**Taxation and Financing the Budget: FY 2017/18**

*The shift towards consumption based taxes represents a game changer in fiscal operations which has the potential to improve tax buoyancy and efficiency and stimulate private sector led growth. However, piece-meal tax reform which does not address these issues runs counter to the central tenets of a good tax system. While the Government has taken steps to address inefficiency in tax collections it has failed to address one of the primary problems with fiscal operations, and that is the bloated public sector. Higher taxation could be the Achilles heel for the five-in-four growth agenda if the fiscal gap observed over the medium-term is filled via this means.*

Minister of Finance and the Public Service Audley Shaw opened the budget debate for the new fiscal administrative year on March 10, 2017 and announced revenue measures amounting to approximately $29 billion (1.7% of GDP) to help finance budgeted expenditure of $715.6 billion. Based on the measures announced, $19.0 billion represents new taxes on corporates and individuals. Of the $19 billion to be collected, $13.5 billion is to go to central government while the remaining amount is to go to the Municipal Councils. The remaining portion of $$11.4 billion will be drawn from the National Housing Trust (NHT).

There is a thrust on the part of the Government of Jamaica (GOJ) to realign the tax system towards consumption based taxes. It is estimated that the informal economy is valued at around 40% of GDP. As a result of this persons and entities on which personal income and corporate taxes are levied pay a disproportionate share of their income as taxes relative to persons and corporates that fall outside the tax net. Consumption taxes capture a broader pool of taxpayers and are much harder to evade and avoid. In Jamaica's case, two of the main consumption taxes are the General Consumption Tax (GCT) (levied on most goods and services) and Special Consumption Tax (SCT) (levied on motor vehicle imports, fuels, alcohol and tobacco based products). These are two of the most efficient tax types - they are levied at source, easy to collect and account for close to 40% of total tax intake.

There are downsides to consumption taxes with the chief one being regressivity whereby lower income earners pay a disproportionately larger share of their income in taxes relative to higher income individuals. In Jamaica's case, the GCT in particular is found to be regressive for the lowest 30% of income earners. However, increases in consumption tax and the resultant impact on this group can be mitigated through transfer payments and/or subsidies. Towards this end the GOJ is using PATH and other social programmes to minimise the impact of increase consumption tax on this group. Increases in bus-fares on public passenger vehicles that may result from higher fuel prices are also likely to be kept at a minimum to help in this regard.

Tax avoidance and evasion negatively impact GOJ finances and therefore brings into sharp focus the need for tax reform to improve tax collection as well as to engender higher real growth in the domestic economy, which will improve tax buoyancy. The shift towards consumption based taxes is supported. Thus we view as positive the new taxes imposed on the basis that they are revenue neutral.

The income tax threshold for workers who pay personal income tax under the P.A.Y.E scheme was increase for the second time in two years to $1.5 million, resulting in a reduction in taxes by approximately $14 billion.

**Table 1: Revenue Measures Announced by the GOJ**

| Central Government Tax Summary | Revenue Yield ($Bn) |
|---|---|
| **Special Consumption Tax:** | |
| Increase Excise on Pure Alcohol | 0.403 |
| increase excise on Tobacco Products | 0.826 |
| Increase in Special SCT on Fuels | 7.459 |
| **General Consumption Tax:** | |
| GCT on Group Health Insurance | 1.884 |
| Reduce the threshold for the application of GCT on the consumption of electricity | 1.498 |
| **Other Taxes** | |
| Increase Motor Vehicle license and Fees by 20% | 0.464 |
| Re-impose Withholding tax on General Insurance Premium paid by Jamaica's Residents to non-residents at rate of 15% | 0.99 |
| **Sub total** | **13.524** |
| **Other Tax and Revenue Measures** | |
| Increase in property tax | 3.9 |
| NHT suppport to central Government | 11.4 |
| | **15.3** |
| **Grand Total** | **28.824** |

Source: Ministry of Finance and JMMBIR

Changes in any tax system will have winners and losers and undoubtedly the tax measures announced will have some adverse consequences, particularly for those persons who earn way below the income tax threshold. It is however satisfying to note that the GOJ is trying to mitigate the impact through expenditure measures. Towards this end $11.5 billion has been allocated to the PATH programme which is $3.7 billion (47.2%) more than the amount paid out last fiscal year. This we believe is net positive as there is a strong correlation between school attendance and performance and the measure is geared towards improving both. A highly educated population bodes well for sustained long-term economic growth and development.

The tax measures will have a one-off impact on inflation that will not be sustained. Following the imposition of similar tax measures last fiscal year, the inflation rate increased on a monthly basis by around 0.2% -0.4% then tapered off. It is our view that the new tax measures will push inflation upward by around 0.8% – 1.5% % in FY 2017-18.

The $11.4 billion drawdown from the NHT is not supported at this time as the money is not being used to improve the physical infrastructure of the country, which is dilapidated. Prior to this the GOJ drew down $44.4 billion or 2.5% GDP from the NHT. It is our view that the money was used in part to prop up the bloated public sector. The Jamaican story is well documented in that for years the sovereign ran high fiscal deficits and accumulated large debt in part due to an excessively large public sector. Given the size of the debt and the number of revenue measures imposed over the last 8 years to plug budget gaps, there is a compelling argument that the country cannot sustain the high public sector wage bill which currently stands close to 10% of GDP.

There is a case for the GOJ to reduce the physical size of the public sector, as wage restraint does not go far or deep enough based on recent history. It simply kicks the can down the road. Thereafter under-paid workers lobby for higher wages, which is likely granted at the end of a political cycle and restarts the process of wage suppression – wage rise over multiple fiscal cycles. The net result of the wage restraint is that large pools of highly skilled and educated workers are leaving the public sector in droves. This is having a negative impact on the delivery of some services, including healthcare. In light of the foregoing and the long-term ramifications it is recommended that the GOJ reduce the size of the public service to help jump start the process of creating fiscal space to improve the remaining public service pay package and maintain sustainable wage dynamics.

**Conclusion**

We recognise that government plays an integral role in most economies around the world, including Jamaica, by providing various goods and services – defence, infrastructure, healthcare etc. The menu of items provided by the government relative to the private sector varies in different countries and is highly correlated to the political philosophy that dominates society. For example, in the United Stated conservatives decry big government and prefer private sector to play the lead role in the economy in the provision of most goods and services while in Western Europe big government is the norm. There are varying arguments for and against big government. The most compelling arguments against big government are the inherent bureaucracy and inefficiencies that it fosters, which retard long-term economic growth and development.

There is a nexus between high taxation and low growth. This is borne out in the Jamaica growth story over the last three decades. Jamaica cannot continue to impose greater taxes on the productive sector and workers and achieve a higher growth rate. Thus the GOJ has to come to terms with reducing the size of the public sector in order to address budgetary short falls, as opposed to draw downs from the NHT and/or the imposition of taxes that are not revenue neutral and do not address the issues of equity, efficiency and simplicity.

While we support the GOJ tax measures we note that there are some kinks with previous tax measures that should be addressed. This includes higher taxation for workers earning above $6.0 million, the asset tax and the skewed taxation on the financial sector. We also note that in the medium-term fiscal framework presented there is a funding gap of around $55 billion (4.7% of GDP). This is concerning, as it begs the question whether the government is prepared to impose new taxes to achieve the debt target. Non-compensatory increase in taxation, if pursued, could be the Achilles heel for the five-in-four growth agenda.

# IMPORTANT DISCLOSURES

**ABSTRACT**—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

**PLEASE NOTE** THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

**UNDERWEIGHT**—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET

**SELL**—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

**HOLD/MARKETWEIGHT**—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

**OVERWEIGHT/BUY**—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB



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