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cutting through complexity

TAX ADVISORY

Overview of The Commonwealth of The Bahamas' 2014-15 National Budget

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Executive Summary

In the following pages, we present a review of the 2014/15 budget as presented to the Honourable House of Assembly by the Prime Minister, on May 28, 2014.

Our overall view is that this budget is a good first step in the right direction, given the current macroeconomic environment, and the fiscal issues being faced by The Bahamas Government. As always, a budget is a balancing act of many variables. Clearly though, there is much more work to do, especially with respect to fiscal responsibility and expenditure cuts/efficiencies, as well as enhanced collection of existing taxes such as Real Property Tax.

Some of the promising features of the budget include (we will explore some of the key features in more detail in this review):

- a projected revenue increase in 2014/15 of a net $305 million over 2013/14[1];
- a projected reduction in the Total Deficit by $166 million to $384 million, which will be the lowest deficit since 2007/8 (excluding 2010/11 where we saw the $210 million BTC sale cash inflow);
- a projected levelling off of the Total Government Debt to 60.9% of Gross Domestic Product ("GDP"), with a gradual reduction in the years following; and
- a projected reduction in the GFS[2] Deficit as a % of GDP to 3.2% from 5.4% in 2013/14.

It is also reassuring that there is now clarity as to when the Value Added Tax ("VAT") regime will become effective, with the VAT implementation date being pegged for January 1, 2015 and the rate at which it will become effective at 7.5%. Certain other key aspects of the new VAT regime have also been addressed (discussed in more detail herein).

However, the budget is not without risk on the revenue side, with much of the revenue increase based on uncertain collection from a new VAT regime, and enhanced collection in other key areas such as Import Tax and Real Property Tax.

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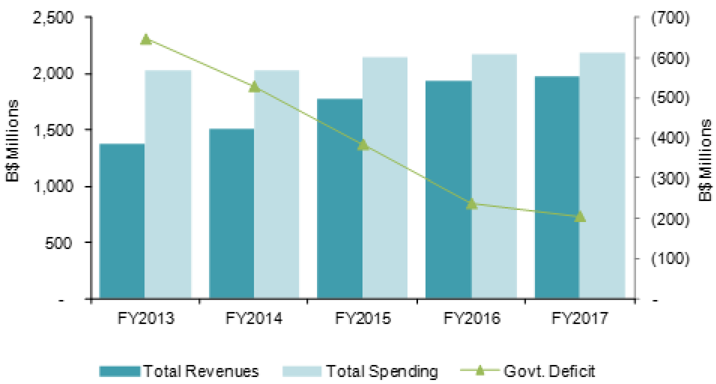
[1] Based on the Projected Outturn for 2013/14, which is the projection based on the actual fiscal performance for the year to date.

[2] Government Finance Statistics, as per the IMF - http://www.imf.org/external/pubs/ft/gfs/manual/gfs.htm

Deficit analysis 2013-2017



The table above illustrates the Government's projections for recurrent revenues, expenditures and the Total Deficit. As can be seen, the plan is for a $350 million narrowing in the Total Deficit by 2017.

It should be noted that the FY2017 $200m deficit is projected to relate wholly to capital expenditure, as a small recurrent surplus is projected.

On the flip side, there are also a number of areas of concern that require close ongoing attention, which we believe can improve the situation further:

- Clearly the "elephant in the room" is **Government expenditure**. While fiscal austerity and efficiency can be pursued in a short time frame, cataclysmic measures usually need to be taken to achieve this. What we see is a Government implementing austerity/efficiency gradually, while at the same time trying to maintain the quantity and quality of public services, economic stability and to stimulate economic growth. There is also the issue of Government capacity to implement such measures at a pace that it would like. The question is, are the measures being taken sufficiently aggressive at this time? The budget shows expenditures increasing by $103 million for 2014/15 over the Projected Outturn for 2013/14 and stabilizing just under the $1.9 billion level over the next few years. There is no doubt that this needs to come down substantially. While the Government payroll is notoriously difficult to address, and represents almost 70% of the budget, there is no doubt this is an area that needs to be closely reviewed at minimum to ensure that there is no leakage in the payroll system through inefficiency or weak payroll control systems. For non-payroll expenses, it is promising that Government appears to be beginning to tackle this through a number of measures including centralization of utilities (electricity/water) procurement, some departmental streamlining of responsibilities, stronger oversight by the Ministry of Finance, the planned introduction of more robust Government procurement policies, more efficient treasury management and so on. That said, we feel the Government should take a much more aggressive approach on this area, and look forward to seeing the mid-term budget once some of these planned improvements are implemented and working.
- The second major concern is **the issue of Crime**. Aside from the terrible impact of crime on society and the affected families, it also has fundamental economic consequences. Firstly, increasing crime calls for increased costs of policing, the justice system, prisons, legal services, Defence Force and social services (indeed the budget for these six areas alone amounts to approximately $350 million[3], 20% of the total recurrent expenditure budget of the country). Secondly, if crime cannot be arrested, it will be highly detrimental for a country that is trying to attract more investment and increased tourism.
- Our third concern is **the issue of collection of existing taxes**. In particular, the worst performers appear to be property taxes and customs duties, with Real Property Tax collection pegged as low as 40% of total billings and by Government's own admission, not all properties are being billed, or consistently assessed. It is clear to us however that better collection of these taxes does not replace the need for the implementation of VAT. Better collection is however critical to fill the gap that VAT and better expense management do not fill. We understand that the Government is taking measures in this area, which include the introduction of new GIS systems and procedures for Real Property Tax management, as well as online submissions and other measures as relates to custom duties collection. These improvements cannot come soon enough and it is evident that the Government is factoring in enhanced collections to this budget. Indeed, it is projecting a $27 million increase in Import Duties (over the prior year approved budget), a $27 million improvement in Excise Tax collection, and a $36 million increase in Real Property Tax collection. Together these represent $90 million in additional revenues in the 2014/15 budget.
- The current **unchecked growth in defined benefit pension liabilities** can be likened to the iceberg that sank the Titanic. It is reassuring that Government is now taking this very seriously and is implementing a committee for the reform of public pensions. Currently Government employees in the public service receive a defined benefit pension, which is paid out of

[3] Includes Police pensions and insurance (estimate) in the Public Service budget, Office of the Attorney General, Judicial Department, Court of Appeal, Prisons, Magistrates Courts, Ministry of National Security, Royal Bahamas Police Force, Royal Bahamas Defence Force, Ministry of Social Services, and the Department of Social Services

recurrent expenditures when they retire – in other words, there is no pension fund supporting these payments. As recently announced by the Minister of State for Finance, public service pension liabilities are estimated at $1.5 billion, increasing to $2.5 billion by 2022 and $4.1 billion by 2032. Annual payments out of recurrent expenditures amount to $60 million per annum with staff gratuities totalling another $25 million. It is expected that these will increase to around $140 million by 2022 (less than 10 years away), as more and more current public service employees retire. Clearly this is unsustainable.

- Despite efforts of successive governments over the past several years, since the commencement of the Global Financial Crisis in 2008/9, **unemployment levels** jumped up and continue to be 4-5% higher than in the 2001-2008 era. The November 2013 figures show it at 15.4%, a slight reduction on the 16.2% figure in May 2013. If many of the projects that are being pursued come to fruition, including the opening of the Baha Mar project, the Albany expansion etc., we expect to see some more meaningful reductions in these unemployment rates and increasing productivity. The demographic of the unemployed is also worrying with i) so many young people looking for work and ii) an apparent relocation of several thousand of the workforce from Grand Bahama to New Providence between 2012 and 2013[4]. However, with recent and proposed investments, we would hope to see this trend reversed.
- **Foreign reserves** are showing a downward trend from a peak of almost $900 million in 2011, to around $740 million at the end of 2013. It is slightly reassuring that this level still significantly exceeds the level of reserves in any year from 2000 to 2008, however much of the buoyancy has been provided by recent US$ borrowing. Key areas that need focus to arrest this trend are:
  1. a continuing improvement in the economy, in particular in the tourism sector;
  2. the continued attraction of foreign direct investment to The Bahamas across all sectors;
  3. energy reform – a meaningful reduction in fuel usage by BEC, coupled with more efficient vehicles, and the gradual introduction of renewable energy sources, etc. all contributing to less oil imports, and hence less US$ outflows; and
  4. a move to more self-sufficiency in food and beverages, reducing the level of such imports. It is clear that the Government is looking at all of these areas, but we all know the results will not happen overnight.
- **Stop-over tourists**. There has continued to be a sluggishness in tourism stop-over visitors. Overall tourist numbers have been buoyant with a 3.5% increase to 6.2 million visitors in 2013 mainly thanks to increased cruise traffic. However, with the developments in Grand Bahama (Sunwing), Bimini (Resorts World), and Baha Mar opening in New Providence, amongst other promising developments in this budget year, one would hope to see a corresponding increase in the higher spending stop-over visitors. Critical also will be for The Bahamas to not only maintain and enhance its customer service, its overall product offering, and its overall tourism strategy, at the same time we need to be as cost-competitive and as value-added as possible. The cost factor is not just about local hotel costs, but every cost from the minute a tourist leaves their home to when they return – so this includes transportation, airlift, entertainment costs, etc. We need to be very wary of, and as far as possible stay ahead of our competitors. Jamaica for instance posted a record year in 2013, surpassing 2 million stop over tourists for the first time, well ahead of The Bahamas even though it is further to travel to North America. They credit this to improved local and international partnerships, new airline linkages, enhanced security measures in tourist areas and better training. Of particular interest is Jamaica's new Tourism Linkages Council which links local suppliers and producers with hoteliers with a view to hotels sourcing as much local product as possible and opening up supply opportunities to local businesses and entrepreneurs. It is therefore promising that the Government has embarked on reform of the way tourism is marketed for The Bahamas, as well as the establishment of the Bahamas Agricultural and Marine Science Institute, but a lot more work needs to be done.

So, all in all, there are some promising features of this budget, but with a general theme of "a lot more work to do". As always the "devil is in the details" when it comes to net budget increases and decreases, and we will be exploring these in more detail herein.

[4] The labour force statistics show New Providence labour force jumping up from 138k in 2012 to 146k in 2013, and Grand Bahama reducing from 29k in 2012 to 25k in 2013

The macro-economics

There is no question that the uncertain and harsh economic environment over the last several years has changed to one of "cautious optimism". Global economic growth is projected to accelerate according to the IMF to 3.6% in 2014, and 3.9% the following year, with an expansion of the US to 2.8% in 2014. An interesting development is also the conversion of the US from a net importer of gas to a net exporter. As we all know, the strength of the US economy is fundamental to the strength of The Bahamas' economy, not least because the vast majority of tourists visiting The Bahamas come from the US. However, we continue to lag the US recovery. One reason for this is due to visitors who would have purchased second homes in good times taking a more conservative approach to vacation ownership in a recovery cycle, and as they rebuild their equity.

On the ground, our view is also one of cautious optimism. We see more activity in a number of areas such as:

- real estate (particularly at the ultra high net worth end of the market), and in particular in the west end of New Providence, Abaco and certain other areas;
- inquiries as to new greenfield and refurbishment developments in The Bahamas – in other words, investors are back;
- more confidence in the banking and investor community when it comes to financing new projects. Indeed KPMG's recent financing survey (click here to view online) of regional banks and resort investors resulted in the highest confidence rating since 2007, and a general theme of "cautious optimism"; and
- growth in various areas of financial services, such as the trust sector (though the broader international private banking business is suffering from ongoing consolidation and increasing regulation).

That said, it is early days, construction activity is patchy, and we await the opening of new resorts. At the same time new industries are still thin on the ground.

In this context, we believe that it is an understandable decision of the Government that, while it has decided based on public consultation to reduce the rate at which VAT will be introduced to 7.5%, it has not at this stage made any adjustments to import duties. There is no doubt that import duties will need to be addressed in 2015/16 as we continue to deal with the WTO. We would expect to see some initial adjustments pre-VAT, followed by a broader tariff regime review with some VAT experience behind it. Given the fiscal situation, and the relatively slow recovery of the US and global economy, it would be somewhat risky at a much lower VAT rate, to reduce import duties across the board at the same time. We therefore expect a measured approach to duty adjustments by Government over the coming 12 months.

There is no question that the uncertain and harsh economic environment over the last several years has changed to one of "cautious optimism".

Revenue measures

The Government is projecting total recurrent revenues to increase by $305 million[5] to $1,770 million in 2014/15. Clearly a large portion of this relates to Value Added Tax implementation, but this is only half of the picture. The table below shows a number of the major revenue increases in the 2014/15 budget as compared to the approved 2013/14 budget:

Revenue Increases 2013/14 vs. 2014/15	FY2014	FY2015	Variance	Growth
Tax Revenue				
Import and Export Duties	$ 387,804,210	$ 414,804,210	$ 27,000,000	7.0%
Excise Tax	$ 272,320,000	$ 299,320,000	$ 27,000,000	9.9%
Stamp Tax	$ 186,411,545	$ 189,970,692	$ 3,559,147	1.9%
Tourism Tax	$ 151,886,035	$ 146,590,320	$ (5,295,715)	-3.5%
Property Tax	$ 110,613,035	$ 146,613,038	$ 36,000,003	32.5%
Motor Vehicles	$ 39,343,805	$ 39,095,054	$ (248,751)	-0.6%
Bank and Trust Fees	$ 23,627,500	$ 23,017,000	$ (610,500)	-2.6%
Company Fees	$ 20,202,600	$ 22,071,204	$ 1,868,604	9.2%
Gaming Tax	$ 12,011,000	$ 20,000,000	$ 7,989,000	66.5%
Other Taxes	$ 546,165	$ 150,557,045	$ 150,010,880	27466.2%
Total Tax Revenue	**$1,204,765,895**	**$1,452,038,563**	**$ 247,272,668**	**20.5%**
Non-Tax Revenue				
Fees and Service Charges	$ 255,613,010	$ 262,852,117	$ 7,239,107	2.8%
Revenue from Government Property	$ 17,822,835	$ 17,843,859	$ 21,024	0.1%
Interest and Dividends	$ 16,602,100	$ 31,456,000	$ 14,853,900	89.5%
Services of a Commercial Nature	$ 6,782,575	$ 6,157,463	$ (625,112)	-9.2%
Reimbursement and Loan Repayment	$ 2,300,000	$ 113,000	$ (2,187,000)	-95.1%
Total Non-Tax Revenue	**$ 299,120,520**	**$ 318,422,439**	**$ 19,301,919**	**6.5%**
Capital Revenue				
Proceeds from Borrow ing	$ 521,258,763	$ 380,689,325	$(140,569,438)	-27.0%
Grants	$ 8,000,000	$ 3,300,000	$ (4,700,000)	-58.8%
Capital Revenue	$ -	$ 1,000	$ 1,000	N/a
Total Capital Revenue	**$ 529,258,763**	**$ 383,990,325**	**$(145,268,438)**	**-27.4%**
Total Revenue	**$2,033,145,178**	**$2,154,451,327**	**$ 121,306,149**	**6.0%**

[5] This is calculated based on the budget presentation documents, which estimate the "outturn" for 2013/14. The outturn is the best estimate as to what will be the actual Government performance for the year, based on actual performance to date and remaining budget. This is different to the tables presented herein, also from the budget communication, which only compare the 2014/15 budget to the Approved 2013/14 budget.

The total net increase in total tax and non-tax revenues is estimated to be around $266.6 million[6], a 26.5% increase on the prior year approved budget (the number is greater if compared to the projected outturn for 2013/14). The main components of this increase are discussed below:

- **Import and export duties and excise tax** are expected to increase by a combined $54 million. We believe the expectation is that these increases will come primarily from improved collections. These improvements may come, in part, with the introduction of VAT, in particular as traders will wish to offset their credits against VAT once introduced. Further, measures being take to improve collection include the new online document submissions system which is replacing the incredibly unwieldy manual system today, one which is ripe for error (and fraud);
- **Real Property Tax** is expected to increase by some $36 million, and again we assume this is founded on improved collections as a result of current initiatives including a new Real Property Tax management GIS system, outsourcing of collections of overdue accounts, and a likely focus on re-assessments for the many properties that have not been reassessed for several years;
- There is an increase in **Gaming Tax** of $8 million. There are a number of major changes in the gaming landscape coming up including the opening of the Baha Mar casino, potential revenue growth of the Bimini Bay Casino. It appears this includes little provision for taxing of webshop/number operators effective July 1, 2014. The number of $8 million therefore appears low considering all of the above. It may also be that certain concessions are contributing to this low growth.
- The reduction in **Tourism Tax** of $5.3 million is a factor of three larger measures. Firstly, as per the budget the Government is increasing the Air Departure Passenger Tax as of October 2014, which is projected to result in an increase in these fees of $8 million. Secondly, an increase in Cruise Departure tax of $8 million is projected, likely due to increased numbers of cruise ship calls for a full year. Finally, the removal of the 10% hotel room tax as of January 1, 2015 (half year) results in a $21.3 million reduction in hotel taxes for the year. At the same time airline Customs processing fees and Customs attendance fees are being reduced as incentives for making a minimum number of rotations.
- The **Other Taxes** increase of $150 million relates almost entirely to the introduction of VAT as at January 1, 2015. A full year of VAT is expected to yield $300 million.
- There is a $7.2 million increase in fees and charges. The single largest contributor to this is an increase of $4.2 million in immigration fees which is a 10% increase.
- Interest and dividends are projected to increase by $14.9 million directly attributable to higher than expected BTC dividends. Total BTC dividends to the Government are expected to be $26.3 million in 2014/15. We note there does not appear to be any allowance for any proceeds of a second cellular license being issued in this fiscal year, though the Government has commenced preparations for this.

Our view on the above is that the successful implementation of not only VAT, but also collection enhancement measures for property tax, and customs and excise duties are absolutely fundamental to this budget. Given the uncertainties of both, we are hopeful the Government has been conservative in its estimates, as any deviation could be material.

Expenditures

The Government is projecting total recurrent expenditures to increase by $103 million to $1,823 million in 2014/15. This expenditure budget is relatively void of any major expense reduction initiatives, while at the same time appears to be one of relative containment with respect to any new expenditures. The recurrent expenditures tables are somewhat difficult to follow in this budget due to the large number of re-allocations, but from what we are able to gather, the more notable increases are outlined below:

- the increase in debt repayments and interest thereon account for a whopping $42 million. Total interest payments are expected to be $259 million in 2014/15, which is a $54 million increase in two years. Total debt redemptions are projected at $98 million. So between the two, we are looking at $357 million in debt service. The Government intends to borrow $343 million this year, with total debt increasing to $5.4 billion from $5.2 billion. This maintains close to a 60% debt to GDP ratio, assuming we are able to grow GDP by 2.3% in 2014/15;
- payroll and other staff costs appear to be increasing by as much as $20 million, including an increase in particular in the areas of Immigration, the Police Force, and the Defense Force;
- under the Deptartment of Environmental Health's budget there is a line "development contracts" of $7 million. We understand these include new contracts to be awarded to the private sector for garbage collection;
- new school bus transport costs of $3.5 million; and
- various additional expenses at the Ministry of Finance related to the implementation of VAT, and strengthening of the Ministry of Finance's capacity to monitor the various Ministries, departments and corporations expenditures.

[6] See note 5

Capital expenditures

The Government is projecting total capital expenditures to increase by $36 million to $331 million in 2014/15. The table below breaks this increase down into its major components:

Capital Expenditure 2013/14 vs. 2014/15	FY2014	FY2015	Variance	Growth
Ministry of Finance	$ 115,600,000	$ 120,800,000	$ 5,200,000	4.5%
Ministry of Works and Urban Development	$ 111,979,248	$ 125,934,120	$ 13,954,872	12.5%
Royal Bahamas Defence Force	$ 28,124,413	$ 39,250,000	$ 11,125,587	39.6%
Ministry of Education, Science and Technology	$ 16,378,600	$ 24,919,136	$ 8,540,536	52.1%
Customs Department	$ 4,213,000	$ 3,700,000	$ (513,000)	-12.2%
Royal Bahamas Police Force	$ 4,190,000	$ 1,855,000	$ (2,335,000)	-55.7%
Heads not Repeated	$ 4,000,000	$ -	$ (4,000,000)	-100.0%
Ministry of Agriculture, Marine Resources & Local Government	$ 2,935,000	$ 1,680,000	$ (1,255,000)	-42.8%
Ministry of Youth, Sports and Culture	$ 2,635,000	$ 8,430,000	$ 5,795,000	219.9%
Department of Civil Aviation	$ 2,200,000	$ 1,975,000	$ (225,000)	-10.2%
Ministry of Health	$ 1,035,000	$ 500,000	$ (535,000)	-51.7%
Department of Housing	$ 750,000	$ 1,200,000	$ 450,000	60.0%
Prisons Department	$ 650,000	$ 650,000	$ -	0.0%
Ministry of National Security	$ 500,000	$ 500,000	$ -	0.0%
Total Capital Expenditure	**$ 295,190,261**	**$ 331,393,256**	**$ 36,202,995**	**12.3%**

We believe that better strategic planning of infrastructure, much improved procurement practices and consistency amongst ministries, departments, and corporations need to be urgently addressed to improve the efficiency of capital expenditure.

We have addressed the major increases below:

- Under the Ministry of Finance header, capital expenditure is projected to increase by $5.2 million. Based on the budget details, this can be analyzed further as follows:
  1. $1 million for the School of Agriculture and Marine Science;
  2. $2 million for the National Cultural Festival (for a total budget of $3 million);
  3. $300k for establishment of a Standards Bureau;
  4. $2 million for the Caribbean Challenge Trust, which we understand relates to a regional endowment that is being established for protection of near shore marine environment;
  5. $7.5 million related to VAT and the tax reform exercise;
  6. An additional $3 million for the Bahamas Agricultural & Industrial Corporation;
  7. An additional $1 million for Antiquities, Monuments & Museum Corp.; and
  8. These increases were offset by approximately $11 million in reductions in prior items not repeated in this budget, special charges not repeated or reduced, and in particular a reduction in Bahamasair subsidies of $5 million.
- The Defence Force accounts for $11.1 million of the increase, of which the vast majority is for new vessels (for a total of $34 million this year on new vessels)
- The Ministry of Works and Urban Development, accounts for another $13.9 million of the increase, which includes:
  1. $2 million for a new Grand Bahama fire station;
  2. $5 million for general construction and expansion of building structures;
  3. $1.8 million in EU funded infrastructure for Acklins, Andros and Ragged Island;
  4. $10.8 million in new road construction in the Family Islands;
  5. $8 million for the New Providence IDB road project Phase 2;
  6. An additional $10 million for construction of the North Abaco Port, Little Abaco Bridge and Fishing Hole Bridge in Grand Bahama;
  7. An additional $2.9 million for New Providence repairs and upkeep of docks and piers;
  8. These are partially offset by reductions as relates to projects completed last year etc.
- The Ministry of Education, Science & Technology saw an increase of $8.5 million, primarily as a result of $4 million for reform of the College of The Bahamas ("COB"), and $4.2 million for COB debt service
- The Ministry of Youth, Sports & Culture accounts for $5.8 million of the increase, with $6 million to cover the cost of the IAAF World Relays. It is not clear what year this relates to and may include a component of budget overrun as relates to the recent relays event.

We would also expect, as the Government has implied, that the actual capital expenditure on public services will be much larger than the $331 million projected, through the use of Public Private Partnerships ("PPPs). The capital needs of The Bahamas far exceed $331 million, and indeed in prior studies we have estimated the total short to midterm need in excess of $2 billion. A primary objective of PPPs is of course not just about investment, but more importantly about higher quality and lower cost service provision to the general public and visitors alike.

At the same time, we believe that better strategic planning of infrastructure, much improved procurement practices and consistency amongst ministries, departments, and corporations need to be urgently addressed to improve the efficiency of capital expenditure, as there is no doubt a significant potential saving in these numbers.

Value Added Tax

A review of this budget would not be a review without giving VAT a section of its own. This is the single largest game changer in the budget, expected to raise $150 million for the second half of the budget year to June 30, 2015.

The major factors to note are:

1. a single rate of VAT of 7.5% is to be introduced (other than the zero rate of VAT applicable to exports);
2. there will be fewer exemptions than those proposed in the draft bill. The list is to be released shortly;
3. VAT is to be implemented by 1 January 2015;
4. there will be VAT inclusive rather than VAT exclusive pricing which should be welcomed by both consumers and retailers;
5. a VAT deferment account will be introduced for imports;
6. a potential introduction of the reverse charge process;
7. there will be a cash accounting/flat rate scheme for small businesses;
8. no wide scale reduction in import duties and excise taxes although there may be at a later date; and
9. the intention is for full administrative capacity and readiness of government to be reached by October 1, 2014 and the implementation of an education program for a large number of organizations.

KPMG comment

We expect the introductory rate of 7.5% will be generally welcomed. It should be noted that this is a particularly low rate of indirect tax in comparison to other jurisdictions in the world. In a recent survey of indirect tax rates undertaken by KPMG only 10 countries have applied a rate of 7.5% or below with most countries implementing a rate of VAT above 10%. The low rate should be welcome for the tourism industry with the removal of the hotel occupancy tax of 10%.

To compensate for the reduction in the VAT rate there are to be fewer exemptions from VAT. This is in line with the suggestions proposed by consultants that recently visited The Bahamas that advocated introducing a low rate of VAT with no or few exceptions. As the list of exemptions has not been released to date we can only speculate what these may be however;

- Food retailers are likely to welcome a removal of the proposal to exempt breadbasket foods from VAT as the exemption would have resulted in a high administrative burden in respect of pricing and having to highlight exempt items on till receipts. Such retailers would also have been unable to recover a percentage of the VAT they incurred on costs and such an increase in costs would have likely been passed on to the consumer by means of increasing prices. Many of the food items that were marked for VAT exemption are however low duty or duty free and price controlled so it remains to be seen how VAT will work alongside price control.
- We believe that the exemption for education/tuition services should and will remain, along with any social welfare services.
- The potential removal of some of the other exemptions that were proposed for social reasons would not receive such a warm reception such as the exemptions for health services.
- Insurance was also originally planned to be VAT exempt.
- Removing the VAT exemption proposed on some transactions such as gambling and some financial transactions could lead to double taxation, something that is not recommended by the OECD in their guidance on introducing VAT. Additionally applying VAT to certain financial and gaming transactions could make it very difficult for Bahamas based casinos to compete in the international arena in which they operate. For example, it would be very unlikely that The Bahamas would be asked to host the world class poker tournament it recently hosted if VAT is applied to the stakes and the additional tourism and marketing dollars generated by these events would be lost.

There is no doubt that limiting the number of exemptions will make VAT less complicated and easier to administer and in that respect should save costs for both businesses and the Government but we should not lose sight of why the exemptions were proposed in the first place. The Bahamas' economy does not have the robustness of a larger more diverse economy where the effect of a price increase through taxation can be spread. In a small island economy heavily reliant on certain core business sectors there is a need to protect those sectors which may mean maintaining certain VAT exemptions. A ripple in a pond is much more visible than a ripple in an ocean and the effect of a loss of just a few businesses in an island can have a noticeably detrimental effect on employment and GDP. The Government will need to weigh up the savings in the administration of VAT against the potential loss of business and the effect this could have on the economy.

The other downside of fewer exemptions relates to lower income earners. Under the original proposal, the majority of expenses for these persons would have been exempt – bread basket foods, insurance, education, health, mortgages and loans, and residential rent. Indeed, today, most breadbasket foods are duty free, and there is no other tax on the other expenditure items noted above. So these individuals will certainly be affected. The social safety net is therefore even more critical, and while it is notable that the Government is taking certain initiatives in this regard, we would suggest this be made an absolute priority over the next six months prior to implementation.

It is, however, hoped that the list of exemptions will be released quickly as businesses cannot start to assess the impact of VAT or start the process of preparing for VAT until they know what will be exempt from VAT and what will not.

There is an audible sigh of relief at the deadline for the introduction of VAT having been moved however, the implementation is only seven months away and now that we know it is definitely coming there is a lot of preparation work to be done by Government and the private sector. The consultation period provided by the Government is now over and the work has to commence.

There are a couple of welcome announcements by the Prime Minister in respect of the introduction of a deferment account, the possibility of introducing a system often referred to as a reverse charge and a scheme to cater for smaller businesses.

A deferment account will let the importer manage their cash flow and cut down on the red tape surrounding importation of goods. Similarly the reverse charge process lets businesses that are registered for VAT account for the importation of services on their VAT returns rather than paying import VAT only to claim it back at a later date. Small businesses also struggle with cash flow and the administration of VAT and the introduction of a scheme especially for smaller businesses can only be welcomed.

With respect to the Government not reducing import duties at this time, we do understand the Government's rationale. At 15% it was possible to reduce import duties, with some margin for error. At 7.5% however, the margin for error is not there, and without the track record of actual collections from VAT, we believe it conservative to delay across the board duty reductions. Ideally, modelling can take place over the next six months with some duty relief on certain key items as of January 1, and more substantial relief to come at a later date, perhaps by July 1, 2015. At the end of the day, we as a country have a $500+ million total deficit to remove. Raising new taxes is inevitable, but at the same time this highlights the importance of fiscal responsibility, expenditure budget cuts/efficiencies where possible, and enhanced collection of existing taxes such as Real Property Tax.

In all we feel the VAT consultation period has been useful for both the Government and the private sector to come to terms with the introduction of VAT. However, for VAT to be effective and provide the required amount of revenue, robust collection systems, procedures and training need to be implemented which is where the challenge will really lie.

Other tax measures of note

There are a number of other interesting measures that the Government has taken, none of them highly material in value, but nevertheless worth addressing in this review.

Departure Tax/Customs Processing fees/Customs attendance fees

There will be an increase in air departure taxes. Currently departure tax per person is $25, and as of October 1st, 2014, the departure tax will be $29 per person. The commercial airlines currently pay a Customs processing fee of $75 on entry and exiting The Bahamas. As of July 1, 2014 all commercial airlines who make a minimum of 300 international rotations (take off and landings) per year and increase seat numbers into The Bahamas will be exempted from paying the Customs processing fee. This designation for the airline is subject to approval by the Ministry of Finance for a one year period with an option for renewal for a further year. Additionally, Customs attendance fees also levied on commercial airlines will be reduced to $2.50 per hour provided the airlines meet specified rotations and increase seat number requirements mentioned above. Currently customs attendance fees range anywhere from $50 to $200 per hour depending on the seating capacity of the aircraft.

It is our understanding that this will create a net benefit to the Government treasury of approximately $5-10 million. We would hope that the commercial airlines, who we assume have been part of a negotiation on these fee reductions, are comfortable that they will in fact be able to increase passenger count despite the increased passenger fees.

Tariff Amendment/Excise Act

The Spirits and Beer Manufacturers Act will be amended to provide for an excise tax on shandy at a rate of $2.00 per imperial gallon. All this comes into effect as of July 1, 2014. We believe this will be of benefit to local producers launching their own shandy style products.

The Tariff Act will also be amended to provide for exemption on capital goods and building materials for businesses outside of the Freeport area of Grand Bahama. This comes into effect July 1, 2014. Clearly this is designed to stimulate economic activity in east and west Grand Bahama, and in part, addresses one of Government's pledges to provide east and west Grand Bahama with the same exemptions as Freeport enjoys. In addition, this may be a net benefit to Freeport as it is probable that the increased flow of building supplies will be shipped into Freeport and sold by Freeport based businesses.

Trucks classified as hybrids will see a reduction in the excise duties from 60% to 25% with effect of July 1, 2014. This is consistent with the current situation for vehicles, and a positive step in encouraging "greener" vehicles.

Further a fee will be levied on the excise tobacco stamps which are currently provided at no cost to the excise registrant. The cost as of July 1, 2014 will be $0.25 for the self-adhesive stamps and $0.20 per dry stamp. We see this as simply a small increase in the tobacco excise cost which will pay for the production of the stamps themselves.

Stamp Duty Amendments

As of July 1, 2014, the Stamp Act will be amended to allow the Treasurer to request records for the purposes of determining stamp tax liability. There will be further amendment to the Stamp Act to require financial institutions to submit a report to the Treasury 30 days after the end of the month. The report will include information on the duty collected with payment. The financial institutions will be subject to a penalty of $1,000 if the report is filed late.

We think this is a sensible amendment to the Act which give the Government more powers to check the underlying records of businesses, a right it does not currently have. Effectively, this gives Government more teeth in the collections process.

Business Licence Amendment

Effective July 1st, 2014 the Business Licence Act will also be amended to clarify the filing date for business licence fees. The deadline for filing business licence renewals is January 31st and the due date for payment is March 31st. This clears up what was an area of some confusion.

Private Banks & Private Trust Company fees

An adjustment was made regarding the increase of fees for Private Banks and Trust companies which was made during the 2013/2014 budget exercise wherein the fees were increased by 50% as of January 1, 2014 and a further increase of 50% on January 1, 2015. This has been adjusted such that both sets of fees are now to increase at 25% as of January 1, 2014 and a further 25% effective January 1st, 2015.

We see this as having a very small financial impact for Government, but beneficial to Private Banks and Trust companies, an industry which we want to keep and ideally grow in The Bahamas.

Other measures

Other revenue measures include the extension of the Family Island Development Encouragement Act and the City of Nassau Revitalization Act which both expire on June 30, 2014 but are now extended for a further year as of July 1, 2014.

Additionally, there are currently no limits specified on duty exemptions for imports directly related to the maintenance and rehabilitation of bridges, however as of July 1, 2014 a limit will be established for the duty exemptions.

It is anticipated that the aforementioned amendments to the various Acts will be published in the official gazette of The Bahamas and made available to the public in due course.

In conclusion, we would characterize the budget as follows:

- **a game changer as relates to revenue enhancement, with the definitive introduction of VAT, and more aggressive projected collection of other taxes in particular, Real Property Tax, import duties and excise duties;**
- **a step in the right direction to arrest the growth of the National Debt, reduce the Total deficit and GFS Deficit;**
- **a budget which to a large extent preserves the status quo on the recurrent expenditure side, with little in the way of meaningful budget cuts**
- **a budget we see as being a little risky as with no material expenditure rationalization, the budget is almost entirely reliant on meeting the revenue-side projections, with VAT as yet untested, and the success of the Government in collecting more of its existing taxes still very much a work in progress.**
- **a budget which is somewhat reliant on an acceleration in economic activity, with GDP growth pegged at 2.3%, the highest rate of GDP growth we will have seen in over eight years, but which appears at present to be supported by the level of economic activity and foreign investment The Bahamas is seeing.**

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