extra regional trade and investment operations.

In the case of Jamaica and Guyana with maximum tax rates of 35% and 46% respectively, any fall in tax rates would result in significant losses for government revenue collections. Significant losses will especially be evident in Guyana due to the existence of a volatile market place and an already poor FDI status, as Table 2.1.1 illustrated. The periods 1992 – 2001 for Barbados revealed fairly stable FDI flows however, their average taxation rate over the last two decades was 27 percent and a standard deviation of three implies some amount of fluctuation in the general level of taxes.

Elasticity - A study done by Peters (2002) illustrates the importance of tax buoyancy. The tax buoyancy coefficient (see Table 4.1.4 for details) assists in showing the responsiveness of tax revenues to changes in income or GDP.

Figure 4.1.1



Source: Based on Data from Table 2.1.1

Table 4.1.4 ~ Tax Buoyancy in Selected CARICOM Countries

| | BAR* | DMA [#] | GDA [#] | GUY* | JAM* | SKN [#] | T&T* |
|--------------------------------|-------------|------------------|------------------|------------|------------|------------------|------------|
| Direct Taxes | -0.9 | 4.6 | 11.5 | 1.4 | 0.9 | 1.1 | 0.9 |
| Taxes on: | | | | | | | |
| Income, Profits, Capital Gains | -0.8 | 3.5 | -0.5 | 1.4 | 0.9 | 1.1 | 0.9 |
| Property | 0.3 | --- | --- | 1.9 | 1.2 | --- | 1.4 |

| Indirect Taxes | 1.0 | 2.2 | 0.5 | 1.2 | 1.1 | 0.8 | 1.3 |
|----------------------------------|------------|------------|------------|------------|------------|------------|------------|
| Taxes on: | | | | | | | |
| International Trade and Transctn | 2.5 | 1.4 | 0.6 | 1.1 | 1.2 | 0.7 | 0.9 |
| Domestic Goods and Services | -0.4 | 5.2 | 0.6 | 1.3 | 1.0 | 1.2 | 1.5 |
| Total Tax Revenue | 0.1 | 3.0 | 0.7 | 1.3 | 1.0 | 0.9 | 1.0 |

Source: ECCB

Note: BAR – Barbados, DMA – Dominica, GDA – Grenada, GUY – Guyana, JAM – Jamaica, SKN – St. Kitts and Nevis, T&T – Trinidad and Tobago, Transctn - Transaction.

* The period 1991 – 1996 was used to derive an average.

The year 1997 was used.

--- Data was not available

The tax buoyancy rate will be used as a measure to determining future tax revenues⁶⁴. For instance, given that Dominica intends to pursue a policy that changes the structure of direct tax policies, the government should consider that the tax buoyancy coefficient is greater than one (elastic) and hence tax revenue is responsive to changes in GDP or income. These changes will further affect savings and the environment for attracting intra and inter regional investments to Dominica, all things remaining constant.

Grenada has the largest tax buoyancy coefficient for direct taxes with 11.5 and the lowest tax buoyancy of 0.5 for indirect tax revenues. Therefore the responsiveness of direct tax revenues to income is highest in Grenada when compared to the rest of CARICOM and direct tax revenue changes proportionately faster than economic activities in other Member States. However, indirect tax revenues are inelastic in Grenada and hence not very responsive to changes in the GDP of the country. Jamaica, St. Kitts and Nevis and Trinidad and Tobago have a tax buoyancy coefficient approximately equal to one for total tax revenues, which implies that revenues from taxes change proportionately to changes in income and GDP. Barbados recorded the lowest tax

⁶⁴ Some econometric forecasting techniques, theories from macroeconomics and trade policies recommend the use of analysis that involves calculations from expectations.

buoyancy for total tax revenue with 0.1 due mainly to negative buoyancies in consumption tax, airport services tax, employment levies and health services levies (ECCB 1999a). Hence, the varying results indicate that for tax harmonization to be successful and regional integration to have a meaningful effect, great consideration will have to be given to the tax revenue sources of CARICOM Member countries and how decreased government revenues from decreased tax rates will affect future policy decisions.

5. RECOMMENDATIONS

This section contains a concise list of alternatives and ideas to be considered for the progress of the regional integration process being pursued by CARICOM. The thoughts and ideas herein are compiled from a variety of sources combined with the

author's appreciation of the efforts by CARICOM to achieve greater competitiveness in world markets through the process transforming CARICOM to the CSME. The following should be considered for implementation or for further development to ensure compatibility with the objectives of CARICOM.

- In collaboration with the findings of Peat Marwick (1985), if decisions on taxation, investment and trade policies are to be effective then CARICOM Member Countries and Associate Members will have to vastly improve their information bases.
- Research needs to be undertaken by the CARICOM Secretariat to establish the effects on individuals and labour by the movement of tax bands. Research in this area is important as movement in tax floors and ceilings affects domestic investment of both individuals and businesses (Peat Marwick 1985).
- CARICOM Member States need to pay closer attention to establishing more non-discriminatory policies such as the reduction or complete elimination of tax holidays. This will enhance the tax structure and improve the integration process of CARICOM.
- The harmonization and convergence of macroeconomic policies needs to be treated with great urgency to maintain fiscal discipline in CARICOM. Particular attention should be given by the CARICOM Secretariat for the creation of policies to establishing a schedule or target for the payment of external and internal debt as a percentage of Member State GDP. Attention to this matter is important because debt payment strongly influences interest rates and tax structures and rates, as governments endeavor to find ways of increasing revenue.

- The CARICOM Secretariat needs to create a *Council for Tax Harmonization, Investment and Trade (COTHIT)* and a *TAX Harmonization, Investment and Trade Unit (THIT)*
 - A Council and Unit should be established within CARICOM to concentrate specifically on the effects that harmonizing tax structures and tax rates have on trade and investment. This will aid in the facilitation of the transformation to the CSME.
 - The Council and Unit should develop links within every Member State, especially with regional statistical institutions and information services, in order to coordinate with the local authorities and official government or executive bodies.
 - The Council and Unit should play an active role in the decision making process of the Regional Tax Policy and Administrative Unit, COFAP, COTED and other applicable bodies of CARICOM. The Unit should be an integrated part of the aforementioned Tax Unit and have the ability to coordinate with the Council in the preparation of periodicals, complete with research analysis, on the progress of its studies exclusively on investment, trade and the tax structures and rates of Member States.
 - COTHIT should work closely with COFAP in carrying out research with respect to Chapter Four “Policies for Sectoral Development” (Articles 68, 69, 70, and 72), Chapter Five “Trade Policy” and any other sections of the Revised Treaty of Chaguaramas Establishing the Caribbean Community Including the CARICOM Single Market and Community which the Council sees fit.

6. CONCLUSION

In the EU and CAN policymakers are facing numerous challenges from liberalization especially, the increase in cross-border mobility of capital. The regional integration process in CARICOM, in preparation for the transformation to the CSME, is no different. The market place for investments into CARICOM has also become

threatened by increased competitiveness from other regions. However, a more regionally integrated group of countries built on the foundations of a 'balanced tax system' have the ability to become attractive to investors⁶⁵. Hence, this reflects the importance of the need for a tax harmonization framework.

A decrease in tax rates and increased capital mobility means a higher net return to investors along with increased attractiveness and would reduce incentives for evasion and corruption. Increase in attractiveness will encourage inter regional and intra regional trade and investment opportunities by reducing risk and uncertainty. Increased factor mobility generates an efficient economy built on decisions made by market forces. In short, for the development of the regional integration process obstacles will have to be eliminated in all Member States that prevents the occurrence of complete unification.

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APPENDIX A

International Organizations

Andean Community (CAN) ►

Bolivia, Colombia, Ecuador, Peru and Venezuela

Andean Community is made up of sovereign States that are presently members and by the institutions of the Andean System of Integration (SAI) composed of the Andean Presidential Council, the Council of Ministers of Foreign Affairs, The Andean Community Commission, the General Secretariat of the Andean Community, the Tribunal of Justice, the Andean Parliament, the Andean Promotion Fund, the Advisory Business Council, the Advisory Labor Council, the Latin American Reserve Fund, the Simon Rodriguez Agreement, the Simon Bolivar Andean University and the Advisory Council's established by the Commission.

Associate Members of CARICOM ►

Current members are Anguilla, British Virgin Islands, Turks and Caicos Islands and Cayman.

CARICOM ►

Members include the Bahamas (a part of the Community only), Barbados, Belize, Guyana, Haiti, Jamaica, OECS countries, Suriname and Trinidad and Tobago.

EU ►

Treaty of Rome 1957: Formed the European Economic Community or Common Market (EEC) – Members at time of signing included Belgium France, the Federal Republic of Germany, Italy, Luxembourg and the Netherlands.

Maastricht Treaty 1991: Transformation to European Union (EU) – Austria, Belgium, Denmark, Federal Republic of Germany, Finland, France, Greece, Italy, Ireland, Luxembourg, Portugal, Spain, Sweden, The Netherlands and United Kingdom are currently the Member Countries.

MERCOSUR ►

Member States are Argentina, Brazil, Paraguay and Uruguay.

OECS ►

The seven Member Countries are Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines.