Structural Adjustment in the Netherlands Antilles - The Need for Broad-based Tax Reform

Speech delivered by Dr. Emsley D. Tromp, President of the Bank van de Nederlandse Antillen on the occasion of the luncheon fundraising of the Female Junior Chamber Curacao
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Ladies and gentlemen, good afternoon,

I join the chairperson in welcoming everyone to this luncheon. I have had the pleasure of speaking here on different occasions, and it is indeed a privilege. Madame chairperson, you asked me to talk about the tax system in the new millennium. I should note at the outset that the topic of taxes cannot be seen in isolation. Taxes are a major source of revenue for the government budget. Therefore, any discussion of taxes has to be carried out in the broader context of overall fiscal policy and its impact on the current economic situation.

Ladies and gentlemen, this is the third time I have been a keynote speaker at a Junior Chamber function. I hope my speech today will enrich your discussion of the likely impact of tax reform on this whole process of economic adjustment.

Madame chairperson, you indicated in your invitation that the objective of the speech is to create an environment conducive to positive change because of the strong need for positive change. I agree with you! However, creating positive change is dependent largely on motivating our young professionals to use their talents to contribute to economic recovery. We must convince them that we are serious in addressing the current crisis and that their help is needed during the restructuring process to create a better place for generations to come.

The current financial-economic crisis is the result of some serious external shocks during the past decade and a half. The combined effect of those external shocks is estimated at approximately 20 to 25% of GDP.

Those shocks eroded government revenues resulting in major imbalances in the public finances. Since we did not go far enough in adjusting expenditures to the lower revenue base, deficits increased rapidly. Those deficits were financed by borrowing. The result has been unsustainably high government debt. The government's growing financing needs reduced the availability of funds for the private sector in the domestic capital market. This "crowding-out" effect resulted in a decline in investments, thereby eroding near-term growth prospects.

It became evident that only a major restructuring of the economy would create a basis for sustainable growth. At the end of 1995, the authorities approached the IMF to help the Netherlands Antilles formulate and implement a structural adjustment program. Since an IMF program is concentrated mainly on restoring financial health, the Inter-American Development Bank was approached in 1997 for proposals to revitalize the economy. In June 1999, this two-tiered approach was consolidated into the comprehensive adjustment program drafted by the National Plan Commission, which I chaired. The recommendations of the IMF, the IADB, and the National Plan Commission focus on a variety of policy areas. These areas include the elimination of fiscal deficits through revenue-enhancing and expenditure-reducing measures, tax reform, pension and health care reform, improving financial management in the public sector, privatization, the liberalization of trade, product and labor markets, and improvement of the business climate.

Considerable progress has been made in a number of areas. The government apparatus has been reduced by approximately 30% through dismissals and the spin-off of government departments into autonomous entities. The wage bill has been contained by a temporary freeze of periodic salary increases and indexation and the elimination of the vacation allowance. The severance pay scheme has been made less generous, while the civil servants' pension system has been partially reformed. These measures have contributed to a substantial reduction of personnel costs. Ladies and gentlemen if in 1986, 68% of all tax revenues of General Government were earmarked for personnel costs, this percentage has declined to 42% in 2001. In addition, subsidies have been reduced steadily. On the revenue side, a shift from direct to indirect taxes has been initiated with the introduction of consumption taxes, the base of which has been gradually broadened. Tax enforcement and collection have been improved, and backlogs have been reduced. Furthermore, user fees for government services have become more widespread. Moreover, the financial administration and reporting in the public sector have been strengthened, and arrears have been regularized.

In the field of structural reform, various measures have been implemented to foster competition and create a more flexible business climate. The labor market legislation has been modernized through the abolishment of the individual dismissal permit, the easier use of part-time and temporary labor, and more freedom in the organization of the workweek, reducing the need for overtime. Concerning product market reform, the authorities have started to phase out the market protection regime by gradually reducing the economic levy, and import bans and exclusive import rights on nonagricultural products have been lifted. Moreover, the authorities are being assisted by the FIAS (Foreign Investment Advisory Services) to develop a plan to improve the investment climate, and by the World Bank to develop a long-term growth strategy.

This overview illustrates that a broad adjustment process has been set in motion. While considerable progress has been achieved, implementation of the measures to support this process has not always been as vigorous as envisaged. Special attention should be given to areas in which progress has been slow, like privatization and health care reform. Another important area of reform is the current tax regime, the topic of my speech today.

Before I elaborate on our tax system and the need for reform, I would like to elaborate on the adjustment process that is underway. I would like to stress that considerable challenges lie ahead, many of them inextricably linked with the recently negotiated IMF program. I am aware that the IMF has been criticized for its obsession on fiscal consolidation. Allow me to elaborate on what I would like to call the “adjustment paradox.” It has been empirically established that the most successful adjustments in terms of sustainable growth are those that emphasize the reduction of expenditures rather than the enhancement of revenues. Yet at the same time, we know that expenditure-reduction measures are characterized by downward rigidity due to social and political constraints. Those constraints often make such measures far less palatable to domestic policymakers.

Given that downward rigidity, inaction leads to increasing fiscal deficits, which have consequences for the investment climate and ultimately for growth and employment. The short-term reaction paradoxically is to look to revenue-enhancing measures to bring the deficit under control. After the deficits have been reduced to amounts that can be financed and progress has been achieved on the expenditure side, the distortionary effects of the increase in taxes will be dealt with. The temporary increases in taxes should then be eliminated or, as in the Netherlands Antilles, the entire tax structure should be revised.

Ladies and gentlemen, the new tax structure we come up with must be a “good” tax structure for the Netherlands Antilles. We need a system under which (i) the distribution of the tax burden is equitable, (ii) interference with the economic system is minimized, (iii) the use of fiscal policy for stabilization and growth objectives is facilitated, (iv) fair and nonarbitrary administration is permitted and understandable to the taxpayer, and (v) the administration and compliance cost is as low as is compatible with the structure’s other objectives.

These and other requirements may be used to appraise the quality of a tax structure. The various objectives are not necessarily compatible, and where they conflict, tradeoffs are needed.

The current tax structure of the Netherlands Antilles has some peculiar characteristics. The economic crisis that has beset our nation during the last decade and a half has led authorities to recur to the introduction, modification, and/or increases of existing taxes. This approach has led to the current tax structure, which is complex and overly dependent on technical assistance to administer. The current tax system discourages investors from investing, workers from working, and the government from governing.

Ladies and gentlemen, while the tax-to-GDP ratio has remained fairly stable internationally during the past decade and a half, this ratio has dropped in the Netherlands Antilles from 39% in 1986 to 28% in 2000. This drop is explained by the sharp drop in tax revenues from the international financial and business services sector as a result of the external shocks alluded to earlier. In 1986, tax revenues from the international financial and business services sector comprised 47% of total tax revenues in the Netherlands Antilles, compared to only 6% in 2000.

However, if we correct for the precipitous drop in tax revenues from the international financial and business services sector, the Antillean tax-to-GDP ratio increased from 21% in 1986 to 27% in 2000. This development also deviates from international trends, indicating that our tax burden has increased. The main explanation for the increase in the tax burden is the introduction of the sales tax (ABB) on Curacao and Bonaire, later replaced by the turnover tax (OB), and the turnover tax (BBO) on the Windward Islands. Our current tax burden (27% in 2000) lies between that of the developed countries (approximately 38% of GDP), and that of the developing countries (approximately 18%).

The composition of our tax structure also is a mix of tax structures typically found in developed and developing countries. Taxes on income and profits have been stable in the Netherlands Antilles during the last 15 years at approximately 13% of GDP. This percentage is about the same as in the developed countries, where this ratio is 14%, compared to 5% in the developing countries. Consumption taxes, defined as the sum of sales and turnover taxes, excises, and import duties, increased in the Netherlands Antilles from 6% of GDP in 1986 to 11% in 2000, reaching the international average. The income-to-consumption tax ratio nearly halved from 1.9 in 1986 to 1.0 in 2000, more in line with the 1.2 ratio in the developed countries than the 0.5 ratio in the developing countries. The decline of this ratio in the Netherlands Antilles reflects a shift from direct to indirect taxes. Another way of expressing this shift is that in 1986, two-thirds of total tax revenues consisted of direct taxes and one-third of indirect taxes, while in 2000 this ratio became approximately fifty-fifty.

Another characteristic of our tax system is its high elasticity. Measured by the "buoyancy coefficient," that is, the responsiveness of tax revenues to changes in the GDP, the elasticity in the Netherlands Antilles amounts to 1.66 for the period 1986-2000. The average of the Eastern Caribbean States amounts to 1.09. The high elasticity in the Netherlands Antilles indicates that tax revenues are rising proportionally much faster than economic activities. This outcome can be attributed to discretionary tax changes, such as the introduction of the sales and turnover taxes, and the increase in import tariffs during this period. The elasticity of taxes on income and profits is 0.96, indicating that tax revenues are rising proportionally to income. However, one would expect an elasticity greater than one, since this tax category has a progressive rate structure. This deviation can be explained by, among other things, exemptions, tax evasion, and backlogs in assessment and collection.

Ladies and gentlemen, it can be concluded that our tax burden has increased significantly and that corporate and personal income taxes are still the largest source of tax revenues for the Netherlands Antilles. Given its complexity, this system is more appropriate for advanced industrial economies than for our small, middle-income economy. This is clearly a major weakness of our present tax system.

As mentioned, the current tax system relies on technical assistance to assess income tax liabilities, and collection costs and evasion are high. In addition, exemptions are numerous and business-reporting standards are not always adequate. Furthermore, our tax system includes numerous small taxes, all of which require an assessment and collection apparatus despite their marginal contribution to total revenues. The structure of import tariffs also is complex with highly detailed descriptions of goods categories, more than 10 basic tariffs, and various economic and other special levies.

The turnover tax still generates less revenue than anticipated due to a lack of control on compliance. If we are to create an environment conducive to sustainable economic growth and durables jobs, we have to reform the current tax system in line with the criteria I outlined above.

The tax reform that I envisage should include a major simplification of our tax structure. In its initial phase, the reform should be budget-neutral because the current weak public finances do not permit a decline in revenues. Once we reach balanced budgets, the second phase of reform should be aimed at lowering the tax burden.

What should be the main features of a reformed tax system? I believe tax reform should be developed along the following six lines:

1. Eliminate the majority of taxes that contribute only marginally to overall tax revenues.
2. Increase reliance on a broad-based consumption tax, preferably with a single rate and minimal exemptions.
3. Import tariffs should have a moderate to low average rate and, most important, limited dispersion of rates.
4. Personal income tax should be characterized by a few brackets with a moderate top marginal rate comparable to the corporate income tax, limited personal exemptions and deductions, an overall exemption limit that excludes persons with modest incomes from paying taxes, and extensive use of final withholding at source.
5. Corporate income tax should be levied at one moderate rate. Provisions, such as depreciation allowances, should be uniform across sectors, and recourse to tax incentive schemes should be minimal.
6. Tax administration should be designed to enhance the accuracy and fairness of assessment, increase the efficiency of collection, and improve taxpayer registration procedures as well as collection enforcement and audit.

Given these main features of tax reform, I shall now try to relate each of them to concrete changes in our tax system.

First, the elimination of taxes that contribute little to total revenues. Currently, 90% of our tax revenues are generated by taxes on income and profits, excises, turnover tax, and import duties. The remaining 10% consist of a large number of small taxes that, in my view, can be reduced substantially to a few taxes administered effectively and efficiently. I will give you a few examples. The motor vehicle tax contributes only 2% to total tax revenues. The collection of this twice-yearly tax entails long queues of taxpayers at the collection offices, and a significant number of vehicle owners pay late or not at all. A much more effective and efficient way to raise revenues for road construction and maintenance would be a special excise built into the price of gasoline. Since every vehicle owner needs gasoline, evasion is ruled out, and the tax burden is closely related to the use of the road network, a more equitable approach. Hotel room tax, car rental tax, and stamp duties each contribute 1% or less to total tax revenues. Abolishing these taxes and compensating the revenue loss in the turnover tax would be an important simplification. Furthermore, numerous activities require licenses for which the government collects a fee. Many of these fees are marginal, and together they contribute only 3% to total tax revenues. Since licenses exist not only to raise revenues but also to exert some control on the licensed activities, simplification could be realized by reducing the number of licenses to a few broad-based licenses.

Second, I mentioned an increased reliance on a broad-based consumption tax. In this area we have already made some progress. A sales tax (ABB) of 6% was introduced on Curacao and Bonaire in July 1996, and it lasted until December 1998. In March 1999, a 2% turnover tax was introduced, the tariff of which was increased to 5% in October 1999. The Windward Islands have had a 3% turnover tax since January 1997, the tariff of which was temporary reduced to 2% from January 1999 through April 2000. The turnover tax now contributes 19% to total tax revenues.

A major drawback of the turnover tax is its cascading effect, which creates uncertainty as to the final tax burden of different goods and services. Therefore, a major reform would be to transition to a general consumption tax comparable to the former ABB, which is levied on the final user of a good or service and imports of individuals. Only one tariff should be applied, and exemptions should be minimal. The tariff should be higher than the current turnover tax rates to compensate for the revenue foregone by the elimination of cascading and some small taxes as I proposed earlier. To reduce its regressive nature, exemptions should be limited in principle to necessities. The proposal that has been drafted for a new sales tax that would eliminate the cascading effects of the current system is a major step in this direction. The replacement of the turnover tax by a general consumption tax should be seen as a stepping-stone to the eventual introduction of a value-added tax (VAT). The VAT is considered the least distorting form of consumption tax, but also the most demanding. It requires not only properly trained tax administrators but also more stringent bookkeeping practices by businesses and the compilation of a comprehensive list of taxpayers. We are not yet ready for the VAT, but should begin planning for a smooth introduction in the near future. Ladies and gentlemen, the objective is to simplify the current tax system. Let us not use this opportunity to introduce new taxes while maintaining the old ones!

Third, our complex system of import duties needs reforming. This reform has two objectives. The first objective is a major simplification aimed at reducing the number of tariffs and replacing the detailed description of a large number of goods categories by a limited number of broad categories. This simplification would contribute to a system much easier for both customs and importers to administer. The result would be faster import procedures. The second objective is to reduce import tariffs as part of an overall program of trade liberalization. A first step has recently been taken with the gradual phasing-out of the economic levies on imported goods with locally manufactured substitutes. The revenue loss associated with this policy could be compensated with an adjustment in the rate of the general consumption tax.

Fourth, our personal income tax, better known as the wage and income tax, is characterized by complex tax tables, many deductions, relatively high tariffs, and large arrears in back levies and refunds. Evasion is especially widespread for the income tax. Presently, a reform package has been sent to Parliament entailing the introduction of tax brackets, a standard tax deduction, and a reduction or elimination of deductible expenses. Although this reform proposal is a step in the right direction, I think the changes should be bolder. For instance, in the new system, six tax brackets will be introduced with tariffs ranging from 15.6% to 57.2%. The new marginal rate is not much lower than the current 60% and is high in an international context. In addition to promoting evasion, a top marginal rate that exceeds the corporate income tax rate by a significant margin creates a distortion that provides strong incentives for taxpayers to choose the corporate form of doing business purely for tax reasons. I propose a tax structure with two brackets, and social insurance premiums could be incorporated in the rates. Initially, the width of the brackets and the corresponding rates should be designed to compensate the gain in revenues from the reduction or elimination of deductible expenses to prevent a higher tax burden. When progress has been made with the restructuring of the public finances, the rate should be no higher than 25 percent.

Fifth, the corporate income tax, better known as the profit tax, has recently undergone a major change. Until 1999, the tax rate ranged from 32% to 39%. With the introduction of the New Fiscal Framework (NFR) and the agreement on the Tax Arrangement of the Kingdom (BRK), an internationally competitive 30% flat rate was introduced. Further reform should focus on tax incentives. While granting tax incentives to promote investments is a common practice around the world, available evidence suggests that their effectiveness in attracting incremental investments is often questionable, and their revenue cost could be high. For foreign investors - the primary target of most tax incentives - the decision to invest in a country would normally depend on a host of factors. A flexible labor market, liberalized trade, a minimum of red tape, well- developed financial, transportation, communication, and other infrastructure facilities, and transparent legal and regulatory systems play a much more important role than incentives. Therefore, I propose a critical review of our current tax-incentives scheme with the aim of arriving at a system with only a few rules-based incentives.

Last, but not least, our reform efforts should focus on creating a strong and well-functioning tax administration. Unfortunately, we are still far away from this goal. Our tax administration is chronically understaffed, and the ill-prepared decentralization is a complicating factor. The restructuring of the tax administration should be finalized as soon as possible, before even considering the various reform proposals that I mentioned. However, a restructuring process also creates challenges. In the new structure, the separation of assessment and collection will be ended, reducing inefficiencies, evasion, and the buildup of arrears. Furthermore, the time is right to modernize the organization along functional lines, to simplify and modernize systems and procedures, and to expand computerization. In addition, greater autonomy should be considered for attracting and developing quality staff resources.

Although a few steps on the road of tax reform have already been taken, much remains to be done. Ladies and gentlemen, to a large extent, economics is the study of getting incentives right. I have tried to place some issues on the political agenda of tax reform to get the incentives in the direction of sustainable growth and durable jobs. Policies intended to create large economic benefits frequently create large social and economic costs. The law of unintended consequences appears when we do not take a comprehensive approach to dealing with the issues. I, therefore, continue to call on our social partners to remain engaged in this process of getting a “good” tax structure.

I hope I have convinced you of the importance of tax reform as part of a total reforms package for our economy. A simplified tax structure with lower rates has many advantages. It is easier to administer by both the taxpayers and the tax administration, saving costs and freeing resources to strengthen audit and enforcement. Lower rates could reduce the incentive for tax evasion, eventually generating more revenues than with the higher rates. Furthermore, tax reform will improve resource allocation and potentially contribute to the achievement of higher rates of sustainable growth over the long term.

I would like to conclude my address with an appeal to you, young Antillean professionals. Our country is in the midst of a major restructuring process, but progress is slow due to capacity constraints. Although we are thankful for the technical assistance from abroad, we need our own people to create a foundation for lasting economic progress. Therefore, I ask you and particularly our professionals abroad to consider actively participating in this process. Your participation includes specifically accepting positions in the government apparatus, where the need for our own professionals is most urgent. Admittedly, the working conditions in the government sector must be improved, and I hope this will be done in the near future—especially for the professionals. It is in the public sector that you can best make a contribution to the current economic situation.