Taxation Patterns in Small Island States

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The various definitions of small states

In this article, a small state is defined as a country with a population of 1.5 million or less. Alternative measures of economic size involve GNP and land area. Each small state is unique and needs to address its development prospects in the context of its own cultural, historical, and social realities.

A report by the Commonwealth Secretariat/ World Bank entitled 'Toward an Outward - Orientated Development Strategy for Small States'[1] (2005) concludes that developing small states do share a number of characteristics that pose special development challenges: they are especially vulnerable to external events, including natural disasters that cause high volatility in national incomes; many of them face an uncertain and difficult economic transition to a changing world trade regime; and they suffer from limited capacity in the public and private sectors.

All states need revenue in order to meet their goals. The appropriate size and role of government is a function of many variables including political ideology, level of economic development, and the size of the state itself. Taxes are the price of civilization. They are fee levied by a government for the services it offers. As is well known taxes maybe imposed directly on income or indirectly on expenditures.

Structures and patterns of taxations are of major relevance in a modern economy. They determine the level of tax burden; hence they affect both the welfare of the country and also its economic performance. In addition taxation effects efficiency in terms of economic performance and has also repercussions on equity in terms of distribution of income. Taxation reduces the level of disposable income, redistributes income, affects prices, reduces the ability to save, and may affect effort and enterprise. Besides, governments often use taxation as an instrument of its fiscal and budgetary policy to control fluctuations in the level of aggregate demand.

Taxes and small states

Small island states have particular characteristics in terms of taxation. They tend to have a very open economy, and a relatively large government owing to the fact that certain functions cannot be downscaled in proportion to the population.

The design of sensible tax policies for small economies requires that careful attention be paid to their international ramifications, i.e. their openness. This is a potentially daunting prospect, since the analysis of tax design in small open economies entails all of the complications and intricacies that appear in larger economies, with the addition of many others, given their high dependence on exports and imports.

Taxation patterns

The taxation patterns and structures can be described as the different forms of taxes applied. The taxes were not made in one day but were a process which took many years and in turn were affected by several different variables such as political ideology and the level of development of the economy concerned. This means that different states have different taxation patterns. Analysing the different taxation patterns of a number of economies may capture a trend showing that taxation patterns of small island states differ from those of larger economies.

The present author carried out such and excercise with a total of 48 countries, divided into 3 categories each comprising 16 countries: developed larges states, developing large states, and developing small states. These

[1] The report can be retrieved from http://siteresources.worldbank.org/PROJECTS/Resourses/40940-1118776867573/AssesmentofrelevanceSSFfulldocument.pdf

populations of these countries range from 290 million (the USA) to 38, 000 (St Kitts and Nevis). It must also be noted that all developing states chosen here are also large states, therefore as a total there are 32 large states and 16 small states.

Taxation patterns of small island states

Figure 1 summarizes the taxation patters in different categories of countries, where tax revenues are expressed as percentages of GDP. It can be seen that small states are more dependent on trade taxes and less dependent on sales and income taxes than larger countries.

	Trade tax	Sales and Vat	Social security	Income and wealth	Other	Total tax as % of GDP
Large developed countries	0.1	9.6	9.0	11.4	0.3	30.4
Large developed countries	2.6	7.2	1.6	6.4	0.3	18.1
Small island states	6.4	5.5	1.7	5.9	0.8	20.3

Figure 1: Taxation Patterns in different categories of countries

Another interesting tendency, shown in Figure 1 relates to the role played by revenue from social security contributions which tend to be marginally higher for small states when compared to other developing countries. However, they are much lower when compared to developed countries.

In general small states obtain relatively higher tax revenues when compared to their GDP, than other developing countries and relatively lower tax revenues when compared to developed countries.

Dependence of trade taxes

One of the most evident features presented in these findings is the heavy reliance of small states on trade taxes, ammounting to 32 per cent of total tax revenue, while that of large states is only 8.4 per cent. This tendency was confirmed by fitting a line, using the Least Squares Method, correlating population and percentage of trade tax, with the results shown in Figure 2. In simple words, this means that the larger the country is, the lower is the tendency to depend on trade taxes.

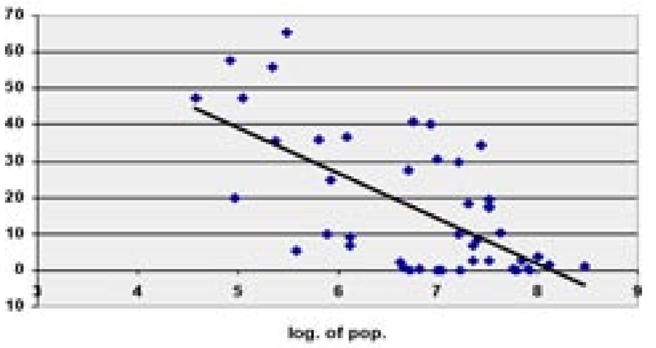

Figure 2: Relation between Population and Trade Taxes

Implications

The structure and sources of tax revenue have various implications especially for small island states which, in the coming years, have to face a new reality where trade taxes and tariffs must go significantly down, in line with WTO rules.

Assessing the relative costs of alternative forms of government finance is an important issue. In a developing economy, the government's ability to collect revenue is affected by the fact that it is costly for the government to collect income taxes; hence the dependence on revenue from trade taxes.

Another issue relates to the attraction of FDI. Tax policies are obviously capable of affecting the volume and location of FDI since, keeping everything else constant, low income tax could encourage FDI and financial flows to small states. This has certainly played a part in the development of the financial sector of many small states. However, such policy is likely to be severely challenged owing to the drive against tax competition being pushed by OECD.

The future

Recent years have seen the progressive liberalization of world trade as a consequence of unilateral liberalization by countries; proliferation of regional trade arrangements; and agreements reached under the auspices of the World Trade Organization (WTO). As a result the trade preference once afforded to SIDS have been eroded and will continue to decrease in the coming years.

The association between trade liberalization and more rapid economic growth can increase revenues for a given level of tariffs. However, trade taxes will be negatively affected with trade liberalization. This implies the need for small island states to reform their taxation structure and shifts their dependence away from trade taxation.

Conclusion

Small island states need to transform their economies in response to the changing economic environment, particularly as a result of the globalization process. Among these there is the issue of trade taxes. In doing so, small island States might find themselves travelling between Scylla and Charybdis. They have to find a way to continue attracting FDI and financial flows, while reducing their relative dependence on trade tax and rely more on VAT and income tax. They will also have to develop capacity in order to build government departments capable of collecting income tax and VAT efficiently and equitably.

Source:
All statistical data refers to the year 1997. Most of the statistical data used in this work is taken from Penn World Tables and from the following website address: www.unpan.org/statitistical_database-publicsector.asp (as per 01.08.2004).

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