REPORT
OF THE NEW ZEALAND
VALUE ADDED TAX MISSION
TO THE BAHAMAS

6 MAY 2014

Executive summary

As a result of an agreement between Prime Minister Christie and New Zealand Prime Minister Key, Dr Don Brash and Mr John Shewan, both of whom had been closely involved in the introduction of New Zealand's Value-Added Tax in 1985-86, visited The Bahamas in late April 2014. They were asked to outline what had made the introduction of a VAT in New Zealand so successful, and to make observations on the Government's proposal to introduce a VAT in The Bahamas. They had discussions with a wide range of stakeholders in the private sector, and with officials.

The success of the New Zealand VAT regime was very largely due to –

- an extensive education programme, aimed at both the business sector and the wider public, about how a VAT system operates, with that education programme largely driven by respected members of the private sector (though funded by government);
- a government commitment to minimise the compliance costs involved with the new tax, particularly by having virtually no items exempt from the tax (only banking services, life insurance and residential rent were exempt);
- a government commitment to offset the effect on the cost of living (prices rose by some 6% as a result of the 10% VAT, after adjusting for the elimination of a wide range of wholesales taxes) by reducing income taxes and, where low income families were not paying income tax, introducing a form of negative income tax, whereby low income families were fully compensated for the increase in their cost of living caused by the introduction of the tax.

The Mission was concerned at the widespread lack of understanding of how a VAT would operate in The Bahamas, and concerned also at the complexity of the VAT proposal as currently envisaged. This complexity would lead to high compliance costs and potentially extensive abuse of the system.

The Appendix to this report deals with a number of technical matters which would materially improve the proposed legislation, but the key conclusions of the Mission are:

1) There is no realistic chance of successfully introducing a VAT on the original proposed date of July 1, 2014. The Government's current plan is to defer the introduction date until at least October 1, 2014 in order to accommodate the commitment to consider the conclusions of the review commissioned by the private sector, now expected in mid-May. The private sector is certainly not yet in a position to play its part in the implementation of a VAT (the consideration of a payroll tax appears to have impeded progress in considering the details of VAT), and we doubt that they will be ready by October 1. A more realistic date would be January 1, 2015 or even April 1, 2015. Such a deferral would also provide more time for completion of the administrative requirements to administer the VAT. Although the Ministry of Finance Implementation Team could probably cope with an implementation date as early as October 1, they will require more time if there are design and implementation

changes made in response to reaction to the draft legislation when it is tabled. The Government announced its revised timeline for the introduction of VAT on April 29, 2014. The Mission considers that while this deferral should be well received, an open mind should be kept as to whether a still later date might be desirable to maximise the prospects of successful implementation.

2) Moving to a single rate of VAT (other than the zero rate applying to exports of goods and services) with no exemptions beyond financial services and residential rent would enormously reduce the compliance costs for the private sector and the enforcement costs for the public sector, and would therefore have a much less damaging effect on economic growth and employment. This would also permit a potentially large reduction in the single rate of VAT – almost certainly to 10% and quite possibly to below that figure. (The actual rate chosen would, of course, also be influenced by the extent to which the Government proposes to reduce Customs duties and other taxes.) Although the proposed exemption of a wide range of food and other essential goods and services, and the application of a lower rate to tourism, is consistent with the approach adopted in a number of other countries in the region, and indeed globally, the Mission considers this to be a sub-optimal and inefficient solution.
3) While moving to a single rate of VAT with no exemptions beyond financial services and residential rent is highly desirable in terms of minimising compliance costs and enabling a lower rate of tax, it also has potentially significant negative effects on the well-being of low income households. It would therefore be vital that the Government also committed to putting in place appropriate mechanisms to protect low income households, whether by an enhanced coupon programme or by some form of direct cash transfer. The proposed reforms to social assistance in The Bahamas appear to provide a suitable delivery mechanism.
4) It would be highly desirable to establish a small committee, perhaps of three people, all of them well respected in the private sector, funded by Government both to embark on a programme of explaining the proposed VAT to the business community and the wider public, and to bring back to the Government any legitimate concerns which arise in particular industries. The committee would consider the draft educational framework and material prepared to date, recommend changes to the strategy and content, and play a key role in assisting the private sector to be at the forefront of implementation. It would explicitly not be a lobbying agent, pushing for exemptions or special privileges for particular sectors. It could be called the VAT Education Office, VAT Coordination Office or similar.
5) Since it is likely that many small businesses will want to opt into the VAT system even if below the currently proposed threshold for registration (of $100,000), and indeed to encourage them to do so, there would be merit in allowing small businesses to adopt a cash basis (rather than an accruals basis) for their VAT returns. Again, with a single rate of VAT and virtually no exemptions, very small businesses would find doing their VAT returns on a cash basis extremely quick and easy.
6) As currently drafted, the VAT legislation envisages that businesses which pay more VAT on their inputs than they receive VAT on their sales have to carry forward their claim for a refund for three three-monthly periods, and receive the refund only in the

fourth three-monthly period. The Mission was advised that it is intended that refunds be entertained after three months. Even with this change, businesses in a start-up situation, or which make unusually large purchases, whether of capital equipment or of inventory, could be out of pocket for potentially very large sums for several weeks. The cash-flow implications could be very serious for many businesses. In New Zealand, businesses can claim a refund at the end of each reporting period and expect to get a refund within two or three weeks of filing their return. There are provisions for even more immediate refunds where very large capital items are purchased. The Mission felt that provisions for refunds should be considerably improved to avoid the potentially serious costs of what is currently proposed.

7) The provisions in the current draft legislation relating to bad and doubtful debts may need revisiting. The Mission was told that in some sectors, particularly public utilities, there is a very high level of non-payment of accounts. While clearly it would be very desirable to rectify that high level of delinquency, for VAT purposes it may be necessary to allow businesses to claim back VAT collected on "sales" more quickly than currently proposed if in fact receivables turn out to be uncollectable.

Background

Over recent years, there has been a strong increase in the debt of the Government of The Bahamas to a level of almost 60% of GDP, double the level of just seven years ago. Moreover, it appears likely that unless remedial steps are taken, government debt will continue to increase in the years ahead, leading to a serious and unsustainable situation. Both Moody's and Standard and Poor's have The Bahamas' credit rating on a negative outlook. The Government is committed to eliminating the imbalance between its revenue and recurrent expenditure and to placing the level of government debt relative to GDP on a steady downward path to more prudent and sustainable levels.

It is intended to achieve that goal by taking a number of measures:

- Modernising the real property tax system, so that that tax generates a doubling of revenues over the medium-term;
- Reforming the operations of the Customs Department to bring them up to international best practice, featuring an improvement of the infrastructure of Customs electronic submissions, thereby strengthening revenue controls and reducing Customs personnel costs;
- Introducing excise stamps for tobacco products to reduce revenue leakage;
- Establishing a Central Revenue Agency and a Revenue Court to improve the efficiency of revenue administration; and
- Implementing a broad programme of tax reform during the fiscal period starting on July 1, 2014, including the introduction of a Value Added Tax (VAT) that would allow a significant reduction in Customs duties and excise taxes and the elimination of the Hotel Room Occupancy Tax.

In total, this revenue plan of action is expected to increase the revenue yield of the tax system by over 4% of GDP.

In the 1985-87 period, New Zealand undertook a very far-reaching reform of its tax system. Much of that reform is not directly relevant to The Bahamas – involving as it did major changes to both the personal and the corporate income tax regimes – but one vital component of the reform programme involved the introduction of a VAT on 1 October 1986. That VAT is widely regarded internationally as perhaps the best in the world – in the sense that it raised significant revenue at low cost in terms of its economic impact.

As a result of a conversation between Prime Minister Christie and the New Zealand Prime Minister (John Key) at a recent meeting of Commonwealth Heads of Government, Prime Minister Key offered to send two people who had been involved in the introduction of New Zealand's VAT to The Bahamas to share New Zealand's experience, both with government officials and with people in The Bahamian private sector. This offer was accepted by Prime Minister Christie, and as a result Dr Don Brash and Mr John Shewan visited The Bahamas between 22 April and 29 April 2014.

Dr Brash was involved in most aspects of the New Zealand tax reform programme in the eighties, and in particular was the chairman of the Advisory Panel established by the New Zealand Government to receive submissions from the public on the initial White Paper explaining what the Government had in mind in introducing a VAT when that was issued in March 1985.

Mr Shewan has been an accountant in public practice for most of his career, and was for 10 years the Chairman of PwC in New Zealand. He was heavily involved in advising a wide range of clients – insurance companies, banks, manufacturers and charities – about the implications of a VAT at the time that tax was first introduced in New Zealand. He chaired the New Zealand Government Tax Education Office from 1988 to 1998. In 2009 and 2010, he was a member of the Tax Working Group established by the New Zealand Government in association with Victoria University to review New Zealand's whole tax system, and recommend changes where those were thought desirable.

Terms of Reference for the New Zealand Mission

The Bahamian Ministry of Finance asked the New Zealand Mission to orient their activities around two main tracks:

- **Public outreach to key stakeholder groups**, sharing with the Cabinet, Parliamentarians, officials and the public the experience of New Zealand with VAT introduction, in terms of:
  # challenges encountered in respect of public and private sector understanding and acceptance (including any sector-specific issues);
  # strategies (media, documentation, visits, etc.) implemented to address these challenges and their success;

the extent to which the specific VAT policy framework was tailored to garner acceptance;
the anticipated benefits of VAT in the New Zealand context compared to the actual outcomes, in terms of economic effects, fiscal impacts, etc.; and

- **Comments on the Proposed VAT.** Based on discussions with relevant stakeholders, provide observations on the following topics:
  # The Bahamas' VAT framework design;
  # implementation plans for The Bahamas; and
  # the overall state of readiness for VAT.

Meetings with Stakeholders

In endeavouring to deliver on these requests, the Mission met with a wide range of Bahamians – the Chamber of Commerce (including members of the Coalition for Responsible Taxation), The Bahamas Institute of Chartered Accountants, senior executives of the Grand Bahama Port Authority, the Bahamas Hotel and Tourism Association, Cabinet Ministers, officials in the Ministry of Finance, and officials in the Customs Department. In addition, they spoke to, and answered questions from, a large group of trade union leaders, church leaders and business people. They met with a number of journalists and answered questions about why New Zealand had adopted a VAT, and why that VAT was designed in the way it was. The combination of these various meetings gave the Mission a good understanding of the current level of understanding of VAT in The Bahamas, and gave those whom the Mission met some understanding of why New Zealand had made the particular design choices which it had chosen in 1985-86.

New Zealand's Value Added Tax

Not long after it was elected in July 1984, the New Zealand Labour Government announced its intention to introduce a major programme of tax reform. At that time, New Zealand had an apparently steeply progressive personal income tax system, with a top marginal rate of 66% applying at a relatively low level of income; a corporate income tax rate of 48%; very substantial scope for legal tax avoidance, making the personal income tax system much less progressive than it appeared; a wide range of wholesale taxes, varying from 10% to 50%, often imposed for what appeared to be totally capricious reasons; excise taxes on alcohol, tobacco and fuel; and a wide range of Customs duties, imposed more to protect domestic manufacturing industry than to garner revenue.

The Government set out to rationalise this system. They closed off virtually all of the previous avenues for tax avoidance and in exchange reduced the top marginal rate of personal income tax from 66% to 33%, and the corporate income tax rate to 28%. They began a programme to substantially phase out Customs duties. They abolished all wholesale taxes. And they introduced a comprehensive VAT.

The New Zealand Government's Approach to the introduction of a VAT and Core Design Features

The Government's intentions with respect to the VAT were set out in a White Paper issued in March 1985. At the same time, they appointed a three person Advisory Panel to which the public could make submissions about any aspect of the new tax. In order to make it clear that this Advisory Panel would be fully independent of the Government, they appointed Dr Brash to chair the Panel, even though he had been a candidate for the opposition National Party less than four years previously and had never been a government employee. The other two members of the Panel were also from the private sector, one the owner and chief executive of a large retail chain and the other a highly regarded tax lawyer. Submissions were to be received by May 17, 1985 and, despite that relatively short time for submissions, nearly 1500 were received.

The Advisory Panel made a very large number of recommendations for change in the original design of the VAT, many of them technical recommendations with respect to the design of the system. Most of these recommendations were accepted by the Government when it issued the Panel's report with its own reactions to the recommendations on June 21, 1985.

The Government's original proposal had envisaged that there would be a single rate of VAT and that virtually no economic activity would be exempt from it and, despite very large numbers of submissions calling for particular products to be exempt from the tax – food, children's clothing, doctors' bills, school fees, books, and many more – the Panel recommended that the Government retain a single rate with virtually no exemptions.

This decision to have a single rate of VAT and to allow virtually no exemptions – in the end, the Government allowed financial services and residential rent to be exempt, the former because no country has found a satisfactory way to apply a VAT to financial services and the latter because residential rent has, for consumers, many of the same characteristics as servicing a mortgage – made the New Zealand VAT internationally unique. Indeed, the Government decided to call the New Zealand VAT by a different name (a Goods and Services Tax, or GST), to differentiate it in the minds of the public from the value added taxes applied in many other countries.

The reason for having a single rate of VAT and for allowing virtually no exemptions was simple. The Government had been advised that in countries which had implemented a VAT with many exemptions and/or multiple rates the costs incurred by the business community in implementing the tax were very high. The Government was committed to minimising those costs, not only to increase public acceptance of the tax but also to minimise the negative effects which any tax has on economic growth and employment.

With a single rate of VAT and no exemptions, it meant that businesses which were registered for VAT and which were buying inputs from other businesses registered for VAT could calculate the VAT they had collected on sales by simply dividing their total sales by a single

number (11 in the case of the proposed 10% VAT); and could calculate the VAT that they had paid on their inputs – and therefore the amount they were entitled to "claim back" – by simply dividing their total purchases by the same single number. If they had charged more VAT to their customers than they had paid in buying their inputs, they could mail off their cheque (this was before the days of internet banking!) to the revenue authority; and if they had paid more VAT on buying inputs than they had charged in making their sales – either because they were in a loss-making position or had made some large purchase – they could promptly claim a refund from the revenue authority. For many small businesses, doing their VAT return was a 15 minute task.

Most countries have felt unable to have a single rate of VAT with no exemptions because of the political pressures to avoid increasing the cost of "necessities", especially when such increased costs are seen as disadvantaging those on low incomes. But while exempting, say, food from VAT may benefit a low income family by perhaps $20 a week, it may benefit a high income family by perhaps $60 a week. While a low income family will typically spend a higher *proportion* of its income on food, a high income family will typically spend much more in *absolute* terms on food. So exempting food from the VAT would have provided a much larger dollar benefit to a high income family than to a low income family. The New Zealand Government felt that that would be a very inefficient way of helping low income families, as well as greatly increasing the cost of operating the tax. Instead, the Government determined to offset the increased cost of living which resulted from the introduction of the VAT by reducing income taxes where people were paying income taxes, and by introducing a so-called Family Tax Credit – in reality a form of "negative income tax" – to protect the living standards of low income families not liable to pay income tax.

The Government also recognised that exempting goods such as food would not mean there would be no increase in food prices. Businesses making exempt supplies incur cost increases in the form of irrecoverable VAT. Inevitably these roll forward into higher prices.

Near the end of 1985, the Government introduced a Bill to implement a single rate, no exemptions, VAT from October 1, 1986. That Bill incorporated the great majority of the recommendations made by the Advisory Panel. (Originally, it had been intended to introduce the tax on April 1, 1986, but the Government decided that, in the interests of ensuring that both the business community and the wider public were fully ready for the introduction of the new tax, the introduction should be deferred by six months.)

Education Programme

In June 1985, the Government established another three person committee, this one under the chairmanship of Mr Jeff Todd, at that time the senior partner in New Zealand for Price Waterhouse. This committee was charged both with explaining how the new tax would operate to the business community and to the wider public, and with receiving further submissions about technical aspects of the proposed tax. They discharged their educational role by commissioning a range of material designed to explain the new tax in simple terms –

through television and radio commercials, brochures and pamphlets, some of them of general application and some targeted at specific industries. They also received a significant number of inquiries of a technical nature: those which were based on a misunderstanding of the proposed legislation, they dealt with; those which seemed to justify some change in the legislation, they channelled to the relevant officials with a view to considering some change in the proposed legislation. The committee operated for some 15 months before the tax was finally introduced on October 1, 1986, and for some three months after that date (and should probably have operated for longer than that after the introduction of the tax), with a continuing focus on public education and with sorting out any remaining anomalies in the legislation. The Government made a number of minor amendments to legislation in order to deal with those anomalies.

Impact of VAT on the New Zealand Economy

What effect did introducing a VAT have on the New Zealand economy? It is impossible to be precise about that because so many other economic policy changes were taking place at the same time in New Zealand – extensive price controls were scrapped, export subsidies were scrapped, Customs duties were phased out, the income tax regime was radically changed, the exchange rate was floated, the monetary policy regime was substantially modified, and so on. But the general consensus in New Zealand is that the overall changes in the New Zealand tax regime were beneficial for economic growth, that those changes removed the distortions created by the previous wholesale tax regime, and that the compliance costs involved in the VAT regime were (and remain) very low. Certainly, the net effect of introducing a VAT at 10% and scrapping the wholesale tax regime was a one-time increase in the price level of an estimated 6% (estimates range from a little below that figure to a little above) but for those households which were paying income tax that increase in the cost of living was offset by a reduction in income tax, while for low income households the effect was offset by the Family Tax Credit.

There were a number of ancillary benefits of introducing the VAT – most businesses improved their accounting systems and gave greater attention to the management of their receivables. One unexpected benefit was that the revenue authority “discovered” a large number of small businesses which had previously operated in the informal economy, evading all tax obligations. The Government had initially expected some 120,000 businesses to register for the VAT; in the event, 180,000 did. The legislation initially allowed any business with annual revenue of less than NZ$24,000 (now NZ$60,000) to remain unregistered. But small businesses quickly realised that being “outside the net” was actually not an advantage – indeed, it was a positive disadvantage. To begin with, they could not claim back the VAT they had paid when buying inputs to their business, so their costs increased to offset at least part of the pricing advantage they had seen initially by not having to charge VAT on their sales. And they also found that those of their customers who were registered for VAT were disinclined to deal with unregistered businesses, because it considerably complicated their own accounting procedures.

A similar realisation dawned on businesses about the advantages and disadvantages of being exempt from VAT. In 1985-86, Mr Shewan acted for the fire and general insurance industry in New Zealand, and they tasked him with persuading the Government to have that industry made exempt from the VAT. The life insurance industry, being closely akin to other businesses in the financial sector, was exempt from the new tax, and the fire and general insurance companies sought similar "relief". Mr Shewan explained to them that being exempt was the last thing they should be seeking because this would prevent them being able to claim back any of the VAT they had to pay on their inputs.

Subsequent Political and Community Reaction to VAT

In the middle of 1987, some 10 months after the introduction of New Zealand's VAT, there was a general election in New Zealand. The National Party, then in Opposition, campaigned on scrapping VAT and replacing it with a retail sales tax. The National Party lost that election by a bigger margin than it had lost the previous election (in 1984) and, while there were many reasons for that outcome, the pledge to abolish the one-rate-no-exemptions VAT did not have any discernible benefit for the Party.

In 1989, the Labour Government increased the VAT from 10% to 12.5% and it remained at that rate until 2010.

In 2009, the Government (by this time a National Party-led Government) set up a Tax Working Group in association with Victoria University, made up of both private sector tax experts and officials from the Treasury (equivalent to the Bahamian Ministry of Finance) and the revenue authority. Mr Shewan was a member of that Group. The Group was charged with looking at the overall structure of the New Zealand tax system, and with making any suggestions for change that they felt would be of benefit. The Group looked at New Zealand's own experience and made an exhaustive study of the international literature on taxation. They found that there is now a widely accepted view that, while all taxes have some adverse effects on economic growth and employment, there is a clear hierarchy in terms of the damage that different taxes do: the most damaging tax from the point of view of growth and employment is a tax on corporate profits; the second most damaging tax is one on personal income (or a payroll tax, which has many of the same characteristics); the third most damaging tax is a value-added tax; and the least damaging tax is one on real property (not least because it is immovable). Put another way, a VAT is the second least damaging tax of the four main classes of taxation. Accordingly, the Tax Working Group recommended that New Zealand's VAT should be increased and some of its income taxes should be reduced, and in 2010 the Government did exactly that, reducing income taxes and increasing the VAT to 15%.

In 2011, the Labour Party, in Opposition at that time, proposed that, if elected, they would remove VAT from fresh fruit and vegetables. The Party did not get elected, and has since dropped that policy.

There is now a very widespread acceptance of the VAT as a low-cost, efficient, tax and one which is relatively difficult to evade. At the moment no political party in New Zealand proposes to change it in any way.

The situation in The Bahamas

Stakeholder Perspectives

The Mission was encouraged to find that, among the leaders of the Bahamian business community, there was a widespread understanding of the need to take measures to improve the country's fiscal position. As in all countries, there was a concern that some government spending was wasteful and inefficient and a belief that improving the quality and reducing the level of government spending should be an important part of the solution to the fiscal problem. There was a strong interest in improved transparency around the fiscal position, and some curiosity expressed about the way in which New Zealand had improved its own fiscal transparency, both through the adoption of General Accepted Accounting Policies in the public sector and through the passage of the Fiscal Responsibility Act in 1994. That legislation mandated a high level of transparency around the fiscal position and can take some credit for New Zealand's fiscal position moving from chronic deficits until that year to ongoing surpluses, from 1994 till 2007.

But there was also an acceptance among most in the business community that there would almost certainly be a need for increased revenue. There was a hope that some of this additional revenue could be sourced from achieving a higher level of compliance with existing taxes, but a recognition on the part of most of those spoken to that some additional tax would nevertheless be needed.

Notwithstanding this agreement, divergent views were evident on what form of additional tax would be best (or least harmful) for The Bahamas. The Coalition for Responsible Taxation has suggested that a payroll tax may be preferable to a VAT, and some other organisations expressed support for examining this alternative. While debate on alternative taxes is healthy, one downside appears to be that it has distracted some in the business community from simultaneously moving forward in discussing the design and mechanics of the VAT. The Mission considers this is one reason why the public and business understanding of VAT is not as advanced as might be expected or desirable.

When the Mission arrived in The Bahamas (on April 22), the official position was still that the new VAT would be implemented on July 1, 2014 at a rate of 15%, though with a large number of exemptions and some offsetting reductions in Customs duties and the Hotel Room Occupancy Tax. The Prime Minister had, however, indicated that he was not likely to introduce the tax at a 15% rate. Internally the implementation timeline had been shifted to October 1, 2014 to accommodate the key inputs into the consultative process. Minister

Halkitis publicly announced this revised timeline on the final day of the Mission's visit (April 29, 2014).

There was a unanimous view among those spoken to by the Mission that a July 1 implementation date was impossible, given that final decisions on a range of issues had not been taken by late April. To be fair to the Government, a key reason for the delay in making final decisions about the shape of the VAT legislation is the Government's commitment to defer final decisions until the recommendations of a study commissioned by the Coalition for Responsible Taxation had been considered, and when the Mission was in The Bahamas that was not expected until the middle of May.

There was also a view – even on the part of those who supported the introduction of a VAT in principle – that the Government was not consulting sufficiently with the business community about some of the practical difficulties in implementing the tax. The Government had established some consultation mechanisms but several people spoken to felt that these were not working effectively. The comment was made that the process had lost momentum, and several parties expressed frustration over the lack of certainty. Again, it may be that this situation will change after the Government is able to make final decisions, following the receipt of the study commissioned by the Coalition for Responsible Taxation.

Although the business community expressed some disappointment over the consultative process, the Mission observed that a reasonable amount of public outreach had occurred since the release of the White Paper on the VAT. The Government established a public/private sector Advisory Committee with representation from a number of sectors – the financial sector, the Institute of Chartered Accountants, the Chamber of Commerce, the churches and trade unions. While some members of the Committee felt that the process had not achieved a great deal, based on feedback from officials from the Ministry of Finance a number of changes to the original draft legislation are to be made in response to the consultative process. These include the adjusted implementation timeline, the shift to VAT-inclusive as opposed to VAT-exclusive pricing in response to concerns over pricing complexities, a deferred payment scheme for VAT on some imports, a flat rate scheme for VAT filing and group registration to eliminate VAT on some Business to Business charges.

Not surprisingly, given the absence of final decisions on the design of the tax and therefore the inability to get underway with any intensive educational programme about how the new tax will work, there was also quite widespread confusion about how the tax would operate. For example, one person in the manufacturing sector expressed serious concern about how the VAT would affect the price of the electricity bought by his business, appearing not to appreciate the fact that the VAT charged on the electricity purchased by his business would be fully refundable through his regular VAT return. A number of others seemed to believe that being exempt from the tax would in some way be to their advantage: as Mr Shewan pointed out at several meetings, VAT is perhaps the single tax which businesses should not want to be exempt from, since it removes their ability to claim back the VAT paid on their

inputs and reduces the willingness of businesses which are included in the VAT net to buy from them.

There also seemed to be some misunderstanding about the effect on consumers of exempting particular products and services from the VAT net. For example, we met people who seemed under the impression that exempting electricity from the VAT would mean there would be no increase in the retail price of electricity. But of course because the company supplying electricity would be incurring VAT on its inputs of fuel, generators, transformers, cables and so on – and would be unable as a company providing an exempt supply to claim a refund of that tax paid – the price of electricity would inevitably rise even if it were to be exempt, albeit not quite to the extent of the VAT itself. It is very important for the public and the business sector to understand that exemption does not equate to zero price impact from VAT.

Design Features of the Proposed Bahamian VAT

The Mission was told that as of late April it was the Government's intention to have three different rates of VAT: a zero rate applying to all goods and services which are exported (as is the international norm, since a VAT is by design a tax on domestic consumption); a relatively low rate for the supply of electricity, potable water, and sewerage services; and the standard rate applying to everything else, except those goods and services which the Government was proposing to exempt from the tax.

As currently drafted, the legislation provides that a very long list of goods and services will be exempt from the VAT. This structure – two different rates, apart from the standard zero rate on exports of goods and services, and a long list of exemptions – hugely increases the compliance costs involved in implementing the tax and opens the way to considerable abuse.

For example, for any retailer selling both VAT-able goods and exempt goods – and most will be selling both – calculating the VAT charged on sales is no longer the simple matter of summing total sales and dividing by a single number. Sales have to be divided into VAT-able and exempt, and the calculation of VAT collected applied only to the first category of sales, of course. That's the easy bit. Much more complicated is the task of determining how much of the VAT paid on inputs can be claimed back. The retailer has to work out which of his inputs are related to VAT-able items (where a refund of the VAT paid can be claimed) and which are related to exempt items (where a refund of the VAT paid cannot be claimed). For some inputs that will be relatively straightforward, but for others – like electricity for lighting and commercial rent – apportioning the inputs will be extremely difficult and time-consuming. As the mix of sales varies, perhaps depending on the season, the proportion of VAT paid on inputs which can be recovered will vary. Compliance costs for the retailer, and indeed enforcement costs for the revenue authority, will rise exponentially.

The Mission was also struck by the potential for abuse in having such a substantial list of exemptions. To take one example: at the moment, it is proposed to exempt vegetables, jams, jellies and fruit juices when "packaged for infant use", and similarly "mineral waters

packaged for infant use". It is not hard to imagine a large increase in the sale of such items, appropriately packaged of course, and a reduction in the sale of items not so packaged.

A further issue with the proposed list of exemptions is the question of where the boundaries should be drawn. For example, under the current list of exemptions fresh fish is fully taxable, but white bread is not. It could be argued that fish is a healthier option.

The Mission acknowledges that the long list of exemptions contemplated in the current draft legislation is not unusual internationally. Numerous VAT systems around the world (including some in the Caribbean) contain exemptions for items such as basic food and health services. Several have split rates, with a lower rate for favoured industries such as tourism. The Mission considers that such systems are seriously sub-optimal. They naturally require VAT to be imposed at a rate higher (sometimes much higher) than would be possible if the base of taxable goods and services was broader, and as a result they are more harmful in terms of the impact on the economy, growth and jobs. Moreover, it is inevitable that exemptions substantially increase compliance and administration costs. Although they are often introduced to achieve social assistance objectives directed at low income households, in dollar terms exemptions in fact benefit high income households most. Countries that have mechanisms to deliver social assistance (and the Mission was encouraged at the reforms The Bahamas is introducing in this area) are therefore much better advised to use targeted mechanisms rather than exemptions to provide appropriate relief. It would be very unfortunate if The Bahamas undermined the efficiency and effectiveness of its VAT system from the start on the basis of social safety net considerations that are more relevant to countries with non-existent or weak social safety net systems.

The New Zealand VAT is considered to be unusual in some quarters for having just three exemptions. It is no coincidence however that the New Zealand system is widely heralded as being one of the best, if not the best, and most efficient VAT systems in the world.

Mission's Conclusions on Design Features, Implementation Plans and State of Readiness

The Mission was asked to provide observations on the proposed design of The Bahamas' VAT and to comment on both implementation plans and the overall state of readiness for the introduction of the VAT.

Based on information provided by the VAT Implementation Team and the Department of Customs, and from our discussions with the Principal of Datatorque, the IT consultancy assisting with the software design process for the VAT, the state of readiness of the parts of the public sector responsible for administering the tax is more advanced than the private sector. The Mission was advised that the design of the Central Revenue Agency is 90% complete, and was provided with about 15 draft guidance notes that have been prepared on various industries and technical issues, such as transition.

The guidance notes are of a reasonable standard. They are brief however, and will most likely require expansion before being released to address questions that the draft legislation is likely to prompt. Further, based on the New Zealand experience considerable kudos and buy-in is likely to be achieved by having these guidance notes reviewed and commented on by one or two key players in industry groups before they are finalised. This would be carried out by the VAT Education Office (or equivalent) recommended in this report.

With regard to systems and other implementation functions, design changes of any substance will take time to incorporate. Recruitment and training are also likely to take considerable time. The Mission considers that deferral of implementation to January 1 or April 1, 2015 would significantly enhance the quality and therefore success of the implementation process.

The Mission reached a number of relatively technical conclusions about design changes which could usefully be made to the VAT as currently proposed in The Bahamas, and these are outlined in the Appendix. But the main conclusions on design, implementation and state of readiness were as follows:

1) There is no realistic chance of successfully introducing a VAT on the originally proposed date of July 1, 2014. The Government's current plan is to defer the introduction date until at least October 1, 2014 to accommodate the commitment to consider the conclusions of the review commissioned by the private sector, now expected in mid-May. The private sector is certainly not yet in a position to play its part in the implementation of such a tax (consideration of a payroll tax appears to have impeded progress in considering the details of VAT), and we doubt that they will be ready in time for October 1, 2014. A more realistic date would be January 1, 2015 or even April 1, 2015. Although the Ministry of Finance Implementation team could probably cope with an implementation date as early as October 1, they will require more time if there are design and implementation changes made in response to reaction to the draft legislation when it is tabled. The Government announced its revised timeline for the implementation of the VAT on April 29, 2014. The Mission considers that while this deferral should be well received, an open mind should be kept to a later date to maximise the prospects of successful implementation.
2) Moving to a single rate of VAT (other than the zero rate applying to exports of goods and services) with no exemptions beyond financial services and residential rent would enormously reduce the compliance costs for the private sector and the enforcement costs for the public sector, and would therefore have a much less damaging effect on economic growth and employment. This would also permit a potentially large reduction in the single rate of VAT – almost certainly to 10% and quite possibly to below that figure. (The actual rate chosen would, of course, also be influenced by the extent to which the Government proposes to reduce Customs duties and other taxes.) Although the proposed exemption of a wide range of food

and other essential goods and services, and the application of a lower rate to tourism, is consistent with the approach adopted in a number of other countries in the region, and globally, the Mission considers this to be a sub-optimal and inefficient solution.

3) While moving to a single rate of VAT with no exemptions beyond financial services and residential rent is highly desirable in terms of minimising compliance costs and enabling a lower rate of tax, it also has potentially significant negative effects on the well-being of low income households. It would therefore be vital that the Government also committed to putting in place appropriate mechanisms to protect low income households, whether by an enhanced coupon programme or by some form of direct cash transfer. The proposed reforms to social assistance in The Bahamas appear to provide a suitable delivery mechanism.
4) It would be highly desirable to establish a small committee, perhaps of three people, all of them well respected in the private sector, funded by Government both to embark on a programme of explaining the proposed VAT to the business community and the wider public, and to bring back to the Government any legitimate concerns which arise in particular industries. The committee would consider the draft educational framework and material prepared to date, recommend changes to the strategy and content, and play a key role in assisting the private sector to be at the forefront of implementation. It would explicitly not be a lobbying agent, pushing for exemptions or special privileges for particular sectors. It could be called the VAT Education Office, VAT Coordination Office or similar. (The Mission met three people who would make excellent members of such a committee – committed to The Bahamas and its future, understanding the logic of a VAT, and highly regarded in the business community – and would be willing to share those names with Government on a confidential basis.)
5) Since it is likely that many small businesses will want to opt into the VAT system even if below the currently proposed threshold for registration (of $100,000), and indeed to encourage them to do so, there would be merit in allowing small businesses to adopt a cash basis (rather than an accruals basis) for their VAT returns. Again, with a single rate of VAT and virtually no exemptions, very small businesses would find doing their VAT returns on a cash basis extremely quick and easy. The Appendix expands on this suggestion.
6) As currently drafted, the VAT legislation envisages that businesses which pay more VAT on their inputs than they receive VAT on their sales have to carry forward their claim for a refund for three three-monthly periods, and receive the refund only in the fourth three-monthly period. The Mission was advised that it is intended that refunds be entertained after three months. Even with this change, businesses in a start-up situation, or which make unusually large purchases, whether of capital equipment or of inventory, could be out of pocket for potentially very large sums for several weeks. The cash-flow implications could be very serious for many businesses. In New Zealand, businesses can claim a refund at the end of each reporting period (one month for large businesses, two months for medium-sized businesses, and six months for very small businesses)

and expect to get a refund within two or three weeks of filing their return. There are administrative arrangements in place to allow for even more immediate refunds where very large capital items are purchased. The Mission felt that provisions for refunds should be considerably improved to avoid the potentially serious costs of what is currently proposed. Again, the Appendix provides additional detail.

7) The provisions in the current draft legislation relating to bad and doubtful debts may need revisiting. The Mission was told that in some sectors, particularly public utilities, there is a very high level of non-payment of accounts. While clearly it would be very desirable to rectify that high level of delinquency, for VAT purposes it may be necessary to allow businesses to claim back VAT collected on "sales" more quickly than currently proposed if in fact receivables turn out to be uncollectable. Possible options are set out in the Appendix.

The Mission wishes to record its thanks for the courtesy shown to it while in The Bahamas, and in particular to Mr John Rolle, Financial Secretary in the Ministry of Finance, and his officials.

Appendix: Technical Issues for Consideration

The Mission undertook a brief comparison of key technical provisions in the draft Bahamian VAT legislation with the equivalent New Zealand provisions. In addition, stakeholders raised a number of technical issues. The summary below sets out matters which might be reviewed to determine if refinements to the draft legislation could streamline the regime and facilitate compliance.

References in this Appendix to the Bill are to the draft Bahamas legislation dated March 6, 2014 (the Value Added Tax Bill, 2014). References to the NZ Act are to the Goods and Services Tax Act 1985 (Goods and Services Tax is the name New Zealand chose to use in place of Value Added Tax, but the two are identical). References to the NZ Act are provided so that the detailed wording can be reviewed should it be decided to consider adopting the New Zealand approach in the particular technical area mentioned.

The NZ Act can be found at www.legislation.govt.nz/1985/act/public/0141/latest/html. Dollar thresholds in the NZ Act have been converted to US dollars.

Return Periods

The Bill provides for two return periods, one month for registrants with annual turnover exceeding $5 million, and three months for those with turnover of less than $5 million. Some stakeholders expressed concern that monthly filing is onerous in compliance terms. The Mission was also advised that a number of businesses are very small, and may find the three monthly return requirement difficult.

It is reasonable to expect larger businesses to file monthly returns. New Zealand requires monthly returns from registrants where turnover exceeds $21 million. Smaller businesses, defined as those with turnover of less than $440,000, have the option to file six monthly returns. All other registrants file returns two monthly. The six monthly option was introduced to accommodate the compliance concerns of small businesses, and is popular.

Payment of VAT – Accruals v Cash Basis

The Bill requires VAT returns to be completed on an accruals basis. This means that supplies that have been made in a return period need to be included in the return (and VAT paid to the VAT Department 21 days following the end of the period) notwithstanding that payment has not been received from the purchaser (and in some cases, particularly involving services, the supply may not have been invoiced).

In New Zealand many small businesses maintain accounts largely on a cash basis. The accruals basis of VAT reporting would have resulted in a significant increase in compliance costs. It would also have caused severe practical problems where it was not possible to estimate accruals accurately at the end of the period (for example, farmers whose produce has

gone to market but the price received has not been finally determined). The New Zealand Government also recognised that the education process required to equip small businesses to comply on an accruals basis would have been very significant and may have heightened concerns over the complexity and compliance costs of VAT. In contrast, if VAT is able to be accounted for on a cash basis the completion of the VAT return is extremely straightforward. The business simply adds up cash received from sales made in the period, deducts cash paid out to suppliers, and multiplies the balance by the VAT fraction (example, 1/11 if the VAT rate is 10%). In New Zealand, small businesses were noticeably more relaxed about the introduction of VAT once they realised that preparation of the VAT return was a simple task.

A further attraction of the cash basis to small businesses is that it avoids the cash flow difficulty that can arise from accounting for VAT on debts that have not been paid by VAT payment date. While this is an issue that affects all businesses, the New Zealand experience suggests that small businesses are more vulnerable to cash flow pressures, and debtors collection procedures tend to be less sophisticated than in larger businesses.

To address these concerns the NZ Act (s. 19 and s.19A) allows suppliers with annual turnover not exceeding $1.75 million to opt to account for VAT on a cash basis. A significant number of small businesses take advantage of this option.

Due Date for Return Filing and Payment of VAT

Under the Bill VAT returns are required to be filed, and any VAT due paid, within 21 days of the end of the return period. Some stakeholders expressed concern that three weeks is insufficient time to complete returns. They also noted that supplies invoiced toward the end of the return period would be unlikely to be paid by the due date for payment of VAT, causing a cash flow strain on the business.

To minimise distortionary effects and compliance costs, the design of a VAT system should strive to ensure that wherever possible the provisions are broadly consistent with normal accounting procedures and commercial practice. In New Zealand a decision was taken to allow four weeks for returns to be prepared and any resulting VAT to be paid. This was considered to be broadly in line with normal commercial procedures. Some businesses complained that while they could file returns within this period, some of the debts included in their returns would not have been paid, and they argued for a later payment date. For audit and compliance reasons policymakers considered it would be inefficient to separate the payment date from the return filing period. Both are 28 days from the end of the return period. Further, it was noted that the cash flow concerns of small businesses would be resolved by them opting into the cash basis of accounting for VAT.

Timing of VAT Refunds

The Bill requires VAT refunds (arising where input tax for a period exceeds output tax) to be carried forward for up to three return periods. If the excess VAT amount has not been able to be used by the end of the third period the taxpayer may file a refund claim. Subject to being satisfied that the refund is valid, the Comptroller of VAT is required to make payment by the

end of the month following the filing of the claim. If an audit of the claim is ordered the refund can be delayed until ten days after the conclusion of the audit.

The Mission was advised that the intent is that refunds for non-zero rated suppliers will be entertained after three months of carry. The nine month carry in the latest draft legislation is a drafting oversight that arose from the introduction of three monthly filing periods.

Several stakeholders expressed concern over delays in refunds. They noted that cash flow is critical, and that a speedy refund mechanism is important if VAT is not to impose a burden.

In design terms it is important that the payment and refund time periods and mechanisms in a VAT system be fair, and be seen to be fair, to both the VAT Department and taxpayers. Because the sums involved are calculated on the basis of flows of gross revenue and gross payments (in contrast to an income tax system that is based on net flows) the amounts involved will often be very significant relative to the net profitability of the operation. For these reasons, in principle VAT due to the VAT Department, and VAT refunds to taxpayers, should be paid as soon as possible following the end of the return period. Against this, from a taxpayer's perspective adequate time is required to prepare and file returns. From a VAT Department perspective adequate time is required to assess the validity of the claim.

In New Zealand the equivalent of the Comptroller of VAT is required to pay VAT refunds not later than 15 working days following receipt of the return (s.46 of the NZ Act). In practice refunds are paid out within 7 to 10 working days. Most returns are filed online, and the system processes the refund automatically on receipt of the return. Online returns are processed and refunds issued faster than paper-based returns. Where Inland Revenue (the VAT-administering department in New Zealand) wishes to investigate a claim further the taxpayer is normally notified, and under the NZ Act the refund must be paid out the next working day after the investigation is complete. The delay is dependent on the time taken by the taxpayer to supply documents in support of the claim and the time Inland Revenue takes to consider them. Except in unusual cases the delay is typically not more than a few days.

In some instances very substantial VAT refunds will arise as a result of the purchase (including by way of import) of a very substantial asset such as building materials, a crane, truck or ship, or significant items of plant or fit-out. In the early stages of the New Zealand VAT regime businesses were concerned over VAT refunds being delayed while sizable claims were audited. These delays extended to months in many cases, and caused significant pressure on business cash flows. Understandably, they also caused tensions to rise. Following discussions between stakeholders such as the Institute of Chartered Accountants and Inland Revenue, administrative procedures were implemented to deal with large refunds. They involve the taxpayer compiling full details in support of the claim ahead of the return period, submitting the claim as soon as possible after the end of the period, Inland Revenue being notified and advised of the circumstances in advance, and an agreed time-frame for the payment of the refund determined. In practice these arrangements, which are purely administrative, have operated well. They have the ancillary advantage of increasing

cooperation and understanding between the government agencies and taxpayers, and providing Inland Revenue with useful information concerning major transactions.

Misunderstanding of VAT Refund Circumstances

For purposes of designing educational material on the VAT, it is appropriate that the Mission draw attention to a misunderstanding around the operation of VAT that seems to be causing some businesses to worry unnecessarily about refunds. Questions raised by several stakeholders indicate that there is a common view that because VAT will be imposed on imports there will be an additional cash cost that will take many months to recover from the VAT Department (indeed, some manufacturers did not appreciate that they would receive any credit or input tax deduction at all for VAT-paid imports).

A profitable business should expect that for most return periods the VAT they collect on supplies will exceed the VAT they pay on their purchases. This means that they will typically be in a net VAT payable position, and will not be waiting on refunds. Businesses such as retailers that sell largely for cash and pay suppliers on invoice should experience a net cash flow benefit from VAT because they are collecting the tax well ahead of the due date for payment to the VAT Department.

Refunds of any size should generally be limited to businesses that –

- have made a major acquisition of a capital asset or very large inventory intake in the return period;
- make zero-rated supplies; or
- are making significant operating losses.

VAT on Bad Debts

A key design issue with a VAT regime is when and how a refund or credit should be allowed for VAT paid on supplies on credit where the debt is unpaid or is only paid in part. The Bill stipulates that a taxpayer may claim an input tax deduction for VAT paid in respect of a taxable supply where the consideration for the supply is subsequently treated in whole or in part as a bad debt. The credit allowed equals the VAT portion of the debt that is written off. However, the credit is not allowable until –

- a minimum of six months has elapsed since the supply took place; and
- the claimant has satisfied the Comptroller of VAT that reasonable efforts have been made to recover the amounts due; and
- the bad debt has been written off in the accounts of the claimant.

Several stakeholders expressed concern that the bad debt provision will cause significant cash flow difficulties. They noted that there are significant delinquent debtor issues in parts of the Bahamian economy. The utilities area, particularly electricity, was mentioned in several different forums.

Based on these comments (which the Mission has not attempted to verify) the level of arrears in debtor payments in The Bahamas appears to be more severe than in New Zealand. However, the issue in principle is the same. The design question is how to accommodate it in a way that is fair to all parties. Consistent with the theme outlined earlier, that VAT accounting should mirror commercial practice wherever possible, solutions include –

- removing the six month restriction (this is not in the NZ Act, which allows a VAT credit when the debt is written off (s.26 of the NZ Act);
- including a special provision that allows an input tax deduction on provisions for doubtful debts in circumstances prescribed in the VAT Regulations; and
- allowing small businesses to account for VAT on a cash or payments basis (as outlined above under the Payment of VAT heading).

The purpose of the doubtful debt provision would be to cater for what seem to be unusual but prevalent practices in The Bahamas around certain supplies, including electricity. The Mission was advised that for accounting purposes overdue debts are retained on the books (so would not qualify for a credit under the bad debt write off provision) so that they can be tracked and pursued. However, for accounting purposes a doubtful debts provision is made at an early stage, often within weeks of the supply being made.

The New Zealand legislation does not include a doubtful debts provision. A VAT credit is allowed at the time the bad debt is written off. There is no six month requirement as is proposed in the Bill. As small businesses can opt to adopt the cash basis of accounting for VAT, they do not have to concern themselves with bad debts (from a VAT perspective).

A doubtful debts provision would be unusual in terms of normal VAT systems, and in designing and implementing it careful consideration would be required to mitigate opportunities for abuse. However, given the severity of the delinquent debtor issue it does seem necessary to accommodate it. The Mission's initial thoughts are that abuse of a doubtful debts allowance could be countered by additional reporting where it is utilised, and a tracking mechanism put in place to monitor the percentage of doubtful debts relative to other suppliers in comparable industries. Further, any payment of a debt subsequent to it having been provided against would trigger a VAT output tax liability, so the Government would not lose out on any VAT revenue in absolute terms. The issue is one of timing.

Duties on Inventory at Commencement Date

Several stakeholders raised concerns over the impact of tariff reductions at the VAT commencement date on the value of inventory on hand. Where Customs duty is reduced to compensate for the VAT, the practical effect is that inventory on hand at the start date reduces in value by an equivalent amount.

When VAT was introduced in New Zealand it replaced a comprehensive system of wholesale sales taxes, which were imposed at rates much higher than the 10% VAT. In response to concerns over the impact of sales tax cuts on inventory on hand the Government introduced a transitional provision (s.83 of the NZ Act) that allowed the sales tax component of inventory

on hand at the start date to be treated as VAT. Under this approach a VAT credit was able to be claimed by the taxpayer in the first VAT return period. There was a degree of controversy around this provision, with some arguing that it was overly generous. The Government's perspective was that the potential commercial cost to licensed wholesalers absent such a provision would have been substantial, and that the provision was warranted to ensure a smooth transition.

Registration Threshold

Some stakeholders suggested the proposed $100,000 VAT registration threshold ($50,000 for operators of hotels, villas and similar, and commercial leases) is too low. An increase would allow more small businesses to avoid the compliance cost associated with VAT.

The registration threshold in New Zealand is $53,000. In practice a number of operators take advantage of the provision that allows them to register voluntarily. They do this to secure the ability to reclaim VAT they pay on their inputs. This is a rational choice, and it is likely that many Bahamian businesses would adopt the same approach. In this context the registration threshold tends not to be a major issue.

Registration of Non-resident Suppliers

The Bahamas is heavily dependent on supplies of goods and services by non-residents. While many non-resident suppliers have no presence at all in The Bahamas, a large number will have some level of presence. This is particularly the case with suppliers of services with personnel on the ground for varying lengths of time.

New Zealand also relies heavily on non-resident suppliers. This was an area of considerable confusion when the VAT was first introduced. There was little guidance on the degree of presence required before a non-resident supplier was either required to register or could register for VAT. In practice many non-resident suppliers with a limited presence in New Zealand did not register initially. However, once the cost increases associated with VAT emerged many decided they should register. Some should not have registered due to their lack of presence in the country, while others that should have registered did so only belatedly. In short, there was a good deal of confusion. The mission draws attention to this issue as –

- the draft Bill and the supporting draft Regulations do not appear to address the issue of the degree of presence required before a non-resident will be considered to be carrying on a taxable activity in the Bahamas;
- at an early stage guidance for non-residents and their Bahamian suppliers will be important if the confusion that arose in New Zealand is to be avoided;
- early consideration should be given to the mechanics of registering non-residents for VAT purposes. One possibility would be to link registrations with work permit applications.

Administrative Fines

The Bill allows the VAT Department to impose fines, which in the case of a company range from $25,000 for a minor offence to $150,000 for a very serious offence. For individuals the range is $12,500 to $50,000. The draft Regulations contain descriptions of how offences will be classified (minor, serious, very serious).

Some concern was expressed by stakeholders at the size of the potential penalties relative to the offence, particularly if the amount of VAT involved is minor. For example, it was suggested that it would seem harsh if a penalty of $50,000 were imposed for non-supply of a VAT invoice within the prescribed time for goods or services having a value of $100. Such a penalty may well be appropriate if the supply is for several million dollars.

The Mission anticipates that the intention is that the VAT Department will have discretion in deciding the level of penalty to be imposed, and will take into account all relevant circumstances before deciding on the quantum. If this is the case it may be helpful if at an early stage in the education process the VAT Department outlines the approach that will be taken in determining the level of fine to be imposed. Comprehensive training of VAT Department staff will be required to ensure discretion is exercised in an even-handed way.

The New Zealand experience with penalties in a VAT context suggests that it is important for taxpayers to be given a degree of leniency in the early stages of the regime provided they have made genuine efforts to comply but have made errors due to a lack of understanding of the rules, systems glitches due to recent software modifications or circumstances that were largely out of their control.

VAT and Incentive Regimes

Several stakeholders expressed concern over the interaction between the VAT and incentive regimes such as the Hotel Encouragement Act and the Industries Encouragement Act, which allow goods to be imported into The Bahamas free of duty. Some expressed the view that supplies that currently fall within these incentive regimes should be exempt or zero-rated. One party commented that a VAT regime is incompatible with such incentive regimes.

We have not reviewed the incentive scheme legislation. However, if its intent is to ensure that goods acquired by eligible business taxpayers should not suffer duty, or taxes akin to duties, there does not appear to be any inconsistency between this objective and the imposition of VAT. VAT paid by a business taxpayer will be available as an input tax deduction, and will, subject to the exemption point noted below, result in no additional tax cost to the purchaser.

An exception to this conclusion arises where goods are imported for the purpose of making exempt supplies. In that situation there may be some irrecoverable VAT, and that might be inconsistent with the incentive regime. However, from the description of eligible industries provided to the Mission, it seems likely that the imports in question will be applied in full in making taxable supplies.

The imposition of VAT will potentially result in cash flow costs that do not currently arise. The same is true for all businesses, but it could be argued that those that are engaged in activities that fall under the incentive regimes should not be exposed to any additional tax or cash flow cost. From a design perspective such issues are best dealt with through the refund mechanism described earlier (thereby eliminating the cash flow drain) rather than introducing exemptions or other mechanisms that complicate the overall VAT regime.

VAT and the Hawksbill Creek Agreement

During the Mission's visit to Grand Bahama a meeting was held with executives from the Grand Bahama Port Authority. They outlined the terms of the Hawksbill Creek Agreement (HCA), and explained in broad terms the workings of the free trade zone.

Issues raised that arise from the HCA and free trade zone include –

- whether all business-to-business supplies made within the zone or imported into the zone by the Port Authority and its licensees should be free of VAT by virtue of the HCA;
- how any relief from VAT that is offered should be incorporated into the Bill;
- how the adverse cash flow consequences of bad debt write-offs in respect of supplies (such as utilities and service charges) to residents can be avoided.

Aside from the question of whether the HCA applies to preclude VAT from being imposed, the first of the above issues is similar to the concerns outlined above in relation to the interaction of VAT and the various industry incentive regimes. A VAT is not inconsistent with the workings of a free trade zone, except in relation to purchases made by a party making exempt supplies. There are cash flow implications, and these can be addressed in the ways described above, with one option being zero-rating. The Mission has received a copy of the chapter from the HCA that refers to duties and taxes. Whether that provision extends to VAT is a legal question which the Mission makes no comment on.

In relation to the second issue above, based on the draft VAT Guidelines the current proposal is to stipulate that the VAT law would not apply in relation to the Hawksbill Creek Port Area where a taxable supply or import within or into the area is made by a taxable person who is a Port licensee to another Port licensee and the goods or services are of a kind and usage referred to in clause 2 of the HCA. If it is decided to leave this special provision in the VAT Guidelines it may be preferable to express such supplies as being zero-rated. The current plan to provide that the law "does not apply" to such supplies could confuse suppliers, and it gives rise to questions around apportionment. It also complicates the legislation.

On the final point above, being the cash flow consequences of paying VAT on what transpire to be bad debts, the earlier comments on how such issues may be addressed apply equally to the Hawksbill Creek Area.

Refunds of VAT to Diplomatic Missions and International Organizations

The Bill provides for refunds to be given for VAT paid or borne on an import by or supply to a diplomatic mission or international organisation and their qualifying staff member in relation to qualifying goods or services (essentially supplies used in carrying out the official business of the mission). While such provisions are not unusual, they are inconsistent with the core design principle that allows VAT credits only where a taxable activity is carried on. The New Zealand regime does not allow refunds to diplomatic missions.

Zero-rating of Professional Services Supplied for Benefit Outside The Bahamas

Consistent with the principle that VAT should not be imposed on goods or services consumed outside of The Bahamas, the services set out in Part II of Schedule Two of the Bill are zero-rated. Clause 9 of the Schedule allows zero-rating of services to the extent that they "are used or the benefit or advantage is obtained" outside The Bahamas.

New Zealand had a similar (but much narrower) provision in its legislation for many years. In practice it was applied in circumstances where, in policy terms, VAT should have been imposed at the standard rate because although there was some benefit obtained offshore, for all practical purposes the services were consumed in New Zealand. An example is legal services supplied in connection with the acquisition of real property situated in New Zealand. The zero-rating provision does not now apply in such circumstances. It is possible that from a policy perspective The Bahamas Government is comfortable that a very wide zero-rating services provision should apply. The comparable New Zealand provision, which may provide some helpful insights, is s.11A of the NZ Act.

Financial Services Exemption

The Bill provides that supplies of financial services other than international financial services or domestic financial services provided for an explicit fee are exempt from VAT. It is normal to exempt most financial services from VAT because it is generally not possible to determine the component of the price (for example, interest on a bank loan) that represents the charge for the service provided. Taxing the full amount of gross interest would significantly over tax the financial services element in the hands of the consumer.

The exemption for banks and other financial institutions means that, except to the extent their services are supplied offshore and are therefore zero-rated, VAT will represent a real cost – i.e. it will fall on the business directly rather than on the consumer. In New Zealand, up to the time when domestic business-to-business zero-rating of banking services was introduced in 2005 the VAT recovery rate was in the order of just 10%. It has now risen to around 40%. The ratio in The Bahamas will depend largely on the level of exported financial services.

An alternative to the exempt treatment of financial services would be to zero-rate them. The basis for doing so would be to relieve financial institutions of the burden of irrecoverable VAT on the basis that this amount will most likely be shifted forward in the form of higher prices charged to households for the consumption of financial services. This treatment would

also reduce compliance costs. However, most countries (including New Zealand) have rejected comprehensive zero-rating on the grounds that –

- it relieves the consumption of financial services from VAT completely, whereas the exemption approach effectively taxes them in part;
- full zero-rating is expensive from a revenue perspective and is inconsistent with the design principle of having the broadest base possible; and
- it is difficult to justify zero-rating one major industry group while not extending this concession to others.

Although the exemption approach is conceptually justifiable in relation to supplies of financial services to end consumers, it is difficult to justify in relation to supplies to taxable businesses. New Zealand addressed this issue comprehensively in 2002, and after significant industry consultation financial services supplied from banks to businesses were zero-rated in 2005. The provision is contained in s.11A(1)(r) of the NZ Act. The Bahamas Government may wish to consider this refinement to the financial services provisions at some future point. The regime is complicated however, and based on the New Zealand experience is best added to an existing regime where there is a reasonable amount of practical experience with the workings of VAT in financial services. Attempting to implement this approach now would be likely to delay implementation of VAT.

General Insurance

The Bill exempts insurance services provided in the course of carrying on an insurance business in or from The Bahamas. A number of VAT systems around the world also exempt insurance, considering it to be part of the broader exemption for financial services. As with banking, the exemption causes VAT to become a cost to insurance businesses, and premiums can be expected to increase to recoup this. To repeat the point made earlier, it is a fallacy to think that prices charged by an exempt supplier will not increase following the introduction of VAT.

Consistent with the core design principle of having as broad a VAT base as possible, with minimal exemptions, New Zealand does not exempt general insurance. The reason is that while it is not possible to separate and value the service or value add component in banking or life insurance, this can be done for general insurance.

New Zealand was the first country to include general insurance in a VAT system (others, such as Australia, have followed), and the decision was at first controversial. This was in part attributable to the mistaken notion that for a business exempt status is "good" and taxable status is "bad". Once the general insurance industry understood that being taxable meant that they could recoup all VAT paid, relative to a recoupment of close to zero if they were exempt, they recognised the commercial benefits of being included. While there was a significant education campaign required, and the actual implementation phase was complex due to the role of reinsurers, agents and other intermediaries, within a couple of years of the October 1986 start date the system had settled down and operated smoothly. There have been no calls to apply exempt status to the industry, and if efforts were made today to change their

status to exempt there would be significant resistance. In contrast, the life insurance industry, which remains exempt, would prefer to be taxable if a workable method could be found to include that industry.

The Mission is not suggesting that general insurance be included in the Bahamian VAT at this point. The time required for design, education and system changes would be significant, and would result in delays to the implementation date. However, the Government may wish to consult with the general insurance industry with a view to bringing general insurance into the VAT within one or two years.

The mechanics of applying VAT to general insurance are more straightforward than might be expected. The normal supply and input tax provisions are followed, with special provisions required to deal with claims payments and recoveries. For reference, these are in s.5(13) and s.20(3)(d) of the NZ Act.

Gambling

The draft Bill exempts games of chance, gambling and lotteries from VAT, presumably on the grounds that these activities are already subject to the gaming tax.

New Zealand does not exempt gambling activities from VAT. Special provisions, s.5(10), s.9(2)(c) and s.10(14) of the NZ Act deem supplies to be made for VAT purposes when amounts are paid to participate in gambling. The practical effect of these provisions is that VAT is imposed on the gross amount bet, less prizes paid out. VAT is payable in addition to casino duty and a problem gambling levy.

The Mission suggests that The Bahamas give consideration to bringing gambling into the VAT. It is difficult to justify exempting gambling if food and essential services are taxable, (one justification may be that the industry is already subject to the gaming tax, but arguments can be made that a consumption tax is justified on top of that). A further advantage of subjecting gambling to VAT is substantial simplification of filing of returns by hotels and other businesses involved in the supply of gambling services.