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“Causation between Tax and Spend: Some Caribbean Empirical Evidence”

Abstract

In this paper we have employed recent developments in econometrics to examine the causal relationship between taxes and spending to determine the effective way of reducing budget deficit and debt problems in four Caribbean countries. There are two cointegration relationships between the variables in The Bahamas, Barbados and Belize, and one cointegration relationship between them in Jamaica. Estimates of autoregressive distributed lag's error correction model show bi-directional causation in The Bahamas, Barbados and Belize. The traditional Granger causality test which includes an intercept term in regressors confirms that taxes cause government spending in Barbados and Belize only. The positive relationship between these variables shows that Friedman's view on increase in taxes causing increase in spending holds for The Bahamas, Belize and to a lesser extent Barbados, as in the latter other tests indicate a bi-directional causation. The preponderance of empirical evidence shows no causal relationship between taxes and spending in Jamaica. Thus a tax cut is the optimal fiscal policy for controlling deficit and debt problems in The Bahamas, Belize and Barbados; whereas in Jamaica, the independence of these variables, and the fact that the institution for collecting taxes and disbursement of government outlays are both controlled by the government show that the budgetary process is determined by inter party competition.

Keywords: Government spending, tax revenues, Granger causality, error correction model, Caribbean.

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