# The Fiscal Experience in the Caribbean

## Emerging Issues and Problems

*Edited by*
*Ramesh Ramsaran*

Caribbean Centre for Monetary Studies
The University of the West Indies, St. Augustine

Governments almost everywhere face high popular expectations to deliver a wide range of goods and services essential for development and social welfare. It is becoming increasingly difficult to sustain ineffective policies and failing institutions in the face of an increasingly competitive setting and falling aid levels. Public revenue and expenditure policies need to become more focused, particularly since they are important levers in public management and the pursuit of development goals. Not surprisingly, fiscal reforms often go hand in hand with structural adjustment programmes addressing growth, employment and balance of payments issues.

In a dynamic setting increasingly reflecting a market ethos, the pressures for a more efficient state are increasing and fiscal systems are being asked to become more responsive to defined social and economic objectives. Some fiscal measures serve several different functions and achieving an optimal mix is often a major challenge.

This volume brings together a set of country essays and thematic studies by experienced researchers and academics who reflect on major fiscal issues and challenges facing Caribbean states in recent years.

**Ramesh Ramsaran** has written widely on Caribbean monetary and fiscal problems and is currently Professor of International Economic Relations at the Institute of International Relations, University of the West Indies, St Augustine.

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*Edited by*

*Ramesh Ramsaran*

***Caribbean Centre for Monetary Studies***
*The University of the West Indies*
*St. Augustine, Trinidad*
*Republic of Trinidad and Tobago*

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# *Preface*

In recent years tax reforms have generally been undertaken as part of a larger exercise involving structural change over a broad front. In any economy, government policies and operations exert a significant influence over economic activity, and how tax and expenditure policies are combined have implications for the outcome of any package of measures. Because these policies influence behaviour, design is an important consideration in a context where fiscal instruments are not only expected to raise revenue, but to encourage growth and exports which are expected to enlarge tax capacity. With governments putting increased emphasis on the private sector as the engine of growth, fiscal policies (and for that matter the whole spectrum of government operations) have to be sensitive to private sector concerns.

There are rapid changes taking place in the domestic and international environments, and Caribbean governments are facing new challenges which call for the modernisation of tax systems and more efficient public sector spending. With limited resources, governments now have to encourage growth and reduce poverty while protecting the environment and making prudent use of resources. While addressing questions of yield and efficiency, tax reforms cannot be unmindful of issues relating to incentives, equity and competitiveness. The growth of the public debt, the increase in crime, the spread of AIDS and the drug problem have put increased pressure on public revenues. Since the budget is an important policy instrument influencing allocation, redistribution, and stabilisation decisions, governments cannot be unmindful of the effects of fiscal measures on social and economic outcomes, which can be affected as much by external factors as internal policies. There are good and bad policies and these determine not only the ease with which particular goals can be achieved, but the time frame as well. Experience has shown that there is often a heavy price to pay for *ad hoc* tinkering with taxes and expenditure patterns genuflecting to populist demands or serving the narrow political agendas of politicians. There are numerous instances of governments misusing or misallocating their own limited resources while scouring the earth for foreign aid.

In late 2000 a number of my colleagues at the University of the West Indies suggested to me that in light of the ongoing fiscal reforms in the Caribbean, the adoption of liberal trade policies, the decline of traditional sectors and the OECD's attack on offshore tax havens, it might be useful to put together a collection which could stimulate further discussions on the financial challenges facing Caribbean governments. I approached a number of persons both in academic and central banking circles who willingly gave their support and offered contributions. Their names are listed in the volume and I am deeply grateful for their interest and encouragement.

I wish also to express my thanks to Ms. Jackie Roberts who undertook the arduous task of retyping and putting the manuscript together. Finally, the meticulousness and care of Ms. Gloria Lawrence who typeset the work need to be acknowledged, as, of course, the assistance of the many others who read and commented on the manuscript. This was a difficult exercise that required a great deal of collaboration.

# *List of Contributors*

**Dr. Ramesh Ramsaran** is Professor of International Economic Relations at the Institute of International Relations, U.W.I., St. Augustine, Trinidad.

**Dr. Gobind Ganga** is Director of Research at the Central Bank of Guyana.

**Dr. Penelope Forde** is Manager, Research Department at the Central Bank of Trinidad and Tobago.

**Dr. Daniel Boamah** is Director of Research at the Central Bank of Barbados.

**Darrin Downes** is an Economist at the Central Bank of Barbados.

**Dr. Nikoloas Karagiannis** is a Research Fellow at the Sir Arthur Lewis Institute of Social and Economic Studies, U.W.I., Mona, Jamaica.

**Dr. Garth Nicholls** is Head of Research at the Eastern Caribbean Central Bank.

**Dr. Karl Bennett** is an Associate Professor of Economics at the University of Waterloo, Canada.

**Dr. Esteban Perez** is an Economist at the Economic Commission for Latin America and the Caribbean, Port of Spain.

**Rudolph Matthias** is a Consultant in the Ministry of Finance, St. Vincent.

**Anthony Birchwood** is a Research Fellow at the Caribbean Centre for Monetary Studies, U.W.I., St. Augustine, Trinidad.

**Dr. Roger Hosein** is a Lecturer in Economics at the Department of Economics, U.W.I., St. Augustine, Trinidad.

**Dr. Dhanayshar Mahabir** is a Lecturer in Economics at the Department of Economics, U.W.I., St. Augustine, Trinidad.

**Ms. Corine Tang** is a Tax Officer in the Inland Revenue Division of the Ministry of Finance, Trinidad and Tobago.

**Richard Woodward** is a Lecturer in the Department of Politics, Univeristy of Hull, England.

**Dr. Godfrey St. Bernard** is a Research Fellow at the Sir Arthur Lewis Institute of Social and Economic Studies, U.W.I., St. Augustine, Trinidad.

**Dave Seerattan** is a Research Fellow at the Caribbean Centre for Monetary Studies, U.W.I., St. Augustine, Trinidad.

**Leslie Charles** is a Junior Research Fellow at the Caribbean Centre for Monetary Studies, U.W.I., St. Augustine, Trinidad.

# Introduction

In the ongoing rethinking of approaches to economic development and poverty reduction, the role of the state has come under critical analysis. Accountability, responsiveness to public concerns, efficiency and development and management policies are receiving greater attention in situations where governments are under pressure to deliver higher quality services and encourage private-sector growth. Additionally, the role of political systems in encouraging or retarding growth and development is also influencing public policy. A widely held view in light of the post-war economic experience is that natural resources have little to do with performance and that the difference between rich and poor countries rests not so much on resource endowment, as on efficiency and policies. Countries that have invested heavily in education, health and the use of modern technology have moved forward at a faster pace than those that have not.

All societies have their own peculiar features and institutions, and some states are subjected to greater challenges than others. The depth of poverty and the extent of inequality, ethnic and class rivalries, control by special interest groups, regional disparities and corruption can, and do exert an influence in the way a government transacts its business. The way governments function and the public policies put in place have broad implications for the society and the economy. Governments not only define the parameters for the macro-economic environment, but also play an active role in the economy, influencing key aggregates in the system. Experience has shown that governments using state institutions and mechanisms can stimulate growth, but can also wreck an economy and precipitate social and economic crises when policies are not carefully thought out. Economic gains easily dissipate in the face of political chaos. Public finance and social instability are not unrelated. The tendency for knee-jerk or *ad hoc* re-actions, or the adoption of measures to satisfy populist pressures does not only wreak havoc with tax systems but can lead to spending with no social value. Expenditure often drives revenue, and in the absence of an elastic or buoyant tax structure, governments will borrow or create money. Improperly managed, both processes have social costs. Higher debt service payments pull resources away from other uses. The unwarranted expansion of the money supply can lead to inflation, reduction in competitiveness and loss of foreign reserves. Frequent changes in the exchange rate may not only discourage saving and lead to capital flight, but increase the burden of the foreign debt. When government finances are under pressure the capital programme often suffers most, leading to a deterioration of the social and economic infrastructure.

Increasingly, the need for a more serious approach to fiscal management is being recognized in many countries. Some governments, however, tend to act only under duress. Tax systems are often tampered with for political rather than economic reasons, and already irrational systems become even more irrational. There are situations where outdated government structures and institutions are delivering less and less, while the cost of keeping them increases steadily. Government savings are low or non-existent in most developing countries, not only because of the inelasticity of the revenue systems, but also because of the poor returns on expenditure. Spending money without undertaking the necessary reforms in institutional structures and delivery systems does not necessarily result in a higher quality of service.

Since the attainment of political independence, the English-speaking Caribbean countries have made progress in a number of areas. Despite departures from the norm in certain cases, this has been accomplished within the framework of political systems based on democratic principles of governments, which allow for the expression of the popular will. Total production has tended to fluctuate over time, but there has been an increase in the standard of living in the majority of countries (see Table 1). The economies, however, remain vulnerable and fragile, still relying on a narrow range of activities for foreign exchange earnings. Though most of the countries enjoy a per capita income that is higher than that of a large number of countries in the developing world, poverty remains a major issue. In most cases over 20% of the population live below the poverty line. Unemployment rates remain at unacceptable levels. Crime has emerged as a major issue in all the countries of the region, not only impacting on tourism and investment, but leading to the emigration of skilled nationals, entrepreneurs and capital. With the increase in social instability questions are being raised not only about the efficacy of prevailing economic and social policies, but of the systems of governance themselves, which need to be modified in light of experience and emerging circumstances. Decision-making structures have become bogged down in archaic rules, regulations and practice. Many institutions have also become unwieldy and ineffective, performing poorly and gobbling up greater and greater resources. Change has been slow and stuttering, raising questions about the ability of these societies not only to govern themselves but to survive in a world where countries are striving for greater efficiency.

Table 1: Selected Indicators of Commonwealth Caribbean Countries

| Countries | Per Capita GDP | | Gross Savings Ratio[2] % | Gross Invest-ment Ratio[2] % | Recurrent Revenue as a % of GDP | Recurrent Expenditure as a % of GDP |
|---|---|---|---|---|---|---|
| | 2000[1] | Average Annual Real Growth % | | | | |
| | US$ | 1990-2000 | 1998-2000 | 1998-2000 | 2000 | 2000 |
| The Bahamas | 14,822 | 0.1 | .. | .. | 21.0 | .. |
| Barbados | 9,682 | 1.7 | 13.5 | 18.3 | 33.1 | 28.9 |
| Belize | 2,913 | 1.6 | 15.3 | 24.7 | 23.1 | 20.2 |
| Jamaica | 2,851 | -0.4 | 16.0 | 26.5 | 30.4 | 29.6 |
| Trinidad & Tobago | 6,190 | 2.3 | 29.6 | 22.3 | 24.2 | 22.4 |
| Guyana | 912 | 5.0 | 28.0 | 39.5 | 31.8 | 32.9 |
| **OECS** | | | | | | |
| Antigua | 9,216 | 2.8 | 34.4 | 45.5 | 18.2 | 21.3 |
| Dominica | 3,753 | 2.0 | 18.5 | 28.8 | 29.2 | 30.3 |
| Grenada | 4,049 | 2.9 | 20.0 | 39.2 | 26.8 | 20.8 |
| Montserrat | 6,841 | -1.0 | (13.1) | 60.6 | 30.3 | 54.8 |
| St. Kitts-Nevis | 7,381 | 4.7 | 18.2 | 39.5 | 28.8 | 33.9 |
| St. Lucia | 4,562 | 0.9 | 15.7 | 24.7 | 24.8 | 20.4 |
| St. Vincent & the Grenadines | 3,009 | 2.6 | 11.7 | 28.5 | 26.6 | 26.2 |

1. current prices
2. average
.. not available

Source: CDB, *Social and Economic Indicators*, Various Issues; CDB, *Annual Reports*, Various Issues; IMF, World Bank *Atlas*, 2002.

In the context of past experience and the changes taking place in the global economy, the ability of Caribbean countries to achieve and sustain a growth rate that can deliver the desired standard of living has come into question. Not only is political management failing to meet the development imperative, but economic policies also lack the coherence, if not the content, to create a platform for treating with the rapidly changing global circumstances. Caribbean economies need to increase their saving and investment rates while trying to achieve higher levels of diversification and competitiveness. Preferential markets are disappearing and reciprocity is fast becoming the norm in an increasingly open world trading system. With a relatively high per capita income, Caribbean economies find it increasingly difficult to access soft loans and aid. Despite the claim of vulnerability, some in the international community feel small size warrants no special treatment, given the favourable experience with growth, and the standard of living attained, as reflected in relatively high per capita incomes. Caribbean countries have to make the best use of their resources in the face of increasing competition for aid and soft loans, and tax policies have to move in this direction.

The decline of the traditional export sectors has not resulted in any radical restructuring of Caribbean economies. Import substitution as a strategy has failed. The new manufacturing activities provide little by way of value-added or employment opportunities. Tourism has emerged as a major foreign exchange earner in the region, but is now going through a period of uncertainty, particularly following the terrorist activities in New York in September, 2001. Increasing costs of air travel, inadequate air transport services, fear of travel, domestic crime, inadequate promotion and an increasingly uncompetitive industry have contributed to the decline. Even where national carriers exist, governments have found it difficult to subsidise them and have sought refuge in various types of privatisation arrangements to escape the fiscal burden. The idea of a regional carrier to replace ailing national airlines has failed to attract attention.

Trade affects every facet of life in Caribbean economies – production, employment, public revenue and public expenditure. Trade can impact on revenue both directly, and indirectly through growth. But because of the tax structure, public revenue may not grow correspondingly with GDP. Also, because tax systems reflect a variety of concerns, they often appear irrational and do not lead to maximum revenue collection. On the other hand, popular expectations, rising administrative costs and the need to improve the infrastructure put tremendous pressure on governments who often turn to borrowing both internally and externally to bridge the fiscal gap. For some governments in the Caribbean, servicing the public debt has become burdensome, and there is little scope for further borrowing. The pressure to reform tax systems and rationalise public expenditure has increased significantly in recent years, but the task of reconciling the different objectives is a difficult one. In the new paradigm the state is becoming more of a facilitator, with the private sector being given the responsibility for driving economic activity. The state's role, however, remains crucial in the growth and redistribution process through the regulatory and institutional framework.

With the moves towards greater trade liberalisation, there is less reliance on import duties, but other taxes have been introduced to pick up the shortfalls. In certain cases a general sales or value added tax has replaced a range of other indirect taxes targetting selected commodities. Despite their regressive nature, the latter are seen as good revenue performers. The absence of an income tax in some countries has led to the adoption of a wide range of devices to raise public revenue. But even with an income tax and other forms of indirect taxes governments have found it necessary to introduce special levies (e.g. health surcharge, a green fund, an unemployment levy, a transport levy, an education levy) for specific objectives which are not necessarily addressed with the revenue raised. The revenue from a health surcharge, for example, may not necessarily be spent on health care. The National Insurance Schemes (NIS) introduced in the Caribbean are seen as precisely that – 'schemes' which extract a fair amount from the revenue stream under a particular guise, but which have been so badly managed that they deliver very little in terms of expected benefits. The credibility of some governments has suffered not because of inadequate resources, but because of incompetence, waste and misallocation of resources. The quality of the Public Services has deteriorated rapidly in some countries. Generally, governments have failed to grasp the link between an efficient public service and growth and development. This is manifested in several areas. One is the inability to recognise the need for a cadre of highly skilled professionals to assist in the management of a modern economy. Another is the difficulty being experienced in the devolution of power from the centre to local bodies. Yet another is the failure to deal adequately with the issues of incompetence and corruption which is a major factor in the high cost of administration. The slow introduction of modern technology at all levels of the Public Service makes nonsense of the concept of the state as a 'facilitator'.

The tendency for expenditure to grow faster than revenue has made it difficult for governments to save. In Caribbean countries, the government remains a major employer both in central government operations and state enterprises. In the OECS personal emoluments account for about half of current expenditure. In some cases interest payments on the public debt account for another 20 per cent. In Jamaica interest payments on the public debt absorb over 40 per cent of current revenue – more than that spent on wages and salaries. In most cases pension payments come out of current revenue in the absence of properly funded schemes. The development of human capital is now widely seen as a critical ingredient in economic growth and development. Yet in many Caribbean countries public expenditure on education and health as a proportion of GDP has been stagnant or falling (see Table 2). Not surprisingly Barbados which is reputed to have the highest Human Development Index (HDI) coefficient among Caribbean countries spends the most (as a % of GDP) on education and health. Trinidad and Tobago which has one of the highest per capita income in the region is among the smaller spenders.

The failure of many states to deal adequately with issues of growth and poverty has drawn increasing attention to public policy and management. State reforms, bureaucratic performance, efficient institutions and monetary and fiscal policy are crucial to the attainment of long-term economic objectives. So too is the more effective use of financial resources, whether these come from taxation or from borrowing. Inept spending and the financing of political agendas have led many a government into situations where they were forced to take decisions that produced serious social consequences that could have been averted with more timely intervention. While governments must always remain sensitive to the needs of the population, the stage of development and resource availability place limits on what can be delivered at any point in time. Expanding possibilities depend increasingly on public finance being more growth-oriented than expedience-driven.

**Table 2: Selected Social Statistics**

| Countries | Public Expenditure on Education[1] | | Public Expenditure on Health[2] | | Life Expectancy at Birth (Years)[3] | |
|---|---|---|---|---|---|---|
| | 1985-87 | 1995-97 | 1990 | 1998 | Male | Female |
| The Bahamas | 4.0 | .. | 2.8 | 2.5 | 71 | 77 |
| Barbados | 6.2[a] | 7.2[a] | 5.0 | 4.5 | 79 | 74 |
| Belize | 4.7 | 5.0 | 2.2 | 2.3 | 75 | 73 |
| Jamaica | 4.9 | 7.5 | 2.6 | 3.0 | 73 | 77 |
| Trinidad & Tobago | 6.3 | 4.4[a] | 2.5 | 2.5 | 77 | 72 |
| Guyana | 8.5 | 5.0 | 2.9 | 4.5 | 67 | 59 |
| **OECS** | | | | | | |
| Antigua | 2.7[a] | .. | 2.8 | 0.4 | 72 | 80 |
| Dominica | 5.6 | .. | 3.9 | 3.8 | 65 | 72 |
| Grenada | 4.5 | 4.7 | 3.3 | 2.9 | 68 | 73 |
| St. Kitts-Nevis | 3.7[b] | 3.8 | 2.7 | 3.1 | 68 | 72 |
| St. Lucia | 5.5 | 9.8[a] | 2.1 | 2.4 | 76 | 71 |
| St. Vincent | 6.0 | 6.3[a] | 4.4 | 4.2 | 68 | 73 |

.. not available
1. % of GDP
2. % of GDP
3. most recent year for which data are available.
a. data refer to a year or period other than that specified
b. data do not include expenditure on tertiary education.

**Source:** UNDP, *Human Development Report*, 2002; Caribbean Development Bank, *Social and Economic Indicators*, Various Issues.

Fiscal systems are constantly evolving in response to pressures emanating both from within countries and from outside. The effects of populist demands and trade liberalisation have to be balanced by the need for a growth-oriented environment which must take into account a range of concerns related to debt levels, the level of taxation, equity, the responsiveness of tax systems, the impact of government spending on inflation and the exchange rate, among others. This volume brings together a set of papers by scholars and practitioners addressing a diverse range of topics in the fiscal field. The volume is divided into two parts. The first covers country experiences and the contributions seek to highlight salient issues and problems against the backdrop of recent experience. In most of the contributions the authors address the performance and structure of tax systems, tax reforms, trends in expenditure and expenditure policies, factors affecting the current balance, the financing of fiscal deficits and the debt situation.

The second section is more issues-oriented and addresses topics of both a theoretical and practical nature. The topics covered include the relationship between fiscal policy and exchange rate management, the approach to stabilisation, the impact of government spending on economic growth, the role of the state, the evolution of CARICOM's Common External Tariff, the link between trade and public finance, the experience with VAT and the direct/indirect tax mix.

# Section 1:
# Country Experiences

1

# Fiscal Experiences in Guyana: Current Issues and Challenges

*Gobind Ganga*

## 1.0 Introduction

Effective fiscal management, fuelled by concerns about governance, accountability and transparency, is at the heart of a country's economic, social and political development. Its importance is greater in countries with a relatively large public sector and a high dependence on external resources than in those with a balanced public sector and low levels of external dependence. A balanced public sector shows a stable path of government budgetary spending relative to GDP and a sustainable debt structure. In developing countries, sound public financial management systems are not only required for the stability and sustainability of public finances but for economic and social development. They are essential tools for enabling government to set macroeconomic targets, to allocate resources, to implement programmes and projects, to maintain international competitiveness and to pursue a balanced path of domestic development between the public and private sectors of the economy.

The need for efficient implementation of government policies and projects that use public funds has resulted in fiscal reforms in several countries, both developing and developed. Initially, this came in the form of measures reining in public expenditure and strengthening revenue collections to support a higher level of public spending or to reduce fiscal deficits. Thereafter, fiscal reforms of programme management moved into structural areas such as reforming laws, regulations, and practices in public financial management to improve the quality of fiscal adjustments within a strengthened economic structure.

Structural reform measures were largely influenced by a number of developments in the theory and concepts of fiscal policy and management (Riechel, 2002). The International Monetary Fund's Code of Good Practices on Fiscal Transparency[1] is recognised as the model for its worldwide membership in support of sound fiscal management and good governance. The Code allows for a better-informed public debate about the design and results of fiscal policy. Consequently, there is more accountability in the implementation of fiscal policy. Although the Code is an important element of IMF reform measures, only a small number of countries have adopted it because of the inherent demand for human resources which are generally scarce in developing countries.

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1 At its fiftieth meeting in Washington, D.C., on April 16, 1998, the Interim Committee of the Board of Governors of the International Monetary Fund adopted the Code of Good Practices on Fiscal transparency - Declaration on Principles.

Since the 1980s, Guyana adopted a number of initiatives, as part of IMF/World Bank structural adjustment programmes, to strengthen the country's fiscal position. These initiatives came in the form of fiscal stabilisation measures and various structural reforms such as modification of the tax structure, reduction of transfers and subsidies, privatisation and strengthening of the income tax and customs administrations. These measures resulted in modest progress in fiscal consolidation. However, there has been pressing need for further structural reforms that would facilitate fiscal sustainability. This arises from the existence of a large public sector, with government expenditure comprising over 40 per cent of GDP in recent years, foreign finance of approximately 16 per cent of government expenditure in an environment of substantial constraints on revenue collections, declining terms of trade and increasing expenditure demands. Under these circumstances, improvements in structural reforms for efficient fiscal practices are of vital economic importance to the country.

In view of this, this paper discusses fiscal experiences and current issues facing Guyana. The organisation of the paper is as follows. Section II discusses fiscal practices and performance prior to 1990; section III discusses the fiscal reforms undertaken during the 1990s; section IV assesses the impact of these reforms; section V discusses the current challenges; and section VI makes some concluding statements.

## 2.0 Public Sector Finances 1980-1990

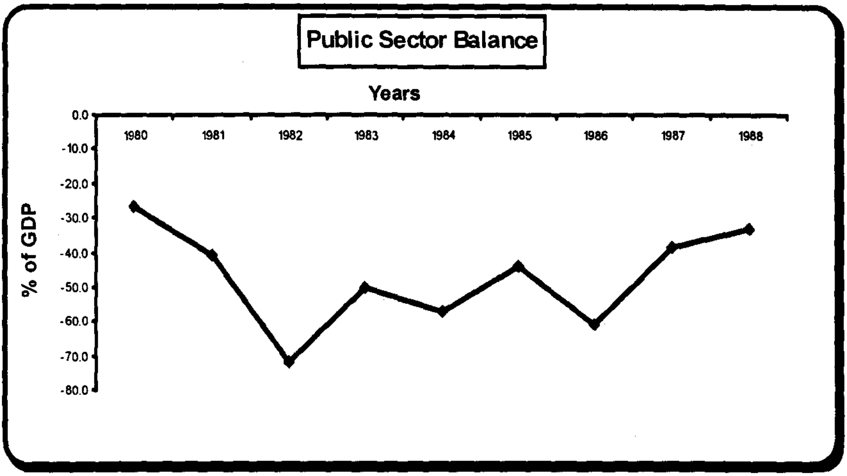
During the 1970s and 1980s, the role of the public sector expanded following nationalisation of major production and distribution enterprises. This led to poor economic performance, with per capita GDP falling and social indicators lagging behind countries in the same income group. At the same time, the overall public sector deficit, as shown in Figure I, deteriorated, peaking at 72 per cent of GDP in 1982. This outturn was as a result of poor financial operations of both the central government and public enterprises as shown in Table I. Central government revenues weakened as a consequence of the decline in real economic activity, the growth of a parallel economy and devaluation losses which depressed the tax base, dropping from 47.2 per cent of GDP in 1986 to 42 per cent in 1989. Simultaneously, growing expenditures, especially interest payments and capital expenditures led to overall central government deficits, which averaged 42 per cent during the 1980-90 period. Lower export receipts and high operating costs contributed to a deterioration of the overall balances of the public enterprises. Capital spending was minimal, resulting in a deterioration of the capital stock, which contributed to low productivity.

**Table 1: Overall Public Sector Operations (1980-1990) (% of GDP)**

| Years | Central Government | Public Corp. | Overall Public Sector |
|---|---|---|---|
| 1980 | -29.7 | 0.0 | -26.9 |
| 1981 | -36.2 | -6.3 | -41.0 |
| 1982 | -66.0 | -8.6 | -71.7 |
| 1983 | -39.1 | -12.9 | -50.3 |
| 1984 | -44.5 | -14.5 | -56.9 |
| 1985 | -37.7 | -8.1 | -44.0 |
| 1986 | -58.8 | -3.7 | -61.0 |
| 1987 | -42.4 | 2.7 | -38.8 |
| 1988 | -31.6 | -1.5 | -33.1 |
| 1989 | -7.0 | -17.0 | -23.9 |
| 1990 | -21.7 | -7.4 | -30.7 |

**Source:** Bank of Guyana's Annual Report (various years).

**Figure I: Public Sector Deficit 1980-1988**




The outturn of the past decade reflected substantial shortcomings in fiscal practices by the central government. On the revenue side, there was a weakening in tax revenue from 1986, as shown in Table 2. The consumption tax, which contributed about 9 per cent of GDP, reflected a dispersed structure of rates, a narrow base consisting of imports and domestic sales of a small number of manufacturers, numerous exemptions, and uneven taxation on inputs. There were seven rates of consumption taxes ranging from 0 per cent to 150 per cent. However, 90 per cent of all scheduled positions were covered by rates ranging from 10 per cent to 30 per cent. Domestic consumption tax collections were largely from a few commodities such as alcohol and tobacco. The latter was taxed at a rate of 150 per cent. This fostered smuggling which became impossible to control. On the other hand, many luxury items such as liquor, beauty products and tableware were taxed at relatively low rates. In addition, close substitutes such as plywood and solid timber were

**Table 2: Central Government Operations (1980-1990)**
**(% of GDP)**

| Years | Total Revenue | Tax Revenue | Income Tax | Property Tax | Prod. & Cons. Tax | Excise Duty | Consumption Tax | Int. Trade Tax | Import Duty | Export Duty | Travel Tax |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1980 | 30.2 | 25.5 | 12.7 | 0.3 | 8.3 | 2.7 | 5.6 | 3.1 | 2.5 | 0.1 | 0.6 |
| 1981 | 36.0 | 30.1 | 13.2 | 0.4 | 11.2 | 2.5 | 8.7 | 4.2 | 2.9 | 0.1 | 1.1 |
| 1982 | 38.3 | 32.7 | 14.5 | 0.6 | 12.1 | 2.6 | 9.4 | 3.6 | 2.0 | 0.1 | 1.5 |
| 1983 | 38.7 | 33.3 | 13.6 | 0.7 | 12.2 | 2.5 | 9.7 | 4.9 | 2.0 | 0.1 | 2.9 |
| 1984 | 41.3 | 34.5 | 14.1 | 0.9 | 13.0 | 2.4 | 10.7 | 4.8 | 1.7 | 0.1 | 3.0 |
| 1985 | 41.3 | 35.5 | 14.8 | 0.8 | 13.3 | 2.5 | 10.8 | 4.3 | 1.6 | 0.3 | 2.4 |
| 1986 | 47.2 | 41.7 | 17.8 | 0.8 | 15.4 | 2.6 | 12.8 | 5.3 | 2.3 | 0.4 | 2.6 |
| 1987 | 38.5 | 30.8 | 12.6 | 0.5 | 11.3 | 1.6 | 9.7 | 4.4 | 2.4 | 0.6 | 1.4 |
| 1988 | 43.3 | 38.4 | 14.8 | 0.4 | 10.2 | 1.7 | 8.5 | 3.8 | 2.2 | 0.4 | 1.2 |
| 1989 | 42.0 | 27.8 | 10.4 | 0.3 | 8.2 | 0.8 | 7.4 | 4.0 | 3.0 | 0.5 | 0.6 |
| 1990 | 48.1 | 32.2 | 11.2 | 0.3 | 8.9 | 0.5 | 8.4 | 4.6 | 3.5 | 0.6 | 0.5 |

**Source:** Bank of Guyana's *Annual Reports* (various years) taxed at differing rates of 40 per cent and 19 per cent respectively, thus discouraging the domestic processing of lumber.

Corporation taxes, which amounted to 8 per cent of GDP, was as a result of varying rates (commercial and non-commercial firms paid 35 per cent and 25 per cent tax on total profits respectively, and 20 per cent income tax on retained earnings each) on a very narrow base. In addition, revenue collections reflected losses by the government's granting of overly generous tax holidays to new companies with limited staff in place to supervise and audit the compliance of larger corporations. Personal income tax contributed 2 per cent of GDP, reflecting a narrow base consisting of public sector employees and employees of relatively large companies. It also reflected a complex structure of six (6) rates and narrow bands.

Import duties, which contributed the equivalent of 5 per cent of GDP, reflected import prohibitions and fiscal incentives granted to encourage investment. It is estimated that the nominal structure of protection combined with exemptions, including subsidies and tax holidays, yielded an average effective rate of protection of 55 per cent. Evasion of import tariffs, either through under-invoicing and smuggling, also explained the trade revenue outturn. The latter, estimated at approximately 25 per cent of official imports, was encouraged by high consumption tax and tariff rates and poor enforcement.

In addition to substantial revenue losses, there was weak expenditure management. Faced with increasing deficits and reduced foreign borrowings, the government borrowed heavily from the domestic financial system, averaging 42 per cent of GDP between 1980 and 1990. Consequently, government's expenditure was dominated by debt service obligations, which averaged 23 per cent

**Table 3: Central Government Operations (1980-1990)**
**(% of GDP)**

| Years | Primary Balance | Current Balance | Capital Expen-diture | Personal Emolu-ments | Debt Charges | Domestic Interest | External Interest | Other Charges | Current Expen-diture |
|---|---|---|---|---|---|---|---|---|---|
| 1980 | 2.8 | -7.6 | 22.4 | 12.4 | 10.4 | 7.7 | 2.7 | 14.7 | 37.5 |
| 1981 | 4.5 | -10.7 | 26.5 | 14.7 | 15.1 | 11.8 | 3.3 | 15.9 | 45.8 |
| 1982 | 8.4 | -11.6 | 54.6 | 16.1 | 20.0 | 16.7 | 3.2 | 13.6 | 49.7 |
| 1983 | 8.6 | -20.4 | 18.8 | 16.3 | 29.0 | 22.7 | 6.3 | 13.7 | 59.0 |
| 1984 | 3.6 | -29.3 | 18.2 | 17.7 | 32.8 | 29.2 | 3.6 | 17.0 | 67.5 |
| 1985 | 2.8 | -14.7 | 24.8 | 17.9 | 17.5 | 13.8 | 3.7 | 18.9 | 54.3 |
| 1986 | 12.3 | -5.0 | 55.0 | 17.4 | 17.3 | 14.7 | 2.6 | 16.3 | 51.0 |
| 1987 | 1.6 | -27.2 | 17.4 | 16.5 | 28.8 | 25.6 | 3.2 | 18.2 | 63.5 |
| 1988 | 10.1 | -10.3 | 22.9 | 13.8 | 20.4 | 12.6 | 7.8 | 17.8 | 51.9 |
| 1989 | 6.3 | -4.8 | 12.7 | 7.2 | 11.2 | 9.2 | 2.0 | 17.5 | 35.9 |
| 1990 | 12.2 | -14.6 | 21.1 | 6.8 | 26.8 | 3.2 | 23.6 | 15.1 | 48.7 |

**Source:** Bank of Guyana's *Annual Report* (various years).

during the review period as shown in Table 3. The growth of the civil service, and hence, high level of central government employees, also contributed to increased current expenditure through personal emoluments, which averaged 16 per cent of GDP between 1980 and 1988. Expenditure on other goods and services as well as current transfers was also high, averaging 17 per cent and 7 per cent of GDP, respectively.

By the end of the 1980s, Guyana had a tax system characterised by high rates of nominal taxes imposed on a relatively small base due to numerous exemptions and the lack of staff to effectively enforce the tax system. Central government's expenditures began to rise on account of debt service obligations stemming from Guyana's debt overhang and sharp increase in current transfer to the Guyana Electricity Corporation and international organisations. The overall deficit was exceptionally high and was financed largely by the domestic financial system.

## 3.0 Public Sector Reform

In light of the deterioration in Guyana's macro-economic performance, the government embarked on a medium-term Economic Recovery Programme (ERP) in mid-1988. The programme consisted of a set of far-reaching adjustment measures and structural reforms to transform Guyana's state dominated economy into a market-oriented one. During the 1989-90 period, the government implemented key measures of the ERP which included removal of price controls, elimination of import prohibition and restrictions, simplification of the external tariff structure, steps to establish a free cambio market system and introduction of a number of public sector reform measures to increase the efficiency of the tax system and control public sector expenditure.

In 1989, the government converted some specific taxes to ad-valorem taxes and eliminated exemptions on consumption taxes as well as import duties specific to public enterprises. In 1990, exemptions on fuel and imports of agricultural, forestry and mining equipment were eliminated, while previously prohibited imports were covered by these taxes. In 1991, the personal income tax system was simplified by replacing allowances and deductions with a non-taxable income threshold and by reducing the number of tax bands from six to three. The highest marginal rate was reduced from 50 per cent to 40 per cent. The corporation tax structure was improved by the adoption of a single tax rate of 35 per cent of gross profits. A 15 per cent withholding tax on interest on resident savings was introduced in lieu of taxation of personal income. The consumption tax rate was reduced to 40 per cent for most commodities previously taxed at 50 per cent.

In 1992, consumption taxes were eliminated for basic items and reduced for a number of luxury items. New travel and hotel taxes were introduced. In 1993, the personal income tax was further simplified with a single rate of 331/3 per cent of all taxable income in excess of a fixed allowance of G$120,000 per year. The tax base was broadened to include the self-employed through the introduction of a minimum tax on gross sales of all companies. During the 1994-2000 period, a number of tax measures were implemented. Excise taxes, which were the main indirect taxes, were eliminated in 1994. Dividends to residents were exempted from withholding and income taxes while a 15 per cent withholding tax was extended to interest paid on loans secured by bonds, as well as on the discount on treasury bills. In 1994, a minimum tax based on gross sales or receipts was introduced. The tax was levied at a rate of 2 per cent and applied to entities, except those in agriculture and tourism, with annual sales on receipts exceeding a threshold amount of G$1.2 million, to ensure that micro-enterprises would not be negatively affected. The minimum tax would be credited against corporation tax. The tariff reduction in the new Caricom Common External Tariff (CET) was implemented; a single consumption tax rate for all vehicles was introduced and the purchase tax adjusted for any revenue loss; a ten per cent consumption tax was levied on overseas telephone bills and on the value of bets. There were also adjustments in the income tax threshold, and a progressive tax system for assessing chargeable income of individuals for income tax was introduced in 1997. A rate of 20 per cent was charged on income that did not exceed G$350,000 and 331/3 per cent for income in excess of G$350,000. The non-taxable income tax threshold in 1997 was increased to G$18,000 per month or G$216,000 per annum.

Export allowances for non-traditional exports were introduced in 1997 with a maximum of 75 per cent of export profit as export allowance. Export taxes on fish and shrimp were waived and consumption taxes on the agriculture, forestry, mining and manufacture equipment, plant and machinery were zero-rated. Special incentives in the form of tax concessions were provided for certain depressed areas.

In addition to measures to reduce the distortionary effects of the tax system, tax administration reforms were initiated. These included the strengthening of the Inland Revenue and Customs Departments, administration and enforcement through computerisation, tighter procedures, especially with valuations and audits, and the establishment of an anti-smuggling squad. There was also the establishment of a new autonomous Revenue Authority, that merged the Inland Revenue and Customs Departments.

Civil service reform was a major strategy to strengthen overall public service management and control increasing expenditure. The overriding concern of the government was to reduce the high number of support and other low-level staff and to fill vacancies for technical positions. During the 1990s, the government made a number of attempts to reduce the size of the public service through voluntary severance, especially at the lowest wage levels. In 2000, there was privatisation of government functions initiated through the security services, to separate activities best provided by the private sector. There were also large across-the-board wage increases as shown in Table 4. In 1993, the government had introduced a 14-band salary structure to pay high rates to skilled workers. Wage increases were intended to bring the public sector wages in line with comparable jobs in the private sector.

Programme budgeting was introduced as another element of fiscal strengthening. This refers to the decentralised planning, execution and monitoring of government programmes by the line ministries, rather than completely channelling and controlling budgeting for the programme through the Ministry of Finance. It started as a pilot project in two Ministries and included the computerisation of Expenditure Programming and Management Units to encourage a systematic approach to programme budgeting and to facilitate disbursements. There was also Civil Service strengthening in various institutions through reorganisations, job descriptions, as well as management and human resource development. For example, economic modelling capacity was strengthened for macroeconomic policy formulation while the treasury function was enhanced to support budget reform.

**Table 4: Salary Awards, Benefits and Allowances, 1989-2000 (In Percent)**

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Wage awards 1/ | 40 | 19 | 70 | 22 | 0 | 10 | 15 | 15 | 15 | 19 | 31 | 27 |
| Average benefits 2/ | 12.4 | 15.8 | 20.8 | 14.7 | 15.9 | 13.4 | 12.4 | 13.4 | 16.2 | 14.1 | ... | ... |
| Maximum benefits 3/ | 46.6 | 47.5 | 59.4 | 68.3 | 62.0 | 59.1 | 57.0 | 51.1 | 41.9 | 52.5 | ... | ... |
| Difference /4 | 34.2 | 31.7 | 38.6 | 53.6 | 46.1 | 45.7 | 44.6 | 37.7 | 25.7 | 38.4 | ... | ... |

**Source:** Ministry of Finance, Government of Guyana.

1/ Average percent increase in wages awarded to government employees.

2/ Average ratio of total benefits plus allowances to total emoluments.

3/ Maximum ratio of benefits plus allowances to total emoluments.

4/ Difference between the maximum ratio (of benefits plus allowances to total emoluments) and the average ratio.

Privatisation was an important strategy pursued in the context of public sector reform. It was implemented through outright sale of enterprises, lease of assets, sale of government's interests in the form of equity and corporisation through management contract with the private sector. In 1994, a privatisation policy paper setting out the privatisation strategy of the government and a list of entities to be privatised was tabled in Parliament to improve procedures of privatisation which lacked transparency prior to 1992. An appropriate regulatory framework was also established to facilitate privatisation.

## 4.0 Assessment of Public Sector Reform

Under the ERP, and in particular, the public sector reform measures, there has been progress in the operation of the public sector - both central government's and public enterprises. This is evidenced by the sharp decline in the overall public sector deficit. Figure II shows that the overall deficit declined from 36 per cent of GDP in 1990 to 22.7 per cent in 1993 to an annual average of 5.9 per cent during the 1994-2001 period. This was reflected in improved fiscal operations of both the central government and public enterprises. The central government's overall deficit declined from 22 per cent of GDP in 1990 to 6.8 per cent in 1993 and to an annual average of 6.0 per cent during the 1995-2001 period.

Improvements in central government operations reflected resource mobilisation and allocation. Table 6 shows that tax revenues increased from 28.5 per cent of GDP in 1991 to 35.1 per cent in 1993 and to an annual average of 30 per cent during the 1995-2001 period. The improvement in tax collections was largely due to improved consumption tax, personal tax and self-employed tax collections. Consumption tax increased slowly from 9 per cent of GDP in 1990 to 9.6 per cent in 1993 and then to an

**Table 5: Overall Public Sector Operations (1990-2001)**
**(% of GDP)**

| Years | Central Gov't | Public Corp. | Overall Public Sector |
|---|---|---|---|
| 1990 | -21.7 | -7.4 | -30.7 |
| 1991 | -23.5 | 1.1 | -35.5 |
| 1992 | -17.1 | 2.2 | -26.3 |
| 1993 | -6.8 | -7.2 | -22.7 |
| 1994 | -6.8 | -0.4 | -12.2 |
| 1995 | -3.3 | 0.0 | -6.5 |
| 1996 | -1.6 | 2.9 | 0.3 |
| 1997 | -6.9 | 2.6 | -4.2 |
| 1998 | -6.4 | 1.9 | -4.1 |
| 1999 | -5.7 | 1.2 | -3.9 |
| 2000 | -7.3 | 0.7 | -7.7 |
| 2001 (preliminary) | -9.5 | 0.3 | -9.2 |

**Source:** Bank of Guyana's *Annual Report* (various years).

**Figure II: Public Sector Deficit 1990-2001**

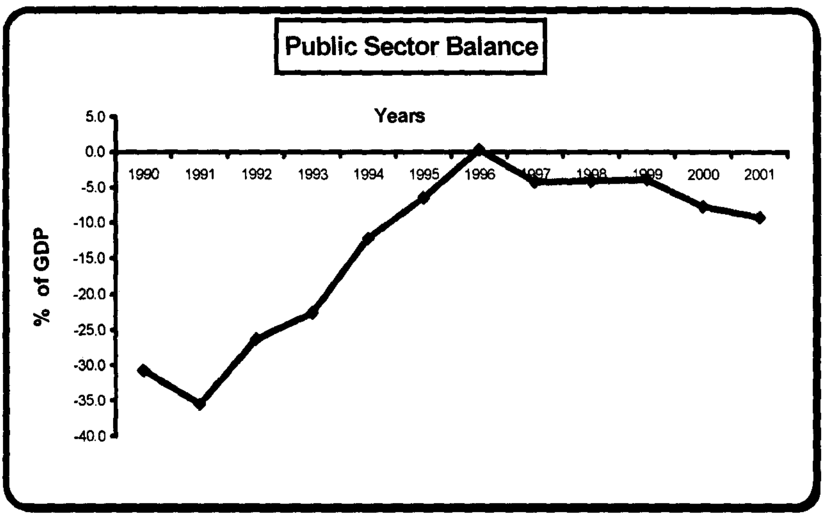


**Table 6: Central Government Operations (1991-2001)**
**(% of GDP)**

| Years | Total Revenue | Tax Revenue | Income Tax | Property Tax | Prod. & Cons. Tax | Excise Duty | Consumption Tax | Int. Trade Tax | Import Duty | Export Duty | Travel Tax |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1991 | 34.8 | 28.5 | 9.0 | 0.2 | 8.7 | 0.2 | 8.5 | 4.0 | 2.9 | 0.5 | 0.6 |
| 1992 | 41.6 | 36.5 | 12.6 | 0.2 | 9.9 | 0.3 | 9.6 | 4.4 | 3.5 | 0.3 | 0.6 |
| 1993 | 40.4 | 35.1 | 12.0 | 0.4 | 9.6 | 0.3 | 9.3 | 5.5 | 4.5 | 0.3 | 0.7 |
| 1994 | 38.6 | 29.8 | 10.8 | 0.5 | 7.7 | 0.1 | 7.6 | 4.6 | 3.8 | 0.2 | 0.6 |
| 1995 | 36.7 | 31.9 | 12.4 | 0.5 | 11.9 | 0.0 | 11.9 | 3.7 | 2.9 | 0.1 | 0.7 |
| 1996 | 38.4 | 32.9 | 13.1 | 0.5 | 11.4 | 0.0 | 11.4 | 4.7 | 3.9 | 0.2 | 0.6 |
| 1997 | 34.7 | 29.4 | 11.6 | 0.5 | 10.5 | 0.0 | 10.5 | 4.1 | 3.5 | 0.0 | 0.6 |
| 1998 | 33.6 | 28.6 | 11.1 | 0.4 | 10.2 | 0.0 | 10.2 | 4.1 | 3.4 | 0.0 | 0.7 |
| 1999 | 29.9 | 26.9 | 11.1 | 0.4 | 9.5 | 0.0 | 9.5 | 3.7 | 3.0 | 0.0 | 0.7 |
| 2000 | 31.8 | 29.4 | 12.3 | 0.5 | 11.5 | 0.0 | 11.8 | 3.9 | 3.0 | 0.0 | 0.8 |
| 2001 | 31.1 | 28.1 | 12.6 | 0.5 | 10.4 | 0.6 | 9.9 | 3.7 | 2.8 | 0.0 | 0.8 |

**Source:** Bank of Guyana's *Annual Report* (various years).

annual average of 11 per cent between 1995 and 2001. The outturn reflected effects of measures implemented during the second half of the 1990s that included an extension in the coverage of consumption tax, elimination of exemptions specific to public enterprises and the shift to an ad-valorem base. Personal income tax increased from 2 per cent of GDP to 3.7 per cent in 1993 and to an annual average of 4.6 per cent during the 1994-2001 period. The improvements in the last half of the 1990s were due to higher wages in the public service and the expansion in private sector employment, reflecting the increase in real economic activity. Self-employed tax collections increased from 0.2 per cent of GDP in 1993 to an annual average of 0.45 per cent during the 1994-2001 period. This was as a result of an improvement in the strengthening of the tax administration and the simplifying of the tax structure. In contrast, corporation tax revenue declined from 8.8 per cent in 1990 to 7.7 per cent in 1992, and reached an annual average of 6.5 per cent during the 1994-2001 period. This performance was due to overly generous tax holidays given in the early 1990s and the limited staff resources to increase supervision and ensure compliance by larger corporations.

Faced with revenue limitations and increasing budget deficits, the government made concerted efforts to reduce both current and capital expenditures. Table 7 shows that current expenditure declined from 49 per cent of GDP in 1990 to 35 per cent in 1993, to an average of 28 per cent between 1994 and 2001 due to a decline in personal emoluments, interest obligations and spending on other goods and services. Personal emoluments declined from an annual average of 15 per cent of GDP during the 1980-1989 period to 7.8 per cent of GDP during the 1990-2001 period. This reflected a conscious effort by the government to rein in personal emolument costs through wage restraint

**Table 7: Central Government Operations (1990-2001)**
**(% of GDP)**

| Years | Primary Balance | Current Balance | Capital Expen-diture | Personal Emolu-ments | Debt Charges | Domestic Interest | External Interest | Other Charges | Current Expen-diture |
|---|---|---|---|---|---|---|---|---|---|
| 1990 | 12.2 | -14.6 | 21.1 | 6.8 | 26.8 | 3.2 | 23.6 | 15.1 | 48.7 |
| 1991 | 8.6 | -16.8 | 11.1 | 5.8 | 25.5 | 10.7 | 14.8 | 16.0 | 47.2 |
| 1992 | 13.0 | -11.3 | 9.4 | 7.0 | 24.4 | 11.3 | 13.1 | 17.9 | 49.4 |
| 1993 | 18.5 | 1.9 | 12.2 | 6.1 | 16.6 | 6.8 | 9.8 | 12.3 | 35.0 |
| 1994 | 16.3 | 0.2 | 14.2 | 6.1 | 16.2 | 6.7 | 9.4 | 8.9 | 31.2 |
| 1995 | 16.3 | 6.5 | 13.1 | 6.5 | 9.8 | 6.1 | 3.7 | 10.7 | 26.9 |
| 1996 | 20.0 | 11.3 | 15.9 | 6.8 | 8.7 | 5.2 | 3.5 | 8.6 | 24.2 |
| 1997 | 15.2 | 5.6 | 15.4 | 8.4 | 9.6 | 3.6 | 6.0 | 8.3 | 26.3 |
| 1998 | 12.4 | 2.7 | 12.1 | 8.5 | 9.7 | 2.9 | 6.9 | 9.8 | 28.0 |
| 1999 | 10.1 | 4.0 | 10.0 | 9.6 | 6.1 | 2.9 | 3.2 | 9.9 | 25.6 |
| 2000 | 8.3 | 0.7 | 13.2 | 11.0 | 7.6 | 3.9 | 3.8 | 12.5 | 32.9 |
| 2001 | 4.5 | -1.5 | 12.4 | 11.1 | 6.0 | 3.6 | 2.4 | 15.5 | 35.9 |

**Source:** Bank of Guyana's *Annual Report* (various years).

so as to maintain real wage levels and to reduce drastically the number of central government employees.

Interest obligations declined from 26 per cent of GDP in 1990 to 16.6 per cent in 1993 and reached an annual average of 9.3 per cent during the 1994-2001 period. This reflected a significant reduction in both domestic and external interest costs. Domestic interest costs declined as a consequence of falling interest rates on a lower volume of securities to sterilise excess liquidity in the financial system as well as domestic financing of a small deficit. External interest cost declined due to debt rescheduling and reduction under various Paris Club arrangements and both the Original and Enhanced Highly Indebted Poor Country (HIPC) Initiative.

Expenditure on other goods and services, i.e., on materials, fuel, equipment supplies, travel, postage and other services were significantly reduced with the ERP. Expenditure on these items declined steadily from 15 per cent of GDP in 1990 to 12.3 per cent of GDP in 1993 and to an average of 10.5 per cent of GDP during the 1994-2001 period. This outturn reflected a reduction in the number of government Ministries and Departments. This performance, however, has impaired the efficient functioning of these institutions and led to improper maintenance of infrastructure.

Since the initiation of the Economic Recovery Programme in 1988, there has been a conscious effort to reduce capital expenditure in the face of resource constraint and to focus resources on those areas that are most critical to the recovery process. The level of capital expenditure which averaged 13 per cent of GDP between 1990 and 2001 was effected through the Public Sector Investment Programme (PSIP) whose objectives were to rehabilitate and strengthen the country's economic and

**Table 8: Central Government Operations (1980-2000) (% of GDP)**

| Years | Deficit | External Financing | Domestic Financing |
|---|---|---|---|
| 1980 | -29.7 | 2.4 | 27.3 |
| 1981 | -36.2 | 17.7 | 18.5 |
| 1982 | -66.0 | 3.6 | 62.4 |
| 1983 | -39.1 | 5.7 | 33.4 |
| 1984 | -44.5 | 3.2 | 41.3 |
| 1985 | -37.7 | 2.0 | 35.7 |
| 1986 | -58.8 | 5.5 | 53.3 |
| 1987 | -42.4 | 2.9 | 39.5 |
| 1988 | -31.6 | -4.0 | 35.6 |
| 1989 | -6.6 | 5.9 | 0.7 |
| 1990 | -21.7 | 17.0 | 4.7 |
| 1991 | -23.5 | 20.4 | 3.1 |
| 1992 | -17.1 | 10.8 | 6.3 |
| 1993 | -6.8 | 7.1 | -0.3 |
| 1994 | -6.8 | 9.7 | -2.9 |
| 1995 | -3.3 | 2.9 | 0.4 |
| 1996 | -1.6 | 8.8 | -7.2 |
| 1997 | -6.9 | 6.9 | 0.0 |
| 1998 | -6.4 | 4.7 | 1.7 |
| 1999 | -5.7 | 4.9 | 0.8 |
| 2000 | -7.3 | 6.0 | 1.3 |
| 2001 | -9.5 | 5.9 | 3.6 |

**Source:** Bank of Guyana's *Annual Reports* (various years).

social infrastructure. Financing the investment programme was covered by donor assistance, counterpart funds and budgetary resources and this is reflected in external financing of central government deficit which averaged 8.8 per cent of GDP during the 1990-2001 period. This was almost three times the average of 3.1 per cent recorded during the 1982-1989 period.

The financial operation of public enterprises markedly improved after 1990, except for 1993. The overall balances improved from a deficit of 7.4 per cent of GDP in 1990 to an average surplus of 1.2 per cent of GDP, except for the 1993-94 period when there was a setback with deficits of 7.2 and 0.4 as a percentage of GDP, respectively. This favourable outturn reflected cost-cutting measures such as the reduction of the labour force; rationalisation of the mining companies; adjustments of the exchange rate and divestment of a large number of public enterprises as shown in Table 10.

### 4.1 Current Issues Facing Guyana

Guyana has seen much progress from the reform measures implemented to improve the tax system, administration and public financial management. However, the tax system is still characterised by high rates of nominal taxes on a relatively small base, while there is disenchantment with the ability of the government to provide goods and services efficiently. The authorities are aware of these problems as well as the need to undertake fundamental reforms to improve the quality of fiscal adjustments and to facilitate fiscal sustainability given the large size of the public sector and the high dependence on external financing. These reforms would include measures to strengthen revenues and enhance public financial management which would require a number of policy actions to address the challenges they are likely to face.

**Table 9: Guyana: Employment in the Public Sector, 1993-99**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|
| | | | | **(Number of employees)** | | | |
| Total Public Sector 1/ | 56,132 | 50,492 | 46,671 | 42,179 | 40,243 | 38,967 | 35,892 |
| Central Government | 15,899 | 14,564 | 12,913 | 12,450 | 12,215 | 12,119 | 12,024 |
| Rest of the Public Sector | 40,233 | 35,928 | 33,758 | 29,729 | 28,028 | 26,848 | 23,868 |
| | | | | **(In percent of Total)** | | | |
| Central Government | 28.3 | 28.8 | 27.7 | 29.5 | 30.4 | 31.1 | 33.5 |
| Rest of the Public Sector | 71.7 | 71.2 | 72.3 | 70.5 | 69.6 | 68.9 | 66.5 |
| | | | | **(12-month percentage change)** | | | |
| Central Government | ... | -8.4 | -11.3 | -3.6 | -1.9 | -0.8 | -0.8 |
| Rest | ... | -10.7 | -6.0 | -11.9 | -5.7 | -4.2 | -11.1 |
| Total Public Sector | ... | -10.0 | -7.6 | -9.6 | -4.6 | -3.2 | -7.9 |

**Sources:** Bureau of Statistics, State Planning Secretariat..

1/ Excludes staff of the Guyana Police Force, Guyana Defense Force, Guyana Fire Service, Guyana Prison Service, Guyana National Service, Teachers, Open Vote Workers, and staff of entities receiving subsidies and contributions.

**Table 10: Guyana: Privatization of Public Enterprises[1]**

| Enterprise | Enterprise Sold | Asset Leased | Share Sold | Closed | Management Contracts | Brought to Point of Sale |
|---|---|---|---|---|---|---|
| Guyana Timbers | 1989 | | | | | |
| Guyana Transport Services Ltd. | 1990 | | | | | |
| Guyana Paint Company | 1990 | | | | | |
| Guyana Fisheries Ltd. | 1990,1994 | 1990 | | | | |
| Guyana National Trading Corporation | 1990 | | | | | |
| GUYSUCO[2] | | | | | 1990 | |
| Guyana Telecommunications Ltd. | 1991 | | | | | |
| Quality Foods Ltd. | 1991 | | | | | |
| Leathercraft Ltd. | 1991 | | | | | |
| Demerara Woods Ltd. | 1991 | | | | | |
| Sijan Plaza | 1991 | | | | | |
| Guyana Nichimo Ltd. | 1991 | | | | | |
| Guyana Rice Milling and Marketing Authority | | | | 1991 | | |
| Seals and Packaging Industrial Ltd. | | | 1991, 1993 [3] | | | 1997 |

**Table 10: Guyana: Privatization of Public Enterprises[1] - Cont'd**

| Enterprise | Enter-prise Sold | Asset Leased | Share Sold | Closed | Manage-ment Contracts | Brought to Point of Sale |
|---|---|---|---|---|---|---|
| Guymine[4] | | | | | 1991 | 1997 |
| Guyana Soap and Detergent Ltd. | 1993 | | | | | |
| Guyana Design and Graphics | | | | 1993 | | |
| Guyana Bank for Trade and Industry | | | 1994[5] | | | |
| National Bank of Industry & Commerce | | | 1994, 1997-98[5] | | | |
| Caterpillar Division of Guyana | 1997[6] | | | | | |
| National Engineering Corp. (GNEC) | | 1994 | | | | |
| Majority of Assets of GNEC | 1995[6] | | | | | |
| Guyana Distillery Ltd. | | | 1995[5] | | | |
| Guyana Stores Ltd. | | | 1995[7] | | | 1999 |
| Guyana National Cooperative Bank | | | | | 1995, 1999 | |
| Guyana Printers Ltd. | | | | | | 1996 |
| Guyana Pharmaceutical Corporation | 1999 | | | | | 1996 |
| The National Edible Oil Company | 1997[6] | 1997, 1998 | | | | |
| Guyana Glassworks Ltd. | | 1997, 1999 | | | | |
| Guyana Stockfeeds Ltd. | | | 1997[3] | | | |

Table 10: Guyana: Privatization of Public Enterprises[1] - Concluded

| Enterprise | Enterprise Sold | Asset Leased | Share Sold | Closed | Management Contracts | Brought to Point of Sale |
|---|---|---|---|---|---|---|
| Guyana Co-operative Insurance Service | | | | | | 1997 |
| Guyana Electricity Corporation | | | 1999 | | | 1997 |
| Wauna Palm Oil Estate | | | | | | 1998 |
| Versailles Dairy Complex | | | | | | 1998 |
| GNCB Trust | | | | | | 1998 |
| Guyana Airways | | | 1999 | | | 1998 |
| Hope Coconut Industries | | | | | | 1999 |
| Guyana Oil Company[2] | | | | | | |
| Guyana National Shipping[2] | | | | | | |
| Sanata | | 2000 | | | | |

1 Enterprises in which public sector has a controlling interest. Both central government and National Insurance Scheme maintain minority shares in a range of private companies.
2 To remain state owned.
3 Maintains a majority of shares.
4 Divided into BERMINE and L
5 Sale of all existing shares.
6 Assets sold.
7 Maintains minority interest.

Specifically, efforts to improve revenue collection would have to address the issues of neutrality by expanding the tax base, reducing some tax rates deemed too high and developing and maintaining effective measures to counter tax evasion and avoidance, and the economic structure underlying fiscal performance

In 1999, the government, through the IMF, undertook a study of Guyana's tax system which would have addressed the challenges the authorities faced. This study, however, fell short of its objectives of reviewing the structure and performance of the tax system in Guyana as well as making recommendations for short and medium-term improvements. The study focused only on the implementation of a value-added tax (VAT) to replace various consumption taxes and the 2 per cent turnover tax which puts pressure on the economic system to reduce activity at the earlier stages of production. The study noted that VAT is an essential component of a modern tax system and has the potential to increase tax revenue by expanding the tax base substantially, replace the turnover tax and provide economic neutrality to the tax system. In 2001, the government, in collaboration with the private sector, sponsored a seminar on VAT where it was noted that despite the virtues of VAT, it could place excessive demands on the government's limited resources and could generate weaker revenue collection through tax evasion. This is because Guyana is still at an early stage of development and most of its business activity is fragmented among small firms. Small-scale agriculture plays an important role in the economy and basic accounting is not widespread. The value-added technique would, therefore, have to be applied in a less than comprehensive manner and would require a high rate on a narrow base to raise the same level of revenue. Consequently, a major challenge is to develop an appropriate tax system, with or without VAT, that is both neutral and efficient in the medium-term. To this end, the government, through the IMF, the US Fiscal Affairs Department (FAD) and Caribbean Regional Technical Assistance Centre (CARTAC) is conducting a comprehensive review of the tax system in Guyana.[2]

In the immediate to short-term, the government would have to strengthen revenue efforts in various untapped areas such as the self-employed and the parallel economy. Over the last decade, there has been an extension of the formal system of taxation to include the self-employed, but the parallel economy is yet to be covered. The self-employed tax as a per cent of GDP increased from 0.2 per cent in 1990 to 0.45 per cent during the 1994-2000 period. This level of contribution, however, is relatively small in relation to tax revenue in view of the level of growth in the economy and the excessive number of activities that take place in these sectors. The challenge is to find innovative measures to increase tax revenues from these sectors which would allow for a reduction in some tax rates to levels that are considered adequate by authorities. Higher property tax is seen as an option in recovering revenue lost from the self-employed and the parallel economy. However, this would increase the tax rates on the narrow base and further compound the inequities on those bearing the burden of taxation which may further undermine tax

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2 A recent study by the US Fiscal Affairs Department recommends broadening the tax base by reducing evasion, eliminating or reducing discretionary exemptions to a minimum; introducing a broad-based tax which includes services in its base; raising the personal income tax threshold and introducing a presumptive tax on income for small businesses and professions as a means of reforming the tax system in Guyana. (Stabroek News, Sunday, June 23, 2002).

collection. The challenge is to collect revenues from these sectors through a modification of the property tax system, implementing other simplified forms of taxes or using a presumptive tax where agents within the sectors are taxed on the average of the sector.

The US Fiscal Affairs Department (FAD) study recommended that the professional group of the self-employed should pay a minimum tax of 33.3 per cent on the professional's income until the Guyana Revenue Authority (GRA) could collect regular income tax from the group. It suggested that the base of the minimum tax be set at the level of the salary of the corresponding professionals in the public sector. In addition, the study further proposed that the licence fee for professionals be increased from $10,000 to US$5,000 per annum since, at the time of the fee's introduction, it was equivalent to this amount. With regard to property tax, the study advised that the government would need to enact legislative changes requiring the results of future evaluations by municipalities based on studies currently underway, and these should be used as the base for calculating taxpayers' assets. The study also recommended that a presumptive tax, based on the presumed income, be imposed on small businesses at the time of introducing VAT. The use of a VAT threshold would provide an incentive for entities that did not sell their output to registered entities to split their businesses so that their turnovers would be below the threshold.

Guyana has been compensating for poor income tax revenue collection with high taxes on foreign trade. However, globalisation and, more specifically, the liberalisation of trade as an ongoing regional effort towards the establishment of a single market and economy for the Caribbean Community (Caricom) have seen a reduction in import tariffs. While increases in import volumes in response to trade liberalisation may mitigate some of the losses in revenue, an additional challenge would be to find ways to maintain tax revenues against the need to avoid impediments to the development of the Caricom single market and economy, and for trade generally. Consequently, there is need for a reexamination of the Guyana Revenue Authority (GRA) customs department to make it more efficient in revenue collection by preventing tax evasion through smuggling.

Extensive fiscal incentives for investment, particularly tax holidays and tax exemptions, are seen as unnecessarily constraining revenue growth and preventing the government from recapturing the costs of providing infrastructure services to the private sector.[3] They are also seen as requiring higher taxes elsewhere, distorting economic activities and imposing inequitable burden on different producers and industries. These arguments, however, need to be taken against the background that Guyana's political and economic environments have been highly unstable and hence, investment has been very risky. Therefore, the purpose of fiscal incentives has been to attract investors who would not otherwise invest in the country or particular activity by reducing the risk and making potential projects viable. However, the IMF tax study noted that such incentives are ineffective and marginal. Factors such as political and macroeconomic stability, adequacy of social and physical infrastructure, cost and availability of skilled and unskilled labour and ease of project repatriation are more effective.

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3 An IMF and Fiscal Affairs Department (2001) study noted that in 1997 total import and consumption tax exemption amounted to 50 per cent of the total taxes collected for the year and by 2001 grew to 59 per cent. The largest and fastest growing category of exemptions was remissions.

Notwithstanding the various arguments, to ensure that fiscal incentives achieve their objectives in attracting investment in Guyana it is imperative that the incentives are economically justifiable and part of the normal tax structure. The provision of fiscal incentives should be justified through a cost-effectiveness assessment where both benefits and costs are quantified. The key issue that needs to be addressed is whether the revenues foregone are sufficiently compensated for by the accrued benefits in terms of employment generation, foreign exchange earning, the transfer of technology, the upgrading of skills of nationals, etc. This approach requires an administrative capacity at **Goinvest** that would allow for efficient implementation and monitoring. In addition, there should be post-importation control to ensure that goods on which duties and taxes are remitted for specific purposes are used for those purposes. The government has been making fiscal incentives an important element of the budgetary exercise and recently tabled an investment code to Parliament so that information on its policy on fiscal concessions are disseminated and consideration is given to the issues of distribution and equity. However, since there are concessions which deviate from these provisions, it is crucial that they are revealed to the public to enhance transparency and to allow for an assessment of changes in government policy. The IMF-FAD study noted that the discretion vested in the Minister of Finance to authorise exemption from duty and tax was not conducive to transparency or efficiency as tax holidays could be abused. The study also recommended that the discretionary powers of the Minister of Finance and the President be removed.

Although the government has made great strides to strengthen tax administration through the Guyana Revenue Authority (GRA), the administration and its procedures need to be enhanced to improve revenue collection. The authority needs to be strengthened with professional and skilled officers who can eliminate corruption[4] and control tax evasion. Revenue collection could also be enhanced through the use of new technological developments to improve compliance by businesses while making corruption more difficult, as well as to improve the services provided to taxpayers. It could also help to reduce the cost of tax administration for the revenue authority. An audit strategy could also make the GRA more effective in its operations by conducting audits on a more selective basis and according to the economic size of enterprises.

The initiatives to strengthen tax revenues need to be complimented with further improvements in fiscal management to boost public sector efficiency in service delivery. The challenges would be to strengthen fiscal controls and improve the quality of public spending in line with international best practices which the government is committed to implementing. This could occur through an improvement in the budgeting process, which focuses on performance orientation and fiscal decentralisation programmes. With regards to the former, the emphasis is on a detailed and refined ex-ante specification of performance measures with an ex-post measurement of the results. The efficiency gains are expected to be maximised in a system of output budgeting and accrual accounting which are seen as best practices in public financial management. This is an advanced form of performance budgeting under which budgetary appro-

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4 The IMF-FAD study recommended the implementation of the employee code of conduct to assist in enhancing the work ethics of GRA officers and to also assist in the elimination of corruption.

priations are linked to specific outputs, of Ministries or government departments and agencies. The definition of outputs in turn permits the establishment of well-defined contracts for delivery as well as a tight evaluation of results, both of which are expected to increase effectiveness and efficiency of budgetary operations. It is important to note that such a system of expenditure management and control is already implemented in a limited way with respect to HIPC resource spending. Also, the Inter-American Development Bank (IDB) Civil Service reform, which entails a staff audit, could assist in the provision of well-defined staff contracts.

Output budgeting, however, requires significant financial support and extensive technical assistance from the donor community to overcome the major constraint of the generally weak Public Service for effective and widespread implementation of the programmes. Local capacity would have to be built to ensure sustainability. This would require further rationalisation of the Public Service and the provision of attractive packages to attract skilled workers committed to giving high quality services. Remuneration packages would have to become transparent, equitable and strictly tied to merit and productivity considerations. Political commitment to the process is a necessary condition for its success.

The decentralisation programmes consisted of devolving revenue sources and expenditure functions from the central government to sub-national jurisdictions, such as the regions and municipalities. The main argument for this is that local government is closer to the people and hence, better equipped to extract information on local preferences and needs at lower costs. In addition, there is likely to be enhanced accountability and transparency in policy making by bringing expenditure assignments closer to revenue sources and hence, to the people. However, the geography of the country and concentration of economic activities in few regions as well as concerns over policy sustainability, governance and macroeconomic management are major challenges for implementation of widespread fiscal decentralisation programmes in Guyana.

In addition to the budgetary initiatives, there is need for greater efficiency of public investment and in particular government's capital projects under the PSIP. Given that these projects which are crucial for the socio-economic growth and development of the country are large, indivisible, subjected to limited financial resources and lack economies of scale because of the geography of the country, it is imperative that there are adequate project selection and implementation procedures. In this regard, project selection/funding should be done on the basis of a detailed cost-benefit analysis. Strong cash flow management based on project progress and evaluation against standard benchmarks should carry out project implementation. In the case of projects contracted out to the private sector, it is necessary that proper tendering procedures are followed to promote good governance and transparency. The government has passed in Parliament amended tender and procurement legislation and corresponding detailed regulations are to follow. These amendments include autonomy of the Central Tender Board, development of standard bidding documents, revision of thresholds and reforms of regional systems and effective enforcement of the agreed standards. The implementation of these would require significant additional skilled resources which are scarce in Guyana.

Privatisation, which is a critical part of the government's modernisation programme, would have to be continued to reduce excessive strains on the budget in the form of transfers and foregone revenues. The loss-making enterprises in the bauxite industry present a serious financial drain on government's revenues. These operations need to be sold or closed at the earliest possible date. In the case of sugar, with which Guyana's economic prospects are closely associated, there is urgent need for a significant increase in financial resources to address the inefficiencies of the Guyana Sugar Corporation (GUYSUCO). This would help to reduce the cost of sugar production to enable the company to compete in the world market. GUYSUCO has been negotiating with a number of international financial institutions to borrow for this purpose. One conditionality by the international financial institutions is to have the high cost areas of production shut down as soon as possible. But, there are corresponding social costs that have to be addressed and agreed to by all interested stakeholders as soon as possible.

The transparency of fiscal policy intentions, as well as the breath and timeliness of fiscal reporting, are important elements in public finance management. While the government's budget is presented as a one-year exercise, it is normally guided by a medium-term fiscal strategy supported by quantified macroeconomic projections and fiscal targets which are not available for wide public scrutiny. Making this information available would undoubtedly enhance transparency and good governance. As regards fiscal reporting, there is need for both revenue collecting and public spending agencies to submit their reports on a timely basis to the Ministry of Finance which is the centralised processing agency of government financial transactions. This would provide for improved analyses of public sector activities and timely audit which would help in subsequent reform measures.

## 5.0 Conclusions

The adoption of the Economic Recovery Programme in 1988 and the successive adjustment programmes with far reaching fiscal reform measures have led to significant improvements in the country's fiscal position and economic situation, with real growth, narrower external balances and lower inflation rates. Despite improvements in fiscal management, the tax system is still characterised by high rates of nominal taxes on a relatively small base while there is disenchantment with the ability of government to provide goods and services efficiently. Authorities are aware of this as well as the need for further fiscal management reforms to improve fiscal governance and facilitate fiscal sustainability. This undoubtedly would require a combination of tax reform measures and enhanced expenditure management practices. On the tax side, there would have to be stronger efforts at marshalling fiscal resources that would come from measures to broaden the tax base, design and implement alternative revenue measures to supplement and/or replace existing revenues, and at the same time, reduce some tax rates from levels considered excessively high by the authorities. Revenue administration effectiveness would also have to be improved by addressing the weaknesses of the internal revenue and customs departments' operations with a view to increasing compliance controls and, at the same time, simplifying the procedures.

On the expenditure side, there is need for enhanced fiscal management reforms. Of particular importance in the medium to short-term is the need to strengthen fiscal control by having broad assessment of benefits and costs on project selection. Enhanced efficiency of the Public Service is also needed with the implementation of efficiency processes based on performance benchmarks. Reforms may also include better budgeting and accounting formats based on international best practices, such as decentralised and output performance budgeting programmes in the medium to long-term. However, implementation of performance budgeting systems must take into consideration the local capacity constraints, sustainability, complexities of output measurement, cost and political commitment. Privatisation of state enterprises would have to be continued as an important element of fiscal management. In addition, there would have to be containment of the growth in recurrent expenditure and, in particular, the wage bill. At the same time, the Public Service would have to be made sufficiently attractive to retain highly skilled employees.

Finally, the strengthening of fiscal governance requires effective manpower improvements in all areas of government in Guyana. There is a great need for training and specialist expertise in many areas that include health, education, engineering, accounting, financial management, etc., to ensure that public funds are efficiently spent. This requires high quality on-the-job training, continued external assistance to overcome resource constraints and tapping into the growing pool of foreign-trained expatriate Guyanese.

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# 2

# Current Fiscal Problems and Related Issues Facing Caribbean States: The Outlook for Trinidad & Tobago

*Penelope Forde**

## 1. Introduction

Towards the end of the 1980's the Trinidad and Tobago (TT) economy was characterized by both fiscal and external disequilibria which propelled the authorities to approach the Washington-

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* The author is Manager, Research Department of the Central Bank of Trinidad and Tobago. Sections I and II of this paper were originally presented at a series of seminars organised by the Trinidad and Tobago Institute of the West Indies and published in the *Trinidad and Tobago Review* Vol.23 Nos.9-10. The views expressed are those of the author and not necessarily those of the Central Bank.

based multilateral financial institutions and to undertake a number of structural adjustment reforms. The disequilibria were evident in large fiscal deficits which had peaked at 13 per cent of GDP by 1983 and balance of payments deficits with consequent losses of foreign exchange reserves especially between 1984 and 1993. By 1995, however, the TT economy had witnessed a reversal of these trends, as the external accounts had returned to balance while there was a major effort at consolidation in the fiscal accounts. The impetus for these developments was the series of structural reforms initiated and undertaken by the TT authorities between 1988 and 1993. These reforms included trade and tariff reform, fiscal reform, privatisation initiatives and financial sector reform, which were designed to make the economy more competitive. The fiscal reform package included both tax and expenditure reform, the centrepiece of which was the introduction of a value added tax (VAT). On the expenditure side of the budget, the major decisions were with respect to the reduction in transfers and subsidies and the privatisation initiatives. By the late 1990's the dis-equilibrium which was evident in the public finances at the start of the decade had virtually disappeared. At the end of the process, the structure of government revenues had shifted from an inordinate dependence on income taxes and, in particular, petroleum taxes (41.8 per cent of current revenues in 1990) to a mixture of indirect and direct taxes with the VAT accounting for around 15 per cent of current revenue in fiscal 1999/2000.

Since 1998, however, the process of fiscal consolidation has weakened and signs of fiscal disequilibrium have re-emerged. Unlike the 1980's, this weakness is not accompanied by external imbalances, but there are some features which are similar to those which prevailed at the end of the 1980's. These include the following: the emergence of a deficit on the current operations in fiscal

1998/1999, the first such deficit since 1992, and overall deficits in fiscal years 1998/1999 (-2.2 per cent of GDP) and 1999/2000 (-0.2 per cent of GDP); the burgeoning of the transfer and subsidy component of current operations especially in 1997 and 1998; the growth in the domestic debt stock from $6,589.8 million (1995) to $9,755.2 million by the end of 2000 (or 22.9 per cent of GDP) and the rise in contingent liabilities; and last, but by no means least, the underlying weakness of non-oil revenues which has been masked at times by the effect of relatively high oil prices.

The emergence of fiscal disequilibrium less than a decade after the reforms raises questions about the effectiveness and sustainability of these reforms. Indeed, some analysts (Theodore, for example) have argued that the "apparent limited impact of fiscal reform is directly related to the virtual equation of fiscal reform with tax structure reform". When this is taken in conjunction with issues of fiscal decentralization and questions in respect of the natural gas taxation regime, the challenges for the public sector over the medium term appear to be formidable.

The paper is divided into three sections. The first contains a description of the major elements of fiscal reform which took place between 1987 and 1993. This is followed by an outline of key fiscal problems facing the economy and the final section contains some thoughts on the way forward.

## 2. Fiscal Reform

At any point in time the tax system existing in any country consists of a series of tax measures which have been influenced by economics, sociology, politics and even ideological perspectives. The tax system in TT in the late

**Table 1: Trinidad andTobago Central Government Fiscal Operations[1] 1990-2000**
**(TT$ Mn)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| **Revenue 5,621.0** | **6,752.1** | **6,101.1** | **6,743.5** | **7,564.8** | **8,511.8** | |
| Current Revenue[2] | 5,534.0 | 6,734.4 | 6,083.2 | 6,721.0 | 7,504.8 | 8,455.8 |
| Oil | 2,317.5 | 2,717.5 | 1,817.6 | 1,802.5 | 1,895.9 | 2,535.9 |
| Non-Oil | 3,216.5 | 4,016.9 | 4,265.6 | 4,918.5 | 5,608.9 | 5,919.9 |
| Income | 1,113.4 | 1,475.1 | 1,813.2 | 2,087.6 | 2,286.6 | 2,686.0 |
| -Individual income taxes | 570.8 | 900.9 | 1,228.7 | 1,344.9 | 1,430.9 | 1,533.4 |
| Property | 40.6 | 44.0 | 39.8 | 72.3 | 109.6 | 61.0 |
| Goods & Services | 1,362.7 | 1,431.3 | 1,437.0 | 1,629.1 | 1,819.5 | 1,974.8 |
| -VAT | 926.6 | 1,054.4 | 968.6 | 1,163.1 | 1,259.0 | 1,344.8 |
| International Trade | 463.0 | 547.6 | 569.1 | 628.5 | 578.8 | 494.0 |
| Non-tax revenue | 236.9 | 518.8 | 406.5 | 501.0 | 814.4 | 704.1 |
| Capital Revenue[3] | 87.0 | 17.7 | 18.0 | 22.5 | 59.9 | 56.0 |
| **Expenditure[4]** | **5,893.9** | **6,805.3** | **6,728.8** | **6,783.3** | **7,571.0** | **8,458.5** |
| Current Expenditure [5] | 5,438.2 | 6,060.6 | 6,279.2 | 6,482.8 | 7,103.4 | 7,836.0 |
| Wages & Salaries | 1,982.8 | 2,223.9 | 2,501.7 | 2,572.7 | 2,591.9 | 2,884.4 |
| Goods & Services | 585.6 | 637.8 | 465.3 | 518.7 | 753.8 | 887.5 |
| Interest | 989.1 | 1,079.1 | 1,235.1 | 1,446.7 | 1,574.4 | 1,576.9 |
| Transfers & Subsidies[6] | 1,880.7 | 2,119.8 | 2,077.1 | 1,944.7 | 2,183.3 | 2,487.2 |
| Capital Expenditure and Net lending[7] | 455.7 | 744.7 | 449.6 | 300.6 | 467.6 | 622.5 |
| **Current Account Balance** | **95.8** | **673.8** | **-196.0** | **238.3** | **401.5** | **619.8** |
| **Overall Balance** - excludes transfers of revenues from the treasury deposit accounts, divestment proceeds and expenditures in the form of transfers to the Revenue Stabilisation Fund | **-272.9** | **-53.2** | **-627.7** | **-39.8** | **-6.2** | **53.3** |

**Table 1: Trinidad and Tobago Central Government Fiscal Operations[1] 1990-2000 - Cont'd**
**(TT$ Mn)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| **Primary Balance** | **716.2** | **1,025.9** | **607.4** | **1,406.8** | **1,568.3** | **1,630.2** |
| **Financing272.9** | **53.2** | **627.7** | **39.8** | **6.2** | **-53.3** | |
| External Financing (Net) | -393.8 | -480.2 | -237.5 | 475.6 | 302.3 | -902.6 |
| Net External Borrowing[8] | -393.8 | -480.2 | -237.5 | -16.8 | -287.0 | -902.6 |
| Disbursements | 248.8 | 101.2 | 649.3 | 1,180.3 | 1,331.9 | 140.4 |
| Repayments | 642.6 | 581.4 | 886.8 | 1,197.1 | 1,618.9 | 1,043.0 |
| Divestment Proceeds | 0.0 | 0.0 | 0.0 | 492.4 | 589.3 | 0.0 |
| Domestic Financing (Net) | 666.7 | 533.4 | 865.2 | -435.8 | -296.1 | 849.3 |
| Treasury Bills(Net) | 0.0 | 0.0 | 0.0 | 0.0 | 8.0 | 0.0 |
| Bonds(Net) | 565.2 | 765.8 | 303.9 | 337.1 | 203.9 | 752.2 |
| Disbursements | 652.5 | 1,301.6 | 434.2 | 436.9 | 442.1 | 903.5 |
| Repayments | 87.3 | 535.8 | 130.3 | 99.8 | 238.2 | 151.3 |
| Divestment Proceeds | 0.0 | 0.0 | 5.9 | 29.8 | 20.8 | 51.1 |
| Uncashed Balances (Net)[9] | 101.5 | -232.4 | 555.4 | -802.7 | -528.8 | 46.0 |
| ***MEMORANDUM ITEMS:*** | | | | | | |
| **Budgeted Oil Price US$** | | | | | | **$16.50** |
| **Actual Oil Price US$** | **$20.62** | **$21.62** | **$20.57** | **$18.45** | **$17.14** | **$18.44** |
| ***Overall Balance/GDP (%)*** | ***-1.2*** | ***-0.2*** | ***-2.7*** | ***-0.2*** | ***0.0*** | ***0.2*** |
| **Overall Balance reported by MOF[10]** | **-272.9** | **-53.2** | **-643.8** | **-39.1** | **-6.0** | **53.3** |
| - includes above the line: | | | | | | |
| Transfers -Treasury Dep. Accounts | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Off-Budget- Police(Sept 98) & Prisons(Dec 99 & Feb 00) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Divestment Proceeds | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Transfers to the Interim Revenue Stabilisation Fund | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Source: Central Bank of Trinidad and Tobago.
n.b.: Figures may not add due to rounding.

**Table 1: Trinidad and Tobago Central Government Fiscal Operations[1] 1990-2000 - Cont'd**
(TT$ Mn)

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| **Revenue** | **9,542.4** | **9,164.5** | **9,658.4** | **9,714.0** | **13,036.5** |
| Current Revenue[2] | 9,536.8 | 9,126.0 | 9,629.4 | 9,613.2 | 13,006.7 |
| Oil | 3,060.7 | 2,069.8 | 1,706.9 | 1,9999.7 | 4,475.6 |
| Non-Oil | 6,476.1 | 7,056.2 | 7,922.5 | 7,613.4 | 8,531.1 |
| Income | 3,035.5 | 3,134.3 | 3,388.5 | 3,448.8 | 3,919.0 |
| -Individual income taxes | 1,786.5 | 1,765.1 | 1,893.7 | 2,008.7 | 2,207.4 |
| Property | 58.9 | 56.8 | 60.1 | 61.5 | 62.3 |
| Goods & Services | 2,101.6 | 2,422.5 | 3,072.0 | 2,543.7 | 2,906.2 |
| -VAT | 1,413.9 | 1,623.9 | 2,153.9 | 1,637.5 | 2,037.7 |
| International Trade | 496.2 | 570.0 | 695.3 | 698.5 | 765.3 |
| Non-tax revenue | 783.9 | 872.6 | 706.6 | 861.0 | 878.3 |
| Capital Revenue[3] | 5.7 | 38.6 | 29.0 | 100.8 | 29.9 |
| **Expenditure[4]** | **9,371.4** | **9,912.3** | **10,399.4** | **11,069.3** | **12,217.5** |
| Current Expenditure [5] | 8,791.0 | 8,770.0 | 9,539.7 | 10,541.9 | 10,993.5 |
| Wages & Salaries | 3,154.7 | 3,218.9 | 3,521.6 | 3,657.0 | 3,190.1 |
| Goods & Services | 918.9 | 938.3 | 959.8 | 1,111.0 | 1,205.4 |
| Interest | 1,580.6 | 1,690.1 | 1,916.0 | 2,344.1 | 2,429.7 |
| Transfers & Subsidies[6] | 3,136.8 | 2,922.8 | 3,142.3 | 3,429.7 | 4,168.3 |
| Capital Expenditure and Net lending[7] | 580.4 | 1,142.3 | 859.8 | 527.4 | 1,224.0 |
| **Current Account Balance** | **745.8** | **355.9** | **89.7** | **-928.7** | **2,013.2** |
| **Overall Balance** - excludes transfers of revenues from the treasury deposit accounts, divestment proceeds and expenditures in the form of transfers to the Revenue Stabilisation Fund. | **171.0** | **-747.8** | **-741.0** | **-1,355.3** | **819.1** |

**Table 1: Trinidad andTobago Central Government Fiscal Operations[1] 1990-2000 - Concluded**
**(TT$ Mn)**

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| **Primary Balance** | **1,751.6** | **942.3** | **1,174.9** | **988.8** | **3,248.8** |
| **Financing** | **-171.0** | **747.8** | **741.0** | **1,355.3** | **-819.1** |
| External Financing (Net) | 133.4 | -711.3 | -435.8 | 896.7 | 878.4 |
| Net External Borrowing[8] | 133.4 | -1,500.5 | -473.4 | 842.8 | 846.9 |
| Disbursements | 1,283.6 | 368.4 | 359.9 | 1,802.3 | 2,344.3 |
| Repayments | 1,150.2 | 1,868.9 | 833.3 | 959.5 | 1,497.4 |
| Divestment Proceeds | 0.0 | 789.2 | 37.6 | 53.9 | 31.5 |
| Domestic Financing (Net) | -304.4 | 1,459.1 | 1,176.9 | 458.6 | -1,697.5 |
| Treasury Bills(Net) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Bonds(Net) | -8.7 | 1,661.7 | -370.0 | 347.0 | 56.8 |
| Disbursements | 27.1 | 1,894.2 | 941.8 | 904.7 | 895.4 |
| Repayments | 35.8 | 232.5 | 1,311.8 | 557.7 | 838.6 |
| Divestment Proceeds | 28.2 | 0.0 | 78.4 | 0.0 | 0.0 |
| Uncashed Balances (Net)[9] | -323.9 | -202.7 | 1,468.5 | 111.6 | -1,754.2 |
| ***MEMORANDUM ITEMS:*** | | | | | |
| **Budgeted Oil Price US$** | **$17.50** | **$20.00** | **$19.00** | | |
| **Actual Oil Price US$** | **$22.20** | **$20.35** | **$14.40** | **$19.25** | **$30.00** |
| ***Overall Balance/GDP (%)*** | ***0.5*** | ***0.1*** | ***-1.9*** | ***-3.2*** | ***1.6*** |
| **Overall Balance reported by MOF[10]** | **171.0** | **41.4** | **-576.6** | **-795.8** | **643.3** |
| - includes above the line: | | | | | |
| Transfers -Treasury Dep. Accounts | 0.0 | 0.0 | 48.5 | 505.6 | 208.0 |
| Off-Budget- Police(Sept 98) & Prisons(Dec 99 & Feb 00) | 0.0 | 0.0 | 290.9 | 304.6 | 289.0 |
| Divestment Proceeds | 0.0 | 789.2 | 116.0 | 53.9 | 31.5 |
| Transfers to the Interim Revenue Stabilisation Fund | 0.0 | 0.0 | 0.0 | 0.0 | 415.3 |

Source: Central Bank of Trinidad and Tobago
n b.: Figures may not add up due to rounding.

**NOTES TO TABLE 1:**

1 Refers to accounts of the Consolidated Fund, Unemployment Fund, Road Improvement Fund, the Infrastructure Development Fund and the Interim Revenue Stabilisation Fund.

2 In 1998, 1999 and 2000, the central government transferred $48.5 million, $505.6 million and $208 million, respectively from the Treasury Deposit Accounts to the Consolidated Fund. However, these are excluded since they do not represent actual revenues received in these periods.

3 Capital Revenue omits the proceeds from the divestment of state-owned enterprises which are recorded as part of the Financing category.

4 In 1998, 1999 and 2000, the central government brought to account $290.9 million, $304.6 million and $289 million, respectively. This represented the deferred liabilities of extra budgetary financing facilities associated with the construction in previous years of police stations and a maximum security prison.

5 From 1995 to 1999, current expenditure includes the issue of emolument bonds in settlement of the outstanding salary arrears to public servants.

6 The data does not include $415.3 million which was transferred to the Interim Revenue Stabilisation Fund in September 2000 since this is not actual expenditure.

7 This is equal to capital expenditure less the repayment of past lending.

8 Figures exclude the disbursement and repayment of loans from the IDB and the EIB received by the government but onlent to the energy sector.

9 Includes errors and omissions, advances from the Central Bank and drawdowns from the treasury deposit accounts. (Negative numbers represent an increase in deposits at the Central Bank.)

10 The Ministry of Finance has given a different accounting treatment to the items listed below. Please refer to footnotes 2, 3, 4 and 6 for an explanation of these differences.

TABLE 2: Trinidad and Tobago Central Government Revenue, 1990-2000

| | Percentage of Current Revenue | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **1990** | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** |
| Current Revenue | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Oil | 41.9 | 40.4 | 29.9 | 26.8 | 25.3 | 30.0 | 32.1 | 22.7 | 17.7 | 20.8 | 34.4 |
| Non-Oil | 58.1 | 59.6 | 70.1 | 73.2 | 74.7 | 70.0 | 67.9 | 77.3 | 82.3 | 79.2 | 65.6 |
| Income | 20.1 | 21.9 | 29.8 | 31.1 | 30.5 | 31.8 | 31.8 | 34.3 | 35.2 | 35.9 | 30.1 |
| -Individual income taxes | 10.3 | 13.4 | 20.2 | 20.0 | 19.1 | 18.1 | 18.7 | 19.3 | 19.7 | 20.9 | 17.0 |
| Property | 0.7 | 0.7 | 0.7 | 1.1 | 1.5 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 |
| Goods & Services | 24.6 | 21.3 | 23.6 | 24.2 | 24.2 | 23.4 | 22.0 | 26.5 | 31.9 | 26.5 | 22.3 |
| -VAT | 16.7 | 15.7 | 15.9 | 17.3 | 16.8 | 15.9 | 14.8 | 17.8 | 22.4 | 17.0 | 15.7 |
| International Trade | 8.4 | 8.1 | 9.4 | 9.4 | 7.7 | 5.8 | 5.2 | 6.2 | 7.2 | 7.3 | 5.9 |
| Non-tax revenue | 4.3 | 7.7 | 6.7 | 7.5 | 10.9 | 8.3 | 8.2 | 9.6 | 7.3 | 9.0 | 6.8 |
| | Percentage of Total Revenue | | | | | | | | | | |
| **Revenue** | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Current Revenue | 98.5 | 99.7 | 99.7 | 99.7 | 99.2 | 99.3 | 99.9 | 99.6 | 99.7 | 99.0 | 99.8 |
| Oil | 41.2 | 40.2 | 29.8 | 26.7 | 25.1 | 29.8 | 32.1 | 22.6 | 17.7 | 20.6 | 34.3 |
| Non-Oil | 57.2 | 59.5 | 69.9 | 72.9 | 74.1 | 69.5 | 67.9 | 77.0 | 82.0 | 78.4 | 65.4 |
| Income | 19.8 | 21.8 | 29.7 | 31.0 | 30.2 | 31.6 | 31.8 | 34.2 | 35.1 | 35.5 | 30.1 |
| -Individual income taxes | 10.2 | 13.3 | 20.1 | 19.9 | 18.9 | 18.0 | 18.7 | 19.3 | 19.6 | 20.7 | 16.9 |
| Property | 0.7 | 0.7 | 0.7 | 1.1 | 1.4 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 |
| Goods & Services | 24.2 | 21.2 | 23.6 | 24.2 | 24.1 | 23.2 | 22.0 | 26.4 | 31.8 | 26.2 | 22.3 |
| -VAT | 16.5 | 15.6 | 15.9 | 17.2 | 16.6 | 15.8 | 14.8 | 17.7 | 22.3 | 16.9 | 15.6 |
| International Trade | 8.2 | 8.1 | 9.3 | 9.3 | 7.7 | 5.8 | 5.2 | 6.2 | 7.2 | 7.2 | 5.9 |
| Non-tax revenue | 4.2 | 7.7 | 6.7 | 7.4 | 10.8 | 8.3 | 8.2 | 9.5 | 7.3 | 8.9 | 6.7 |
| Capital Revenue | 1.5 | 0.3 | 0.3 | 0.3 | 0.8 | 0.7 | 0.1 | 0.4 | 0.3 | 1.0 | 0.2 |

Source: Central Bank of Trinidad and Tobago.

**Table 3: Trinidad and Tobago Central Government Expenditure, 1990-2000**

| | Percentage of Current Expenditure | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
| Current Expenditure | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Wages & Salaries | 36.5 | 36.7 | 39.8 | 39.7 | 36.5 | 36.8 | 35.9 | 36.7 | 36.9 | 34.7 | 29.0 |
| Goods & Services | 10.8 | 10.5 | 7.4 | 8.0 | 10.6 | 11.3 | 10.5 | 10.7 | 10.1 | 10.5 | 11.0 |
| Interest | 18.2 | 17.8 | 19.7 | 22.3 | 22.2 | 20.1 | 18.0 | 19.3 | 20.1 | 22.2 | 22.1 |
| Transfers & Subsidies | 34.6 | 35.0 | 33.1 | 30.0 | 30.7 | 31.7 | 35.7 | 33.3 | 32.9 | 32.5 | 37.9 |
| | Percentage of Total Expenditure | | | | | | | | | | |
| **Expenditure** | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Current Expenditure | 92.3 | 89.1 | 93.3 | 95.6 | 93.8 | 92.6 | 93.8 | 88.5 | 91.7 | 95.2 | 90.0 |
| Wages & Salaries | 33.6 | 32.7 | 37.2 | 37.9 | 34.2 | 34.1 | 33.7 | 32.5 | 33.9 | 33.0 | 26.1 |
| Goods & Services | 9.9 | 9.4 | 6.9 | 7.6 | 10.0 | 10.5 | 9.8 | 9.5 | 9.2 | 10.0 | 9.9 |
| Interest | 16.8 | 15.9 | 18.4 | 21.3 | 20.8 | 18.6 | 16.9 | 17.1 | 18.4 | 21.2 | 19.9 |
| Transfers & Subsidies | 31.9 | 31.1 | 30.9 | 28.7 | 28.8 | 29.4 | 33.5 | 29.5 | 30.2 | 31.0 | 34.1 |
| Capital Expenditure and Net lending | 7.7 | 10.9 | 6.7 | 4.4 | 6.2 | 7.4 | 6.2 | 11.5 | 8.3 | 4.8 | 10.0 |

**Source**: Same as Table 1.

1980's reflected the several efforts at tax reform which had been implemented over two previous decades, as well *as ad* hoc budgetary measures designed to either raise revenues or provide a measure of tax relief. Indeed, Trinidad and Tobago's tax system met several of the criteria that Ghandi (1992) had highlighted as necessary for a country to embark on tax reform. The personal income tax system comprised a complex series of tax reliefs and rebates, imposed upon income tax brackets which appeared to be somewhat arbitrary, and with marginal tax rates ranging from 5 per cent to 50 per cent. At the corporate level, four separate taxes were levied on non-petroleum companies with a maximum rate of 49.5 per cent. In the area of indirect taxes, the purchase tax regime had been introduced in 1962 and represented the first steps towards consumption taxation and a movement away from direct taxation.

### *Tax Reform*

It was against this background that in January 1989, in the context of a structural adjustment programme, tax reform was introduced in two phases. Under phase I the income tax system was reformed in such a way that taxes at the lower end of the income scale were reduced and the computation of tax liability was simplified. The second phase involved a further lowering of the income tax rates and the introduction in 1990 of a system of value added taxation (VAT) which replaced purchase taxes and luxury taxes. The introduction of a VAT of the consumption type at a single rate of 15 per cent also included exemptions and zero-rating for mainly food items and medicines. In respect of the personal income tax, reforms included a reduction in the number of income tax brackets to four from eleven, while the system of tax credits and deductions was replaced by a small number of allowances.

In the non-oil sector, the corporate tax structure was unified in 1989 with the consolidation of four separate taxes and a reduction in the maximum rate to 45 per cent. By 1996 the rate had been lowered in stages over the period to the current level of 35 per cent and further simplified to two tax brackets. With respect to the petroleum and petrochemical companies, the regime which existed in the 1980's had been designed to deal with declining oil revenues and the secular decline in production. By 1992, however, the petroleum sector was subjected to new legislation which favoured land operations and new activity. However, while the price of petroleum remains a key ingredient in the budgetary process, the oil sector in the post reform period now contributes no more than 20 per cent of current government revenues with income taxes and VAT together accounting for about 48 per cent.

***Expenditure Reform***

While it may be easy to implement most kinds of tax reform measures, the existence of **fiscal rigidities** (i.e. the lack of discretionary control over some categories of spending) poses greater difficulties for restructuring of government expenditure. Prior to the introduction of structural adjustment in the late 1980's, wages and salaries and interest payments together amounted to just over 55 per cent of current expenditure. In addition, transfers and subsidies which had peaked at $2.3 billion in 1987 accounted for just over one third (1/3) of current expenditure. Given the nature of this latter category of expenditure, the general trend in the overall public finances was not sustainable especially in the light of the transfers to a number of loss-making state enterprises and utilities.

Expenditure reform, therefore, involved a reduction in the wages and salaries component of government expenditure either through a cut in employment, a cut in the wage rate or a combination of both. Expenditure reform entailed, in part, a change in philosophy for the role of the state, as the state had to confine its participation in the economy to certain strategic areas and embark on a process of rationalization and divestment of state assets. With the reduction of the number of state-owned enterprises, the level of subventions which had averaged $1,232 million between 1982 and 1985 fell to $487.3 million by 1990 and averaged around $539 million in the mid-1990's.

### *Debt Management*

The third and most critical element of the fiscal reform package was the debt reduction and refinancing strategy that was undertaken between 1988 and 1994. The external disequilibrium associated with the onset of the adjustment period had been made more difficult with the bunching of public sector external debt repayments in the 1988-1990 period. In the mid-1970's the public sector external debt represented less than US$200 million; however, by the end of 1986 this had grown to US$2,090.3 million, in large measure because of the increased debt of the state enterprises and public utilities. More importantly, the debt service ratio stood at 24.3 per cent in 1987 compared with 13 per cent in 1985 and was projected to reach 29 per cent by 1990. In addition, the actual debt service in 1988 was projected at US$470 million and if it were met, would have led to net negative foreign reserves by the end of 1988. Projected debt service between 1988 and 1992 amounted to US$1,055 million, a sum which it was unlikely TT had the resources to meet.

The rescheduling agreements under the London and Paris Club arrangements therefore postponed the bunching to 1992-1994 when annual external debt service rose to around US$600 million and was designed to allow the authorities more breathing room. The prudent debt management strategy of the 1990's which consisted of debt refinancing to lengthen shorter-term maturities led to a reduction in the public sector external debt outstanding from just under US$2,500 million at the end of the 1980's to US$1,679 million at the end of 2000. There has also been a sharp reduction in the debt service ratio to under 10 per cent of the exports of goods and services from a peak of over 30 per cent in the early 1990's, while the outlook for the medium-term is fairly comfortable.

In many respects, the complete overhaul of the public finances contributed to the success of the structural reform agenda and the resumption of economic growth by 1994. The trend towards fiscal consolidation continued until 1998 when signs began to emerge of a disequilibrium in the fiscal accounts. These signs were masked (partly) by the change in the fiscal year in 1998 and the spike in petroleum prices in 2000, but are particularly worrisome when considered against the challenges to be faced by the public sector over the medium-term.[1]

## 3. Structural and Policy Issues for the Medium-Term

Over the medium-term the public sector will be faced with a number of important challenges which range from rebuilding the physical and social infrastructure to fostering the process of sustainable development. In meeting the goals of sustainable development, the provision of social services is key to that process. Thus, expenditure

1 In 1998, with the passage of the Financial Year Act (23 of 1998) the government's fiscal year was changed from a calendar year to a twelve month period October 1 – September 30.

on primary, secondary and tertiary education as well as expenditure on health must rise dramatically above the lows of around 10 per cent of total expenditure in 1995. In the pre-adjustment period, the tariffs of the public utilities were well below the cost of production and led to highly subsidized prices for these entities. In this regard, therefore, public utility reform requires tariffs for electricity, water, and port services which meet the cost of production and eliminate subsidies on current operations. It is against this background, therefore, that one can identify at least four major challenges facing the state: fiscal reform which includes elements of tax and expenditure reform, an optimal debt management strategy, pension reform and fiscal decentralization issues. These reforms must take place against a macro economic environment in which real GDP is expected to grow by just under 4 per cent per annum and the potential for increased revenues from the energy sector might be realized. Fiscal reform in a period of an upswing in the economy may become all the more difficult for the authorities.

### *Fiscal Reform - Taxes*

Ghandi (1992) has identified several characteristics of countries whose tax systems need a major overhaul. Some of these are as follows: the tax system contains all the major tax bases (income, consumption, wealth) but these have been eroded over time with tailor-made reliefs to selected interest groups; the tax structure has not been revised over time to account for the changing structure of the economy or changing characteristics of the tax paying population; the tax system rewards different factors of production by differential methods of taxation. Some or all of these characteristics are extremely relevant when one considers the TT tax system.

Since the last tax reform effort a decade or so ago the economy has undergone major structural changes. In particular, several tax bases have been eroded while new tax bases have been ignored. For example, since 1997 the structure of production in the energy-based sector has been altered with natural gas production surpassing that of crude oil in barrels of oil equivalent. This implies that the economy has moved from dependence on crude oil to dependence on natural gas. Yet, at this point in time, a natural gas taxation regime does not exist as natural gas is still viewed as jointly produced with crude oil, while the natural gas royalty has remained relatively unchanged since the 1960's.[2] Tax reform urgently requires, therefore, a reconsideration of the corporate income taxation for the energy-based sectors.

The second important tax base is that of the VAT regime introduced in 1990 which has been subjected to discrete adjustments over the course of the past 10 years. Indeed, some may argue that by all standards the TT experience with VAT is one of relative success. VAT was introduced at a single rate (15 per cent) with appropriate exemptions and zero rating. The tax yield rose from around 4.3 per cent of GDP in 1990 to just under 5 per cent by the end of the decade. The VAT's contribution to the current revenue amounted to 16.5 per cent in 1990 and has remained around that level except for 1998 (22.3 per cent).

Over the last few years, however, there have been several comments by policymakers in respect of the performance of VAT and in particular, the view that VAT

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2 See Racha (2000), however, for some thoughts on a natural gas regime for Trinidad and Tobago.

has been under performing. Nonetheless, these comments must be considered in light of several parallel developments. Firstly, the TT VAT is a consumption-based tax and to the extent that the economy is growing, there is a view that the tax base should grow. However, over the past 4-5 years GDP has grown in large measure because exports have risen faster than consumption, but exports are non-vatable; hence, the VAT base cannot keep pace with GDP growth.

The consumption base itself has been eroded over time, given the various discrete tax changes. In addition, there has been some variation of the annual sales threshold level for registered firms in respect of VAT. This level was lowered to $100,000 in 1994 but raised to $150,000 in 1996. There were also administrative changes in respect of the scope of items subject to zero rating. Although the changes were designed to reduce the regressitivity of VAT, they also served to erode the VAT base. Crude estimates suggest that VAT-exempt expenditure items now represent 56.2 per cent of private final consumption, compared with 50 per cent in 1990 [3]

### *Fiscal Reform: Expenditure*

As Theodore (2002) has convincingly argued, fiscal reform needs to focus not only on changing the system of taxation but also on the scale, effectiveness and cost of public expenditure. It is in this context therefore, that fiscal reform must address the transfers and subsidies budget. At the onset of the recession of the 1980's the

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3 Author's estimates and see as well *Report on the Introduction of a Value Added Tax System* (Ferguson Tax Performance Committee), 1988. See Technical Appendix below.

size of the transfers and subsidies component was large enough to be a cause of some concern as it accounted for well over 60 per cent of current expenditure. Since 1997, however, all the gains which had been observed in the early 1990's were eroded as transfers and subsidies rose to 37.9 per cent of current expenditure in 2000. The largest element in this reflects transfers to households in the form of pensions, welfare assistance, etc. in sharp contrast to two decades earlier when transfers to state enterprises and public utilities dominated. The growth in transfers to households is a direct consequence of increased Old Age Pensions (OAP), but discussion of this issue is taken up in the section on pension reform below.

### *Debt Management*

The second major challenge relates to debt management and the choice of an optimal debt strategy. During the adjustment phase the immediate focus of policy was on the reduction of the public sector external debt outstanding. Thus, efforts were directed towards lowering the external debt service ratio from over 30 per cent (1992) of exports of goods and services to under 15 per cent by the end of the 1990's. This goal has now been achieved and, as indicated earlier, this ratio will remain well under 10 per cent over the medium-term. The current issue, however, is the sharp rise in the domestic debt outstanding and in particular, the contingent liabilities of the central government. The size of the domestic debt outstanding (excluding contingent liabilities) rose from around \$6.6 billion in 1995 to \$9.2 billion (21.5 per cent of GDP) in 1999. By the end of the fiscal year in September 2000 there was also a rapid increase in contingent liabilities of the central government from \$2.5 billion (1995) to \$9.1 billion. By international standards the country's total debt GDP ratio (i.e. both internal and external debt) at around 60 per cent is not unduly large; however, of much greater concern is the sharp rise in the contingent liabilities with the potential for crowding out of private investment and the consequence for interest rates.

Following the work of Buiter (1985) and others, the analysis of standard public debt dynamics leads to an important relationship between the debt GDP ratio, the primary budget balance and interest rates. In the absence of central bank financing and no growth, stabilizing the level of real debt requires the government to run a primary budget surplus equal to the interest charges. If real GDP is growing, debt sustainability requires very high primary surpluses and a long-lasting fiscal effort. How then is this likely to play out in the Trinidad and Tobago context? With real GDP growing at around 3.5 per cent per annum in the late 1990's, and with real interest rate at around 9 per cent, the debt GDP ratio can be stabilised with a primary surplus of around 3.5 per cent. If one abstracts from calendar 2000 when a primary budget surplus of over 5 per cent was achieved, largely because of the spike in crude oil price, primary surpluses have averaged around 3 per cent. This means that current fiscal effort is barely sufficient to maintain debt sustainability.

In the preceding analysis, the discussion of debt dynamics took no account of the distinction between domestic and foreign debt. But if this is taken into account then the exchange rate and foreign exchange availability complicate the analysis further. The main message from the analysis, however, is the importance of maintaining high primary surpluses if the debt process is to be stabilized.

### *Fiscal Decentralization*

A third series of challenges has a more international dimension, linked as it is to the growing demand worldwide for greater local autonomy at sub-national levels of government, e.g. Quebec, Scotland, Nevis, Tobago. This trend towards fiscal decentralization or what has been described as a "more democratic and participatory approach to government" has emerged for several reasons. The conservative revolution of the 1980's (the so-called Reagan-Thatcher consensus) resulted in a greater focus on market forces, a reduction in 'big government' and more emphasis on local government. More importantly, however, the on-going changes within the European Union and the move towards a single currency also brought an important list of questions to the fore. Indeed, with the trend towards one currency and a cohesive monetary policy, what role, if any, was there for a cohesive fiscal policy? Which levels of government should be responsible for income re-distribution and stabilization? Which functions of resource allocation should be left to member states and which to the European Parliament? These questions are not unlike a number of issues which arose in the recent past with respect to the relationship between the Tobago House of Assembly (THA) and the Central Government and the Central Government and the Regional Corporations.

The public finance literature distinguishes between fiscal and administrative decentralization. Fiscal decentralization exists when sub-national governments have the power, either constitutionally or by law, to raise taxes or carry out spending activities (e.g. Canada, United States, Argentina, Brazil, Switzerland, Nigeria). The relationship between the THA and the central government, however, is closer to one of administrative decentralization, whereby taxes are raised centrally and funds are allocated to decentralized bodies to carry out spending activities according to the guidelines imposed by the central government. In the case of fiscal decentralization or fiscal federalism, as discussed in the traditional public finance textbooks, three critical questions are usually raised:

Which level of government makes the final determination on expenditure priorities? What are the mechanisms to determine a consensus approach to revenue sharing? And what rules should be used to determine borrowing by sub-national governments? While the second question posed has usually been the source of difficulties within many federal systems, it is perhaps the last issue which has created the most tension within decentralized systems.

The literature has identified three possible approaches to dealing with the latter issue. The first is usually described as a rules-based approach where borrowing by sub-national governments is specified in law with absolute limits on the level of indebtedness (e.g. US, Switzerland). A second approach, market discipline, allows the sub-national government to borrow on the capital market without government guarantee (e.g. Quebec, Brazil). It must be noted that in situations such as these, the credit rating of the sub-national government becomes an important determinant in their borrowing costs. The third approach, direct control, sets out annual limits on debt accumulation and may not be written into law. What then is the relevance of these approaches in the local setting?

The establishment of the Tobago House of Assembly (THA) gave greater autonomy to local government authorities in Tobago, but at the same time created the potential for conflict with the central government in the area of macroeconomic management. Although the THA Act (Act 40 of 1996) appears to have granted to the THA all the borrowing and revenue-raising powers associated with fiscal decentralization as described above, the reality is that the THA has no legal standing to collect revenues raised in Tobago or to raise funds on the domestic/foreign capital market. For this to be operative additional legislative changes need to be made to give effect to that section of the THA Act which allows for the collection of revenue and the funding of the THA.

At the heart of recent budgetary tensions between the central government and the THA are the implementation of the latter's medium-term development plan and how the THA can acquire the additional resources required. For the 1996-2000 period, the data (See Table 4) suggest that differences between funds allocated and amounts requested averaged around $600 million per annum in the last two fiscal years. In light of the continuous shortfalls, the THA resorted to the Dispute Resolution Commission (DRC) as allowed for under the THA Act.[4] In September 2000 the Commission recommended, and Cabinet agreed that Tobago be allocated between 4.03 per cent and 6.9 per cent of the national budget.[5] The ruling of the DRC has provided a temporary solution to the first of the questions posed above, but tensions will continue until appropriate decentralization arrangements are put in place.

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4 Section 56 of the THA Act allows for the appointment of a Dispute Resolution Commission.

5 See Report of the Dispute Resolution Commission, September 14, 2000 mimeo.

**Table 4: THA: Budgetary Requests and Budgetary Allocations**

| Year | Allocations (TT$M) | |
|---|---|---|
| | **Requested** | **Actual** |
| 1996 | 508.7 | 295.3 |
| 1997 | 586.4 | 432.3 |
| 1998 | 1,027.9 | 266.6 |
| 1998/1999 | 1,041.2 | 346.4 |
| 1999/2000 | 2,441.3 | 417.7 |

**Source:** Des Vignes (2000).

### *Pension Reform*

The fourth major series of challenges stems from the current arrangements of public sector pensions and, in particular, the unfunded liabilities of this Pay-As-You-Go (PAYG) system. At present, the public pension system comprises three main elements: a non-contributory system of pensions for civil service workers; a non-contributory means-tested arrangement of Old Age Pensions (OAP) for persons 65 years and over and the system of national insurance (NIS) based on contributions by employers and employees. The contributory NIS is a typical defined-benefit system which is not yet at demographic and financial maturity and very many of the problems which are associated with the NIS relate to issues of governance and will not be discussed here. Indeed, the necessary reform peculiar to the NIS can be carried out if there is the political will to implement recommendations from ongoing actuarial reviews.

Of much greater concern, however, is the relationship between the quantum of the OAP and the NIS pension. In the past, successive governments have tinkered with the level of the OAP without reference to what is happening with the NIS. The situation is now further aggravated as the non-contributory OAP is higher than that obtained under the contributory NIS. The ageing of the workforce, together with rising trends in OAP, will tend to increase the transfer component of the annual budget well above current levels of 37 per cent of recurrent expenditure unless the system is appropriately rationalised. The wider public sector pension arrangement is further complicated, given that pensions for civil service workers are non-contributory. In 1980 pensions and gratuities amounted to 2.4 per cent of the current expenditure and by 1998 had grown to around 6 per cent. No estimates are available, however, of these costs over the medium to long-term, nor of the distribution of the costs in the near-term.

The combination of unfunded public sector pension liabilities and gradual greying of the workforce has served as an impetus for pension reform in very many OECD countries. While our demographic trends are not as pressing as in very many of those countries, pension reform requires that the transition towards a fully funded system should commence and further, that the disparity between the OAP and the NIS be eliminated. Miles (1998), in writing on the OECD situation, argues that there is no simple solution for the transition path and the most difficult time to embark on it is when demographic changes begin to place strain on the unfunded schemes. Crude estimates suggest that a period of 15-20 years may be needed for transition from an unfunded system to a funded one. The relevant lesson for TT is that with a relatively young population of working age, the time to transit to a fully funded system is here and now.

**4. Conclusion**

This paper has focussed on a number of broad themes in respect of current fiscal problems facing Trinidad and Tobago. The analysis suggests that the most critical challenges are in the area of pension reform and fiscal decentralization. In the discussion above the analysis is descriptive rather than prescriptive since additional research is needed before any concrete solutions are detailed. Nonetheless, urgency is needed in the area of pension reform as the imperative here is the initiation of the process which has a medium-term horizon.

In many respects, however, the above discussion may be considered as static in nature and dealing with those issues which look back to the last quarter of the twentieth century, rather than forward to the new millennium. The recent public finance literature has tried to incorporate trends in globalization and their impact on tax systems. This literature suggests that tax systems worldwide have become even more fragile when faced with the effects of globalization, technological change and institutional developments. Tanzi (2000) has argued that in many OECD countries the tax base has been impacted adversely by the existence of 'fiscal termites' gnawing away at the foundations of the tax systems. Some of the termites identified are electronic commerce, electronic money, off-shore financial centres, derivatives and hedge funds. While Tanzi describes these as termites, these activities really reflect Ghandi's concern that some tax systems have not been revised to take account of changes in economic structure or the tax-paying population. In this respect, this paper has ignored the real issue of fiscal termites and their likely effects on tax revenues in TT or the wider Caribbean. Any proactive research agenda points, therefore, to the need to focus on these areas and identify initiatives that are needed to counteract the efforts of fiscal termites.

Technological changes and institutional developments also have the potential to erode the region's already fragile tax bases. The imperative of any future research agenda must focus on initiatives which would serve to eliminate the effects of such termites.

## TECHNICAL APPENDIX*

## ESTIMATING THE VAT BASE AND POTENTIAL VAT[1] FOR TRINIDAD AND TOBAGO FOR FISCAL YEAR 1999/2000

### Background

1. The Value Added Tax (VAT) for Trinidad and Tobago is a destination-based tax on consumption. In order to estimate the potential yield from VAT, it is important to obtain a reliable estimate of private consumption expenditure.

2. Trinidad and Tobago's VAT system is typical of other systems and contains items of consumption expenditure which are exempted from the tax or are zero-rated. Therefore any measure of the VAT base must be adjusted downward to take account of this.[2]

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* Prepared by Susan Ramirez and Penelope Forde.

1 In this note, VAT refers to the revenue collected from the value added tax **net of refunds**.

2 In the absence of an annual data series on consumption expenditure by type, private consumption expenditure was adjusted in accordance with the weighting scheme of the retail price index. Consequently the items "Food" and "Meals Out" with weights of 217 and 14, respectively represented the zero-rated and exempt items. Adjustments were also made to "Transportation," "Housing," "Household Supplies and Services," "Health and Personal Care" and "Reading Recreation and Education." Altogether, VAT-exempt expenditure items represented approximately 56.2 per cent of consumption. Therefore, of total consumption expenditure, the base to which VAT is applied is estimated to have a weight of 438 out of 1000 units or 43.8 per cent of the total.

3. Net VAT receipts for Trinidad and Tobago may be computed by applying the VAT rate of 15 per cent to the *vattable PCE (the portion of expenditure on goods and services that are subject to VAT)*, that is the VAT base. However, these are potential estimates which differ from the recoverable VAT since they do not take into account collection leakages arising from taxpayer non-compliance and administrative inefficiencies.

**Methodology**

4. POTENTIAL VAT = 15% of VAT BASE
VAT BASE = PCE adj.

where:

"PCE adj." = final private consumption expenditure adjusted for exempted items of expenditure.

5. Based on the adjustments to PCE to take into account not only exempted items but also changes in the level of exemptions and the VAT threshold that have taken place since 1990, the VAT base is estimated to range between 43 per cent and 50 per cent of final private consumption expenditure. This range is not inconsistent with the estimates derived in the theoretical literature. Furthermore, in the "Report On the Introduction of a Value Added Tax" prepared by the "Ferguson Committee," the VAT base for 1987 was estimated at 50 per cent of private consumption expenditure.

**Estimates**

6. Using this methodology, a series of PCE adj. has been generated for the period 1993-2000 and for

the fiscal year 1999/2000 at both the lower limit of 43.8 per cent of PCE and the upper limit of 50 per cent of PCE.[3] This is represented in Table A1. As a share of GDP, the VAT base ranged between 23.8 per cent and 27.2 per cent on average for this seven-year period. For comparison we examined a study on Zambia which estimated the VAT base for 1995. Using the consumption expenditure method and adjusting mainly for exemption and non-compliance, the VAT base for Zambia was estimated to be 20 per cent of GDP in 1995.

7. The application of the VAT rate to the adjusted private consumption expenditure yielded the results shown in Table A2. Potential VAT receipts for 1999 were estimated to range between $1,506.4 million and $1,719.7 million or between 3.7 per cent and 4.2 per cent of GDP.[4] This result appears to be reasonably accurate when it is compared with the actual VAT (net of refunds) for 1999 of $1,667.1 million or 4.1 per cent of GDP. Historically, the actual VAT yield for Trinidad and Tobago accounts on average for 4.4 per cent of GDP. This is illustrated in Table 3.

8. **For the fiscal period 1999/2000, the PCE adj. is estimated to be $22,372.2 million and potential VAT is projected to range between $1,469.9 million and $1,677.9 million.**

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3 A statistical technique was used to convert an annual series into a quarterly so as to obtain estimates for the fiscal year.

4 Data for 1998 suggest that this year is an outlier and the results shown reflect administrative problems around that time.

**Further Work**

9. There are two additional approaches to estimating the VAT base and, by extension, the potential VAT for any country. The first method uses the GDP as the starting point of estimation since this represents the total value added in the production of goods and services. This is depicted by the national income accounting identity:

$$GDP = C + I + G_c + G_w + (X - M) \qquad (1)$$

where $C$ is private consumption expenditure, $I$ is investment expenditure, $G_c$ is government expenditure net of wages and salaries, $G_w$ is government expenditure on wages and salaries and $(X\text{-}M)$ is the trade balance, that is, exports minus imports.

The equation is rearranged to arrive at Final Consumption Expenditure:

$$C + G_c = GDP - I - G_w - (X - M) \qquad (2)$$

The method presented above is a rough approximation of this approach.

10. The second method utilizes econometric tools to build a simulation model, which links VAT to key economic variables in the economy.

11. Further work will also encompass efforts to improve upon the estimates of consumption expenditure by type as well as the derivation of quarterly consumption estimates.

## APPENDIX 1

**Table A1: Private Consumption Expenditure Adj. 1993-2000, 1999/2000**
**(Dollars Millions)**

| SECTIONS | 93=100 Weights | Actuals | | | | | | | Estimates | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 1999/ 2000 |
| All Items | 1000 | 15,490.8 | 15,025.7 | 15,478.7 | 16,992.4 | 18,910.5 | 23,196.5 | 22,929.2 | 20,689.4 | 22,372.21 |
| All Items Adj. (min) | 438 | 6,785.0 | 6,581.3 | 6,779.7 | 7,442.7 | 8,282.8 | 10,160.1 | 10,043.0 | 9,062.0 | 9,799.0 |
| All Items Adj. (max) | 500 | 7,745.4 | 7,512.9 | 7,739.4 | 8,496.2 | 9,455.3 | 11,598.3 | 11,464.6 | 10,344.7 | 11,186.1 |

**Table A2**
**Estimated Potential Vat 1993-2000, 1999/2000**
(Dollars Millions)

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 1999/2000 |
|---|---|---|---|---|---|---|---|---|---|
| **Using Lower Limit of 43.8% of PCE adj.** | | | | | | | | | |
| Estimated net VAT | 1,017.7 | 987.2 | 1,017.0 | 1,116.4 | 1,242.4 | 1,524.0 | 1,506.4 | 1,359.3 | 1,469.9 |
| as % GDP | 4.2 | 3.4 | 3.2 | 3.2 | 3.4 | 4.0 | 3.7 | 3.1 | |
| **Using Upper Limit of 50% of PCE adj.** | | | | | | | | | |
| Estimated net VAT | 1,161.8 | 1,126.9 | 1,160.9 | 1,274.4 | 1,418.3 | 1,739.7 | 1,719.7 | 1,551.7 | 1,677.9 |
| as % GDP | 4.7 | 3.8 | 3.7 | 3.7 | 3.9 | 4.6 | 4.2 | 3.5 | |
| Historical net VAT series | 1,163.07 | 1,259.03 | 1,344.76 | 1,413.87 | 1,623.94 | 2,153.88 | 1,667.12 | | |
| as % GDP | 4.7 | 4.3 | 4.2 | 4.1 | 4.4 | 5.6 | 4.1 | | |

**Table A3: Actual VAT/GDP Ratio for Trinidad and Tobago 1993-1999**

| Year | VAT ($M) | GDP ($M) | *VAT/GDP Ratio* (%) |
|---|---|---|---|
| 1990 | 926.6 | 21,539.3 | 4.3 |
| 1991 | 1,054.4 | 22,379.8 | 4.7 |
| 1992 | 968.6 | 23,117.6 | 4.1 |
| 1993 | 1,163.1 | 24,490.5 | 4.7 |
| 1994 | 1,259.0 | 29,311.7 | 4.2 |
| 1995 | 1,344.8 | 31,697.0 | 4.2 |
| 1996 | 1,413.9 | 34,448.1 | 4.1 |
| 1997 | 1,623.9 | 36,552.4 | 4.4 |
| 1998 | 2,153.9 | 38,197.1 | 5.6 |
| 1999 | 1,667.1 | 41,044.9 | 4.1 |

**Table A4: Gross Domestic Expenditure – Structure and Growth, 1983-1999**

**(Per cent)**

| ITEM | Per Cent of GDP | | | | | | | Growth Rates | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1983-1986* | 1987-1994* | 1995-1999* | 1996ʳ | 1997ʳ | 1998ʳ | 1999ᵖ | 1996 | 1997 | 1998ʳ | 1999ᵖ |
| Consumption Expenditure | 81.1 | 74.9 | 68.8 | 65.2 | 67.0 | 77.2 | 72.0 | 9.5 | 9.0 | 20.4 | 0.3 |
| Private | 58.7 | 57.4 | 52.9 | 49.3 | 51.7 | 60.7 | 55.9 | 9.8 | 11.35 | 22.7 | -1.2 |
| Government | 22.4 | 17.4 | 15.9 | 15.9 | 15.3 | 16.4 | 16.2 | 8.8 | 1.9 | 12.6 | 5.7 |
| Gross Capital Formation | 22.6 | 16.1 | 27.6 | 24.4 | 36.2 | 28.1 | 22.0 | 27.5 | 57.4 | -18.7 | -16.0 |
| ***Gross Domestic Expenditure*** | ***103.6*** | ***90.9*** | ***96.4*** | ***89.6*** | ***103.2*** | ***105.3*** | ***94.0*** | ***13.9*** | ***22.2*** | ***6.7*** | ***-4.0*** |
| LESS: Imports of goods and non-factor services | **35.8** | **32.8** | **48.0** | **41.2** | **56.0** | **53.6** | **46.0** | **14.1** | **44.2** | **0.1** | **-7.7** |
| PLUS: Exports of goods and non-factor services | **32.2** | **41.9** | **51.5** | **51.6** | **52.8** | **48.3** | **52.0** | **4.3** | **8.6** | **-4.4** | **15.7** |
| ***Gross Domestic Product at Market Prices*** | ***100.0*** | ***100.0*** | ***100.0*** | ***100.0*** | ***100.0*** | ***100.0*** | ***100.0*** | ***8.7*** | ***6.1*** | ***4.5*** | ***7.5*** |

**Source:** Central Statistical Office

*Annual Average
p – provisional r - revised

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# 3

# Fiscal Policy in Post-Independence Barbados: Trends and Challenges Ahead

*Daniel O. Boamah & Darrin A. Downes*

## 1. Introduction

The problems of adjustment and growth in developing countries very often owe their genesis to excess domestic demand which originates from overly expansionary fiscal policies. Such policies usually lead to inflation and deterioration in the external current account. The usual responses to such situations in most developing countries have tended not to address the original fiscal problems, but often to impose domestic price controls and resort to restrictions on credit, trade and foreign exchange transactions. These measures, however, constrain further growth in the economy and exacerbate supply shortfalls, as the curtailment of imports could limit domestic capacity utilisation and exports. The cutback on retained imports could also weaken the tax base to the extent that those countries depend crucially on taxes on international trade. Thus, the ability to contain the fiscal deficits is further circumscribed.

In the post-central bank era, the Barbados economy has undergone three relatively short periods of recession (1974-75, 1981-82 and 1990-92) interspersed with long periods of positive growth. A common trait of these downturns was that they were either preceded or accompanied by periods of relatively large fiscal deficits. These deficits triggered current account disequilibria, sometimes exacerbated by developments in the external economy. For instance, the four-fold increase in oil prices in 1974-75 exacerbated the first recession, as Government's effort to increase expenditure to revive the economy further undermined the fiscal situation. Similarly, under the strain of the second oil price shock of 1979 and the accompanying rise in international inflation, the country was thrown into balance of payments problems, which persisted throughout the first half of the 1980s, forcing the Government to borrow heavily overseas for balance of payment support. If the proximate causes of the recessions in 1974-75 and 1981-82 were external factors, the 1990-92 recession was brought on largely by domestic aggregate demand pressures.

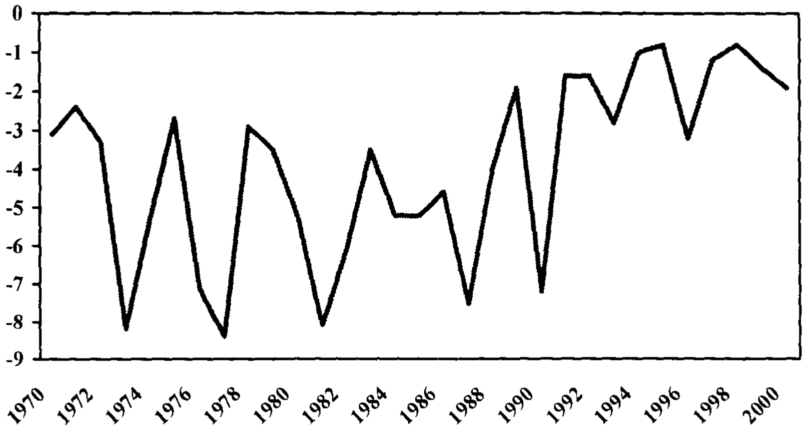
The main objective of this paper is to describe the evolution of Barbados' public finances over the period 1971-2000, discussing, where appropriate, the underlying causes of any fiscal problems over this period. The paper begins with a discussion of the trends in fiscal performance during the last thirty years, then touches on the possible impact of Government's budgetary policy on resource allocations, income distribution and equity, as well as the key challenges that are likely to confront Barbadian authorities in the medium to long term. The final section provides a summary and conclusions.

## 2. Fiscal Trends and Performance

A useful precursor to an analysis of the fiscal policies of any government is to examine the patterns of revenue and expenditure and their resultant impacts on the fiscal deficit. This section, therefore, dissects the fiscal performance of successive Barbadian governments over the past thirty years, focussing primarily on the evolution of revenue and expenditure outcomes.

Chart 1 displays the evolution of the fiscal deficit-to-GDP ratio over the period 1971 to 2000. In general, the period 1971-80 could be considered one of moderate to extreme fiscal disequilibrium, characterised by an average annual deficit-to-GDP ratio of 4.9% (see Table 1). Despite a healthy rate of revenue collections during this period, there was also a rapid increase in total government expenditure, which averaged close to 19% per annum, almost three percentage points faster than the trend growth rate in nominal GDP at market prices. This was a period when public policy emphasised the use of the budgetary process to influence real economic activity in the country. In particular, capital expenditure grew at an average annual rate of 23.3%, more than five times the rate of increase recorded in the decade ending in 1970, as large infrastructural projects were undertaken, including the expansion of the Deep Water Harbour and the airport, as well as the construction of the Barbados Community College, the Samuel Jackman Prescod Polytechnic and the Heywoods Village Resort. The strengthened infrastructural base firmly laid the foundation for the strong economic growth witnessed in the following two decades. Current spending also rose significantly, led by large increases in wages and salaries, especially in 1976 and 1980-81 when wage settlements were in the region of 25% and 30%, respectively.[1]

**Chart 1: Fiscal Deficit to GDP Ratio (1971-2000)**




In the decade that followed (1981-90), the operations of the central government resulted in greater fiscal imbalance, which could be considered a proximate cause of the economic downturn in 1990-92, the worst in Barbados' post-independence era. In these years, the deficit-to-GDP ratio rose to an average of 5.3% per annum. Expenditure growth exhibited the same pattern as in the 1971-80 period, as the rise in government expenditure (9.6%) continued to be higher than that of nominal Gross Domestic Product (6.8%). However, unlike in the previous

1 See *Annual Report (1976) and (1980),* Central Bank of Barbados.

**Table 1: Selected Indicators of Fiscal Performance**

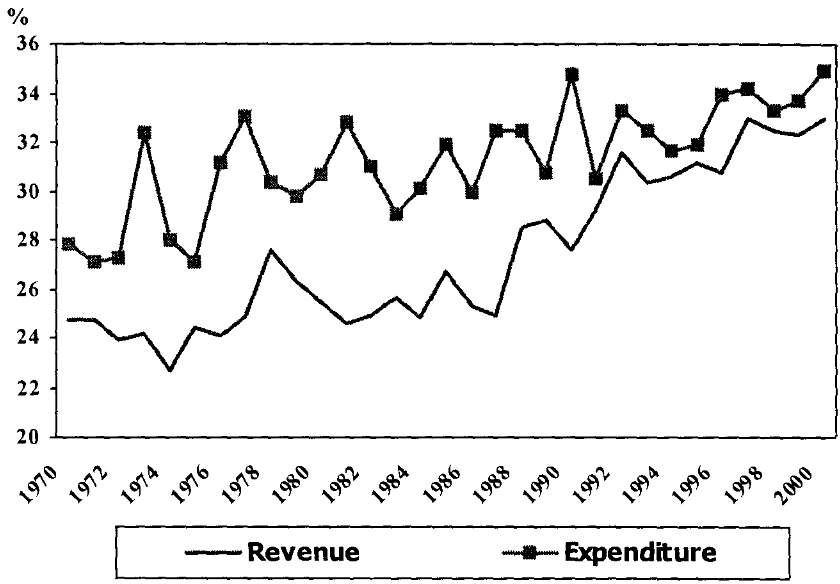
| Year | Nominal GDP (Market Prices) | Fiscal Balance | Fiscal Balance/ GDP (%) | Total Revenue | Total Expendi-ture | Total Revenue/ GDP (%) | Total Expendi-ture/ GDP (%) |
|---|---|---|---|---|---|---|---|
| 1971 | 40.0 | -9.7 | -2.4 | 100.8 | 110.5 | 24.7 | 27.1 |
| 1973 | 516.5 | -42.3 | -8.2 | 125.1 | 167.4 | 4.2 | 32.4 |
| 1975 | 812.4 | -21.6 | -2.7 | 198.5 | 220.1 | 24.4 | 27.1 |
| 1977 | 993.5 | -83.0 | -8.4 | 246.2 | 329.2 | 24.8 | 33.1 |
| 1979 | 1348.3 | -46.9 | -3.5 | 354.3 | 401.2 | 26.3 | 29.8 |
| 1980 | 1730.5 | -89.7 | -5.2 | 441.1 | 530.8 | 25.5 | 30.7 |
| **1971-80** | **894.4** | **-43.9** | **-4.9** | **225.0** | **268.9** | **24.8** | **29.7** |
| 1981 | 1904.6 | -154.9 | -8.1 | 469.4 | 624.3 | 24.6 | 32.8 |
| 1983 | 2112.6 | -73.4 | -3.5 | 541.1 | 614.5 | 25.6 | 29.1 |
| 1985 | 240.0 | -125.6 | -5.2 | 643.6 | 769.2 | 26.7 | 31.9 |
| 1987 | 2913.8 | -219.7 | -7.5 | 726.7 | 946.4 | 24.9 | 32.5 |
| 1989 | 3427.2 | 56.5 | -1. | 987.6 | 1054.1 | 28.8 | 30.8 |
| 1990 | 3440.1 | -48.2 | -7.2 | 949.5 | 1197.7 | 27.6 | 34.8 |
| **1981-90** | **2624.6** | **-137..5** | **-5.3** | **693.8** | **831.3** | **26.2** | **31.5** |
| 1991 | 3393.7 | -53.5 | -1.6 | 990.3 | 1043.8 | 29.2 | 30.8 |
| 1993 | 3308.9 | -68.8 | -2.1 | 1006.2 | 1075.0 | 30.4 | 32.5 |
| 1995 | 3742.4 | -28.7 | -0.8 | 1165.8 | 1194.5 | 31.2 | 31.9 |
| 1997 | 4412.6 | -52.2 | -1.2 | 1458.3 | 1510.5 | 33.0 | 34.2 |
| 1999 | 4970.0 | -70.6 | -1.4 | 1603.3 | 1673.9 | 32.3 | 33.7 |
| 2000 | 52.00.9 | -98.1 | -1.9 | 1717.1 | 1815.2 | 3.0 | 34.9 |
| **1991-00** | **4043.2** | **-62.5** | **-1.6** | **1279.0** | **1341.4** | **31.5** | **33.0** |

**Source:** Central Bank of Barbados.

decade, the expansion in aggregate government expenditure was driven largely by sharp increases in current spending, the majority of which were transfers to the social services (education, health, housing), followed by payments of wages and salaries. For instance, government expenditure on wages and salaries accounted for 44.2% of current expenditure in 1990/91, a rise of four percentage points from the 1981/82 level, in part reflecting a steady expansion in public sector employment. In addition, this period also marked a nearly seven-fold rise in debt servicing charges, a result of the extensive foreign borrowings that were undertaken during that time. Government revenue improved after 1985 in tandem with the expansion in real economic activity; however, the growth rate of government expenditure was faster, resulting in a rise in the expenditure-to-GDP ratio from an average annual of 29.7% during 1971-80 to around 32% by the end of the 1981-90 decade (see Chart 2).

In contrast, the last decade under analysis (1991-00) was a period of relatively low fiscal disequilibrium, with a recorded fiscal deficit averaging only 1.6% of GDP at market prices each year. An important feature of this period was the realisation of eight successive years of real economic expansion, the longest in the economic history of Barbados. Compared with the previous two decades, total expenditure growth slowed considerably to an annual rate of 4.6% on average during the years of 1991-2000. Although employment in the public sector continued to grow strongly, especially between 1995-2000, overall recurrent expenditure expanded on average by 5.7%, owing to moderate public sector wage increases, commensurate with a relatively modest period of price inflation.

**Chart 2: Ratios of Revenue and Expenditure to GDP (at Market Prices) (1971-2000)**



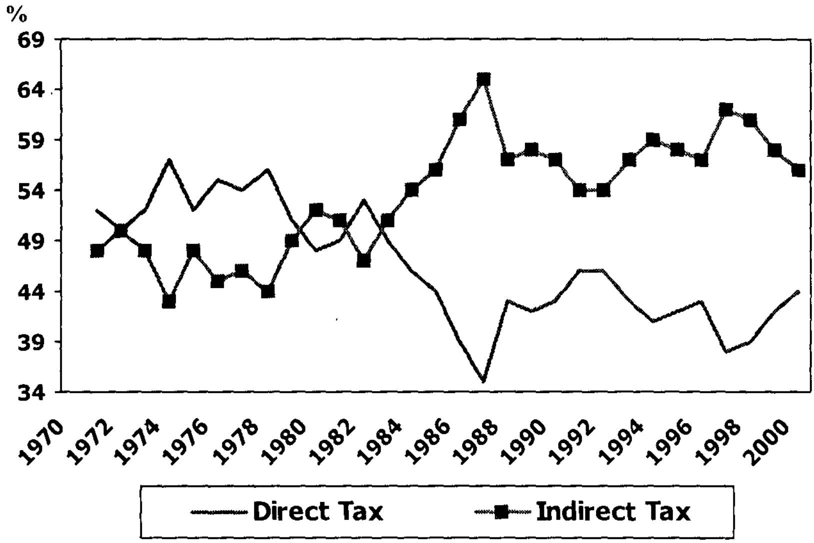

As shown in Table 1, by the end of 2000, the revenue-to-GDP ratio had risen to almost 32%, compared with 27.6% at year end 1990, largely due to government's emphasis on discretionary changes rather than the natural responsiveness of the tax system to real GDP growth. In a recent study, the overall tax elasticity for the period 1977 to 1999 was estimated to be 0.88, compared to a tax buoyancy of about 1.29 (see Skeete, 2001). This suggests that the Barbadian tax system during this period was relatively inelastic, and that government was forced to rely on frequent discretionary changes for revenue to keep up with GDP growth.

## 3. Evolution of Reforms to the Tax System

Government taxation policy has undergone some changes during the thirty-year period under review. Between 1971-80, taxation policy initially focussed more on the government's role to facilitate economic growth and increase employment than on income distribution. Heavy reliance was placed on the direct mode of taxation and while the income tax system was highly progressive, the threshold of income tax incidence was quite low. After 1977, trends in budgetary policy shifted in favour of direct redistribution of income. Although a new tax credit system was implemented in 1977 to decrease the tax burden on low-income earners, the tax system remained highly progressive, as an income of $30,000 or more attracted a marginal tax rate of 70%.

In 1980, government fiscal policy was directed more towards expenditure taxation than income taxation. A new tax rate structure was introduced and there were sizeable reductions in personal income tax liabilities, as the top marginal rate was lowered to 65% by 1985. In 1986, further revisions were made to the direct tax system. The top marginal rate was lowered to 50% and personal allowances were raised from $13,000 to $15,000, in addition to the existing standard deductions for full mortgage interest payments and life insurance premiums. Also, from 1980 onwards, the scope of consumption taxes was gradually widened and by the end of 1990, the ratio of indirect tax to overall tax revenue averaged 56%, almost nine percentage points above the ratio in the previous decade (see Chart 3). The emphasis on expenditure taxation continued into the decade ending in 2000, a period marked by important reforms in the taxation system.

**Chart 3: Ratios of Direct Tax and Indirect Tax to Total Tax Revenue (1971-2000)**




As indicated earlier, discretionary changes in tax rates, income tax bands and concessions have been important components in the arsenal of fiscal tools that have been utilised to manage the fiscal system in Barbados. However, following the 1990-92 recession, major reforms of both the direct and indirect tax systems were undertaken as part of the measures to restructure various sectors of the Barbados economy.

### *Direct Tax Reform*

Over time, the direct tax system had become highly complicated due a complex system of itemised allowances, an abundance of payroll taxes (levies) and concessions, which tended to be discriminatory in that they appeared to favour the high-income group. The broad thrust of the 1992 direct tax reform was, therefore, to simplify the direct tax system and broaden the tax base, while reducing the scope of direct taxation further in anticipation of the intended introduction of the all-embracing value-added tax.

Personal allowances were standardised to $13,000 and most tax-exempt allowances, such as deductions for life insurance payments and full mortgage interest payments were removed. In addition, income tax bands were widened, the top marginal income tax rate was reduced from 50% to 40% and four levies comprising the training, health, employment and transportation were abolished.

While the reforms broadened the tax base and the abolition of itemised deductions introduced a measure of revenue efficiency in the tax system, there was little impact on the share of direct taxation, as the ratio of indirect taxation remained high at 58% over the period 1993-96. This was partly because personal allowances were raised again to $15,000 in 1995 and deductions for mortgage interest payments were re-introduced with a cap in 1996. Moreover, provision was made for a reverse tax credit to those individuals who fell below the income tax threshold of $15,000 while there was a 30% increase in the personal allowance for pensioners to $30,000. Since 1998, budgetary policy has refocused on resource allocation with a range of concessions for saving and investment. These have included significant allowances for investment in venture capital funds and mutual funds, as well as an increased allowance for savings in credit unions.

An important facet of the direct tax system in the decade of the 1990s was its changing composition, marked by the growing importance of revenue from the international business and financial services sector, otherwise known as the "offshore" sector. Despite the relatively low tax rates (ranging from 0% to 2.5%) levied on the profits of international business companies, the evidence in 1998 and 1999 suggests that these tax revenues contributed in the neighbourhood of approximately 37% of corporation tax revenue or almost 4% of government's total revenue.[2] Without the contribution from the offshore sector, the dominance of indirect taxation in the overall tax intake would have been even more pronounced.

### *Indirect Tax Reform*

Arguably, the most important change in the taxation system in Barbados was the introduction of the value-added tax (VAT) in 1997, as part of the reform of the indirect tax system. The major justification for this change was that the indirect tax system had become complex, characterised by multiple rates, cascading, protectionism and non-transparency, which impaired the proper functioning of the tax system. With its simplicity of administration, neutrality and revenue efficiency, the VAT was considered the appropriate form of taxation to improve the functioning of the system. It replaced eleven taxes[3]

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2 See Harmful Tax Competition: Tax Convergence and other Possible Responses, Central Bank of Barbados (2001).

3 These were the consumption tax, surcharge on luxury imports, stamp duty on imports, public entertainment tax, hotel and restaurants sales tax, service tax, tax on quarriable minerals, travel ticket tax and tax on overseas telephone calls.

and was levied at a standard rate of 15% on all goods and services and 7.5% on hotel accommodation, with few exemptions and zero-ratings. Excise taxes were retained on alcohol and tobacco, motor vehicles, land and petroleum products.

## 4. Changes in Tax Regime: Impact on Government Revenue and Equity

Governmental activities and revenue programmes usually affect the overall patterns of distribution of real income in the economy. There were a number of instances where taxation policy in Barbados was deliberately directed at redistributing income towards the lower income group. Nevertheless, to the extent that there may be unintentional distributional effects from fiscal policy measures, it is pertinent to discuss whether the impact of various taxation regimes served their intended purposes.

In an evaluation of the impact of the 1986 tax measures, Mascoll (1991) calculated the tax payable by representative individuals in the high, middle and low-income groups when account is taken of the existing regime of concessions and tax exemptions. Mascoll found that the measures gave rise to a sharp decline of more than 7 percentage points in the average effective tax rate (ETR)[4] of individuals earning more than $100,000 per annum, compared to declines of only 0.2 and 2.1 percentage points for the representative middle and lower income individuals, respectively. He therefore concluded that the middle-

4 This is calculated as the ratio of income tax payable to total assessable income.

income representative carried a disproportionate tax burden in the aftermath of the 1986 direct tax revisions.

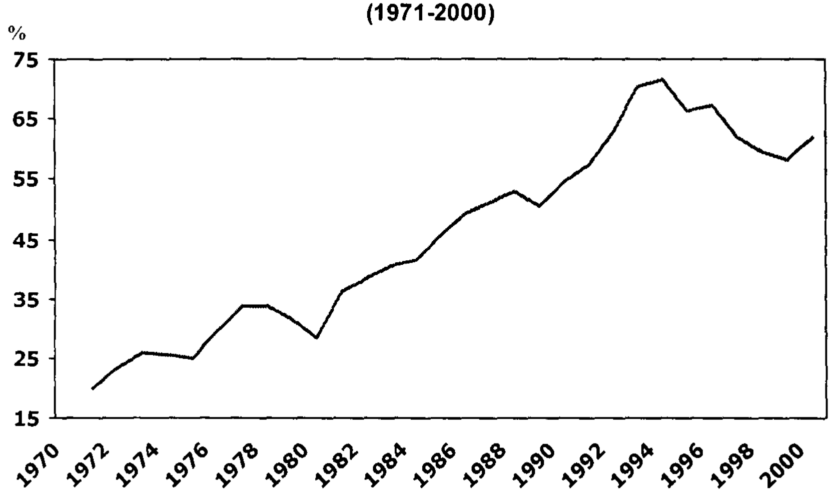
As a follow up to Mascoll's study, Howard and Mascoll (1994) intimated that the elimination of the various levies and the elimination of the plethora of allowances embodied in the 1992 direct tax reform introduced a measure of fairness to the system. While these reforms made the system less progressive, the fact that the effective tax rates fell by about six percentage points for the lower income individuals helped to ease the tax burden somewhat for this group. Additionally, the 1992 direct tax reform introduced a measure of revenue efficiency, as the tax yield improved. The average tax to GDP ratio for the period 1992 to 1996 (before the VAT was implemented) moved to 30.8 per cent from 28.4% for the period 1981 to 1992. However, it was the introduction of the VAT which boosted revenue performance even more considerably.

The VAT, designed to be nearly revenue neutral (in terms of the taxes it replaced), yielded about 35% more than the taxes it replaced (Dalrymple, 1998 p.72). However, with the gradual re-introduction of the itemised deductions that were phased out in 1992 and the subsequent introduction of a range of new direct tax concessions for savings and investment related instruments (which tended to favour the high income groups), the tax burden appeared to have shifted even more against the low income group. This point is reinforced by a recent study by Boamah, Byron and Maxwell (2002), which reveals an overall increase in income inequality over the period 1987 to 1999, as the distribution of income appeared to have favoured the middle and upper-income individuals. If account is taken of the known regressivity of the VAT system, the relative disadvantaged position of low-income individuals would become even more pronounced.

## 5. Fiscal Policy and Public Debt

It is not unusual in many developing countries for total public debt to be determined largely by chronic fiscal imbalances. When such imbalances are financed by money creation in an atmosphere of falling demand for money, this could lead to inflationary pressures in the economy. In Barbados, there has been more that a forty-fold increase in public debt since 1970. However, this occurred mainly during the period 1977 to about 1990 when the government's fiscal policy stance was deemed to have affected the overall indebtedness of the public sector. Chart 4 shows the growth of public debt over the period 1971-2000. Total public debt to GDP (at market prices) rose from about 20% in 1971 to a high of about 71% in 1994, accelerating sharply during the 1980s, as Government incurred large fiscal deficits. Between 1994 and 1999, when the country's access to external borrowing was limited, the debt-to-GDP

**Chart 4: Total Public Debt-to-GDP Ratio (1971-2000)**



ratio fell to approximately 58%, but by the year 2000, it had risen to 62%, the level that existed in the early 1990s, with both higher domestic and external debt.

In Barbados, domestic debt has usually been the largest component of public debt, although its share has varied according to the emphasis placed on the main sources of financing public sector deficits. For instance, during the period 1978 to 1988, when Government borrowed heavily overseas for infrastructural development and balance of payments support, the ratio of domestic debt to total debt gradually declined from 76% to about 50% (Table 2). During this period, the stock of external debt actually rose almost ten-fold to approximately $820 million, as Government secured loans on the Japanese and European markets and extensively used project fund inflows from international lending agencies. However, between 1988 and 1999, Government reverted to domestic sources for the bulk of its deficit financing and the share of domestic debt rose sharply to 76%, the level witnessed in the late 1970s. In addition, Government incurred large contingent liabilities in 1992 and 1994 when long-term debt instruments were issued to restructure the balance sheet of a public lending institution overburdened by the debt of the sugar industry.

Despite the recent increases in the public debt ratio, the Government of Barbados has, since 1991, been registering consistent primary fiscal surpluses, compared to the previous two decades when primary deficits of about 2% of GDP[5] were registered. This gives a measure of sustainability to the island's public debt profile for the foreseeable future.

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5 See Archibald and Greenidge (2002).

**Table 2: Composition of Total Public Debt**

| Year | Domestic | External | Total Debt | Total Debt/GDP (%) |
|---|---|---|---|---|
| 1971 | 51.2 | 30.2 | 81.4 | 20.0 |
| 1972 | 71.9 | 32.0 | 103.9 | 23.3 |
| 1973 | 77.8 | 55.4 | 133.2 | 25.8 |
| 1974 | 136.2 | 42.7 | 178.9 | 25.5 |
| 1975 | 158.1 | 44.1 | 202.2 | 24.9 |
| 1976 | 208.5 | 49.5 | 258.0 | 29.5 |
| 1977 | 279.5 | 55.2 | 334.7 | 33.7 |
| 1978 | 282.9 | 89.2 | 372.1 | 33.5 |
| 1979 | 314.2 | 112.1 | 426.3 | 31.6 |
| 1980 | 329.3 | 163.9 | 493.2 | 28.5 |
| 1981 | 426.5 | 259.4 | 685.9 | 36.0 |
| 1982 | 475.5 | 286.9 | 762.4 | 38.3 |
| 1983 | 516.4 | 337.3 | 853.7 | 40.4 |
| 1984 | 590.2 | 365.2 | 955.4 | 41.5 |
| 1985 | 651.7 | 444.0 | 1,095.7 | 45.5 |
| 1986 | 713.0 | 588.3 | 1,301.3 | 49.2 |
| 1987 | 753.0 | 738.1 | 1,491.1 | 51.2 |
| 1988 | 821.0 | 817.0 | 1,638.0 | 52.9 |
| 1989 | 878.0 | 852.8 | 1,730.8 | 50.5 |
| 1990 | 1,020.6 | 859.4 | 1,880.0 | 54.6 |
| 1991 | 1,113.5 | 834.4 | 1,947.9 | 57.4 |
| 1992 | 1,236.6 | 755.0 | 1,991.6 | 62.7 |
| 1993 | 1,617.9 | 706.6 | 2,324.5 | 70.2 |
| 1994 | 1,777.8 | 714.4 | 2,492.2 | 71.5 |
| 1995 | 1,762.2 | 717.7 | 2,479.9 | 66.3 |
| 1996 | 1,967.0 | 722.0 | 2,689.0 | 67.3 |
| 1997 | 2,036.9 | 697.5 | 2,734.4 | 62.0 |
| 1998 | 2,141.4 | 684.3 | 2,825.7 | 59.5 |
| 1999 | 2,108.6 | 788.9 | 2,97.5 | 58.3 |
| 2000 | 2,204.1 | 1,021.9 | 3,226.0 | 62.0 |

Source: Central Bank of Barbados.

## 6. Current Reforms and the Challenges Ahead

Notwithstanding the fiscal discipline exhibited throughout the 1990s, the Barbados government faces important policy challenges on the threshold of the new millennium. Apart from managing the current economic recession largely attributable to recent global uncertainties, ongoing changes in the international economy are forcing Barbados, as well as other small, open economies to implement accelerated structural reforms that show little recognition of the special characteristics of small size and economic vulnerability.

In this global environment characterised by increasing geo-political and economic uncertainties, chief among these challenges is the sustainable management of the globalisation process into the 21st Century, particularly the maintenance of a sustainable fiscal position. Critical to the achievement of such an outcome must be tight controls on public recurrent expenditure, prudent debt management and the streamlining of the tax system to boost external competitiveness, while safeguarding the revenue base. For instance, the recent "Harmful Tax Competition" issue championed by the Organisation for Economic Cooperation and Development in 2000 has brought to the fore the need to address the present wide disparity between the tax rates applicable to domestic and "offshore" firms. Reinforcing the urgency for reform of the direct tax system is the fact that the present corporate tax rate of 37.5% still ranks among the highest in the region[6] and warrants a downward adjustment to enhance the private sector's ability to effectively compete with its

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6 For instance, the corporate tax rate is 33% in Jamaica and 35% in Trinidad and Tobago.

regional counterparts. In this regard, the Barbados government has embarked upon a phased reform[7] of the direct tax system, with a view to reducing the corporate tax rate to 25% by the year 2006, while at the same time rationalising the existing regime of corporate tax incentives. Personal income taxes will also undergo a gradual reduction over a period of two years.

These reforms mean that in the medium term, the Government would have to rely more on indirect taxes to make up for the revenue shortfall arising from the direct tax reforms. Since expenditure taxes tend to be regressive in nature, there is likely to be a further increase in the inequities of the income tax system. While Government could address the growing inequities by expanding the social programmes targeted at the poor or raising the income threshold further, such polices would make it difficult for it to keep its fiscal deficit-to-GDP ratio within sustainable limits. Already the fiscal deficit has widened significantly during the period 2001-02, the result of a deliberate counter-cyclical policy stance to increase capital expenditure so as to ameliorate the impact of the present economic recession. Unless sustainable economic growth resumes in the shortest possible time, keeping the fiscal deficit within the desirable range of 2% to 3% of GDP, while maintaining a tax system that exhibits the desired characteristics of fairness, simplicity and equity will certainly be a challenge.

Another key requirement is for Government to implement appropriate reforms of the National Insurance Scheme (NIS) to achieve actuarial balance for its long-term viability. A recent actuarial review of the NIS pointed to

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7 These reforms were implemented in fiscal year 2002/03.

the need for urgent action to maintain its viability. According to the study, changes in the age distribution of the population, declining fertility and increasing longevity of Barbadian citizens could reduce the contributory support ratio of the scheme from about 6 working-age persons per pensioner as at 1999 to only 2.5 by the year 2030.[8] Moreover, the projected reserve ratio[9] of the Fund was expected to become insolvent by the year 2020, and, indeed, become negative by 2030. Therefore, the key issue is to implement appropriate reforms to ensure that the scheme provides a reasonable retirement income for eligible contributors in the years ahead.

In its Economic and Financial Policy Statement in 2002, Government announced plans for incrementally higher contributions plus an increase in the mandatory retirement age to 67 years over a period of 12 years beginning in 2006. In addition, persons would have the option to work until age 70. Obviously, this has adverse welfare implications, as prospective pensioners have to contend with likely welfare losses arising from having two fewer years to enjoy their pension. Even then, unless there is an attempt by the fiscal authorities to change the demographic profile of the adult population with a deliberate policy action, the problem of a dwindling contribution ratio is likely to recur in the years ahead. Furthermore, the idea of a labour force supported by an

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8 See Tenth Actuarial Report of the Operation of the Barbados National Insurance Scheme, p. 7.

9 The ratio of the Fund to one year's benefit expenditure and administrative expenses.

increasing proportion of aging workers could have adverse implications for future real output in the economy. As Barr (2002) surmises, increasing real economic activity is the only effective way of assuring that future output can be converted into sufficient goods and services to meet the needs of pensioners. It appears, therefore, that policy makers would continue to grapple with the question of devising an appropriate social security system that is fair and viable for sometime yet.

## 7. Summary and Conclusions

The preceding analysis demonstrates how the Barbadian fiscal system has changed between 1971 and 2000, moving from a system characterised by relatively large fiscal imbalances in the first two decades to one of relative fiscal prudence. Growth in expenditure was initially driven mainly by an emphasis on infrastructural development, but there were periods, especially in the decade ending in 1990, when current spending dominated.

The tax system has also shifted from one dominated by direct taxation towards one of indirect taxation. There have also been major reforms of both the direct and indirect tax systems, but there remain inherent inequities to the extent that the direct tax system appears to discriminate against the relatively worse off in the economy.

The improvement in Barbados' fiscal policy stance, especially since 1991, brought a measure of sustainability to the fiscal system. Nevertheless, there are some challenges that need to be addressed if the budgetary instrument is to continue to facilitate continued growth and development. Apart from the need to zero in on the inequities in the direct tax system, the fiscal authorities are faced with the task of adjusting the corporate tax rate to reduce the tax burden on the business sector, as well as the challenge of reforming the social security system to ensure its viability.

Government is making every effort to address these issues, but more needs to be done, given an increasingly uncertain international economic environment.

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# 4

# Fiscal and Development Challenges Facing the Bahamas at the Turn of the Century

*Ramesh Ramsaran & Nikolaos Karagiannis*

## Introduction

The post-war development experience and the increasing liberalisation of the world economy have challenged the assumptions of many old theories and created an environment which encourages creative thinking on how development could best be approached. The fact that some countries with little natural resources have managed to make spectacular progress downplays size and endowment, and points to the importance of policy. New perspectives have emerged on the role of the state, foreign investment, and the relationship between the public and private sector, import substitution versus export development, inter-action between the domestic economy and the international economy, international trade policy and the significance of size. As the colonial ties dissipate and the rich countries forge new relationships among themselves, developing countries are being forced to develop new activities and pay greater attention to competition. In the global market place there is less sympathy for 'special and differential' treatment. Countries are increasingly being forced to establish their own niche in the international market place.

Based on the growth of tourism in the post-war period and a tax haven environment, the Bahamas has been able to create a high standard of living for its citizens with a combination of imaginative policies and certain natural assets. Its position near the large United States market has helped in making the Bahamas one of the world's leading tourist resorts and tax havens. The Bahamas currently receives close to 1.5 million stop-over visitors and over 2.5 million cruise-ship visitors per year. As of June, 2000, there were over 400 banks and trust companies registered in the Bahamas.

In recent years a number of issues which reflect the changing times have emerged and raised questions not only about the ability of the Bahamas to sustain the momentum of previous years, but whether it can hold on to the gains already made. To be sure, the heavy reliance on tourism with its extremely high import content has been widely recognised as a major source of vulnerability, and despite frequent expressions of the need to transform tourism into a more competitive product and to encourage industrial and agricultural activities, little headway has been made in this direction.[1] Following the example of The Bahamas a number of other resorts in the Caribbean and elsewhere have adopted the strategy of promoting tourism-cum-offshore financial activities as foreign exchange earners and to create employment, thus increasing the competition for tourists and capital seeking a tax-free haven. In the 1990s, a conjuncture of events raised serious questions about the sustainability of the Bahamas' model of development. Concern about money laundering and the use of tax havens by companies and citizens to escape taxation in their home country led the OECD (Organisation for Economic Cooperation and Development) to adopt a very hostile attitude towards tax havens and called for retaliatory action against countries which did not adopt stricter measures to increase transparency and discourage illegal activities. "Member countries have concluded that they need to act collectively and individually to curb harmful tax competition and to counter the spread of harmful preferential tax regimes directed at financial and service activities. Harmful preferential tax regimes can distort trade and investment patterns, and are a threat both to domestic tax systems and to the overall structure of international taxation."[2]

Around the same time the Financial Action Task Force (FATF) on money laundering was putting together its own proposals to force countries to be more cooperative in the

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1 See G. Fraser, "Can the Sir Stafford Sands Model of the Bahamian Economy Survive Today's Global Economy?" Paper presented at the XXXIII Conference of the Caribbean Centre for Monetary Studies, Belize, Nov. 2001.

2 OECD, *Harmful Tax Competition – An Emerging Global Issue*, Paris, 1997, p. 56.

international fight against money laundering.[3] "In today's open and global financial world, characterized by a high mobility of funds and the rapid development of new payment technologies, the tools for laundering the proceeds of serious crimes as well as the means for anonymous protection of illegal assets in certain countries or territories make them even more attractive for money laundering." In July of 2002 the discussions on the Bill in the US Congress to establish the Homeland Security Development embraced a suggestion that the new agency should not enter into contracts with publicly traded companies incorporated in ten named countries and territories.[4] Among them was the Bahamas. The decision stemmed from a feeling that some US companies were using tax havens to reduce their tax payments. Incidentally, the tax haven status of the Bahamas has always been viewed with suspicion by the US tax authorities.

The global trend towards lower tariffs to encourage trade raises a particular difficulty for countries like the Bahamas, without an individual or corporate income tax and which depend heavily on trade taxes for revenue. Participation in trade arrangements which call for lower import duties would require the institution of new sources of taxation. These can take the form of income taxes at relatively lower rates or the introduction of sales or value-added taxes. The political feasibility of this change in taxation philosophy is one issue. The other is this: the Bahamas is essentially an exporter of services, and would need to weigh very carefully the costs and benefits of joining

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3 See FATF *Report on Non-Cooperative Countries and Territories*, Paris, 2000, p. 1.

4 *Business Guardian*, August 1, 2002.

any free trade grouping. The old thinking was that because of its narrow resource base and high wage rates, the scope for the development of a vibrant goods producing sector was limited. Given today's technology and mobility of factors of production, competitive advantage has become a dynamic process, and with greater investment in infrastructure and human development there is no reason why the Bahamas could not create a more vibrant and diversified export sector. At the moment the Bahamas is a member of the Caribbean Community, but is not part of the Common Market, and this allows it to keep its own tariffs. It is not certain whether there would be any such accommodation in the Free Trade Area of the Americas (FTAA). The global environment is changing and the Bahamas may be forced to rethink some of its policies. The impact of the September 11, 2001 terrorist attacks on the travel industry shows the danger of too heavy a reliance on an industry which is changing and also subject to volatile factors, particularly the transport industry and developments in the oil market.

The use of the Bahamas to smuggle drugs and people into the United States has put added pressure on the government. It has been estimated that about 12% of the cocaine heading to the US from South America flows through the Jamaica-Cuba-Bahamas corridor, mostly arriving in the Bahamas by speed boat from Jamaica.[5]

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5 EIU *Country Report*, June, 2002, p. 12.

This paper focuses on the fiscal challenges being faced by the Bahamas and some of the issues that arise from participation in a free trade area. The first part discusses the structural features of the country and recent economic performance. The second analyses the fiscal system and public debt situation, while the third outlines some of the trade issues arising from participation in an integration scheme. The final section of the paper discusses the mutual benefits between tourism and agro-industry on the grounds of production-oriented growth, endogenous competency and competitiveness; identifies key strategic requirements; and offers alternative development policy considerations, which the 'strategic' approach implies and suggests.

## 1. Structural Features and Recent Economic Performance

Even in countries comprising of one land mass, there are concerns arising from ineffective decentralised administration and unequal regional development. For multi-island states the problem can be even more challenging. The Bahamas is an archipelagic state lying about 60 miles off the Florida coast and consisting of some 29 major islands, 661 cays (small islands) and over 2,000 rocks amounting to 5,382 sq. miles. Since 1970 the population has been growing at an average rate of 2.6% per annum reaching an estimated 304,000 in 2000 as compared to 168,000 three decades earlier. More than half the population live on one island, New Providence, and another 15% in Grand Bahama.

The economy is extremely open, with imports of goods and services and exports of goods and services amounting to between 50 and 60% of GDP, respectively. Taxes on international trade and transactions contribute over 60% to tax revenue. The export of services far outweighs the export of goods which is confined to a narrow range of products such as fish (including crawfish), rum, salt, chemicals and fruit and vegetables. The merchandise account is in continuous deficit, a large part of which is covered by surplus in the services account. Services, dominated by tourism and to a lesser extent by financial activities, contribute some 90% to GDP. Agriculture and manufacturing contribute less than 5% respectively to total production.

The Bahamian economy is closely tied to the economy of the US which is its largest single trading partner, taking an average of over 60% of non-oil exports in recent years and supplying over 90% of non-oil imports. An average of over 80% of stopover visitors to the Bahamas come from the United States. The Bahamian dollar is pegged to the US dollar one to one, and the inflation rate mirrors that in the United States.

Between 1975 and 1990 real GDP in the Bahamas is estimated to have grown by an average rate of almost 6% per year, while real per capita GDP increased by about 3.8% per year.[6] Between 1975 and 2000 real per capita GDP is estimated to have increased by 1.5% per year with the growth rate being considerably lower (0.1%) in the 1990s than in the earlier years.[7] In the first half of the 1990s, the economy slowed down considerably with total real income falling by 2% between 1990 and 1995. With increased inflows of foreign capital from the mid-90s, the

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6 The GDP (current prices) estimates used in this paper are largely those of the World Bank and IMF.

7 See UNDP, *Human Development Report 2002,* New York, 2002, p. 190.

economy resumed growing, but slumped in 2001, partly reflecting the difficulties facing the international travel industry. Real per capita GDP in 2001 was almost the same as in 1989, but 75% higher than in 1975.

In nominal terms, per capita GDP increased from almost US$4,000 in 1975 to almost US$15,000 in 2000. When other social indicators are taken into account, the Bahamas enjoys a standard of living far above a large number of other developing countries. The unemployment rate in recent years has been under 10%. Life expectancy at birth is 74 years and the adult literacy rate is 96%. Ninety seven percent of the population has access to safe water while there are 23 physicians per thousand people. The Bahamas is ranked by the UNDP as a country with high human development.

While a combination of factors has contributed to the growth of the modern Bahamas, tourism and foreign investment have been the dominant forces. Tourism contributes close to 75% to GNP and employs two thirds of the labour force. The number of stopover and cruise-ship visitors grew from less than 20,000 in 1946 to over one million in 1968 and to over two million in 1983. In the year 2000 cruise and stop-over visitors numbered over four million. Tourist expenditure increased from US$230 million in 1970 to US$1.8 billion in 2000. In 2000 earnings from exports of goods and services amounted to US$2.828 billion, of which US$1.814 billion (64%) came from tourist spending.

The economy is not only service-driven, but it is at the same time highly dependent on imports to satisfy consumption and investment needs. Private and government spending account for about 80% of total expenditure on GDP. As indicated earlier, the trade balance tends to be consistently negative, averaging 28%

**Table 1: Selected Economic Indicators**

| Year | 1 | | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
|---|---|---|---|---|---|---|---|---|---|---|
| | Real Growth Rate (%) | | Per Caita GDP | Un-employ-ment | Inflation Rate | Stopover Visitor | Cruise Passenger | Visitor Expendi-ture | Long-Term Capital Flows (net) | Licensed Banks and Trust Companies |
| | Total GDP | Per Caita GDP | (Current US$) | % | % | '000 | '000 | US$mn | US$mn | |
| 1975 | .. | .. | 3,860 | .. | .. | 903.0 | 421.3 | 317.5 | 38.0 | 275 |
| 1990 | 1.3 | -0.8 | 12,453 | 11.7 | 4.7 | 1,561.7 | 1,853.9 | 1,333 | 38.6 | 394 |
| 1991 | -2.7 | -4.3 | 12,000 | 12.2 | 7.1 | 1,427.0 | 2,020.0 | 1,193 | 159.0 | 396 |
| 1992 | -2.0 | -3.5 | 12,038 | 14.8 | 5.7 | 1,398.9 | 2,139.4 | 1,244 | 56.7 | 404 |
| 1993 | 1.7 | -0.2 | 11,914 | 13.1 | 2.7 | 1,488.7 | 2,047.0 | 1,304 | 7.8 | 415 |
| 1994 | 0.9 | -1.7 | 11,402 | 13.3 | 1.3 | 1,516.0 | 1,805.6 | 1,333 | 64.5 | 413 |
| 1995 | 0.3 | -1.0 | 11,273 | 11.1 | 2.2 | 1,317.0 | 1,922.0 | 1,346 | 78.5 | 418 |
| 1996 | 4.2 | 2.1 | 12,764 | 11.5 | 1.4 | 1,368.0 | 2,047.8 | 1,398 | 134.0 | 425 |
| 1997 | 3.3 | 1.9 | 13,368 | 9.8 | 0.5 | 1,368.1 | 2,085.7 | 1,416 | 344.2 | 418 |
| 1998 | 3.0 | 1.3 | 14,078 | 7.8 | 1.3 | 1,304.9 | 2,042.8 | 1,354 | 830.0 | 418 |
| 1999 | 5.9 | 4.2 | 14,430 | 7.5 | 1.3 | 1,438.9 | 2,209.2 | 1,583 | 491.7 | 415 |
| 2000[e] | 5.0 | 3.0 | 14,803 | .. | 1.6 | 1,481.5 | 2,722.3 | 1,814 | 439.0 | 410 |
| 2001[e] | -0.5 | -1.1 | 15,196 | .. | 1.8 | 1,439.0 | 2,749.3 | .. | .. | 356 |

.. Not available
e: Estimate

**Source:** IMF, *Country Reports*, Various Issues; Central Bank, *Quarterly Reviews*, Various Issues; EIU, *Country Reports*, Various Issues.

**Table 2: Trends in the Balance of Payments, 1990-2001**

| Year | (1) Trade Balance US$mn | (2) Services Balance US$mn | (3) Current Account Balance US$mn | (4) Capital Account Balance US$mn | (5) Change in External Reserves[1] US$mn | (6) (1) as a % of GDP | (7) (3) as a % of GDP | (8) Gross Foreign Reserves (Official) US$mn | (9) (8) in Months of Imports of Goods and Services |
|---|---|---|---|---|---|---|---|---|---|
| 1990 | -977.6 | 793.2 | -174.0 | 64.7 | -12.5 | -30.7 | -5.5 | 158.2 | 1.1 |
| 1991 | -725.8 | 616.2 | -89.3 | 175.1 | -14.3 | -23.4 | -2.9 | 181.3 | 1.4 |
| 1992 | -759.0 | 711.5 | -34.1 | 5.7 | 27.9 | -24.0 | -1.1 | 155.3 | 1.2 |
| 1993 | -843.5 | 38.7 | -92.0 | 13.8 | -18.3 | -26.3 | -2.9 | 172.3 | 1.4 |
| 1994 | -903.2 | 693.3 | -189.2 | 103.5 | -9.3 | -28.7 | -6.0 | 176.6 | 1.3 |
| 1995 | -913.3 | 905.0 | -148.2 | 103.7 | 3.1 | -29.7 | -4.7 | 179.2 | 1.2 |
| 1996 | -1,059.9 | 856.9 | -207.7 | 121.4 | 7.6 | -29.2 | -5.7 | 171.4 | 1.0 |
| 1997 | -1,301.8 | 745.1 | -665.1 | 370.0 | -56.5 | -33.8 | -17.3 | 227.0 | 1.2 |
| 1998 | -1,373.9 | 542.8 | -995.7 | 860.0 | -119.3 | -33.3 | -24.1 | 346.5 | 1.5 |
| 1999 | -1,249.3 | 933.5 | -409.0 | 583.6 | -65.3 | -29.0 | -9.5 | 410.5 | 1.8 |
| 2000[e] | -1,312.8 | 1,034.3 | -408.1 | 469.3 | 61.5 | -29.2 | -9.1 | 349.6 | 1.4 |
| 2001[e] | -998.3 | 979.7 | -152.2 | 215.7 | 30.2 | -22.2 | -3.4 | 319.3 | .. |

1: Minus sign indicates increase; .. Indicates not available; e: Estimate.

**Source:** Central Bank, *Quarterly Review*, Various Issues, EIU *Country Reports*, Various Issues.

of GDP between 1990 and 2000. The services balance on the other hand tends to be positive, averaging 36% of GDP in the period, but these balances have not been able to cover the trade deficits and as a result, the current account balance has also been consistently negative. Private capital inflows and public sector borrowing have played a crucial role in financing the deficits.

## 2. Trends in Revenue and Expenditure

Modern economies are generally mixed economies, with the state undertaking a range of functions. The extent of intervention varies from state to state, but clearly the government has a certain role to play, with substantial effects on the economy and society. State intervention can extend from covering a range of public services to facilitating or promoting industrial competency and endogenous development (or even to its direct involvement in the productive process). In this connection the tax system plays a crucial role in not only providing the government with revenues to meet social and economic needs but in attaining policy objectives such as stimulating growth or influencing liquidity. Population growth increases the demands on governments regardless of ideological positions, and a salient feature of a good tax system is one that captures for the government a sufficient share of the fruits of growth to provide the desired level of goods and services. In the absence of resources to meet its basic functions or to finance capital projects, governments tend to find themselves carrying an increasingly heavy debt burden, which can have implications for future generations.

An inelastic tax system is one in which tax revenues rise proportionately slower than income, while an elastic system is one in which tax revenues rise proportionately faster than income, as income increases. An examination of Table 3 shows that in the 1990s, the tax/GDP ratio averaged 17%, only marginally higher than in the 1970s. Over the last two decades import duties (which contribute around 60% of tax revenue) have averaged around 10%. In the 1970s and 1980s the tax system, as indicated by a coefficient less than one, was not very buoyant. It, however, improved in the 1980s, as a result of some rationalization and improved efficiency and administration.

**Table 3: The Relationship Between Tax Revenue and GDP[1]**

| Period | As a % of GDP[2] | | Elasticity (Buoyancy) Coefficients | |
|---|---|---|---|---|
| | Total Tax Revenue | Import Duty[3] | Total Tax Revenue | Import Duty |
| 1975-1980 | 16.2 | 10.9 | 0.82 | 0.88 |
| 1980-1990 | 13.8 | 9.6 | 0.85 | 0.73 |
| 1990-2000 | 17.0 | 9.2 | 2.31 | 1.15 |
| 1975-2000 | 15.7 | 9.7 | 1.20 | 0.84 |

1. At market prices.
2. Average for the period.
3. If stamp taxes are included these figures would increase by 2% to 3%. Taxes on international trade and transactions average about 12% of GDP.

**Source:** Authors' computation.

The Bahamas does not have an individual or corporate income tax, inheritance taxes or capital gains taxes. It relies on a range of direct and indirect taxes for revenues, the most important being import duties (which average 32.8%) and a 7% stamp tax on trade, and these account for between 50 and 60% of current revenue. Tourism taxes contribute between 8 and 10%, while miscellaneous taxes

**Table 4: Composition of Current Revenue, 1975-2000**
**(In Percent)**

| Taxes | 1975 | 1980 | 1991 | 2000 |
|---|---|---|---|---|
| *Tax Revenue* | *81.4* | *82.4* | *86.8* | *92.1* |
| *Taxes on international Trade* | | | *57.9* | *55.9* |
| Import duties | 54.1 | 57.4 | 51.9 | 43.7 |
| Export duty | .. | .. | 1.5 | 10.8 |
| Other | .. | .. | 4.5 | 1.4 |
| *Tourism Taxes* | .. | .. | *8.3* | *8.9* |
| Departure tax | 3.6 | 3.2 | 6.7 | 6.3 |
| Hotel occupancy tax | .. | .. | 1.5 | 2.4 |
| Ticket tax | .. | .. | 0.2 | 0.3 |
| *Miscellaneous Taxes* | *23.7* | *21.8* | *20.6* | *23.1* |
| Company fees | .. | .. | 6.1 | 6.1 |
| Motor Vehicle tax | 2.1 | 1.4 | 2.6 | 1.8 |
| Property tax | 3.0 | 2.5 | 3.9 | 3.3 |
| Stamp tax | 6.0 | 6.5 | 4.9 | 9.4 |
| Gaming tax | .. | .. | 3.9 | 2.3 |
| *Non-Tax Revenue* | *18.6* | *17.6* | *13.2* | *7.9* |
| **Total Current Revenue** | **100.0** | **100.0** | **100.0** | **100.0** |

.. Included in 'miscellaneous taxes'.

**Source:** Central Bank, *Quarterly Review*, Various Issues.

(property, stamp tax, gaming tax, company fees, etc.) account for about 20%. The absence of a progressive income tax not only deprives the government of an important management tool, but also increases the reliance on indirect taxes which tend to be regressive. It also reduces the scope for using the tax system as an incentive vehicle to influence economic activity. In the past, the government, for instance, has reduced or eliminated import duties on certain items to assist particular sectors, but there are real limits to which it can do this without shrinking the tax base.

Current expenditure has tended to grow at a slightly lower pace than current revenue, leading to a small savings on current account – around 1% of GDP in recent years (see Table 5). When capital spending and debt repayment are taken into account, the overall balance has generally been in deficit. Over half of current expenditure has traditionally been for personal emoluments as compared to 20 to 25% for purchase of goods and services. The shares for interest payments and subsidies and transfers have been increasing since the 1970s. At the same time, current spending on education and health as a % of GDP has not changed significantly since the 1980s.

### 3. The Public Debt

Both in absolute terms and as a % of GDP, the Bahamian dollar debt has increased sharply since the 1970s and 1980s, averaging around 30% of GDP in recent years. Servicing of this debt fluctuates from year to year but has come close to 20% of current revenue in some years. The foreign currency debt has increased less sharply and as a % of GDP has fallen to around 9% of GDP in recent years. The debt service ratio has hovered around 6% for most of the 1990s, while debt service payments as

**Table 5: Trends in Revenue and Expenditure , 1975-2000**

| Year | (1) Current Revenue | (2) Current Expendi-tire | (3) Current Balance | (4) Capital Expendi-ture and Net Lending | (5) Overall Balance | (6) (1) as a % of GDP[1] | (7) (3) as a % of GDP[1] | (8) (5) as a % of GDP[1] | (8) Total Expendi-ture as a % of GDP[1] |
|---|---|---|---|---|---|---|---|---|---|
| 1975 | 116.5 | 114.5 | 2.0 | 17.6 | -15.6 | 22.5 | 0.3 | -3.0 | 22.1 |
| 1980 | 244.1 | 208.0 | 36.1 | 43.8 | -7.8 | 18.3 | 2.7 | -0.6 | 18.9 |
| 1990 | 497.8 | 485.8 | 12.0 | 83.8 | -71. 9 | 16.3 | 0.3 | -2.2 | 17.9 |
| 1991 | 508.3 | 539.8 | -31.5 | 87.1 | -105.1 | 16.3 | -1.0 | -3.4 | 20.2 |
| 1992 | 538.2 | 520.5 | 17.7 | 98.0 | -88.1 | 17.0 | 0.6 | -2.8 | 20.0 |
| 1993 | 533.8 | 562.6 | 28.8 | 87.1 | -117.4 | 16.7 | 0.9 | -3.6 | 20.3 |
| 1994 | 619.9 | 562.8 | 57.1 | 93.4 | -31.1 | 19.7 | 1.8 | -1.0 | 20.8 |
| 1995 | 640.8 | 583.7 | 57.1 | 102.1 | -31.8 | 20.4 | 1.8 | -1.0 | 21.9 |
| 1996 | 683.4 | 677.8 | 5.6 | 149.4 | -142.9 | 21.8 | 0.1 | -3.9 | 22.8 |
| 1997 | 762.8 | 713.6 | 49.2 | 123.7 | -73.2 | 19.8 | 1.2 | -1.9 | 21.7 |
| 1998 | 803.7 | 746.8 | 56.9 | 127.2 | -70.2 | 19.5 | 1.4 | -1.7 | 21.2 |
| 1999 | 918.2 | 817.4 | 100.8 | 138.8 | -37.7 | 21.3 | 2.3 | -0.9 | 22.2 |
| 2000[p] | 957.4 | 846.1 | 111.3 | 133.2 | -21.8 | 21.2 | 2.5 | -0.5 | 21.7 |

p.: Provisional.
1.: A current market prices.

**Source:** Central Bank, *Quarterly Economic Review*, Various Issues; IMF, *Country Reports*, Various Issues.

**Table 6: Composition of Current Expenditure (%), 1975-2000**

| Economic Classification | 1975 | 1980 | 1985 | 1990 | 1995 | 2000 |
|---|---|---|---|---|---|---|
| Purchase of Goods and Services | 26.3 | 27.5 | 21.5 | 21.0 | 21.7 | 21.6 |
| Personal Emoluments | 57.0 | 55.0 | 56.6 | 59.6 | 52.7 | 43.0 |
| Interest Payments | 8.8 | 10.6 | 14.6 | 12.7 | 13.9 | 10.7 |
| Subsidies and Other Transfer Fees | 7.9 | 6.7 | 7.9 | 6.7 | 11.7 | 24.7 |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

**Source:** Central Bank, *Quarterly Review*, Various Issues.

**Table 7: Expenditure by Functional Classification, 1983 and 2000**

| | 1983 | | | 2000 | | |
|---|---|---|---|---|---|---|
| | (1) Current Expendi-ture BSmn | (2) % | (3) (1) as a % GDP | (1) Current Expendi-ture B$mn | (2) % | (3) (1) as a % of GDP |
| General Public Service | 60.3 | 20.5 | 3.5 | 237.0 | 28.0 | 5.3 |
| Defence | 8.2 | 2.8 | 0.5 | 24.7 | 2.9 | 0.5 |
| Education | 70.6 | 24.0 | 4.1 | 169.0 | 20.0 | 3.7 |
| Health | 49.2 | 16.8 | 2.8 | 141.5 | 16.7 | 3.1 |
| Other Social Services | 15.3 | 5.2 | 0.9 | 59.8 | 7.1 | 1.3 |
| Housing | 1.1 | 0.4 | 0.0 | 2.4 | 0.3 | 0.0 |
| Other Community Services | 2.2 | 0.7 | 0.1 | 8.5 | 1.0 | 0.2 |
| Economic Services | 49.9 | 17.0 | 2.9 | 112.8 | 13.3 | 2.5 |
| Interest | 36.9 | 12.6 | 2.1 | 90.5 | 10.7 | 2.0 |
| **Total** | **293.7** | **100.0** | **16.9** | **846.1** | **100.0** | **18.8** |

**Source:** Central Bank and Authors' Computation.

**Table 8: Public Debt Indicators**

| Year | (1) Bahamian Dollar Debt US$mn | (2) Foreign Currency Debt | | (3) Contingent Liabilities US$mn | (4) Foreign Currency Debt Service | | (5) (1) as a % of GDP | (6) (2) as a % of GDP |
|---|---|---|---|---|---|---|---|---|
| | | Central Gov't US$mn | Public Corpora-tions | | (a) Debt Service Ratio (%) | (b) % of Gov't Revenue | | |
| 1975 | 63.2 | 64.0 | .. | 44.5 | .. | | 10.5 | .. |
| 1985 | 331.5 | 146.7 | 46.5 | 67.3 | 3.4 | 9.0 | 14.3 | 8.3 |
| 1990 | 625.5 | 140.8 | 126.9 | 146.0 | 2.4 | 6.1 | 19.6 | 8.4 |
| 1991 | 714.2 | 142.9 | 264.3 | 298.2 | 4.2 | 7.1 | 23.0 | 13.0 |
| 1992 | 806.4 | 145.9 | 287.9 | 337.0 | 5.6 | 8.0 | 25.5 | 13.7 |
| 1993 | 897.4 | 167.3 | 278.6 | 345.7 | 5.5 | 8.6 | 28.0 | 13.9 |
| 1994 | 987.4 | 148.8 | 261.5 | 337.7 | 6.2 | 6.9 | 31.4 | 13.0 |
| 1995 | 1,010.3 | 155.6 | 236.3 | 322.4 | 5.4 | 5.6 | 32.0 | 12.5 |
| 1996 | 1,102.3 | 133.3 | 223.9 | 307.6 | 5.5 | 6.3 | 30.4 | 9.8 |
| 1997 | 1,230.0 | 145.1 | 239.4 | 330.9 | 5.4 | 4.0 | 31.9 | 10.0 |
| 1998 | 1,296.2 | 138.1 | 260.0 | 349.0 | 3.8 | 3.8 | 31.4 | 9.7 |
| 1999 | 1,375.9 | 135.4 | 254.0 | 376.3 | 3.1 | 4.1 | 32.0 | 9.0 |
| 2000 | 1,380.8 | 135.5 | 256.9 | 369.9 | 2.7 | 4.6 | 30.7 | 8.7 |
| 2001[e] | 1,447.0 | 160.0 | 228.3 | 361.3 | .. | 5.5 | 31.1 | 8.3 |

.. Not available
e: Estimate
**Source:** Central Bank, *Quarterly Statistical Digest*, Various Issues.

a % of current revenue have tended to increase over the last 3 years.

## 4. The Bahamas and the Emerging Regional and International Trading Environment

Tourism and financial activities have generated a level of income which allows Bahamians to enjoy a high standard of living but this rests heavily on the ability to import. The import content of tourism itself is extremely high. Due to the negligible level of local production, both the marginal and average propensity to import are high. Declines in foreign exchange earnings have an immediate impact not only on consumption, but on the availability of raw materials and capital goods. Tourism is an increasingly competitive business and policy discussions for some time have stressed the need to create a more competitive tourism product while exploring the possibilities for developing new foreign exchange earners in an increasingly open world economy offering new challenges and opportunities. Given the greater ease with which money moves internationally, tax havens are under attack, and it would be interesting to see how the new regulatory requirements demanded by the rich countries impact on the financial industry. The Bahamas has already amended some of its regulations with a view to improving the regulatory framework.

Integration schemes are springing up everywhere, and they are not seen as being in conflict with global free trade. In the Hemisphere discussions are on-going to create the Free Trade Area of the Americas (FTAA) which, if successful, will undoubtedly merge existing regional movements into one large bloc. Many of the concerns raised with respect to global trade liberalisation apply at the regional level as well. Imperfections in the market place require mechanisms and institutions to counter the unequal division of benefits in a world of countries with unequal sizes, with different resource endowments and levels of development, and with different degrees of access to technology. The neoclassical theory of international trade argues for efficiency and optimal resource allocation on a specific set of assumptions which many argue are not necessary to make the case for free trade. The theory of integration which is an extension of neoclassical theory also makes assumptions which may not apply to developing countries, and the case for free trade can be argued on a different set of objectives. The phenomenon of 'cumulative causation' and the free working of the market system promote an imbalance in regional resource use, and the play of forces in the market normally tends to increase rather than decrease the inequalities between regions. There are many well-known reasons why an unfettered market system would not perform as well as one involving (some forms of) government intervention, and there are many well-known examples where the differences between private and social returns would lead the private sector to under-provide a variety of goods and services and/or under-invest.

The rationale for a free trade area is based on the underlying assumption that through the removal of trade 'distortions', tariffs and other impediments to trade, market forces will allocate resources efficiently and the people in the area will be better off. During the first Summit of the Americas held in Miami, Florida in 1994, the leaders of 34 countries including the Bahamas agreed to begin the process for the gradual removal of barriers and impediments to free trade and investment, leading to the establishment of a Free Trade Area (FTAA) by year 2002.

As indicated earlier, the Bahamas derives over half of its tax revenue from import taxes. Some idea of the levels of different types of import duties can be gained from Table 9. Tariffs range from 10 to 65%. Tariffs in the

Bahamas serve more as a revenue raising function than as a protective function. Given the dependence on trade taxes, any reduction in import duties will need to be accompanied by the introduction of new tax measures such as a sales or value-added tax. The other question is how

**Table 9: The Different Types of Import Duties**

| ISIC Code | | Tariff Rates |
|---|---|---|
| 5122 | Food, Beverages & Tobacco (1) | 10%-35% |
| 5139 | Other Household Goods | 30% |
| 5141 | Solid, Liquid & Gaseous Fuels & Related Products | 30%-35% |
| 5143 | Construction materials, Hardware, Plumbing & Heating Equipment, & Supplies | 35% |
| 5206 | Motor Vehicles | 45%-65% |
| 5207 | Maintenance & Repair of Motor Vehicles | 35% |
| 5208 | Motor Vehicle Parts & Accessories | 35%-65% |
| 5209 | Sale, Maintenance & Repair of Motorcycles & Related Parts & Accessories | 35% |
| 5210 | Automotive Fuel | 35% |
| 5219 | Other | 35% |
| 5220 | Food, Beverages & Tobacco in Specialized Stores | 35%-55% |
| 5221 | Liquor in Specialized Stores | 35%-55% |
| 5231 | Pharmaceutical Medical Goods, Cosmetic 7 Toilet Articles | 35%-65% |
| 5232 | Textiles, Clothing, Footwear & Leather Goods | 25%-35% |
| 5233 | Household Appliances, Articles & Equipment [2] | 35% |
| 5234 | Hardware, Paint & Glass | 35% |
| 5239 | Other Retail Sale in Specialized Stores | 35% |
| 5260 | Repair of Personal & Household Goods | 35% |

1. Turkey, ducks & geese 10%, fish & seafood 30%, citrus & other fruits 20%-30%, vegetables 25%, frozen/preserved vegetables 30%, prepared/preserved meat & seafood 35%, manufactured food products 35%, jam/jelly 20%-35%, juices 30%-50%, and animal feeds 0% (exemption).

2. Electronics 50%.

**Source:** Department of Statistics, Nassau.

would the Bahamas benefit from being part of a Free Trade Area. Theoretically it would have access to a larger market but can it transform a 'weak' real sector into a competitive platform offering a new range of goods and services? There is need for greater emphasis on human capital formation and the encouragement of a scientific and technological infrastructure linked to the development of 'strategic' sectors which can lead the transformation process.

## 5. The Potential for Agro-Industrial Development in the Bahamas

### *Towards a New Development Paradigm*

An important point which should be made concerns the goals the Bahamian government has embraced from the standpoint of endogenous development. Attention will have to be drawn to the part played by tourism in the Bahamian economy, as the lack of an overall integrated policy has limited its contribution to the country's socio-economic development.

In order to maximise the benefits from tourism, the sector must provide an effective stimulus for local agriculture and agro-industrial production. However, the benefits from tourism growth have been inadequately exploited because of insufficient linkages with domestic food, beverage, and other commodity production sectors, and failure to upgrade complementary and related service industries such as information services and communication. The fact that decisions relating to a particular sector (e.g. the tourism industry) tend to have broader implications for the national economy as a whole requires a clear examination of the interacting influences between the promising activities from the point of view of endogenous competency, and those that may provide short-term benefits but offer little hope as a secure basis for future national well-being.

In formulating policies for economic restructuring and diversification, it is essential, therefore, to recognise the critical elements of the system in terms of deriving a long-term strategy. Simultaneously, it is necessary to juxtapose certain facts relating to the structure of the Bahamian economy in order to provide what might be called "an integrated development perspective of the system," and to show the relative position of endogenous strategic components. Failure to do so can easily lead not only to short-run, highly partial considerations, and short-term measures dictated by pressing problems (e.g. job creation, trade deficit) but also to the adoption of an *ad hoc* approach to development which may be in basic conflict with the goal of a stronger economic fabric (Ramsaran, 1983: 378; Karagiannis, 2002).

At present, the direction in which the Bahamian economy is pointed seems to be somewhat random and instinctive, depending on the current state of the global market rather than based on a long-term development plan. Prospects for future growth in the Bahamas have been frustrated and lowered significantly due to foreign exploitation and underutilisation of existing resources, an inadequate policy framework and the economic difficulties the economy has repeatedly faced with its balance of payments. The underutilisation of part of its productive capacity is proof of this considerable growth potential. As the Bahamian economy operates at well below its level of physical and human capacity, policies to increase aggregate demand can yield substantial economic gains.

Thus, a first requirement of a thorough development strategy is that the expansion of tourism must represent a net addition to the effective use of resources and, therefore, to the overall growth of the system. On the other hand, aggregate demand must be sufficient to stimulate production up to the adequate rate of capacity utilisation. However, growth of local production must go hand in hand with special consideration of the country's external trade and resource endowment. In connection with this, the competitiveness of the Bahamian economy must come to the fore (Lopez, 1998: 6).

In order to expand industrial production and employment, firms must have the financial means to invest in the necessary machinery, capital equipment, critical kinds of science and technology initiatives, and skills training and upgrading; and short-run bottlenecks preventing a fuller utilisation of capacities must be taken care of. These bottlenecks may include a lack of the necessary resources and skills, difficulties in obtaining finance, and a lack of business confidence.

Hence, a second requirement of the proposed Developmental State strategy is that selective economic policies should provide the resources and stimuli to carry out the investment in both working and fixed capital, infrastructure, and the modern factors of development necessary to raise output and to improve the production and commercial conditions of industries (Lopez, 1998: 11-12). Active fiscal policy ought to ensure investments necessary to improve the supply conditions of businesses and to support the other expenditures associated with the selective policy. Monetary policy ought to ensure that sufficient financial resources are channelled to firms and to intermediary agencies at reasonable interest rates. Besides, it should be considered that the increase in output would translate into higher profits and savings (Lopez, 1998: 12). There is need for greater emphasis on savings policies.

However, bottlenecks at the firm or macro level often hamper a more efficient capacity utilisation. These bottlenecks must be seriously considered; this would require addressing a number of issues simultaneously, and accordingly, a medium- and long-term development strategy should have as a basic requirement a close link with a deliberate industrial strategy. Such a directed state action should: (1) consolidate and improve existing production lines; (2) select and give priority to investments in new and technically promising activities; and (3) adjust quickly in anticipation of, and in response to, global changes in demand and technological innovation (Lopez, 1998: 12-13; Bernal, 2000: 107).

Indeed, industrial targeting should single out areas of emphasis in selected fields, and should be directed towards strengthening the national industrial core and upgrading international competitiveness. It should be concentrated on a few focal areas having favourable prospects for development, and be selectively designed so as to support a small group of key dynamic firms managed by modern entrepreneurs. Even a small group of key propulsive industries can be instrumental in emphasising the accelerators of endogenous competency and growth, exert pressure to adapt on other supply firms, and introduce modern concepts of policy-making and labour relations. The various spheres of policy (e.g. industrial policy, regional policy) should be directed towards consolidating these focal areas, correcting the imbalances which continually emerge in the wake of restructuring and repositioning, reconciling contradictory elements therein, and smoothing the path for industrial growth.

What has been asserted should not be taken to imply a rejection of the problems that could arise with the proposed development strategy. But to face them, a sound economic approach ought to complement short-run measures with a thorough plan for the future, which includes a long-term industrial or structural change strategy aimed at diversifying local production, strengthening technological capabilities, and promoting innovation. Greater levels of production, employment, and profits that would be achieved in the short-term owing to the fuller use of available resources, would actually spur a transition to a more structurally efficient economy. Part of this increased production and income in the Bahamas would go to higher spending on the 'accelerators' of endogenous competency and lead to faster development of skills of the labour force. Not only higher profits would allow additional investment expenditure but also a greater proportion of income growth would be channelled towards investment. The aim should be to bring about a general improvement in the competency and efficiency of the economy, in the level of technological infrastructure it relies on, and in the quality of workmanship and service, so that more and more activities may become increasingly competitive. Hence, in the future, it would be relatively easier to incorporate more modern technology and increase productivity, while at the same time raising accumulation rates (Lopez, 1998: 18-19).

Obviously, for purposes of designing endogenous competency strategies to achieve the development of productive forces, and the transformation and diversification of the structure of Bahamian production, technically proficient strategic planning is absolutely necessary – indeed, it is inevitable – and should be directed towards the creation of new conditions and processes to be effectively and directly determined by the planning authorities. Strategic planning is a pragmatic attempt to increase the country's long-run capacity to transform itself by building up the infrastructure and the requisite skills. It is this national strategic planning that can give the

Bahamas its internal autonomy, and determine its capacity for self-determined self-sustained growth and development. In the development of these strategies, local communities generate not only the capacity to spread the use of modern knowledge and industrial techniques into all elements of the economic transformation intended to spur local industrial activities, but they also create a dynamic basis for engagement in the world economy through higher levels of exports (Thomas, 1974: 58-60).

Modern production techniques, precisely because of their flexibility, make it possible to manufacture in small amounts on a viable basis. Targeting and flexibility are possible, especially if they can draw on modern industrial planning. Assuming predominance of clear focal areas and/or initiatives carried out by both a competent administrative machine and dynamic local businesses, demand for imported capital and goods could decline and exports of local products expand. Given the growth of local production and the improvement of national competitiveness, a large part of the additional goods produced would be devoted to exports. Consequently, the country would make a greater and better use of its productive resources and capacity, while at the same time easing the constraints on its balance of payments.

In addition, as indigenous technology is the basis for an organic integration of domestic production and demand structures (i.e. human capital formation coupled with consistent technical progress), investment priorities and the choice of technique are determined by the strategies of transformation and diversification, and by the product choices to which these strategies give rise. The overall purpose is to increase the capacity of the Bahamian economy to respond at the level of the government, firms, and the population as a whole.

In order to assure realisation of these development goals, an economically active state must play a significant role. Likewise, well-educated, well-trained and efficient technocratic planners play key roles. The government provides the "national purpose" framework, while the technocrats supply planning and overview. This "national purpose" makes it possible to bring together social and political forces in the interest of a socially defined agenda. In addition, the growth-oriented transformation must lead in a corporatist direction and strategic partnership between a developmental state, forward-looking businesses, and various social segments. A broad-based consensus is also required and could afford scope for national strategic planning. Besides, if such thorough alternative strategies are to solve such problems, they presuppose participation. Indeed, participation is vital to ensure that sufficient motivation, creativity, and human effort are forthcoming to guarantee that such technically proficient strategies can be successfully carried out in the Bahamas.

Lastly, any economy is underpinned and imbued by social values, codes of behaviour and ethics, which are, in turn, reflected in the structure and functioning of government sector institutions and private sector firms. As political will may not be clearly agglomerated and administrative capacity is inadequate in the Bahamas, governments have not been successful in indicating a clear course for the public sector to adopt. Yet, the adjustment of its social and political conditions to the country's urgent social and developmental needs cannot be avoided. If the Bahamas is to develop growth-oriented, learning-based productive activities, therefore, it would be necessary to adopt a number of measures to remodel the key social, economic, and institutional factors that will be required to provide the necessary underpinning (Clayton, 2001: 15). More importantly, these thorough development strategies assume a much better state action, and would require an efficient and competent administrative machine. But so does any strategy capable of overcoming barriers and laying down the basis of endogenous competency and growth in any developing economy.

Devising the necessary action to nurture and promote vibrant agro-industrial activities, along with the further development of tourism and financial services, while raising the quantity and quality of productive investment necessary to allow the fullest and most efficient utilisation of existing resources, seems to be a more sensible way to confront the future. Such an approach seems, certainly, a better option for the endogenous development and competency of the Bahamian economy than a frantic search for accelerated 'Western-style' modernisation – a 'vision' that decision and policy-makers in the Bahamas aspire to. The alternative and more realistic development paradigm would require the pursuit of Developmental State strategies and policies. (Lopez, 1998: 19).

### *Issues of Selection*

Initially, it is important to divide consideration of the key issues related to the structure of the Bahamian economy into three sections: (1) issues influenced by state policy and general policy issues; (2) issues influenced by specific industries or sectors; and (3) market-driven issues.[8] On this account, we limit strategic intervention to those parts of the Bahamian economy where state action is going to have its most significant potential impact on the dynamism of the economy as a whole. The criteria are obviously dynamic and forward-looking.

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8 Obviously, there is a strong relationship among them.

With this background in mind, it is imperative to develop and strengthen the links between tourism and the agro-processing industry, which appear viable, advantageous, warranted, and strategically important in a long-term perspective, and which will set up incentives and open up possibilities for a wide range of new economic activities, for the following reasons (Cowling, 1990: 19):

- a large market exists for agro-business in the tourism industry, as there is growth in tourist consumption of local food and beverage. Additionally, the country is close to one of the world's major markets, the United States;

- they can allow the local capture of a high percentage of value-added, and thus, generate profits and contribute to the process of capital accumulation;

- such development promoting links will be accompanied by a higher degree of domestic resource and capacity utilisation, will build strategic alliances, and diagonally integrate with tourism-related and non-related activities;

- they will give a great boost to the structural transformation and diversification of the Bahamian economy;

- they will enhance the local skills base, introduce the know-how and innovation, stimulate technical change, create entrepreneurial and managerial talents, and increase productivity and, in turn, will impart the momentum for "economic take-off";[9]

- it is a realistic and feasible proposal for Bahamian endogenous development.

The above proposal – which must take place within the framework of thorough development planning – takes into account the inter-relations among a number of "stylised facts" such as domestic resources, capital, social structure, the level of technology and skills, scale and transformation.[10] Indeed, economies of scale and learning will bring about multiple effects on, and changes in, the structure of Bahamian production. The object, of course, would be to increase value-added to the prioritised sectors and activities and strengthen inter-sectoral linkages, which would then be capable of spilling their expansionary forces into other economic activities.

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9 The infant industry argument for intervention is very important and relevant here, as full exposure to competition is likely to precipitate a dramatic reduction in the size of these industries.

10 This approach allows "considerable autonomy in determining the mode of operation, and adjusting it as experience accumulates". The main objective is "a dynamic economy rather than sticking to a set of rigid rules imposed by a central bureaucracy" (Cowling, 1990: 25).

## *The Way Forward: The Strategic Approach*

It is clear from the previous discussion that a coherent strategy is necessary for the endogenous development of the Bahamian economy. In doing so, the government should adopt a strategic view of prospective industrial development in the Bahamian economy and provide a range of support mechanisms to those sectors deemed to have a key role to play in the future. Indeed, strategic industrial policy targets and centres around strategic sectors, which can be expected to fuel future economic growth. By recognising differentiation of sectors and industries, policy can address the problems that are rooted in the development of these sectors and industries, and thus become effective.

First of all, a "central core" is needed – a powerhouse dedicated to raising both the quantity and quality of investment expenditure towards facilitating the 'targeted' sectors. This core planning staff should consist of a small, entrepreneurial team rather than a vast bureaucracy – we must avoid squandering people and resources over a whole range of bureaucratic activities (also, this arrangement minimises the impact of inter-departmental squabbling that can slow down policy-making in the Bahamas). The team should be recruited partly from within the Bahamian Civil Service but also from business, professionals, and the academic and scientific world: a "new look" Bureau would need some well-educated, well-trained, and efficient technocratic planners. This new Bureau should be organised around the requirements of a Strategic Planning Agency with a long-term commitment and the power to intervene decisively and take the necessary policy action

(Cowling, 1990: 24).[11,12] With the assistance of consultants, the government forms a consensus on the best policies to pursue.

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11 It is argued here that, even under the current conditions of globalisation and the pressures from international organisations such as WTO and IMF, the Bahamian government still has room for Developmental State policies. In a rather similar vein, Chang claims that:

> ... intelligent governments should try [...] to use TNCs in a strategic way in order to acquire necessary capital, technology, marketing networks, and so on. What exactly the "strategic way" means will depend on various factors, such as the country's relative bargaining position, the technological nature of the industry, the role of the particular industry concerned in the bigger scheme of industrial development, and so on ..." (Chang, 1998: 111).
>
> "An intelligent government pursuing a strategic industrial policy will not have a "uniform" policy towards TNCs across industries, as many neoliberal economists recommend. Each industry serves different functions in the greater scheme of industrial development, and it would be foolish to have either uniformly restrictive or uniformly liberal policies towards TNCs across different industries. This also means that the same industry may, and indeed should, become more or less open to FDI over time, depending on the changes in the various internal and external conditions that affect it" (Chang, 1998: 111-12).

12 'Power' in the sense that the government is able to credibly commit itself to "national purpose" policy making; serious and capable of signalling its commitment to sustainable economic growth and development.

The next step of industrial policy is to increase the domestic technological infrastructure, machinery, equipment and knowledge which are absolutely necessary and needed for the establishment of these 'new' targeted propulsive industries in the Bahamas. Instead of subsidising unsuccessful businesses, the Bahamian government can sponsor (i.e., finance and direct) the development of technologies that can be used by the specific firms to improve their efficiency, profitability, quality and competitiveness. The new industries will rely on utilising the modern knowledge – ideas for raw materials, product designs, manufacturing processes and commercial products – and transforming it into new technologies and products. In addition to funding R&D, this alternative development strategy includes government support of technical knowledge and new manufacturing techniques, especially to the small firms, which often lag behind in technological development.

Improvements in production result from investments in plant and equipment, and a combination of R&D, skills and innovation. Expenditures from the Bahamian budget must be directed to planned productive investments in infrastructure and human capital, technical change and its implementation. However, private investment spending on the modern factors of competitiveness is both desirable and essential. In fact, investment in advanced training and the continuous development of scientific and managerial manpower in the Bahamas can overcome many of the characteristics of labour force impediments to greater productivity, and will accelerate the adoption of new and more advanced techniques applied to production.

Therefore, the mutually beneficial relationship between agro-processing industries and tourism as a means of diversifying local production and attaining food security should be strengthened and extended. The production of high-quality products and a sustained supply of them could make the tourism industry self-reliant in its indigenous food and beverage sector. Indeed, the growth of demand for an authentic Bahamian flavour (tourist consumption plus food and beverage souvenirs) provides the opportunities for the growth of supply of local specialties by local producers.

Arguably, decision and policy-makers in the Bahamas have formulated no long-term strategies incorporating all these relevant issues. However, the Bahamian economy needs broad industrial strategies on the grounds of long-term, dynamic efficiency. A national economic strategy should be imposed, with the market playing a substantial, indeed crucial, role. Yet, the transfer of this alternative strategy for the Bahamas to highly competitive environments may be self-defeating in the absence of active state policies and politico-institutional structures required for its effective implementation.

A much greater commitment to understanding the extent to which the tourism sector can contribute to the long-term development of the Bahamas, and especially how this can be achieved, seems essential. Tourism cannot be considered in isolation: the extent to which the tourist spending leaks out, the degree to which local supply of food and manufactured products and other service sectors can be stimulated, the country's carrying capacity and public services, the impact of tourism on the community and the environment, all need to be considered in an overall framework.

Above all, such a thorough development strategy requires continuity, consistency, and commitment to the process and direction of endogenous development. It also requires a high degree of incentive-compatibility of government policies and development and economic performance, as well as the creation of politico-institutional arrangements that constitute a stable political and economic environment, in which consensus-building concerning developmental strategies works (Ahrens, 1997: 119, 126).[13] Without such commitments, capacity, competence, accountability, professionalism, seriousness, and effectiveness, such policy will founder on short-term expedients, the inefficiency and ineffectiveness of the civil service, the power of the transnationals and foreign interests, or the mindset of the people.

In short, the construction of a production-orientation framework for the Bahamas, based on development-promoting links between tourism, complementary and related service industries and commodity production sectors, is seen to be necessary to resolve the country's deeper structural problems. These linkages could boost the Bahamian endogenous competency and overall competitiveness, while improving the country's macroeconomic performance. Such prioritized industries will have to be provided with the resources and commitment to allow them to grow and mature. With respect to the question of integration with the world

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13 In fact, "institutions can formalise the commitment to such [development strategies], and their structure, procedures and personnel can act to ensure that such commitments cannot easily be reversed, but they are simply ratifying [plans] already established. [Past development efforts in The Bahamas] show how fragile was the commitment, despite the creation of [a number of] institutions, and [the lack of teeth of these institutions was quite obvious]. With clear goals, and a determination to pursue them, institutions with teeth should be forthcoming" (Cowling, 1990: 23).

economy, the Bahamian government should seek a "strategic" or "managed" but not a "close" integration with the global economy. This mixture of inward and outward-oriented development should constitute the foremost priority of conscious state action.

## Concluding Remarks

Despite a relatively high per capita income compared to most developing countries, the Bahamian economy remains extremely vulnerable and externally driven. In the 1990s real per capita GDP is estimated to have grown by an average of 0.1% per year. Government savings are generally negative. Despite positive balances in the services account, the current account of the balance of payments is also generally negative. Imports are more than three times greater than exports. The overall position has been helped significantly by inflows of private capital.

Diversification of the economy and a policy framework that extracts greater benefits from the tourist industry have long been touted as possible development paths, but this requires more conscious development planning. The international economy is becoming increasingly competitive and challenging and a situation where policy-makers are more prone to re-act could prove costly to Bahamian well-being. Sustained growth requires coming to terms with the changing economic environment in which competitive edges are created and comparative advantage can change. Physical resources still count but they are not as important as they used to be. Technology and human resource development have changed the global production configurations and to be part of the evolving process countries now have to adopt more imaginative approaches to development. Some formulae that worked in the past may encounter greater difficulty now, and policies now have to be constantly re-mixed and reshaped.

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# 5

# Growth and Public Finance in Jamaica: The Recent Experience

*Ramesh Ramsaran*

## Introduction

Jamaica attained political independence from Britain in 1962 against the background of an expanding economy and a great deal of euphoria. Based on increasing production of bauxite and alumina and a rapidly growing manufacturing sector, the economy continued on a buoyant growth path in the following decade. Real production grew by over 5% per year between the early 1950s and 1973. Since then the economy has struggled to overcome the effects of both internal policy failures and developments in the international economy. Between 1973 and 1985 real GDP fell by some 20%, but this was followed by a resumption of growth until 1995 when the economy again went into a sharp decline. It is now widely accepted that there is no necessary correlation between growth and an improvement in social conditions. Despite the favourable conditions of the 1960s, unemployment increased from 13.5% in 1960 to 23.2% in 1972 and the indications are that the distribution of income during that period became increasingly unequal.

The Jamaican economy is a highly open one with exports of goods and services amounting to over 40% of GDP and imports of goods and services to over 50%. While foreign exchange earnings continue to depend on the export of a narrow range of goods and services, the country is heavily dependent on foreign sources for fuel, raw materials, capital equipment, medicinal supplies, food and consumer goods. Sharp increases in the price of fuel in the 1970s worsened the terms of trade problem, leading to a sharp deterioration in the country's external position. Total international reserves dropped sharply in the 1970s and by 1975 net foreign assets had become negative.

With a deteriorating economy and increasing social polarization, the response of the People's National Party (PNP) elected in 1972 was to increase the role of the state in the economy and to embrace 'democratic socialism' as part of its ideological base. The desire to exercise greater control over the critical bauxite industry, increase economic self-reliance and improve social conditions gave rise to a more interventionist state, but problems of management and implementation continued to plague the economy. The political rhetoric of the PNP, an increasingly hostile business class, falling investment levels and declining foreign earnings pushed the economy into further difficulties. "In the election year of 1976, the fiscal deficit had reached 15 per cent of GDP, growth was negative at 6.5 per cent, and exchange reserves were depleted. Credit was unobtainable without an IMF agreement."[1]

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1 K. Levitt, *The Origins and Consequences of Jamaica's Debt Crisis, 1970-1990,* Consortium Graduate School of Social Sciences, Mona, Jamaica, 1990, p. 13.

Jamaica's recent experience with the IMF started in July 1977 when the first Standby Agreement came into effect, and both the Fund and the World Bank have since exercised a deep influence on the management of the Jamaican economy through a number of subsequent agreements. Despite changes in governments and experiments with a wide range of policies, the economy remains unsettled and the social situation volatile. This paper discusses the economic performance in recent years and the effects on the fiscal position. The first part describes the recent economic experience, while the second discusses trends in the public finance situation. The third provides some insights into the public debt. The final part offers some concluding observations.

**Recent Economic Performance**

In the 1960s real per capita GDP in Jamaica grew by over 3% per year. The 1970s decade was a more difficult one with falling production of bauxite and alumina (the country's leading foreign exchange earners), declining earnings from the tourist industry and higher costs for imports, particularly oil and food. Real GDP increased by 15% between 1970 and 1973 and then fell by 30% between 1975 and 1980. Real per capita GDP is estimated to have declined at an average rate of over 2% per year in the 1970s. Total foreign exchange fell from US$184.1 million (2.7 months' imports) at the end of 1974 to US$63.2 million (less than one month's imports) at the end of 1983. Public borrowing increased sharply in this period. Outstanding external medium and long-term debt more than doubled between 1975 and 1980, reaching US$1,877 million (70% of GDP) in the latter year. The actual debt service ratio increased from less than 10% in 1970 to almost 20% in 1980. By the latter year the government was already having difficulty meeting foreign debt service obligations. The 3-year IMF Extended Fund Facility signed with the IMF in

**Table 1: Growth of Real Income and Nominal Per Capita GDP, 1960-2000**

| Period | Average Annual Growth of Real Income % | | Year | Nominal Per Capita GDP[1] US$ |
|---|---|---|---|---|
| | Total GDP | Per Capita GDP | | |
| 1960-1970 | 4.6 | 3.2 | 1960 | 407 |
| 1970-1980 | -0.8 | -2.1 | 1970 | 751 |
| 1980-1990 | 2.5 | 1.2 | 1980 | 1,240 |
| 1990-2000 | 1.0 | 0.2 | 2000 | 2,856 |

1. At current market prices.

**Sources:** Computed from official data.

1978 was terminated in late 1979 "on account of failure to meet requirements to effect a large reduction of the fiscal deficit. The fiscal burden of the debt service in terms of devalued Jamaican dollars contributed to the breakdown of the agreement. Commercial banks refused to reschedule debts contracted in 1973-75 and the Manley government was defeated at the polls in 1980."[2]

Jamaica entered the 1980s with a new government "riding a tide of external and domestic popularity and was massively financed by multilateral and bi-lateral loans,

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2 *Ibid.*, p. 8.

principally from the IMF, World Bank, IDB and USAID."[3] Real GDP increased by 6% between 1980 and 1983. The long and medium-term external debt increased from US$1,867 million in 1980 to US$3,587 million in 1985, or by 92%. The share of the multilateral debt increased from 29.1% in 1980 to 38.5% in 1985 and was to increase further by the late 1980s. Corresponding with this access to multilateral funds was an increasing control over domestic economic policy by institutions such as the IMF and World Bank through short-term and structural adjustment programmes. Tax increases, reduction in the public sector work force, privatisation and liberalisation of the trade and exchange rate regime did have some effect on the fiscal and external deficits in the mid-1980s and the economy returned to a positive growth path in the late 1980s, and this continued into the early 1990s. Though the un-employment rate dropped from 25% in 1985 to 15% in 1990, the social costs of adjustment were high. The exchange rate moved from J$1.781 per US dollar at the end of 1982 to J$5.559 per US dollar at the end of 1985, but by 1990 had begun to depreciate again. The inflation rate which averaged 5.5% between 1980 and 1983 increased to an average of 16.4% over the rest of the decade. With a rapid depreciation of the currency in the first half of the 1990s, the inflation rate climbed to over 25% per year, and then declined with some degree of stabilisation in the exchange rate. Writing with respect to social conditions in the mid-1980s and drawing upon several studies, one writer noted: "Much of the Jamaican population lives near a subsistence level of income. In addition, the distribution of income is very unequal. It was estimated that ... 40 per cent of the national income was

3 *Ibid.*, p. 6.

earned by the top 10 per cent of the population, and that this inequality had not been significantly reduced in the previous two decades. The distribution of land wealth, as might be expected, was even more skewed – half of the total assessed value of land was attributable to 5 per cent of the total land parcels."[4]

The expiration of the three-year extended arrangement with the IMF in December 1995 marked the completion of almost two decades of unbroken association with various borrowing and policy conditionalities of IMF programmes.[5] The reform efforts of the late 1980s continued into the first half of the 1990s, with real GDP increasing by 32% between 1986 and 1995, but only by 4.5% between 1995 and 2000. Total real GDP in the decade of the 1990s grew by an average rate of around 1% per year. Real per capita GDP in 2000, however, was only 1.9% higher than the level in 1990. The unemployment rate held at around 15%, and the inflation rate fell dramatically from an average close to 40% per year in the first half of the decade to under 10% in the latter half, even though the currency depreciated by 22% between 1995 and 2000, and the fiscal account went from a surplus to a deficit in both the current and overall account. While the external debt as a percentage of GDP fell between 1992 and 2000, in the 1990s the current account of the balance of payments was generally negative but with capital inflows the overall balance was for the most part positive which led to an

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4 Roy Bahl, "The Jamaican Tax Reform: Its Design and Performance." In Wayne Thirsk (ed.) *Tax Reform in Developing Countries,* The World Bank, Washington, D.C., 1997.

5 See Bank of Jamaica *Annual Report,* 1996.

increase in net international reserves from US$31 million in 1993 to over US$2 billion in 2001.

**The Public Finance Experience**

In the first half of the 1990s, savings in the current budget averaged over 5% of GDP with the overall surplus hovering around 3% of GDP. Despite this, the inflation rate averaged close to 40%. In the second half of the decade, economic activities stagnated with deficits emerging both in the current account and in the overall position. While the external debt/GDP ratio declined after 1992, the domestic debt/GDP ratio increased sharply after 1993. Incidentally, despite the fiscal deficits, the inflation rate came down dramatically, prompting one source to note that "while strong fiscal policy is essential to control aggregate demand – inflationary pressures in recent years (the first half of the 1990s) have emanated from other factors, such as changes in wages, the exchange rate and money."[6]

Large public sector deficits have been a feature of the government operations for many years. Structural reforms since the late 1970s have embraced actions in several areas including reduction of the public sector work force, privatisation of public enterprises and reform of the tax system. "The personal income tax and the corporate tax were overhauled in 1986 and 1987 to make them more equitable and efficient, and a number of indirect taxes were replaced by a general consumption tax (GCT) in 1991. In addition, tax administration was strengthened through

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6 IMF, *Staff Country Report* (No. 96/97), September 1996, p. 15.

**Table 2: Selected Economic Indicators, 1990-2000**

| Year | Real Growth Rate[1] (%) | | Inflation Rate | Unemployment Rate % | Gross Fixed Capital Formulation[2] % | Gross National Savings[2] % | Foreign Savings[2] % |
|---|---|---|---|---|---|---|---|
| | Total GDP | Per Capita GDP | | | | | |
| 1990 | 5.5 | 4.4 | 29.8 | 15.3 | 27.4 | 12.0 | 7.7 |
| 1991 | 0.8 | -0.1 | 80.2 | 15.4 | 26.1 | 10.6 | 16.0 |
| 1992 | 1.9 | 0.9 | 40.2 | 15.7 | 32.7 | 21.6 | 9.8 |
| 1993 | 2.0 | 1.0 | 30.1 | 16.3 | 33.8 | 18.8 | 14.0 |
| 1994 | 0.9 | -0.2 | 26.8 | 15.3 | 32.8 | 23.7 | 7.5 |
| 1995 | 1.0 | -0.2 | 25.6 | 16.2 | 29.3 | 17.0 | .. |
| 1996 | -1.3 | -2.4 | 15.8 | 16.0 | 29.9 | 28.5 | 1.6 |
| 1997 | -1.8 | -2.8 | 9.2 | 16.5 | 30.0 | 25.9 | 4.4 |
| 1998 | -0.5 | -1.4 | 7.9 | 15.5 | 27.1 | 23.6 | 3.6 |
| 1999 | -0.5 | -1.2 | 6.8 | 15.3 | 25.5 | 21.6 | 4.0 |
| 2000 | 0.8 | 0.1 | 6.1 | 15.5 | 26.6 | 22.5 | 4.3 |
| 2001e | 1.4 | .. | 8.7 | 15.0 | .. | .. | .. |

1. GDP in producers' values at constant 1986 prices.
2. % of GDP.
.. Not available.
e: Estimated.

**Source**: Official Publications and IMF, *Country Reports*, Various Issues.

Table 3: Selected External Accounts Data, 1990-2000

| Year | Exchange Rate[1] | Net International Reserves[2] US$mn | Visitor Expenditure US$mn | Balance of Payments[3] | | |
|---|---|---|---|---|---|---|
| | | | | Current Account Balance | Capital Account Balance | Overall Balance |
| 1990 | 7.2 | -749.0 | 739.9 | -5.0 | 7.5 | 2.5 |
| 1991 | 12.1 | -547.4 | 770.8 | -4.9 | 6.2 | 1.3 |
| 1992 | 22.9 | -145.0 | 858.1 | -0.1 | 5.2 | 5.1 |
| 1993 | 24.9 | 31.1 | 947.5 | -1.4 | 4.9 | 3.5 |
| 1994 | 33.1 | 434.7 | 926.6 | 0.0 | 9.7 | 9.7 |
| 1995 | 35.1 | 632.8 | 1,074.9 | -6.2 | 7.2 | 1.1 |
| 1996 | 37.1 | 916.2 | 1,092.3 | -1.4 | 0.5 | 2.2 |
| 1997 | 35.4 | 821.1 | 1,130.8 | -5.4 | 0.2 | -0.8 |
| 1998 | 36.6 | 839.9 | 1,196.91 | -3.0 | 0.2 | -0.2 |
| 1999 | 39.0 | 841.9 | 1,279.5 | -4.3 | 0.2 | 1.7 |
| 2000 | 42.7 | 1,421.4 | 1,332.6 | -4.3 | 0.2 | 8.0 |
| 2001 | 46.0 | 2,359.9 | 1,279.2 | .. | .. | .. |

1. Jamaican $ per US dollar (period average)
2. End of period
3. % of GDP
.. Not available.

**Source:** Bank of Jamaica, *Statistical Digest*, Various Issues.

**Table 4: Central Government Fiscal Operations, 1990-2000**

| Year | (1) Current[1] Revenue | (2) Current Expen-diture | (3) Current Balance | (4) Total Expen-diture & Net Lending | (5) Overall Surplus (Deficit) | (6) (3) as a % of GDP | (7) (5) as a % of GDP | (8) Tax Revenue[2] as a % of GDP |
|---|---|---|---|---|---|---|---|---|
| 1990 | 9,450 | 7,470 | 1,980 | 8,842 | 977 | 6.5 | 3.2 | 25.9 |
| 1991 | 14,226 | 10,639 | 3,587 | 13,018 | 2,057 | 7.3 | 4.2 | 23.4 |
| 1992 | 22,832 | 16,322 | 6,510 | 20,386 | 3,172 | 7.8 | 3.8 | 22.9 |
| 1993 | 32,708 | 25,369 | 7,339 | 29,997 | 3,617 | 6.3 | 3.1 | 24.9 |
| 1994 | 43,719 | 34,455 | 9,264 | 39,803 | 4,793 | 5.9 | 3.1 | 24.4 |
| 1995 | 57,824 | 44,442 | 13,382 | 54,718 | 3,806 | 6.8 | 1.9 | 25.4 |
| 1996 | 62,359 | 64,225 | -1,866 | 78,052 | -14,966 | -0.8 | -6.4 | 23.6 |
| 1997 | 65,989 | 72,113 | -6,124 | 86,388 | -19,892 | -2.4 | -7.8 | 23.3 |
| 1998 | 73,487 | 84,504 | -11,017 | 92,997 | -18,912 | 4.1 | -7.0 | 24.9 |
| 1999 | 84,776 | 93,166 | -8,390 | 102,948 | -12,575 | -2.9 | -4.4 | 26.4 |
| 2000 | 99,348 | 95,781 | 3,567 | 104,175 | -3,172 | 1.1 | -1.0 | 27.1 |

1. Including grants and bauxite levy/CD transfer.
2. Excluding bauxite levy/CD transfer.

**Source:** Bank of Jamaica, *Statistical Digest*, Various Issues.

the establishment of a Special Tax Compliance Program in early 1992. The authorities also adopted an ambitious tax package in June 1993, with an estimated yield of 4½ per cent of GDP in FY 1993/94. The main elements of the package were increases in the coverage and in the rate of the GCT (from 10 per cent to 12.5 per cent), upward adjustments in various charges and fees, a broadening of the coverage of the withholding tax on interest income, and a substantial revaluation of properties for tax purposes."[7]

Despite these reforms, tax revenues as a % of GDP has averaged around 25% in the 1990s. The buoyancy coefficient for the 1990-2000 period was estimated to be one, indicating a tax system proportional to income. However, the contribution of the various taxes to total revenue (and as a % of GDP) in the 1990s changed. For example, the share of income and profit taxes fell, while that of international trade increased (see Table 5). The most important of the indirect taxes was the General Consumption Tax which in 2000 accounted for 25% of total tax revenue.

With respect to current expenditure, the share taken by wages and salaries fell slightly from around 38.2% in 1990 to 36.7% in 2000. Interest payments, on the other hand, increased from 39% to 45% over the period. Interest payments in 2000 amounted to almost half of total tax revenue. As a percentage of GDP, interest payments increased from about 9% in 1990 to an estimated 13% in 2000. Interest on the domestic debt accounted for over 80% of total interest payments.

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7 *Ibid.*, p. 3.

**Table 5: Tax Structure, 1989 and 1999**

| Taxes | 1989 | | | 1999 | | |
|---|---|---|---|---|---|---|
| | J$mn | % of Total Taxes | % of GDP | J$mn | % of Total Taxes | % of GDP |
| Income & Profits | 2,663 | 41.8 | 10.8 | 29,390 | 38.7 | 9.9 |
| Production & Consumption | 2,098 | 33.0 | 8.5 | 23,105 | 30.4 | 7.8 |
| International Trade | 1,534 | 24.1 | 6.2 | 23,470 | 30.9 | 7.9 |
| Other | 71 | 1.1 | 0.3 | - | - | - |
| ***Total Taxes*** | ***6,366*** | ***100.0*** | ***25.7*** | ***75,965*** | ***100.0*** | ***25.7*** |
| Other Revenue | | | | | | |
| Bauxite Levy | 367.6 | | 1.6 | 5,405 | | 1.9 |
| Non-Tax Revenue | 388.1 | | 1.7 | 5,271 | | 1.8 |

**Source:** Bank of Jamaica, *Statistical Digest*, Various Issues.

**Table 6: Composition of Recurrent Expenditure**

| | As a % of Recurrent Expenditure | | | As a % of Tax Revenue | | |
|---|---|---|---|---|---|---|
| | Wages and Salaries | Interest | Other | Wages and Salaries | Interest | Other |
| 1990 | 38.2 | 39.2 | 22.6 | 36.0 | 36.9 | 21.2 |
| 1993 | 35.6 | 40.4 | 24.0 | 31.4 | 35.7 | 21.2 |
| 2000 | 36.7 | 44.8 | 18.5 | 40.4 | 49.3 | 20.3 |

**Source:** Bank of Jamaica, *Statistical Digest*, Various Issues.

## The Public Debt

Between 1975 and 1985, Jamaica's outstanding external debt (long and medium-term) increased from US$0.7mn (31% of GDP) to US$1.9 billion (206% of GDP). The actual debt service ratio increased from 7.4% to 39.8% over the period. By the late 1980s, the outstanding debt was averaging over US$4.9 billion, and while the debt/GDP ratio had fallen, the actual debt service ratio had climbed to over 40%. In the 1990s the nominal debt fell, gradually reaching US$3.00 billion at the end of 1999, but has been increasing since then. As a % of GDP, the external debt also declined from over 100% in 1991 and 1992 to under 50% in 1999. As a % of exports of goods and services the debt also fell. Because of inability to meet debt service obligations, accrued payments tend to be higher than actual payments. In 1996 the actual and the accrued ratios were of the same magnitude - 16.62%. The ratio has fluctuated since, reaching 13.39% in 2000. Between 1990 and 2000 total debt service payments (principal and interest) amounted to US$6,411.5 million or 19% of total exports of goods and services.

**Table 7: Debt and Debt Service Indicators**
**US$ mn.**

| | 1990+ | 1991+ | 1992 | 1993 | 1994+ | 1995+ |
|---|---|---|---|---|---|---|
| Total external Debt Service(accrued) | 861.05 | 736.89 | 756.64 | 651.85 | 657.27 | 661.00 |
| Total External Debt Service (actual) | 663.54 | 620.57 | 637.88 | 542.12 | 536.04 | 592.56 |
| Principal | 371.24 | 364.67 | 393.42 | 340.55 | 349.55 | 400.39 |
| Interest | 292.30 | 255.90 | 244.46 | 201.57 | 186.49 | 192.17 |
| Gross Exports of Goods and Services | 2,328.30 | 1,270.20 | 2,353.50 | 2,394.30 | 3,149.60 | 3,555.60 |
| **(PERCENTAGE)** | | | | | | |
| External Debt Service Ratio (accrued) | 36.98 | 32.46 | 32.15 | 27.23 | 20.87 | 18.59 |
| External Debt Service Ratio (actual) | 28.50 | 27.34 | 27.10 | 22.64 | 17.02 | 16.67 |
| External Interest/Exports of Goods & Services | 12.55 | 11.27 | 10.39 | 8.42 | 5.92 | 5.41 |
| External Debt Outstanding/Exports of Goods and Services | 178.35 | 170.66 | 156.28 | 154.00 | 115.95 | 97.09 |
| External Debt/GDP | 97.75 | 110.87 | 115.52 | 94.71 | 90.08 | 71.32 |
| Domestic Debt/GDP | 32.66 | 22.68 | 25.97 | 24.97 | 49.20 | 45.01 |
| Total Debt/GDP | 130.41 | 133.55 | 141.49 | 119.68 | 139.28 | 116.33 |

**Table 7: Debt and Debt Service Indicators - Concluded**
**US$ mn.**

| | 1996+ | 1997+ | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Total external Debt Service(accrued) | 579.47 | 523.07 | 635.60 | 603.45 | 477.20 |
| Total External Debt Service (actual) | 579.47 | 523.07 | 635.60 | 603.45 | 477.20 |
| Principal | 392.28 | 344.77 | 438.93 | 418.05 | 308.16 |
| Interest | 187.19 | 178.30 | 196.67 | 185.40 | 169.04 |
| Gross Exports of Goods and Services | 3,487.20 | 3,555.80 | 3,483.50 | 3,483.50 | 3,564.10 |
| **(PERCENTAGE)** | | | | | |
| External Debt Service Ratio (accrued) | 16.62 | 14.68 | 17.88 | 17.32 | 13.39 |
| External Debt Service Ratio (actual) | 16.62 | 14.68 | 17.88 | 17.32 | 13.39 |
| External Interest/Exports of Goods & Services | 5.37 | 5.01 | 5.53 | 5.32 | 4.74 |
| External Debt Outstanding/Exports of Goods and Services | 92.68 | 92.01 | 92.98 | 86.81 | 94.70 |
| External Debt/GDP | 58.42 | 51.76 | 50.95 | 46.32 | 50.28 |
| Domestic Debt/GDP | 45.67 | 49.90 | 54.39 | 68.82 | .. |
| Total Debt/GDP | 104.09 | 101.66 | 105.34 | 115.14 | .. |

\+ Revised
.. Not available
**Source:** Bank of Jamaica, *Statistical Digest,* Various Issues.

With respect to the sources of borrowing, there were some significant changes in the 1980s and 1990s. In 1980, commercial loans accounted for 22% of the outstanding debt but by the end of the decade this had dropped to around 10%. In the 1990s, this trend continued, so that by 2000, commercial loans accounted for about 4% of the outstanding debt. From the mid-1980s, the bilateral share climbed to over 40%, as compared to 25% in 1980. In 2001, the composition of the outstanding external debt was as follows: bilateral (25.6%), multilateral (27.3%), commercial (2.3%), other (4.8%) and bonds (40%) (see Table 8). The share of the multilateral debt dropped from a high of 40% in 1988 to 27% in 2001. Since multilateral institutions do not reschedule their debt, a high dependence on multilateral funds creates a difficult situation for a country, in the event servicing problems arise.

Unlike the declining trend in the external debt position, the domestic debt increased sharply in the 1990s. In nominal terms, the domestic debt increased from under J$10 billion (33% of GDP) in 1990 to J$292.2 billion (69%) of GDP in 1999. The domestic and foreign debt taken together were in excess of 100% of GDP in 1999. While interest payments on the external debt declined from US$292 million in 1990 to US$169.0 million in 2000, payments on the internal debt increased from J$824 million to J$35,704 million over the period. This was the result of not only increased borrowing, but sharp increases in interest rates in the 1980s, and the first half of the 1990s (See Table 9). Total interest payments (internal and external) in 2000 accounted for 45% of recurrent expenditure and almost half of tax revenue.

Table 8: Medium and Long-Term Public and Publicly Guaranteed External Debt, 1992-2000

| End of Period | Bilateral | Multilateral | Commercial | Other | Bonds | Total |
|---|---|---|---|---|---|---|
| 1992 | 1,850.6 | 1,300.0 | 333.4 | 193.9 | - | 3,678.0 |
| 1993 | 1,791.8 | 1,284.3 | 347.1 | 224.0 | - | 3,647.2 |
| 1994 | 1,805.7 | 1,369.2 | 360.2 | 116.8 | - | 3,651.8 |
| 1995 | 1,802.1 | 1,219.0 | 338.2 | 92.6 | - | 3,451.9 |
| 1996 | 1,726.0 | 1,133.1 | 276.4 | 78.3 | 47.2 | 3,261.0 |
| 1997 | 1,545.1 | 1,165.1 | 267.6 | 50.3 | 249.5 | 3,277.6 |
| 1998 | 1,476.2 | 1,087.3 | 165.1 | 27.8 | 550.0 | 3,306.4 |
| 1999 | 1,367.5 | 1,027.5 | 147.2 | 31.9 | 450.0 | 3,024.1 |
| 2000 | 1,218.5 | 1,115.3 | 132.8 | 45.9 | 862.8 | 3,375.3 |
| 2001 | 1,063.1 | 1,127.3 | 97.7 | 202.2 | 1,655.7 | 4,146.0 |

**Source:** Bank of Jamaica, *Statistical Digest*, Various Issues.

**Table 9: Movements in the Level of the Domestic Debt and Commercial Banks' Interest Rates**

| Year End | Domestic Debt (Net) | Interest Rates | |
|---|---|---|---|
| | J$ mn. | Deposit Rates[1] (%) | Loan Rates[2] (%) |
| 1990 | 9,968.1 | 24.50 | 31.59 |
| 1991 | 10,183.4 | 27.50 | 34.03 |
| 1992 | 19,025.1 | 23.00 | 46.04 |
| 1993 | 24,390.0 | 39.80 | 49.60 |
| 1994 | 41,899.0 | 27.85 | 45.79 |
| 1995 | 49,804.8 | 26.22 | 48.56 |
| 1996 | 85,181.2[4] | 16.79 | 37.81 |
| 1997 | 101,351.2 | 10.79 | 31.93 |
| 1998 | 119,955.0 | 11.28 | 30.08 |
| 1999 | 176,717.5 | 9.74 | 24.64 |
| 2000 | 187,520.2 | 8.92 | 22.12 |
| 2001[3] | 292,262.8 | 7.59 | 19.50 |

1. Overall average weighted deposit rate of commercial banks at year end.
2. Overall average weighted loan rates of commercial banks at year end.
3. End of September, 2001.
4. End of March, 1997.

**Source:** Bank of Jamaica, *Statistical Digest*, Various Issues.

At the end of September, almost 80% of the domestic debt fell in the category of 'Locally Registered Stock' (LRS). Around three quarters of the domestic debt was at floating interest rates and 10 per cent US dollar-linked (including FIWSAC securities in US dollars). Over 70% of domestic debt matures in the next two to three years.[8]

**Concluding Observations**

In July, 2000, the Government of Jamaica requested a staff-monitored programme (SMP) from the Fund for the period April 2000 through March 2002 as a signal to official creditors, donors and financial markets. The principal objectives of the authorities' economic programme are to restore growth of at least 3% a year; reduce inflation to about 4% a year; and increase the stock of net international reserves.[9] These goals call for continued fiscal consolidation, debt reduction and divestment of public sector assets; further reform to strengthen the financial sector; structural reform to accelerate growth; and monetary and exchange rate policies to reduce inflation and interest rates, and to avoid losses in external competitiveness.[10]

Preliminary figures for 2001 indicate that growth was 1.4%, the inflation rate 6.9%, while net foreign reserves increased from US$1,421mn at the end of 2000 to US$2,360mn at the end of 2001. Indications are that the external debt and debt service ratio increased in 2001,

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8 See IMF *Country Report* No. 01/83, p. 7.

9 IMF, *Country Report* No. 01/83, June 2001.

10 *Ibid.*

giving some indication of the difficulties facing the authorities.

One source has concluded that "years of economic stagnation have exacerbated economic and social deprivation, contributing to high crime rates."[11] Bauxite and alumina production stagnated in the 1990s, production at the end of the decade hardly exceeding that at the start. Sugarcane and banana production also floundered. Bauxite, alumina, bananas and sugar still account for more than half of Jamaica's exports, despite the efforts made to diversify the economy. Receipts from tourism contribute 40 to 45% to foreign exchange earnings, and while receipts almost doubled between 1990 and 2000, the worsening crime situation (the murder rate increased by 30% in 2001) could adversely affect the performance of the industry. The formal sector has been in difficulty for many years, but a large informal sector, an expanding social safety net and remittances from abroad (US$950 million in 2000, which amounted to more than half of the earnings from domestic exports), have helped to cushion the decline.

In assessing the impact of the stabilisation and structural adjustment policies of the 1980s, one scholar has noted that "banks and insurance companies have done very well, while the mass of the population has suffered a substantial decline in real income. The growth of the 'high income' economy has largely excluded the rest of the population. The structural transformation associated with adjustment has widened the disjuncture within the national economy and the society."[12] One study done in

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11 EIU, *Country Report* April, 2002, p. 13.

12 Levitt, *op.cit.* p. 13

the 1980s noted that 10% of the population of Kingston, 36% of the population of other towns and 41% of rural populations lived in poverty.[13] Many of these trends continued into the 1990s. In 2000, the UNDP[14] ranked Jamaica 86th in the 'medium human development' category with an index of 0.741. The adult literacy rate was 86.9%, the combined primary, secondary and tertiary gross evolvement ratio was 62%, the life expectancy index was 0.84 and the GDP per capita (in PPP US$) was US$3,639. The comparable GDP figures for the United States, Barbados and Trinidad & Tobago were US$34,142, US$15,494 and US$8,964 respectively. The Gini index estimated for Jamaica was 37.9. The richest 20% of the population enjoyed 46.0% of consumption while the poorest 20% were associated with 6.7%.

The interest rates and inflation rate have come down to more acceptable levels in recent years, but with the emergence of fiscal deficits, the public debt could increase further. The high level of the domestic debt is a legacy of the period of high inflation rates and the financial crisis of the mid-1990s, and is highly abnormal. Real interest rates remain at high levels. Unemployment is estimated to be in the region of 15%, and to reduce this there is need to increase the investment and savings rates. In light of the crime situation, the flight of people and capital makes this challenge even more difficult.

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13 Cited in Levitt, *op. cit.* p. 23.

14 UNDP, *Human Development Report 2002.*

# 6

# An Analysis of Fiscal Performance in the Eastern Caribbean Currency Union (ECCU)

*Garth Nicholls*

## 1. Introduction and Overview

In recent years the Eastern Caribbean Currency Union (ECCU) has received considerable attention, since it has been able to achieve sustained growth and a moderately high rating in the United Nations' Human Development Index, whilst also being able to avoid the monetary and fiscal excesses of other developing countries. This suggests that its policy of openness to the rest of the world with strong export orientation and a well-structured public sector investment programme (PSIP) in the 1980s and early 1990s have paid off. In the late 1990s and early 2000s, however, the export sectors came under severe stress as a result of falling terms of trade, declining volumes of both banana exports and tourist arrivals and a coordinated Organisation for Economic Cooperation and Development (OECD) assault on the offshore financial services sectors causing many closures. This assault has been reinforced under provisions made for fighting the international war on terror. In addition, activity on the PSIPs has substantially abated as a result of low implementation rates.

These developments have had an almost immediate impact on the fiscal performance of these economies. The resulting shocks have put the spotlight on the various structural weaknesses which need to be addressed to facilitate further sustained growth and development in the ECCU. It is, of course, true that a number of countries around the world have run into significant fiscal and financial difficulties in the recent past. It is also true that those countries which have taken significant and determined measures to consolidate their fiscal positions have strengthened respective financial positions, whilst those which have avoided fiscal consolidation are still in turmoil.

The fiscal performances of the economies which comprise the ECCU are determined primarily by the performance of the export sectors and the economic management philosophy adopted. For the major part of the period under consideration, the economies experienced reasonably rapid expansion in economic growth. Economic growth during the 1980s and 1990s was driven by the resuscitation of the banana industry financed by significant aid, and also massive foreign direct investment inflows in the tourist industry *via* hotel construction. The performance of the foreign exchange sectors has fluctuated over the period under review. In particular, in the earlier part of the period, 1984-1992, banana exports and tourist arrivals experienced strong growth, and GDP moved in tandem. Similarly, in the latter period 1992-2000, the performance of the foreign exchange earning sectors deteriorated, and so did the growth performance of GDP. These developments have impacted negatively on the fiscal performance of the ECCU countries in addition to an already high unemployment and poverty rate. Moreover, given the small open nature of these economies and their almost total dependence on foreign trade, the process of globalization and trade liberalization is expected to significantly affect these economies. The globalization process has accelerated the shift in the economic structure of these countries from a heavy dependence on traditional agriculture to services. These factors, coupled with the emergent internet and communications technology, provide a further mechanism for economic agents to by-pass the tax net. The fiscal policy authorities, as a matter of urgency, need to reform the fiscal regimes in the ECCU, to take account of these developments.

Meanwhile, the emergent weaknesses in the foreign exchange earning sectors and an expansionary fiscal stance have resulted in significant debt accumulation. The rapid debt accumulation, coupled with declining concessionality, rising debt servicing costs and payment arrears, has raised fears about the overall sustainability of governments' fiscal policy packages. In a sense, this unsustainable fiscal situation has arisen partly because of the weak budgetary processes, and a general lack of technical capacity in member countries, along with the impact of sizeable adverse exogenous shocks. For example, Antigua and Barbuda and St. Kitts and Nevis are experiencing the consequences of five hurricanes between 1995 to 2000.

Moreover, the development of a single financial space has created a new dimension to policy within the context of the ECCU. The development of a single financial space, through the removal of barriers to financial flows across the currency union, will facilitate the transmission of individual governments' financial policy initiatives on other members and the central bank itself. Therefore, policy actions by individual member countries can potentially contaminate the ECCB's reputation in the international financial community. The effects of individual policy initiatives are therefore no longer confined to the domestic jurisdiction, but can have important spill-over effects on other countries within the arrangement.

This chapter is concerned primarily with the fiscal performance of the ECCU economies over the 1980 to 2000 period. According to Tanzi *et. al.* (1999), the fiscal performance of an economy can be assessed in at least four ways: quality of the tax system; level and composition of public expenditure; fiscal stance and fiscal sustainability. In this chapter emphasis is placed on the tax and public expenditure systems. In the following chapter the sustainability of fiscal policy is analysed.

This chapter has four specific objectives: to delineate the context of fiscal policy in the ECCU; to identify trends in expenditure and revenue; to identify the key issues as they relate to fiscal performance in the ECCU; and finally, to identify the main administrative deficiencies in the conduct of fiscal policy in the ECCU.

The outline for the remainder of the presentation is as follows. In section two, the context of fiscal performance is analysed, whilst the theoretical perspectives on fiscal performance are provided in section three. The main trends in fiscal balances are provided in section four, whilst an analysis of government revenues and expenditure performances is given in sections five and six respectively. Some administrative issues in fiscal performance are discussed in section seven. In section eight selected fiscal and other policy reform initiatives over the period are outlined. Finally, in section nine a conclusion is provided.

## 2. Context of Fiscal Performance of the ECCU

### 2.1. The Policy Framework

The countries of the ECCU operate within the context of a currency union, which comprise a common central bank and currency. The central bank is solely responsible for the management of the exchange rate. To facilitate this process, the central bank imposes tight limits on the extension of domestic credit to its membership and has in place a decision-making structure which reinforces such. The central bank is also interested in the issue of financial stability and the development of money and capital markets within the currency union. The ultimate goal of this initiative is to develop a single financial space within the ECCU. Fiscal policy on the other hand is the preserve of the individual member governments. They are responsible for their fiscal and debt policy packages. Recently, the governments and the central bank have cooperated to develop a regional market for government securities.

Given the overall policy framework, a number of events have revealed the emergent need for Public policy coordination in the ECCU. A new dimension has also been added to policy within the context of the ECCU. The first relates to the development of a single financial space, through the removal of barriers to financial flows across the currency union. The second relates to the impact of individual government financial policy initiatives on other members of the central bank and the central bank itself. In both cases, the effects of individual country policy actions are no longer confined to the domestic jurisdiction, but have important spillover effects to other countries within the arrangement.

## 2.2. Economic Performance

### *2.2.1. Economic Growth*

Average growth in the ECCU over the period 1980 to 2000 was 5 per cent per annum. There were three distinct patterns of growth experienced by the ECCU between 1980 and 2000. The first was in the period 1980-84, when growth averaged 5 per cent per annum. The growth experienced during this period was significant, given the recession in the international economic environment. This recession affected both tourist arrivals and the screwdriver type manufacturing entities which had emerged in an earlier period. The second period 1984-1992 was one of relatively high growth, averaging 7 per cent per annum. This period also corresponds with the banana export and foreign direct investment inflow boom in the ECCU. In the mid 1980s to 1990 period, banana output and income were relatively high and this redounded to the benefit of St. Vincent and the Grenadines, St. Lucia and Dominica. However, the problem of frequent windstorms and uncertain external markets has since generally affected confidence and performance in the industry. This period also witnessed significant public sector investment articulated through structured public sector investment programs. In the final period 1992-2000 growth decelerated and averaged 3 per cent per annum. This period corresponds with a fall-off in the performance of the main foreign exchange earning sectors, such as bananas and tourism, and a slow-down in foreign direct investment inflows. A significant factor in economic growth has been the deterioration in the export sector performance (deterioration in the terms of trade and appreciation of the real exchange rate).

**Table 1: Economic Growth and Inflation Performance, 1980 –2000 (Period Averages)**

| Country | Average Annual Growth % | | | | Inflation Rate % | | | |
|---|---|---|---|---|---|---|---|---|
| | 1908-2000 | 1980-1984 | 1984-1992 | 1992-2000 | 1980-2000 | 1980-1984 | 1984-1992 | 1992-2000 |
| Anguilla | | | 7 | 5 | | | 7 | 3 |
| Antigua and Barbuda | 5 | 5 | 6 | 4 | 5 | 7 | 6 | 4 |
| Dominica | 4 | 6 | 4.5 | 2 | 4 | 5 | 5.4 | 3 |
| Grenada | 5 | 3 | 5 | 3.5 | 4 | 4 | 5 | 2.5 |
| Montserrat | -2 | 1 | 4.5 | -1 | 4 | 8 | 3.5 | 4 |
| St. Kitts/Nevis | 4 | 2 | 7 | 3.5 | 6 | 8 | 6 | 4.5 |
| St. Lucia | 5 | 5 | 8 | 2 | 4 | 5 | 4.5 | 3 |
| St. Vincent & the Grenadines | 5 | 5 | 7 | 3 | 4 | 9 | 4 | 2.5 |
| **ECCU** | **5** | **5** | **7** | **3** | **4** | **6** | **5** | **2.5** |

**Source:** Author's Calculations.

### 2.2.2. Inflation

Prices have generally been stable over the period under review, averaging 4 per cent per annum. Again, as in the case of growth, there were three main patterns of inflation. In the first period, 1980/84, inflation averaged approximately 6 per cent per annum. This period corresponds to a period of inflation in the international environment, in line with a spike in oil prices during this period. During the second period, 1984/92, inflation averaged 5 per cent per annum. In the final period, 1992/2000, inflation averaged 2.5 per cent per annum, in line with the international fall in prices.

### 2.2.3. Poverty and Unemployment

High levels of poverty and unemployment continue to plague the ECCU countries. Based on information reported in Greene (1995), estimates of poverty as a proportion of the total population average approximately 10 per cent or more. Poverty is especially acute in Dominica, Grenada and St. Vincent and the Grenadines. This level of hard-core poverty and measures for reducing it must be a major policy question. In line with these estimates is the general lack of labour absorptive capacity of these economies. As revealed in Table 2, unemployment has remained stubbornly high in some countries. Moreover, shocks to real economic activity in the banana and tourism sectors, along with the inability to generate jobs, have resulted in a large informal sector in some islands.

**Table 2: Unemployment Rates and Poverty as a Percent of the Total Population**

| Country | Unemployment Rates % | | | Poverty % of Population |
|---|---|---|---|---|
| | 1970 | 1980 | 1991 | 1992 |
| Anguilla | N/A | N/A | 6.3 | N/A |
| Antigua and Barbuda | N/A | N/A | 6.7 | 12 |
| Dominica | 8.1 | 18.6 | 9.9 | 18 |
| Grenada | 10.1 | 17.4 | 15.2 | 20 |
| Montserrat | 8.6 | 13 | 2.5 | N/A |
| St. Kitts and Nevis | 8.2 | 10.3 | 3.1 | 15 |
| St. Lucia | 9.2 | 17.2 | 14.5 | 15 |
| St. Vincent and the Grenadines | 12.9 | 23.5 | 19.8 | 18 |

**Source**: Population Census, (1970, 1980, 1991). *Reducing Poverty in the Caribbean*. Greene, PAHO, 1995.

## 2.3. The Economic Structure

The economies in the ECCU are small and highly open. Indeed, the ratio of imports and exports to GDP is well over 100 per cent. Therefore, trade with the rest of the world is a key factor in the economic performance of the ECCU. In this context, the main elements of exports foreign exchange earners in the ECCU are tourism services and the traditional agricultural exports which are in general secular decline. However, a number of these new service activities are not captured in the tax net or indeed in the calculation of national accounts and the balance of payments statistics.

### 2.4. Impact of International Trading Arrangements

All ECCU member countries are signatories to the World Trade Organisation (WTO) and Free Trade Area of the Americas (FTAA) trade provisions. However, given the existing structure of these economies, the lion's share of revenues originates from taxes on international trade and transactions. A number of these tax regimes can be considered to be in violation of the letter and spirit of these treaties. In addition, given the specific provisions of FTAA, there is an urgent need for the countries within the ECCU to re-examine their fiscal regimes and to redesign these in a manner which promotes competitiveness and encourages exports.

### 2.5. Technology and Communications

Improvements in technology and communications have changed the scope and effectiveness of public policy. During the 19th century, inventions in information and communications technology served to strengthen the hand of the state relative to the individual and the market. The innovations today are, however, having the opposite effect. In the age of the Internet, controls on private financial transactions become increasingly easy to evade. Developments such as these, as they become more prevalent, are likely to negatively impact on government revenues, other things being equal.

## 2.6. Areas of Discontent with the Existing Tax System

(i) The high levels of concessions mean that the effective tax base is on only a few commodities.

(ii) In some countries the tax base is narrow, with loopholes, incoherent provisions, concessions, unfocused incentives and weak compliance. Even for those concessions which are part of the policy architecture, there is minimal monitoring or evaluation of the various projects which qualify for these concessions. As a result, the potential exists, for significant abuse.

(iii) Tax arrears owed to the Inland Revenue department appear to be high. A number of countries are plagued by significant tax arrears to the Inland Revenue departments. Amnesties are regularly provided, but there is a view that these create perverse incentives for private agents not to pay taxes when due, but to await the next amnesty.

(iv) The impact of the tax systems on saving, labour supply and risk taking and investment by the private sector is often not taken into account when new measures are proposed. The primary concern is usually revenue.

(v) In some countries there are a number of structural weaknesses. For example, the tax rates are too high, and this creates incentives for avoidance. In addition, the bases of corporate and non-corporate tax are difficult to control.

(vi) The tax system in some countries comprises an array of separate taxes and charges on the one hand, while on the other hand many taxes are levied on similar bases and then there are a significant number of exemptions. This particular combination creates problems for the effective management of the tax regime.

vii. In countries where income taxes do not now exist, the authorities have introduced a number of specific levies earmarked for specific expenditures. These include expenditures on health, education, social services, etc. However, there is a perception by the general public that these funds are invariably not used for the purposes for which they are promoted. In at least one such levy, the government has commissioned an inquiry into the operation and use and misuse of the funds. In addition to these implicit income tax-type arrangements, the levies are changed with some degree of regularity.

### 2.7. The Impact of Globalisation

Globalisation has resulted in a situation where the room for fiscal manoeuvre on the part of the government is considerably reduced. It requires that the revenue systems worldwide be at least compatible and skewed in the direction of relatively immobile factors, at least in the short-term. The other implication, of course, is the pressure to tax expenditure generally, but particularly consumption, more heavily relative to other activities. However, given the discussion above on the perceived high tax rates which already exist in these countries, and the fact that the tax system is already focused largely on taxing consumption, it means that the degrees of freedom for action are considerably reduced. The expected net result of the increased mobility of the factors of production is a fiscal squeeze on the public sector as revenues stagnate but expenditures are difficult to contain.

## 2.8 A Weak Domestic Private Sector

The domestic private sector has traditionally been weak and except in the case of the banana farmers, depends largely on government expenditures for its revenues. There is also significant foreign investment in these countries, partly as a result of generous fiscal regimes. The majority of these foreign investments are in the tourism-related activities and communications. The impact of these investments is likely to be indirect, precisely because of the significant levels of concessions which are usually provided.

## 2.9 Demographic Trends

There are three main factors affecting the demographic trends in the ECCU. First, the general population in the ECCU is getting older. This development is because of increased life expectancy and a declining birth rate. The aging of the population would require a substantial increase in medical expenditures for the treatment of illnesses associated with old age over the medium-term.

As shown in Table 3, the **ECCU** would have a progressively older population by 2050, as expressed by the higher dependency ratio. Of all countries, Anguilla is projected to have the oldest population by 2050, followed by St. Vincent and the Grenadines. Based on data from the 1980 and 1991 population censuses, the population of some countries, e.g. Antigua and Barbuda and Dominica. This is not unexpected, given the significant levels of migration from these countries. Finally, the emergence of new types of diseases such as HIV/AIDS, which reduce the productivity of the young workers, is likely to impact on economic performance over the medium-term. Indeed, sub-Saharan Africa apart, statistics suggest that the

**Table 3: Projections of Dependency Ratios in ECCU Countries 1980 - 2050**

| Country | 1980 | 1991 | 2000 | 2010 | 2020 | 2050 |
|---|---|---|---|---|---|---|
| Anguilla | 10.0 | 14.0 | 18.0 | 22 | 24 | 28 |
| Antigua & Barbuda | 16.0 | 15.8 | 15.6 | 15 | 14 | 25 |
| Dominica | 15.1 | 15.8 | 13.6 | 10 | 9.7 | 21.9 |
| Grenada | 12.7 | 14.8 | 16.4 | 18.5 | 20 | 25 |
| Montserrat | 23.2 | 23.3 | — | — | — | — |
| St Kitts & Nevis | 18.9 | 17.9 | 16.2 | 16.7 | 17.5 | 25 |
| St Lucia | 12.0 | 10.5 | 8.2 | 8.3 | 8.4 | 24.4 |
| St Vincent & the Grenadines | 13.7 | 12.5 | 9.2 | 9.4 | 10.0 | 26.4 |
| Average[1] | 14.3 | 13.9 | 13.5 | 13.8 | 14.4 | 24.7 |

**Source:** Population census (1980,1991) of various countries, *Digest of Selected Demographic and Social Indicators, 1960-94,* Economic Commission for Latin America and the Caribbean 1995; Author's calculations.

1. Calculated by weighting each country's dependency ratio by its share of the group's total (projected) population. The dependency ratio is calculated by expressing the population age 65+ as a percentage of the population aged between 15 to 64.

Caribbean on per capita terms has one of the highest HIV infection rates in the world (World Bank, 2000). These developments are likely to have a significant impact on fiscal performance over the medium-term.

### 2.10. Political Economy Factors

Over the years under review, most governments in the ECCU have subscribed to the general philosophy of free enterprise and respect for property and the principles of a liberal Democracy. Elections to Parliament, which have been deemed to be generally free and fair, are held every five years. Within this general broad theme some political parties have identified the private sector as the engine of growth. Others have, however, perceived the private sector to be weak and have instead relied heavily on the public sector to determine economic transformation. A particularly extreme manifestation of this was the People's Revolutionary Government in Grenada, which came to power as a result of a *coup d'etat* in 1979, but eventually collapsed due to political infighting. This regime attempted to transform the economy of that country through massive government intervention. In this general context the fiscal numbers observed over the years for the ECCU public sector tend to be a reflection of the philosophy, programmes, social pressures and external shocks faced by the different political administrations.

### 2.11 Organisational and Institutional Structure of the Public Sector

The public sector as obtains in the ECCU is large and varies from country to country. The basic structure of the public sector in general has the following elements:

(i) Central Government

(ii) Public sector enterprises.

(iii) Government guarantees for loans to both the domestic and foreign private sector.

(iv) Local Government

### *(i) The Central Government and Public Sector Enterprises*

The number of public sector enterprises varies from country to country. Among the ECCU countries, St. Vincent and the Grenadines has the largest number of statutory corporations on the books. Under this general heading, the activities which governments have traditionally owned are: the Utilities – water and electricity bodies, telephones, etc. In St. Kitts and Nevis, electricity and water are departments of the central government account. In Antigua and Barbuda, water, electricity and telephones have been merged together in a public enterprise entitled the Antigua Public Utilities Authority (APUA). Moreover, it is common in the ECCU countries for the public sector to be engaged in all sectors of the economy, from agriculture to finance and commercial banking. Part of the list would include agricultural farms, quarry and mining, distribution, marketing boards, hotels, transportation, communications, banks and insurance, real estate and housing, as examples of the broad categories. This, in a sense, emerged from the philosophical view that the state was required to provide direction to the rest of the economy, since the private sector was incapable or unwilling to undertake such. As a result of the size of the public sector, generally, it is in most cases the single largest source of employment in all these economies.

The public sector enterprises are generally established by a statute of Parliament and operate under the guidance of a board of directors which provides general policy direction. It is generally intended that these public sector enterprises would be able to fund their own operations, after which any surpluses are to be paid over to the consolidated fund. However, only a few have been able to do so. As a result, the central government has been required to provide transfers or loan guarantees to a number of these enterprises. This outturn is largely related to a lack of managerial capacity at a number of these public enterprises. It is extremely difficult to obtain basic information on the operations of some public enterprises. Moreover, in a number of cases audited, financial statements are not available over a period of years or are available only with a significant lag. In some countries the public sector enterprises have been the primary source of debt problems for the government. This again has resulted because of the lack of appropriate coordination and debt authorization procedures.

### *(ii)* ***Government Guarantees for Loans to both the Domestic and Foreign Private Sector***

The basic view is that in a number of cases enterprises requiring foreign financing to set up economic activity locally may require government backing. One such example is the Ottley Hall shipyard facility in St. Vincent and the Grenadines, where the government provided guarantees for the foreign loans secured for the project. Governments have also provided guarantees locally to domestic financial institutions for some private sector enterprises.

### *(iii)* ***The Contingent Liabilities***

The social security schemes, which have been established by all governments in the ECCU, are, in a fundamental sense, a contingent liability of the state, if the schemes are unable to pay its pension obligations when they fall due. Recently, however, a number of governments have engaged the private sector to finance and build capital projects, which the governments rent – the so-called build, operate and transfer projects.

### *(iv) Local Government*

In general terms, all countries within the ECCU have provisions for local government in the legislation. However, some countries have de-emphasised local governments. Local governments range from the city/town councils, administration of out islands or units within a federation, and village councils. Of all the countries, St. Kitts and Nevis is the only one which operates a federal system of government; other countries have a unitary state arrangement. In the case of Nevis' Island Administration, there exists a specific revenue sharing arrangement with the federal government, and it can borrow funds to finance capital projects, once this is guaranteed by the federal government.

The analysis in this paper focuses primarily on the fiscal performance of the central government. The confinement of the study to the central government is because of the limited credible information which is available on the rest of the public sector activities. It is recognized, however, that other aspects of the public sector, in particular the public sector enterprises, can and have on many occasions been the major source of fiscal difficulties for the central government finances.

## 3. Theoretical Perspectives on Fiscal Policy

The requirements for the effective functioning of private market are very strict. In particular, information must be available, and markets for all goods and services must exist. Even in such situations, according to Coase (1998), if there are no transactions costs then government may not be required to intervene. Externalities usually cause otherwise well functioning markets to fail. An important externality is the concept of public goods. These are goods and services for which there is non-rivalry in consumption and non-excludability. These features violate the characteristics of private goods, which focus on the establishment and protection of property rights. Externalities and, in particular, public goods provide an economic rationale for the provision of goods and services by the public sector.

The endogenous growth theory suggests that government ought to concentrate its expenditures on those activities which reveal a clear association with economic growth. Empirical studies across a large cross section of countries have revealed that education (years of schooling), health and other networking structures, which build social capital, have a strong association with long-term growth. In the context of a developing economy, the government may need to undertake certain strategic investments which may be deemed too risky and uncertain for the domestic private sector to contemplate (Stiglitz, 1986). Easterly and Rebelo (1993) reported that public investment in transport and communication is positively related to economic growth. Such investments increase both the aggregate supply and demand in the economy. By so doing, the government's capital expenditure increases the capacity of the domestic economy and it is also likely to increase the return on private sector investments (crowd in private investment) and thereby increase the rate of GDP growth. It is further argued that transfer payments, which facilitate a stable social environment, is positively associated with economic growth, (Cashin, 1995 and Sala-I-Martin, 1996). The basic idea is that if these programmes (social protection framework) are managed well, they can protect the most vulnerable sections of society during macroeconomic shocks and adjustments. There is a caveat in pushing this view too far however. Using public choice theory, it suggests that bureaucratic failure in the public sector may result in a worse outcome if government intervenes. Under this interpretation, government intervention in the economy would negatively impact total factor productivity growth and the efficient allocation of resources.

The role of governments in the economy also includes stabilization of the economy and income redistribution. In the context of the Caribbean generally, and the ECCU in particular, history has been a key factor in the determination of the public sector's involvement in the economy. In particular, given the initial domination by slavery and the plantation system – characterized by severe wealth and income inequities, it was perceived by governments that their intervention was a necessary condition to reorder and restructure the economies and societies. This reordering was based on their futuristic plans for these societies. This is seen clearly in some countries such as Antigua and Barbuda, where within a generation the sugar industry was replaced by tourism as the main source of income and employment. Much of the credit for the transformation rests with the relentless pursuit of the government at the time for employment creation activities outside the sugar industry and the plantation system. In St. Kitts and Nevis, on the other hand, greater emphasis was placed by the authorities on transferring resources to other segments of the society through the education and health systems, whilst retaining the sugar industry and the plantation system.

## 4. Fiscal Balances

Fiscal balances are key summary indicators of fiscal performance. They are, of course, the result of various taxes and expenditure plans of the public sector. In this section, three summary indicators of fiscal performance, the current account/government savings, the overall balance and the primary deficit, are analysed. However, as shall be revealed later in the chapter, these indicators by themselves can be misleading. It is usually necessary to look at a combination of indicators to ascertain the true picture of the fiscal performance. Each of these indicators is discussed in turn.

### *4.1.1. Current Account Balances*

Central government savings for the ECCU countries averaged approximately 1.6 per cent of GDP over the 1980 to 2000 period (see Table 4). St. Vincent and the Grenadines and St. Lucia generated savings in excess of 3 per cent of GDP. On the other hand, Antigua (-0.5 per cent) Grenada (-0.3 per cent) and St. Kitts and Nevis (-0.16 per cent) generated deficits, on average. Central government savings, after averaging negative 0.46 per cent of GDP in the sub-period 1980 to 1984, improved strongly over the next two sub-periods, averaging 2.3 per cent of GDP (1984-1988) and 2.53 per cent of GDP (1988-1992). Since then, central government savings for the combined ECCU has trended downwards, averaging 2.4 per cent in the sub-period 1992 to 1996 and 1.9 per cent of GDP in the period 1996 to 2000.

Antigua and Barbuda, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines (SVG) initially experienced an upward trend in central government

**Table 4: Fiscal Balances in the ECCU**
**(In percent of GDP, 1980-2000 average)**

| Categories | ECCU | Anguilla | Antigua | Domi-nica | Grenada | Mont-serrat | St. Kitts/ Nevis | St. Lucia | St. Vincent & the Grena-dines |
|---|---|---|---|---|---|---|---|---|---|
| Current Account Balance | 1.64 | 1.78 | -0.54 | 0.65 | -0.3 | 2.6 | -0.11 | 3.99 | 5.32 |
| Overall Balance | -2.89 | -0.97 | -3.73 | -6.98 | -7.1 | 0.83 | -0.71 | -0.71 | 1.2 |
| Primary Balance | -0.98 | -1.35 | -0.76 | -4.82 | -4.66 | 0.95 | -0.77 | 0.35 | 2.4 |

**Source:** Author's Calculations.

savings. However, in the last two sub-periods, the trend of central government savings has been downwards (see Table 5). Importantly, though St. Lucia and SVG still maintained positive savings balances, the balances for Antigua and Barbuda and St. Kitts and Nevis became negative on average. On the other hand, after initially trending downwards for the first half of the period under consideration, central government savings in Anguilla, Grenada and Dominica shifted to an upward trend in the last two sub-periods generally.

**Table 5: Trends in Central Government Savings**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| Anguilla | N.A. | 2.63 | 2.0 | 1.37 | 1.76 |
| Antigua/Barbuda | -2.26 | 2.25 | -0.78 | -0.01 | -1.04 |
| Dominica | -0.29 | 2.07 | 2.51 | -0.65 | 0.21 |
| Grenada | -2.08 | -1.83 | -1.66 | 1.56 | 2.64 |
| Montserrat | 1.25 | 0.56 | 2.44 | 4.47 | 4.46 |
| St. Kitts/Nevis | -0.85 | 0.17 | 0.90 | 0.66 | -1.0 |
| St. Lucia | 0.26 | 3.2 | 6.16 | 5.47 | 5.24 |
| St. Vincent & the Grenadines | 2.25 | 7.4 | 7.6 | 5.98 | 3.62 |
| **ECCU** | **-0.46** | **2.27** | **2.53** | **2.46** | **1.89** |

N.A.: Not Available.
**Source:** Author's Calculations.

#### *4.1.2. Overall Fiscal balance*

Over the period 1980 to 2000 the overall fiscal balance of the countries in the ECCU averaged approximately negative 2.9 per cent of GDP (see Table 4). Grenada (negative 7.1 per cent), Dominica (negative 7 per cent) and Antigua and Barbuda (negative 3.7 per cent) registered the largest overall fiscal imbalances. Interestingly on average the overall balance for St. Vincent and the Grenadines and Montserrat was positive for the period under consideration.

**Table 6: Trends in Central Government Overall Balances**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| Anguilla | N.A. | -0.11 | -1.76 | -0.57 | -0.99 |
| Antigua/Barbuda | -7.27 | -1.78 | -2.49 | -1.87 | -3.63 |
| Dominica | -8.53 | -7.39 | -8.96 | -5.5 | -4.32 |
| Grenada | -13.8 | -8.7 | -7.38 | -1.13 | -3.08 |
| Montserrat | 0.58 | -1.2 | -0.58 | 1.20 | 4.20 |
| St. Kitts/Nevis | 3.4 | -1.45 | -2.83 | -3.11 | -8.52 |
| St. Lucia | -3.76 | -0.14 | 0.80 | -1.09 | 0.67 |
| St. Vincent & the Grenadines | 0.32 | 5.3 | 1.94 | 0.46 | -2.1 |
| **ECCU** | **-5.13** | **-1.95** | **-2.4** | **-1.7** | **-2.72** |

N.A. Not Available.
**Source:** Author's Calculations.

The overall balance for the ECCU does not have a particular sustained trend based on the sub-periods identified (see Table 6). Instead, it appears to initially deteriorate and then improve in the sub-period which immediately follows. This pattern may indicate the cyclical nature of governments' capital expenditure programmes.

A couple of the countries stand out: first, St. Vincent and the Grenadines, which has, based on the sub-periods chosen, experienced overall surplus balances (declining trend) over all sub-periods, except for the final sub-period. Dominica and Montserrat experienced a steady improvement in their overall balance positions over the period of analysis. In general, this overall balance outturn largely reflects the performance of the public sector investment programmes of member countries. Invariably, capital expenditures are usually the first line of expenditure which is cut as the governments run into fiscal difficulties requiring stabilization of its finances.

**Table 7: Trends in Central Government Primary Balances**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| Anguilla | | | -1.35 | -0.47 | -0.84 |
| Antigua/Barbuda | -3.2 | 0.42 | 1.13 | 0.71 | -1.33 |
| Dominica | -6.26 | -6.02 | -7.63 | -3.31 | -1.11 |
| Grenada | 0.06 | -6.05 | -4.62 | 1.29 | -0.85 |
| Montserrat | -0.47 | -1.02 | -0.36 | 1.93 | 5.2 |
| St. Kitts/Nevis | 4.17 | 1.19 | -0.09 | -0.71 | -4.99 |
| St. Lucia | -2.72 | 1.21 | 1.66 | -0.28 | 1.88 |
| St. Vincent & the Grenadines | 0.90 | 6.71 | 2.97 | 1.8 | -0.15 |
| **ECCU** | **-3.24** | **-0.17** | **-0.43** | **0.07** | **-0.61** |

**Source:** Author's Calculations.

### *4.1.3. Primary Balances*

Over the period 1980 to 2000 the primary balance of the ECCU central governments averaged approximately – 0.98 per cent of GDP (see Table 4). Two countries, St. Lucia (0.35 per cent of GDP) and St. Vincent and the Grenadines (2.4 per cent of GDP) experienced positive primary balances over the period under consideration. On the other hand, Dominica (4.82 per cent of GDP) and Grenada (4.7 per cent of GDP) experienced the largest negative primary balances.

For the ECCU combined governments as a whole, the primary balances follow no particular trend (see Table 7). The pattern appears to be an improvement, followed by deterioration. However, compared with the first sub-period, all other sub-periods were an improvement. On an individual country basis there has been a gradual deterioration in the primary balances of St. Vincent and the Grenadines, St. Kitts and Nevis and Antigua and Barbuda. On the other hand, the primary balance in the case of Dominica appears to be improving. In the next chapter a fuller analysis of the primary balances and gaps are undertaken to ascertain the sustainability of governments' fiscal policy packages.

## 5. An Analysis of Public Sector Revenues

Taxation is the means by which fundamental economic and social objectives of the ECCU economies requiring public spending are financed. Taxation, however, affects most economic behaviour and therefore the design of tax policy is important. There are at least three features which a tax system ought to focus on. These are:

(i) Effects of tax on incentives which impact on efficiency.

(ii) The distribution across the population, which impacts on equity and fairness of the tax system.

(iii) Enforceability - administrative feasibility.

There are four general guiding principles of tax policy that countries ought to follow. They are the following:

(i) Raising revenue. Based on current expenditure patterns sufficient revenues are not being collected. In any case there is a perception in some countries that tax rates are too high. Therefore, there is a need to look at expenditures simultaneously with revenues.

(ii) Efficiency

(iii) Equity: Given the significant changes in the economy including migration, ageing population and public debt, there is a strong case for the authorities to assess the impact of these measures on the inter-generational transfer of resources from one generation to another.

(iv) Enforceability: This appears to be a problem is some countries as reflected in the high tax arrears.

Two issues, which are normally of importance in the analysis of the revenue side of the public budget, are the tax system and an analysis of revenues. Each of these are addressed in turn.

### 5.1. Assessing the Tax System

Under this criterion the burden of the tax system on economic activity and the structure of the tax system is analysed. The measurement of tax burdens is subject to controversy. The ratio of taxes to GDP is used as a rough indicator, but has some drawbacks.[1] There are some non-trivial differences in the tax systems across the ECCU countries. In the Windward Islands, there is a mixture of direct and indirect taxation including personal income tax. However, in the Leeward Islands, personal income tax has been abolished. The Leeward Islands have also witnessed an increase in the use of special levies and charges, which in substance operate in the same manner as personal income tax. In addition, Dominica has introduced a sales tax which over time is expected to replace import duties.

#### *5.1.1. Tax Structure of the ECCU*

For the ECCU, current revenues averaged approximately 92.2 per cent of total revenues over the period 1980 to 2000. Of this, tax revenues represented approximately 76.4 per cent of total revenues. Direct taxes accounted for

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1 Institutional set-ups differ across countries in ways that significantly affect the reported tax to GDP ratios without having much impact on the burdens imposed by taxation. Some taxes may have a stronger impact on economic behaviour. It is therefore useful to examine the breakdown of tax revenues by the tax base. Different forms of taxation may also interact to result in pronounced differences in marginal effective tax rates faced by particular groups, thus heavily affecting their economic choices. Tax burdens need to be assessed in a wider context, including the 'burden' stemming from regulation that mandates the private sector to provide social protection or public goods and services in government's place.

approximately 25 per cent of total tax revenues within the ECCU. On an individual country basis, Montserrat (37.9 per cent), St. Vincent and the Grenadines (31.8 per cent), St. Lucia (30 per cent) and Dominica (28.6 per cent) were above the benchmark (see Table 8). In Anguilla direct tax revenues accounted for only 0.5 per cent of total tax revenues. Within the direct taxes category, taxes on income and profit represented approximately 23.6 per cent of total tax revenues in the ECCU. Dominica (28 per cent), Montserrat (33.1 per cent), St. Lucia (29.2 per cent) and St. Vincent and The Grenadines (30.8 per cent) were above the ECCU average, whilst the remaining countries were below.

Within the taxes on income and profit category, taxes on personal income represented approximately 39.4 per cent or 9.3 per cent of total tax revenues. On an individual country basis, Dominica (15.3 per cent) and Montserrat (24.7 per cent of total revenues) were the highest over the period. On the other hand, taxes on corporate income represented approximately 10.2 per cent of total tax revenues for the ECCU on average over the review period. St. Kitts and Nevis (15.6 per cent) and St. Vincent and the Grenadines (15.5 per cent of total revenues) were the highest in the ECCU.

Indirect taxes accounted for 75 per cent of total tax revenues for the ECCU over the period under consideration. Anguilla (99.5 per cent), Antigua and Barbuda (85.6 per cent), Grenada (78.5 per cent) and St. Kitts and Nevis (75.8 per cent) were above the ECCU benchmark. Of the other countries, Montserrat had the lowest ratio of 62.1 per cent of total revenues. Within the indirect category, taxes on international trade represented approximately 57.7 per cent, whilst taxes on domestic goods and services represented approximately 17.3 per cent of total tax revenues.

**Table 8: Taxes as a percentage of Total Tax Revenues, Period Average 1980 to 2000**

| Categories | ECCU | Anguilla | Antigua and Barbuda | Dominica | Grenada | Mont-serrat | St. Kitts/ Nevis | Lucia | St. Vincent & the Grenadines |
|---|---|---|---|---|---|---|---|---|---|
| Direct Tax Revenues | 25.0 | 0.5 | 14.4 | 28.6 | 21.5 | 37.9 | 24.2 | 30.0 | 31.8 |
| **Taxes on Income & Profit** | **23.6** | **0.0** | **12.7** | **28.0** | **19.1** | **33.1** | **22.4** | **29.2** | **30.8** |
| *Taxes on Personal Income* | 9.3 | 0.0 | 0.4 | 15.3 | 3.2 | 24.7 | 7.2 | 10.4 | 13.2 |
| *Taxes on Corporate Income* | 10.2 | 0.0 | 9.8 | 12.7 | 7.7 | 6.5 | 15.6 | 13.3 | 15.5 |
| Taxes on Property | 1.4 | 0.5 | 1.7 | 0.6 | 2.4 | 4.8 | 1.8 | 0.7 | 1.0 |
| **Indirect Tax Revenues** | **75.0** | **99.5** | **85.6** | **71.4** | **78.5** | **62.1** | **75.8** | **70.0** | **68.2** |
| **Taxes on Domestic Goods & Services** | **17.3** | **29.0** | **20.3** | **13.0** | **21.7** | **21.2** | **14.9** | **15.2** | **15.0** |
| *Consumption Tax* | 2.4 | 0.0 | 0.0 | 3.3 | 9.4 | 0.0 | 0.2 | 2.9 | 3.0 |
| *Hotel Occupancy Tax* | 4.2 | 13.1 | 8.1 | 0.3 | 0.0 | 0.8 | 5.5 | 4.0 | 1.7 |
| *Entertainment Tax* | 0.03 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 |
| *Telecommunication Tax* | 0.83 | 0.0 | 3.7 | 0.0 | 0.0 | 0.0 | 0.8 | 0.7 | 1.4 |
| *Insurance Levy* | 0.45 | 0.0 | 0.5 | 0.0 | 0.0 | 1.0 | 0.6 | 0.9 | 0.6 |
| *Licences* | 4.1 | 8.1 | 1.4 | 4.9 | 2.8 | 7.1 | 2.4 | 2.1 | 3.8 |
| **Taxes on International Trade** | **57.7** | **70.5** | **65.3** | **58.4** | **56.8** | **40.9** | **60.9** | **54.8** | **53.3** |
| *Import Duty* | 22.2 | 58.2 | 20.2 | 15.3 | 16.1 | 11.0 | 24.5 | 19.4 | 13.1 |
| *Export Duty* | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 |
| *Consumption Tax* | 25.5 | 0.0 | 31.1 | 35.3 | 35.3 | 20.9 | 21.7 | 28.8 | 31.1 |
| *Customs Service Charge* | 5.6 | 0.0 | 6.9 | 2.2 | 6.1 | 14.7 | 4 | 7.2 | 3.4 |
| *Foreign Exchange Tax* | 1.7 | 2.9 | 2.4 | 0.0 | 1.9 | 4.2 | 0.4 | 0.7 | 0.8 |
| *Travel Tax* | 0.4 | 0.0 | 1.3 | 0.0 | 0.0 | 0.0 | 0.9 | 0.3 | 0.4 |
| *Embarkation Tax* | 1.3 | 4.1 | 2.6 | 1.2 | 0.3 | 0.0 | 0.9 | 0.0 | 1.2 |
| **Total Tax Revenues** | **100** | **100** | **100** | **100** | **100** | **100** | **100** | **100** | **100** |

**Source:** Author's Calculations.

Table 9: Trends in the Tax Structure of the ECCU, in Per Cent of GDP

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| | Direct Taxes | | | | |
| Anguilla | 0.68 | 0.83 | 0.38 | 0.50 | 0.58 |
| Antigua/Barbuda | 18.32 | 16.40 | 13.95 | 11.60 | 12.02 |
| Dominica | 31.13 | 27.30 | 23.71 | 27.41 | 31.40 |
| Grenada | 30.65 | 16.76 | 16.43 | 26.50 | 19.10 |
| Montserrat | 38.54 | 39.08 | 35.78 | 39.37 | 37.39 |
| St. Kitts/Nevis | 16.16 | 21.27 | 26.60 | 26.11 | 28.46 |
| St. Lucia | 32.64 | 30.24 | 28.44 | 28.64 | 29.47 |
| St. Vincent & the Grenadines | 33.17 | 28.16 | 29.45 | 33.07 | 34.18 |
| **ECCU** | **28.27** | **24.30** | **23.15** | **24.97** | **24.48** |
| | Taxes on Income and Profit | | | | |
| Anguilla | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Antigua/Barbuda | 15.91 | 14.78 | 12.35 | 10.14 | 10.46 |
| Dominica | 31.13 | 27.30 | 23.71 | 27.41 | 29.97 |
| Grenada | 29.30 | 14.78 | 13.78 | 23.94 | 15.87 |
| Montserrat | 32.90 | 34.31 | 31.18 | 34.60 | 33.74 |
| St. Kitts/Nevis | 15.32 | 19.45 | 24.63 | 24.54 | 26.36 |
| St. Lucia | 31.30 | 29.29 | 27.76 | 28.28 | 28.99 |
| St. Vincent & the Grenadines | 32.24 | 27.20 | 28.62 | 31.97 | 33.10 |
| **ECCU** | **26.94** | **22.95** | **21.74** | **23.57** | **23.06** |

**Table 9: Trends in the Tax Structure of the ECCU, in Per Cent of GDP - Cont'd**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| | **Indirect Taxes** | | | | |
| Anguilla | 99.13 | 99.14 | 99.62 | 99.44 | 99.35 |
| Antigua/Barbuda | 81.95 | 83.60 | 85.97 | 88.40 | 87.98 |
| Dominica | 68.87 | 72.70 | 76.29 | 71.27 | 68.60 |
| Grenada | 69.35 | 83.24 | 83.57 | 73.42 | 80.90 |
| Montserrat | 61.51 | 60.78 | 64.22 | 60.79 | 62.61 |
| St. Kitts/Nevis | 83.79 | 78.75 | 73.44 | 73.33 | 71.50 |
| St. Lucia | 67.48 | 69.76 | 71.60 | 71.41 | 70.65 |
| St. Vincent & the Grenadines | 66.90 | 71.87 | 70.42 | 66.93 | 65.82 |
| **ECCU** | **71.85** | **75.68** | **76.85** | **75.03** | **75.39** |
| | **Taxes on Domestic Transactions** | | | | |
| Anguilla | 23.00 | 26.22 | 22.05 | 33.41 | 31.06 |
| Antigua/Barbuda | 14.51 | 21.74 | 21.30 | 21.73 | 21.75 |
| Dominica | 7.93 | 9.95 | 15.40 | 16.15 | 15.25 |
| Grenada | 32.02 | 25.87 | 18.00 | 16.52 | 19.23 |
| Montserrat | 28.75 | 32.35 | 14.94 | 13.01 | 13.62 |
| St. Kitts/Nevis | 7.22 | 13.41 | 14.18 | 18.72 | 20.33 |
| St. Lucia | 22.00 | 14.05 | 11.58 | 12.66 | 14.61 |
| St. Vincent & the Grenadines | 11.99 | 14.80 | 16.52 | 15.46 | 16.31 |
| **ECCU** | **17.84** | **17.90** | **15.98** | **16.86** | **18.13** |

**Table 9: Trends in the Tax Structure of the ECCU, in Per Cent of GDP - Concluded**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| | Taxes on International Trade | | | | |
| Anguilla | 76.14 | 72.92 | 77.62 | 66.08 | 68.34 |
| Antigua/Barbuda | 67.46 | 61.86 | 64.81 | 66.67 | 66.23 |
| Dominica | 60.95 | 62.79 | 61.04 | 55.24 | 53.40 |
| Grenada | 37.33 | 57.37 | 65.58 | 56.85 | 61.68 |
| Montserrat | 32.76 | 28.46 | 49.28 | 47.61 | 49.24 |
| St. Kitts/Nevis | 76.62 | 65.33 | 59.27 | 54.61 | 51.31 |
| St. Lucia | 45.35 | 55.83 | 60.02 | 58.75 | 56.04 |
| St. Vincent & the Grenadines | 54.88 | 57.15 | 54.03 | 51.44 | 49.73 |
| **ECCU** | **53.93** | **57.79** | **60.87** | **58.17** | **57.38** |

**Source:** Author's Calculations.

Hotel occupancy taxes (4.2 per cent) and licences (4.1 per cent respectively of total revenues) were the largest contributors to tax revenue within the taxes on domestic goods and services category. Within the taxes in the international trade category, consumption tax (25.5 per cent) and import duty (22.2 per cent) represented the largest contributors. On an individual country basis, Anguilla obtained approximately 58.2 per cent of tax revenues from import duty, whilst Montserrat and St. Vincent and the Grenadines, at 13.1 per cent of total revenues, were the lowest. In respect of consumption tax revenues, Dominica and Grenada, at approximately 35.3 per cent of their tax revenues, were the highest.

In terms of trends at the ECCU level, direct tax revenues as a per cent of total tax revenues have declined consistently over the period under review (see Table 9). In this category, tax revenues on income and profit as a proportion of total tax revenues declined between 1980 and the sub-period 1988-92, after which they rose. Indirect tax revenues as a proportion of tax revenues initially rose between 1980 and the sub-period 1988-92, after which they declined marginally. Within the indirect tax category, taxes on international trade, after initially rising between 1980 and 1988/92, commenced a gradual decline in the last two sub-periods.

In respect of individual countries, there has been a decline in the proportion of indirect tax revenues to total tax revenues for Antigua and Barbuda, Grenada and St. Lucia, but more gradual relative to the others. On the other hand, in Montserrat, along with Dominica and St. Vincent and the Grenadines, the population rose. Antigua and Barbuda, Dominica (gradual), Grenada and St. Lucia (gradual) also experienced a decline in revenue from taxes on profits and income over the period. On the other hand, St. Kitts and Nevis, St. Vincent and the Grenadines and Montserrat experienced a rise.

In respect of indirect taxes, Antigua and Barbuda, Grenada, Dominica (up to 1992/96), St. Vincent and the Grenadines (up to 1988/92) and St. Lucia (up to 1988/92) experienced growth in indirect tax revenues from total tax revenues. St. Kitts and Nevis, St. Lucia (after 1992) and St. Vincent and the Grenadines (after 1992) experienced a fall in indirect tax revenues as a proportion of total revenues. There appears to be a generalized decline in the proportion of tax revenues from international trade relative to total tax revenues.

### *5.1.2. Tax Burdens in the ECCU*[2]

Over the period 1980 to 2000 total revenues to GDP for the ECCU averaged 28.6 per cent (see Table 10). On an individual country basis, Montserrat, Dominica, Grenada and St. Vincent and the Grenadines, over the 1980 to 2000 period, experienced the highest ratio of total revenues to GDP at 43.5 per cent of GDP, 33.8 per cent of GDP, 32.6 per cent of GDP and 32.1 per cent of GDP, respectively. Two distinct patterns emerge from the data over the different sub-periods. First, between 1980 and 1996 total revenues as a percentage of GDP gradually declined. However, in the final sub-period 1996 to 2000 total revenues to GDP began trending upwards.

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2 Tax burdens in this note are measured as tax revenues to GDP ratios. This is used as a scaling factor. To the extent that tax systems matter for economic efficiency, their costs are important, since such costs can change economic behaviour.

**Table 10: Government Fiscal Operations in Percent of GDP, Period Average 1980-2000**

| Category | ECCU | Anguilla | Antigua/ Barbuda | Domi-nica | Grenada | Miont-serrat | St. Kitts/ Nevis | St. Lucia | St. Vincent/ the Grenadine |
|---|---|---|---|---|---|---|---|---|---|
| Total revenues | 28.60 | 25.80 | 22.66 | 33.77 | 32.57 | 43.51 | 29.38 | 26.17 | 32.11 |
| Current revenues | 25.29 | 23.24 | 21.35 | 27.88 | 25.59 | 33.89 | 27.19 | 24.18 | 29.49 |
| Tax Revenues | 21.29 | 15.84 | 17.71 | 24.40 | 22.86 | 22.60 | 19.33 | 21.96 | 24.41 |
| Direct | 5.35 | 0.08 | 2.56 | 7.01 | 5.14 | 8.64 | 4.55 | 6.57 | 7.75 |
| Taxes on income &profit | 5.06 | 0.00 | 2.27 | 6.88 | 4.62 | 7.64 | 4.22 | 6.41 | 7.52 |
| Taxes on property | 0.29 | 0.08 | 0.30 | 0.13 | 0.53 | 1.00 | 0.33 | 0.16 | 0.23 |
| Indirect | 15.93 | 15.76 | 15.15 | 17.38 | 17.72 | 13.96 | 14.79 | 15.40 | 16.66 |
| Taxes on domestic goods & services | 3.70 | 4.70 | 3.58 | 3.07 | 5.24 | 4.12 | 2.78 | 3.30 | 3.62 |
| Taxes on international trade | 12.23 | 11.06 | 11.57 | 14.31 | 12.48 | 9.84 | 12.00 | 12.10 | 13.05 |
| Non-tax Revenues | 3.89 | 7.40 | 3.63 | 3.48 | 2.74 | 2.98 | 7.86 | 2.22 | 5.08 |
| Capital Revenue | 0.42 | 1.10 | 0.61 | 0.50 | 0.53 | 0.05 | 0.42 | 0.11 | 0.18 |
| Grants | 2.89 | 1.43 | 0.70 | 5.39 | 6.44 | 9.57 | 1.77 | 1.88 | 2.44 |
| *of which:* Capital Grants | 0.47 | 1.43 | 0.16 | 0.74 | 0.00 | 0.00 | 0.24 | 0.82 | 0.79 |

**Source:** Author's Calculations.

Current revenues as a percentage of GDP followed the pattern set by total revenues. Five countries (Anguilla, Grenada, Dominica, St. Kitts and Nevis, and St. Vincent and the Grenadines) experienced a pattern of initially declining total revenues to GDP, but a subsequent increase. In respect of the other countries, Antigua and Barbuda experienced a downward trend in total revenues to GDP, whilst Montserrat experienced an upward trend. In respect of St. Lucia, total revenues to GDP first followed an upward trend, declined, and then commenced an upward trend in the final sub-period.

Tax burdens for the ECCU averaged approximately 21.3 per cent of GDP. Dominica and St. Vincent and the Grenadines both with tax revenues to GDP of approximately 24.4 per cent, represented the highest tax burdens in the ECCU. The lowest tax to GDP ratio over the period of analysis was Anguilla at 15.9 per cent of GDP. Between 1980 and 1996 the average tax burdens for the ECCU countries trended slightly downwards. In the 1996 to 2000 sub-period average tax burdens returned to its pre 1988/92 levels (21.5 per cent).

Except for Anguilla, Antigua and Barbuda and St. Lucia, tax revenues to GDP initially trended downward, and then began trending upward in the final sub-period. In the case of Anguilla, tax revenues to GDP trended upwards for the entire period under review. After trending upwards initially, tax revenues to GDP in Antigua and Barbuda commenced a downward trend in the two final sub-periods. On the other hand, in St. Lucia three patterns are discernible: first an upward trend between 1980 to 1992, a declining trend in the sub-period 1992 to 1996, and finally, an upward trend in the sub-period 1996 to 2000.

In respect of the different categories, direct taxes as a whole averaged approximately 5.4 per cent of GDP over the entire period. Direct tax revenues to GDP were highest in Montserrat at 8.6 per cent of GDP. St. Vincent and the Grenadines at 7.8 per cent and Dominica at 7 per cent of GDP, respectively followed closely. Taxes on income and profit to GDP were highest in SVG and Montserrat at 7.5 per cent and 7.6 per cent of GDP, respectively. For the individual sub-periods the pattern of direct taxes to GDP have conformed to the pattern set by that of total revenues. Except for Anguilla, Grenada, and St. Lucia, all countries experienced an initial decline in direct tax revenues to GDP, followed by an upward trend in the final sub-periods. In the case of the Anguilla, direct tax burden trended upwards over the entire period. For Grenada, direct tax revenues to GDP initially trended downwards, changed to an upward trend in the 1992 to 1996 sub-period, but reverted to a downward trend in the 1996 to 2000 sub-period. For St. Lucia direct tax revenues to GDP initially trended upwards, changed to a downward trend in the 1992 to 1996 sub-period, but reverted to an upward trend in the final sub-period.

Within the direct category, taxes on income and profit averaged approximately 5.1 per cent of GDP. Indirect taxes to GDP averaged approximately 15.9 per cent of GDP for the ECCU over the period under review. On an individual country basis, the burden of indirect taxation was highest in Grenada (17.7 per cent of GDP), followed closely by Dominica (17.4 per cent) and St. Vincent and the Grenadines (16.7 per cent of GDP). Montserrat (14 per cent of GDP) and St. Kitts/Nevis (14.8 per cent of GDP) experienced the lowest burden of indirect taxation over the period of analysis. After initially rising between the first two sub-periods to 16.3 per cent of GDP, indirect taxes to GDP declined for the next two sub-periods before rising in the second sub-period to represent 16.2 per cent of GDP in the final sub-period. In respect of the individual countries, six different patterns are recognized. First, Grenada, Montserrat and St. Vincent and the Grenadines, experienced a pattern of initially upward trending indirect taxes, followed by a downward trend, which reverted to an upward trend in the final sub-period. Antigua and Barbuda initially experienced an upward trend in indirect tax revenues to GDP, but changed to a downward trend in the final sub-period. In the case of St. Kitts and Nevis, after initially trending downwards, indirect tax revenues to GDP changed to an upward trend in the final sub-period, 1996 to 2000. Finally, whilst indirect tax revenues to GDP trended downwards for St. Lucia over the entire period of analysis, the opposite was the case in Anguilla.

Within the indirect taxes category, taxes on international trade represented approximately 12.2 per cent of GDP over the entire period of analysis. Taxes on international trade as a percentage of GDP rose in all sub-periods, except in the 1992 to 1996 sub-period. In respect of taxes on international trade, St. Vincent and the Grenadines (13.1 per cent of GDP) and Dominica 14.3 per cent of GDP experienced the highest tax burdens, whilst Montserrat (9.8 per cent of GDP) and Anguilla 11.1 per cent of GDP were the lowest. St. Vincent and the Grenadines, St. Kitts and Nevis and Dominica experienced an initial trend decline in revenues from taxes on international trade, which changed in the final sub-period to an upward trend. In St. Lucia the trend was initially upward, but changed to a downward trend in the sub-period 1988-1992. Except for Anguilla, which experienced an upward trend, there was no clearly discernable pattern for the other countries.

### 5.2. Revenue Analysis

In this section the buoyancy of the tax system is analysed.[3] The buoyancy of the tax system is defined as the increase in revenues collected, compared with the relative increase in GDP. A ratio greater than one is indicative of a buoyant tax system, meaning that revenue growth is at least keeping pace with GDP growth.

#### *5.2.1. Buoyancy*

From an overall perspective, total revenue for the ECCU over the review period, with a ratio of 0.95, was not buoyant (see Table 11). Indeed, the buoyancy ratio remained less than one for three of the five sub-periods. For the other two, 1992-96 and 1996-2000 the buoyancy recorded was 1.2 and 1 respectively. Three countries, Antigua and Barbuda, Grenada and St. Kitts and Nevis experienced average revenue buoyancy of less than one over the 1980 to 2000 period, whilst St. Lucia achieved a buoyancy of –8.9 per cent. For the remaining countries, Dominica achieved the highest buoyancy of total revenues of 3.3 per cent averaged over the period 1980 to 2000.

Tax revenues for the ECCU as a whole over the 1980 to 2000 period have been marginally buoyant – a ratio of 1.04. The period of highest buoyancy was between 1992 to 2000. Grenada (0.10 per cent) and St. Lucia (0.23 per cent) achieved the lowest tax buoyancy over the review

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3 Another important factor in revenue analysis is the elasticity of the tax system. However, to calculate the elasticity of the tax system requires precise information on the changes in the tax rates and bases overtime. That is, the elasticity of the tax system is a calculation of changes in revenue growth given unchanged tax rates.

**Table 11: Buoyancy of Revenues, Period Average: 1980 - 2000**

| Category | ECCU | Anguilla | Antigua/ Barbuda | Domi-nica | Grenada | Miont-serrat | St. Kitts/ Nevis | St. Lucia | St. Vincent/ the Grenadines |
|---|---|---|---|---|---|---|---|---|---|
| Total Revenues | 0.95 | 1.24 | 0.48 | 3.28 | 0.88 | 1.38 | 0.67 | -8.94 | 1.04 |
| Current Revenues | 1.04 | 1.68 | 0.64 | 2.28 | -0.02 | 1.55 | 1.27 | -1.51 | 1.15 |
| Tax Revenues | 1.04 | 2.77 | 0.68 | 2.30 | 0.10 | 1.42 | 3.00 | 0.23 | 1.13 |
| Direct | 1.17 | | 1.96 | 6.15 | 1.10 | 1.70 | 3.09 | 3.31 | 1.48 |
| Taxes on Income and Profit | 1.16 | | 2.35 | 6.35 | 1.19 | 1.63 | 3.66 | 3.52 | 1.45 |
| Taxes on Property | 1.58 | | -1.11 | | 1.61 | 3.06 | -27.10 | -11.02 | 4.06 |
| Indirect | 1.01 | 2.72 | 0.52 | 0.69 | -0.05 | 1.26 | 3.00 | -1.01 | 1.00 |
| Taxes on Domestic Goods & Services | 1.38 | 4.66 | 0.78 | 2.00 | -1.97 | 1.81 | 0.90 | -1.48 | 1.49 |
| Taxes on International Trade | 0.91 | 2.25 | 0.47 | 0.37 | 0.60 | 1.34 | 3.10 | -0.80 | 0.89 |
| Non-Tax Revenues | 1.03 | 0.45 | 0.61 | 2.56 | -1.02 | 3.40 | -2.04 | -20.67 | 1.36 |

**Source:** Author's Calculations.

period. St. Kitts and Nevis (3 per cent) achieved the highest average tax buoyancy over the period. The period 1980 to 1992 marked a period when tax revenues generally lacked buoyancy, partly on account of the extent of exemptions, which were allowed/provided by the authorities during this period for a number of sectors, productive and non-productive, legislated and *ad hoc.*

Direct tax revenues were generally more buoyant with a ratio of 1.17 relative to indirect tax revenues at a ratio of 1.01. In this category, Dominica (6.2 per cent) achieved the highest buoyancy. This performance was followed by St. Kitts and Nevis (3.1 per cent) and St. Lucia (3.3 per cent). Grenada, at 1.1 per cent experienced the lowest buoyancy in this category. Within the direct category, property taxes on average had a higher average buoyancy ratio at 1.58, relative to the tax revenues from income and profit at a ratio of 1.16. The buoyancy of income and profit taxes was characterised by significant swings over the review period. Indeed, there are two sub-periods when the average buoyancy ratio was less than one: 1984-1988 and 1992-96. The sub-period 1996-2000 is characterized by a strong recovery. These large swings in buoyancy may be related to the various tax reform efforts of some governments within the arrangement. For example, St. Lucia and St. Vincent and Dominica would have adjusted the income tax threshold upwards, thereby exempting a host of taxpayers. Meanwhile, Grenada would have experimented with the suspension of the personal income tax in the mid-1980s. St. Lucia (3.5 per cent) and St. Kitts and Nevis (3.7 per cent) achieved the highest buoyancy on taxes on income and profits.

For the indirect category of taxes, taxes on domestic goods and services had an average buoyancy ratio of approximately 1.38 between 1980 and 2000. There were, however, two sub-periods, 1984-1988 and 1988-92, when

**Table 12: Trends in Tax Buoyancy Ratios**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| | **Total Tax Revenues** | | | | |
| Anguilla | N.A. | N.A. | 1.75 | 3.58 | 1.97 |
| Antigua/Barbuda | 1.25 | 1.23 | 0.81 | 0.82 | -0.15 |
| Dominica | 0.56 | 1.1 | 1.0 | 1.33 | 6.4 |
| Grenada | 1.4 | 0.75 | 1.25 | -3.3 | 1.2 |
| Montserrat | 1.03 | 0.88 | 0.23 | 3.86 | 0.02 |
| St. Kitts/Nevis | 9.5 | 1.02 | 0.38 | 2.65 | 1.11 |
| St. Lucia | 1.72 | 1.18 | 1.02 | -3.74 | 1.65 |
| St. Vincent & the Grenadines | 1.24 | 1.09 | 0.47 | 1.74 | 1.07 |
| **ECCU** | **0.99** | **1.0** | **0.87** | **1.17** | **1.05** |
| | **Direct Taxes** | | | | |
| Anguilla | N.A. | N.A. | N.A. | N.A. | 2.41 |
| Antigua/Barbuda | 1.83 | 0.99 | 0.52 | 2.84 | 2.65 |
| Dominica | 0.18 | 0.77 | 1.4 | 1.9 | 23.01 |
| Grenada | 1.5 | 0.2 | 3.8 | -0.5 | 0.8 |
| Montserrat | 1.9 | 0.32 | 0.74 | 5.5 | -0.5 |
| St. Kitts/Nevis | 9.0 | 1.3 | 0.86 | 1.9 | 2.1 |
| St. Lucia | 1.44 | 1.1 | 1.2 | 7.9 | 2.6 |
| St. Vincent & the Grenadines | 1.08 | 0.6 | 1.0 | 3.0 | 1.2 |
| **ECCU** | **1.04** | **0.62** | **1.47** | **0.78** | **1.65** |
| | **Taxes on Income and Profit** | | | | |
| Anguilla | N.A. | N.A. | N.A. | N.A. | 2.4 |
| Antigua/Barbuda | 1.86 | 1.22 | 0.72 | 4.1 | 2.84 |
| Dominica | 0.18 | 0.77 | 1.4 | 1.9 | 23.0 |
| Grenada | 1.6 | -0.07 | 4.5 | -0.69 | 0.72 |
| Montserrat | 2.3 | 0.34 | 0.83 | 5.11 | -0.65 |
| St. Kitts/Nevis | 11.8 | 1.3 | 0.9 | 1.7 | 2.3 |
| St. Lucia | 1.5 | 1.1 | 1.23 | 8.9 | 2.5 |
| St. Vincent & the Grenadines | 1.02 | 0.64 | 1.0 | 2.82 | 1.2 |
| **ECCU** | **1.02** | **0.62** | **1.52** | **0.69** | **1.68** |

**Table 12: Trends in Tax Buoyancy Ratios - Concluded**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| | **Indirect Taxes** | | | | |
| Anguilla | N.A. | N.A. | 1.72 | 3.5 | 1.98 |
| Antigua/Barbuda | 1.17 | 1.29 | 0.88 | 0.57 | -0.53 |
| Dominica | 0.74 | 1.3 | 0.9 | 1.1 | -0.3 |
| Grenada | 1.4 | 1.1 | 0.81 | -4.0 | 1.5 |
| Montserrat | 0.51 | 1.3 | -0.05 | 2.9 | 0.3 |
| St. Kitts/Nevis | 9.8 | 0.96 | 0.3 | 2.95 | 0.74 |
| St. Lucia | 1.9 | 1.3 | 0.95 | -8.5 | 1.3 |
| St. Vincent & the Grenadines | 1.33 | 1.31 | 0.3 | 1.2 | 1.06 |
| **ECCU** | **0.98** | **1.14** | **0.7** | **1.33** | **0.86** |
| | **Taxes on International Trade** | | | | |
| Anguilla | N.A. | N.A. | -1.48 | 1.88 | 1.23 |
| Antigua/Barbuda | 1.01 | 1.14 | 0.95 | 0.50 | -0.60 |
| Dominica | 0.75 | 1.2 | 0.64 | 1.2 | -1.23 |
| Grenada | 0.59 | 2.1 | 1.5 | -2.3 | 1.5 |
| Montserrat | 0.10 | 0.76 | 1.2 | 2.2 | 0.5 |
| St. Kitts/Nevis | 11.2 | 0.9 | -0.01 | 2.5 | 0.82 |
| St. Lucia | 2.7 | 1.4 | 0.92 | -7.5 | 0.43 |
| St. Vincent & the Grenadines | 1.31 | 1.32 | .022 | 1.2 | 0.63 |
| **ECCU** | **1.36** | **0.98** | **0.80** | **1.9** | **1.5** |

N.A.: Not Available.

**Source:** Author's Calculations.

the buoyancy ratio of the tax was less than one. In the last two sub-periods 1992-96 and 1996-2000 the buoyancy ratio averaged 1.9 and 1.5 respectively. St. Kitts and Nevis (3 per cent) achieved the highest buoyancy on this tax. However, for Grenada and St. Lucia the results were negative. Tax revenues from international trade had a buoyancy ratio of 0.9, or less than one. Indeed, there are only two sub-periods, 1984-1988 and 1992-96, when the buoyancy ratio was greater than one. It would appear that this result is consistent with the high degree of exemptions and imports generally which are not caught within the public tax net. Except for Montserrat (1.4 per cent) and St. Kitts and Nevis (3.1 per cent) and St. Lucia (0.8 per cent), the buoyancy was less than one for all countries. Finally, non-tax revenues registered an average buoyancy ratio of 1.03 for the period under consideration.

Table 12 provides information on the trends in the buoyancy ratios for the ECCU countries. Casual observation reveals that there is no particular discernible trend in the buoyancy ratios of the ECCU countries.

### *5.2.2. Special Issues - The contribution of the offshore sector*

While the offshore financial services sector has been in existence in the some countries of the ECCU, e.g. St. Vincent and the Grenadines, since the early 1970s information on their contribution to the economy has not been analysed. The information which is provided in this note was collected from the Ministries of Finance in each country and covers only the period 1996 to 2000 (see Table 13). These numbers capture the direct revenue effect of offshore financial services to the general revenues of the government. As a proportion of total government revenues, earnings from the offshore financial services appear to be small. However, the overall impact of the offshore financial

**Table 13: Government Revenue from Offshore Financial Services (ECM$)**

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| **ANGUILLA** | | | | | |
| Economic Citizenship | — | — | — | — | — |
| Offshore Banking | 0.002[@] | 0.003[@] | 0.004[@] | 0.004[@] | 0.004[@] |
| IBCs | 0.077[*] | 0.12[*] | 0.11[*] | 0.12[*] | 0.12[*] |
| Internet Gaming | — | — | — | — | — |
| Exempt Trust | 0.041[#] | 0.063[#] | 0.060[#] | 0.06[#] | 0.062[#] |
| Exempt Insurance Management Companies | 0.106 | 0.15 | 0.14 | 0.17 | 0.2 |
| **Total** | **0.23** | **0.34** | **0.31** | **0.36** | **0.38** |
| **ANTIGUA AND BARBUDA** | | | | | |
| Economic Citizenship | | | | | |
| Offshore Banking | | | | 1.2 | 0.9 |
| IBCs | | | | 1.8 | 1.6 |
| Internet Gaming | | | | | |
| Exempt Trust | | | | 0.11 | 0.12 |
| Exempt Insurance | | | | 0.028 | 0.028 |
| Management Companies | | | | | |
| Miscellaneous | | | | 0.14 | 0.16 |
| **Total** | | | | **3.4** | **2.8** |
| **DOMINICA** | | | | | |
| Economic Citizenship | 4.6 | 8.7 | 7.8 | 7.8 | 3.5 |
| Offshore Banking | 43 | 0.140 | 0.115 | 0.133 | 0.174 |
| IBCs | — | 0.750 | 0.722 | 0.331 | 0.030 |
| Internet Gaming | — | 0.442 | 1.2 | 1.4 | 1.5 |
| Exempt Trust | — | — | 0.018 | 0.021 | 0.029 |
| Exempt Insurance | — | — | 0.006 | 0.022 | 0.013 |
| Management Companies | — | — | 0.006 | 0.011 | — |
| Other Services | — | — | | 0.014 | 0.041 |
| **Total** | **4.6** | **10.1** | **9.9** | **9.7** | **5.2** |

**Table 13: Government Revenue from Offshore Financial Services - Cont'd (ECM$)**

| ANGUILLA | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| GRENADA | | | | | |
| Economic Citizenship | | | | 8.2 | 6.9 |
| Bank and Trust Applications | | | | 0.0 | 0.0 |
| Bank and Trust Licences | | | | 0.2 | 0.8 |
| Licence Renewals | | | | 0.0 | 0.5 |
| International Business Companies | | | | 1.6 | 0.5 |
| Internet Gaming | | | | 0.0 | 0.0 |
| Annual Registration Renewal Fee (IBCs) | | | | 0.0 | 2.5 |
| Bank & Trust Capitalisation | | | | 0.0 | 0.0 |
| **Total** | | | | **10.0** | **11.2** |
| MONTSERRAT | | | | | |
| Economic Citizenship | | | | | |
| Offshore Banking | | | | 0.53 | 0.49 |
| IBCs | | | | 0.021 | 0.011 |
| Internet Gaming | | | | — | — |
| Exempt Trust | | | | — | — |
| Exempt Insurance | | | | — | — |
| Management Companies | | | | — | — |
| Other Services | | | | — | — |
| **Total** | | | | **0.55** | **0.503** |
| ST. KITTS & NEVIS | | | | | |
| Economic Citizenship | — | — | — | — | — |
| Offshore Banking | — | — | — | — | — |
| IBCs | 0.93 | 2.0 | 2.2 | 2.7 | 3. |
| Internet Gaming | | | | | |
| Exempt Trust | 0.11 | 0.188 | 0.53 | 0.27 | 0.25 |
| Exempt Insurance | — | — | — | — | — |
| Management Companies | — | — | — | — | — |
| Other Revenue | 1.7 | 2.1 | 2.7 | 3.6 | 4.6 |
| **Total** | **2.8** | **4.3** | **5.4** | **6.61** | **7.8** |

**Table 13: Government Revenue from Offshore Financial Services - Concluded (ECM$)**

| ANGUILLA | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| ST. LUCIA | | | | | |
| IBCs | | | | | 0.081 |
| Offshore Banking | | | | | 0.067 |
| Exempt Insurance | | | | | 0.020 |
| Other Services | | | | | 0.041 |
| Management Companies | | | | | — |
| **Total** | | | | | **0.21** |
| ST. VINCENT & THE GRENADINES | | | | | |
| Registered Agents | | 0.02 | 0.02 | 0.007 | 0.015 |
| Offshore Banking | | 0.08 | 0.36 | 0.37 | 0.639 |
| IBCs | | 0.6 | 0.72 | 2.5 | 2.9 |
| Exempt Trust | | 0.12 | 0.14 | 0.37 | 0.28 |
| Exempt Insurance | | — | — | 0.007 | 0.014 |
| Mutual funds | | — | — | 0.007 | 0.028 |
| Filing | | 0.039 | 0.065 | 0.092 | — |
| Continuance fee | | 0.11 | 0.091 | 0.0013 | 0.0012 |
| Annual fee | | 0.7 | 0.91 | — | — |
| Other | | — | — | — | 0.300 |
| **Total** | | **1.5** | **2.3** | **3.4** | **3.9** |
| **ECCU** | **2.8** | **5.8** | **7.7** | **10.5** | **12.4** |

**Source:** Individual Ministries of Finance; International Financial Sector Regulatory Authority (IFSRA)

**Notes:** Anguilla:

* Approximations based on 64 per cent allocation of company incorporation and annual fees for IBCs.

# Approximations based on 34 per cent allocation of company incorporation and annual fees for local or domestic companies (including trust companies).

@ Approximation based on a residual 2 per cent from the total company incorporation and annual fees. St. Kitts and Nevis: 1996 represents revenue collected for Nevis only. St. Vincent & The Grenadines: *For 1999 and 2000 annual fees are recorded under the respective categories to which they pertain.

sector activities is likely to have a potentially large effect in most of the economies affected, especially as it relates to foreign direct investment inflows and employment income effects as a result of their purchases of services from other sectors of the economy. However, the attempt to diversify economic activity in this direction has come at a considerable cost to the economies, in light of the OECD's charges that they are tax havens practising unfair tax competition. The OECD's action has had a ripple effect on other parts of the economy, as onshore banking transactions with the rest of the world were affected.

## 6. An Analysis of Public Sector Expenditures

### 6.1. The Structure of Public Expenditure

Total public expenditures for the ECCU averaged approximately 31.5 per cent of GDP over the 1980 to 2000 period (see Table 14). Total expenditure to GDP on average over the 1980-2000 period was highest in Montserrat (42.7 per cent), Dominica (40.8 per cent) and Grenada (39.7 per cent). Three countries, Anguilla (26.8 per cent), Antigua and Barbuda (26.4 per cent) and St. Lucia (26.9 per cent) were below the ECCU average, whilst the remaining two met the average.

Current expenditure averaged 23.7 per cent of GDP for the ECCU over the period under review. For individual countries, Montserrat (31.3 per cent), St. Kitts-Nevis (27.3 per cent) and Dominica (27.2 per cent) were the highest. St. Lucia at 20.2 per cent GDP had the lowest ratio of current expenditure to GDP. Under the current expenditure category an interesting picture emerges. Expenditure on personal emoluments averaged 12.3 per cent of GDP for the ECCU as a whole. In the case of individual countries, Dominica and Montserrat, at 16.5 per cent and 14.9 per cent of GDP respectively, had the highest personal

**Table 14: Expenditure Structure, in the ECCU: In Percent of GDP, 1980-2000 Average**

| Category | ECCU | Anguilla | Antigua/ Barbuda | Domi- nica | Grenada | Miont- serrat | St. Kitts/ Nevis | St. Lucia | St. Vincent/ the Grenadine |
|---|---|---|---|---|---|---|---|---|---|
| Current Expenditure | 23.7 | 21.5 | 21.9 | 27.2 | 25.9 | 31.3 | 27.3 | 20.2 | 24.2 |
| Personal Emoluments | 12.3 | 11.4 | 11.1 | 16.5 | 13.4 | 14.9 | 12.1 | 10.0? | 13.0 |
| Goods and Services | 6.3 | 10.9 | 6.1 | 5.0 | 4.7 | 12.7 | 11.0 | 4.5 | 8.0 |
| Interest Payments | 1.9 | 0.3 | 3.0 | 2.3 | 2.5 | 0.5 | 2.4 | 1.1 | 1.3 |
| Transfers | 3.1 | 0.7 | 1.8 | 3.6 | 5.5 | 3.2 | 1.8 | 3.9 | 1.9 |
| Capital Expenditures & Net Lending | 7.9 | 5.3 | 4.5 | 13.5 | 13.8 | 11.4 | 4.5 | 6.7 | 6.8 |
| **Total Expenditures** | **31.5** | **26.8** | **26.4** | **40.8** | **39.7** | **42.7** | **31.8** | **26.9** | **31.0** |

**Source:** Author's Calculations.

emolument expenditure to GDP. Goods and services as a ratio to GDP in the ECCU accounted for approximately 6.3 per cent of GDP. In this category, Anguilla (10.9 per cent), Montserrat (12.7 per cent) and St. Kitts and Nevis (11 per cent of GDP) were the main contributors to expenditure on goods and services. Interest payments averaged well over 2 per cent of GDP in four countries of the ECCU: Antigua (3 per cent), Dominica (2.3 per cent), Grenada (2.5 per cent) and St. Kitts and Nevis (2.4 per cent) of GDP respectively. The average for the ECCU was 1.9 per cent of GDP.

Transfers averaged 3.1 per cent of GDP at the ECCU level over the period under review. In four countries, transfers as a percentage of GDP were above the ECCU average. These countries were: Dominica (3.6 per cent), Grenada (5.5 per cent), Montserrat (3.2 per cent) and St. Lucia (3.9 per cent) of GDP respectively. These transfers represent two main items: public sector pension payments, and contributions to regional and international organisations. The pension payment component is emerging as a significant factor driving expenditures, especially over the medium-term.

Finally, capital expenditure and net lending averaged approximately 7.9 per cent of GDP over the period 1980 to 2000. Of the individual countries, Dominica averaged 13.5 per cent, Grenada 13.8 per cent, and Montserrat 11.4 per cent of GDP, respectively. Capital expenditure and net lending for the remaining countries were below the ECCU average.

In terms of trends, total expenditure and net lending have trended downwards between 1980 and 96 as a ratio to GDP for the ECCU (see Table 13). However, between 1996 and 2000 there was a trend increase in total expenditures. Again for personal emoluments there was

**Table 15: Trends in Central Government Expenditures, as a Percentage of GDP**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| | **Personal Emoluments** | | | | |
| Anguilla | N.A. | 12.73 | 10.61 | 10.83 | 12.01 |
| Antigua/Barbuda | 10.2 | 9.3 | 11.5 | 12.4 | 11.84 |
| Dominica | 19.8 | 15.6 | 14.5 | 15.7 | 16.1 |
| Grenada | 14.6 | 14.2 | 13.7 | 12.5 | 11.9 |
| Montserrat | 12.9 | 13.0 | 12.8 | 13.5 | 20.6 |
| St. Kitts/Nevis | 13.9 | 10.7 | 9.0 | 11.2 | 15.3 |
| St. Lucia | 10.5 | 10.44 | 9.1 | 10.31 | 10.9 |
| St. Vincent & the Grenadines | 13.5 | 13.3 | 12.2 | 12.6 | 13.2 |
| **ECCU** | **13.3** | **11.8** | **11.3** | **12.1** | **12.7** |
| | **Goods and Services** | | | | |
| Anguilla | N.A. | 8.9 | 9.5 | 8.4 | 9.4 |
| Antigua/Barbuda | 7.8 | 7.3 | 5.7 | 4.6 | 4.9 |
| Dominica | 6.3 | 4.9 | 4.7 | 4.4 | 4.5 |
| Grenada | 5.9 | 5.0 | 4.5 | 3.9 | 3.8 |
| Montserrat | 7.0 | 8.0 | 8.4 | 8.7 | 6.2 |
| St. Kitts/Nevis | 17.5 | 10.0 | 8.6 | 8.6 | 8.8 |
| St. Lucia | 5.7 | 5.0 | 4.0 | 4.0 | 4.0 |
| St. Vincent & the Grenadines | 13.2 | 9.1 | 6.2 | 5.9 | 5.6 |
| **ECCU** | **8.5** | **6.7** | **5.6** | **5.1** | **5.5** |
| | **Interest Payments** | | | | |
| Anguilla | N.A. | 0.50 | 0.41 | 0.09 | 0.15 |
| Antigua/Barbuda | 4.1 | 2.2 | 3.6 | 2.6 | 2.3 |
| Dominica | 2.3 | 1.4 | 1.4 | 2.2 | 3.2 |
| Grenada | 2.3 | 2.7 | 2.8 | 2.4 | 2.2 |
| Montserrat | 0.3 | 0.2 | 0.2 | 0.7 | 1.0 |
| St. Kitts/Nevis | 0.8 | 2.6 | 2.8 | 2.4 | 3.5 |
| St. Lucia | 1.1 | 1.4 | 0.9 | 0.8 | 1.2 |
| St. Vincent & the Grenadines | 0.60 | 1.4 | 1.0 | 1.4 | 2.0 |
| **ECCU** | **1.9** | **1.8** | **2.0** | **1.8** | **2.1** |

**Table 15: Trends in Central Government Expenditures, as a Percentage of GDP - Concluded**

| Country | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|
| | **Transfers** | | | | |
| Anguilla | N.A. | 0.58 | 0.49 | 0.71 | 0.85 |
| Antigua/Barbuda | 1.9 | 1.6 | 1.3 | 1.7 | 2.3 |
| Dominica | 3.1 | 2.6 | 3.5 | 4.0 | 4.5 |
| Grenada | 7.2 | 5.7 | 4.6 | 4.7 | 4.7 |
| Montserrat | 3.0 | 2.3 | 1.6 | 2.0 | 6.2 |
| St. Kitts/Nevis | 1.1 | 1.0 | 1.4 | 2.4 | 3.4 |
| St. Lucia | 3.5 | 3.9 | 4.0 | 4.4 | 4.0 |
| St. Vincent & the Grenadines | 1.3 | 1.4 | 1.0 | 1.8 | 4.1 |
| **ECCU** | **3.1** | **2.8** | **2.6** | **3.1** | **5.5** |
| | **Capital Expenditures** | | | | |
| Anguilla | N.A. | 7.8 | 6.4 | 4.4 | 4.6 |
| Antigua/Barbuda | 7.1 | 5.2 | 3.8 | 2.5 | 3.3 |
| Dominica | 16.6 | 19.0 | 17.5 | 7.3 | 7.2 |
| Grenada | 26.0 | 16.2 | 8.1 | 6.8 | 9.6 |
| Montserrat | 5. 0 | 7.8 | 11.1 | 11.4 | 15.8 |
| St. Kitts/Nevis | 0.5 | 4.3 | 5.8 | 4.2 | 8.3 |
| St. Lucia | 6.4 | 5.5 | 6.4 | 8.3 | 6.7 |
| St. Vincent & the Grenadines | 6.3 | 5.2 | 7.9 | 6.5 | 7.8 |
| **ECCU** | **10.3** | **8.3** | **7.4** | **6.0** | **6.7** |

N.A.: Not Available.

**Source:** Author's Calculations.

a trend decline between 1980 and 1992. However, from 1992 to 2000 expenditures on personal emoluments have trended upwards. Interest payments on average rose over the period under consideration, a reflection of the growth in the stock of public debt and a gradual movement to less concessional borrowings in some countries. On the other hand, the capital expenditures appear to have stagnated, with no clear trend discernible. This result reflects the rather low project implementation ratios, which these countries have experienced over the period. Transfer payments declined relative to GDP between 1980 and 1988; since then, they begun a slight upward trend.

In Dominica, after initially trending downwards, current expenditures have trended upwards as a proportion of GDP. Important in this is the upward trend in interest payments as a proportion of GDP. Personnel emoluments, after initially declining slightly, have changed to an upward trend in the last two sub-periods. A similar pattern is also observed for the expenditure on goods and services. Expenditure on transfers has consistently risen over the period of review. A worrying trend, given Dominica is an undeveloped country, is the decline in the ratio of capital expenditure to GDP over the review period.

In Grenada, total expenditures to GDP have trended downwards over the period under consideration. This trend is followed by current expenditures, which also declined relative to GDP over the period. Spending on personnel emoluments declined from 14.5 per cent of GDP in the 1980/84 sub-period to 11.9 per cent of GDP in the 1996/2000 sub-period(s). The trend fall in expenditures is, however, most apparent for the capital expenditures, which were 26 per cent of GDP in the period 1980/84, but declined to 9.8 per cent of GDP in the sub-period 1996/2000.

In Montserrat, total expenditure has trended upwards from 28.5 per cent of GDP in 1980/84 to 69.4 percent of GDP in 1996/2000. Both capital and current expenditures have trended upwards over the period. In terms of current expenditures, personal emoluments and goods and services were the areas which rose most. This result for Montserrat is explained by the decline in GDP and population on the one hand, and the required increases in expenditures occasioned by the volcanic eruptions since 1995, which are still occurring.

After trending downwards between 1980 and 1992, total expenditures as a ratio to GDP in St. Kitts and Nevis shifted to a sharp upward trend over the last two sub-periods. Current expenditures moved in sympathy with total expenditures. In particular, spending on personal emoluments rose from 10.7 per cent of GDP in the 1980/88 sub-period to 15.3 per cent of GDP in the 1996/2000 sub-period. However, capital expenditures rose from 0.45 per cent of GDP in the 1980/84 sub-period(s) to 8.3 per cent of GDP in the 1996/2000 sub-period. These developments partly reflect expenditures related to restoration work and capital replacements, in the wake of destruction from hurricanes which affected St. Kitts and Nevis in the 1995-2000 period. The government's programme on social infrastructure would have also contributed to the increased expenditures. An additional explanation is the increased cost of capital once the World Bank graduated St. Kitts and Nevis from conditional soft lending, a consequence of its high per capita income.

In St. Lucia total expenditures to GDP have generally remained constant over the period of analysis. This pattern is repeated for all other expenditure categories. In St. Vincent and the Grenadines there has been a slight upward trend in total expenditures since 1984/88. After trending downwards between 1980 to 1992, current expenditures as a ratio to GDP began to trend upwards, but were still below the level of 1980/84 at the end of the period. An important trend is the upward movement of interest payments from 0.59 per cent of GDP in the 1980/84 sub-period(s) to 1.95 per cent of GDP in the 1996-2000 sub-period. Moreover, whilst personal emoluments have remained generally constant, expenditure on goods and services has trended downwards. In contrast, transfers have revealed a strong upward trend, especially in the 1996/2000 sub-period. There was no particular trend in the movement of capital expenditure as a ratio of GDP over the period under consideration.

In Antigua, total expenditures as a ratio to GDP have trended slightly downwards over the period. Expenditure on personal emoluments has trended slightly upwards as goods and services have trended downwards over the entire period of review. Transfers, however, have trended upwards over the period, whilst capital expenditures have trended downwards. Given the tight fiscal situation in Antigua and Barbuda, along with capacity and organizational constraints, the public sector investment programme is severely compromised.

### 6.2. Expenditure on Health and Education

Education and health accounted for approximately 30 per cent of the total current expenditure of the ECCU governments over the period 1990 to 98 (see Table 16). These results are important from two perspectives. First, the literature on the proximate causes of GDP growth has argued that expenditures on health and education are robust predictors of future growth. Within the context of the ECCU, however, there is a high level of emigration of the skilled population. Therefore, expenditure on education and health care may actually be a good predictor of gross national disposable income and not production.

**Table 16: Government Expenditures on Health as a Percentage of Total Expenditures**

| Year | Dominica | Grenada | Montserrat | St. Kitts/ Nevis | St. Lucia | St. Vincent & the Grenadines |
|---|---|---|---|---|---|---|
| 1990 | 9.2 | 14.8 | 15 | 8.3 | 11.7 | |
| 1991 | | | | | | |
| 1992 | | | | | | |
| 1993 | 11 | 12.7 | | 8.9 | 12.9 | 11.9 |
| 1994 | | | | | | |
| 1995 | 13.9 | 10.9 | 33.6 | 7.6 | 13.3 | 11.5 |
| 1996 | | | | | | |
| 1997 | | 12.5 | | 8 | | 10.4 |
| 1998 | | | | | | |
| 1999 | | 9.6 | | 8.9 | 11.9 | 12 |
| 2000 | | | | | | |

**Source:** OECS Human Development Report, 2002.

**Table 17: Government Expenditures on Education as a Percentage of Total Expenditures**

| Year | Antigua/ Barbuda | Dominica | Grenada | Montserrat | St. Kitts/ Nevis | St. Lucia | St. Vincent & the Grenadines |
|---|---|---|---|---|---|---|---|
| 1990 | 13.5 | | 14 | 13.6 | 19.9 | 14.8 | |
| 1991 | | 13.8 | 15.4 | 15.9 | 18.8 | 15.5 | 14.9 |
| 1992 | 12.6 | 15.3 | 13.8 | 19 | 9.8 | 15.7 | 15 |
| 1993 | 11.9 | 14.6 | 12.7 | 20.5 | 9.6 | 13.6 | 16.6 |
| 1994 | 13.1 | 14.8 | 13.1 | 17.3 | 9.8 | 15.8 | 17 |
| 1995 | 11.8 | 13.8 | 13.8 | 18.5 | 13.2 | 20.1 | 15.5 |
| 1996 | 8.3 | 15.5 | 13 | 14.2 | 12.4 | 18.6 | 14.1 |
| 1997 | N.A. | 13.6 | 16 | 7.5 | 16.3 | N.A. | 16.6 |
| 1998 | N.A. | N.A. | 16.3 | N.A. | 14.8 | N.A. | 16.2 |
| 1999 | N.A. | N.A. | N.A. | N.A. | 15.8 | N.A. | N.A. |
| 2000 | N.A. | N.A. | 16 | N.A. | 16 | N.A. | 17.3 |

N.A.: Not Available.

**Source:** OECS Human Development Report. 2002.

The next factor is the efficiency of these public expenditures. What was achieved from these expenditures on health and education? Is output experiencing increasing, constant or decreasing returns? Also, could these results been possible with lower expenditures? Is the level of resources available sufficient to the task at hand? These are important issues which the policy authorities would need to address in a frontal manner over the medium-term.

Some problems related to quality and funding, have begun to surface in both the education and health sectors. In the education sector, for example, the issue of quality has arisen precisely because of the high pupil teacher ratio in some countries, which is reflected in the relatively low examination passes obtained over time. This problem and the issue of adequate school places are fundamentally related to availability of resources by the public sector to spend on the education sector. This may be compounded over the medium-term as most governments seek to achieve their stated goal of universal primary and secondary education. The solution to inadequate resources may, in fact, rest with the introduction of some element of user charges or partial cost recovery for some of the expendi-tures provided by the public sector. This is a reasonable proposal, since education is both a public and a private good. The issue now is to determine who will pay and how.

The health sector also faces inadequate funding and has only recently had to face the strain of an exodus of qualified personnel to some OECD countries. The authorities will need to raise the relative remuneration of the workers in both the health and education sectors if they are to continue to retain qualified personnel, given the internationalistion of the labour market. Therefore, the allocations for health and education would need to increase over time. In addition, with such devastating diseases as HIV/AIDS, and with an ageing population, a tremendous strain will be put on the health budget. In sum, a combination of more resources and an increase in the productivity of the education and the health sectors would be required.

Finally, in the area of social protection, which is also currently under-funded, much work is required. This is especially important to lubricate the functioning of the regional labour market. For example, as the structure of these economies changes from time to time, labour would be dislocated. It is important that mechanisms exist which can facilitate the retraining and maintenance of labour so that they can find gainful employment in short order. The experience of the banana shock revealed that in the absence of a well-functioning social protection mechanism, the dislocated labour flowed into the informal sector or migrated where this was possible. These difficulties arose even in the presence of a significant stock of financial resources under the STABEX arrangement for economic restructuring and diversification.

## 7. Administrative Issues in Fiscal Performance

There are a number of administrative and technical challenges which confront the budgetary processes in the ECCU. This can help to explain some of the governments' expenditure and revenue trends which were observed early in the paper.[4] The following are some weaknesses.

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4 This section draws heavily on preliminary information in the East Caribbean Economic Management Project (ECEMP) III assessment on the budgetary processes in the ECCU countries.

### *(i) The Budgetary Preparation Process is Weak*

There are no multi-year recurrent estimates linked to capital estimates.[5] Budgets are prepared with a planning horizon of one year. In addition, some estimates for income and expenditures are not based on tight analysis. Hence, there is no long-term view of government's tax and expenditure programmes. The result is an attempt to accomplish every possible programme in the one-year budget horizon, which makes it unrealistic. In most cases the budget is treated solely as a legal document. The budget is very centralised and is executed only when funds are available. The basic systems for the management of the budget are not always fully integrated and can be the source of numerous errors. For example, a number of countries have difficulty in the timely preparation of bank reconciliation. These problems create difficulties for the Treasury in recording important financial transactions of the government. Moreover, the public accounts committee of Parliament in some countries is ineffective. The accounts are invariably too far behind for the committee to meet regularly and be effective.

### *(ii) Policy Evaluation*

Minimal monitoring of results (outputs of the budget) is undertaken. The budget evaluation is mainly focused on inputs as opposed to results. Expenditure policy diagnosis is either non-existent or minimally done. The evaluation of effectiveness, efficiency, alternatives, optional scenarios or approaches of government programmes are

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5 The government of St. Vincent and The Grenadines has recently converted its budget to a multi-year framework.

limited. This is quite evident in relation to the relatively low emphasis given to the prioritization of projects in the public sector investment programme, leading to poor project selection practices. In any case, the implementation rates for the PSIP in most countries are generally low – less than 50 per cent. Finally, the current expenditure implications of capital projects are often not adequately captured in the project impact analysis. In any case, the current budget departments in many countries are too small with limited capacity, to effectively undertake this function.

### *(iii) The Fiscal Stance is Expenditure-Driven*

Capital expenditure is driven by the availability of loans. Therefore, debt is linked to specific capital projects. For example, customs and other revenue rates are adjusted as quick fixes to meet expenditure. There is generally limited tax policy analysis. Instead, each year, revenue is extrapolated based on the previous year's outturn plus a factor. This lack of analysis often results in significant over estimation, which in turn affects the fiscal and debt outturns. In general, therefore, expenditures drive the agenda. A more balanced approach to the budget and fiscal policy is therefore required. The first step is to forecast revenues for the upcoming period. Important variables in this process would be the tax policy for the future, and the state of the economy. On the other side, expenditure policy must be based on a framework which integrates the capital and current budgets into a multi-year planning horizon.[6] The next decision, which must be made based

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6 St. Vincent and The Grenadines has recently begun the preparation of the budget within a multi-year framework.

on the information from the previous stages, is the allocation of financial surpluses or new borrowing, privatizations and so on.

### *(iv) Lack of a Consistent Policy Framework*

Policy is generally not conducted within a consistent medium-term macroeconomic framework. As a result, fiscal policy has a tendency to be procyclical, amplifying the business cycle and the authorities' ability to respond to exogenous shocks is compromised. No sustainability analysis is conducted which often results in inconsistent financial policies and rapid accumulation of debt and payment arrears. The result of this inadequate policy framework is the rapid accumulation of public debt in some countries.

### *(v) Technical Capacity*

Technical capacity is severely limited within the ECCU countries generally, but more so in some countries. This is important in the areas of policy development - economic forecasting, tax policy, debt management and expenditure policy. An important component in this reformed budgetary framework is the extent of capacity within the various MOF. This capacity issue must be seen in the context of a public sector that generally has in most countries more labour than it requires to adequately complete its mandate. Perhaps precisely because of the large labour force, the required resources are not available to remunerate staff of the desired quality in sufficient numbers to conduct adequate policy analysis.

## 8. Fiscal Policy Reform and Other Initiatives

Some element of tax reform has been implemented in most countries. In St. Lucia, St. Vincent and the

Grenadines and Dominica, a major overhaul of the personal income tax arrangements was undertaken during the 1980s. The main thrust of this exercise was to raise the threshold and reduce the tax band.[7] The main elements of the tax reform measures in the various countries included the following:

### *(i) St. Vincent and The Grenadines*

The country entered two IMF programmes (November 1980, a standby arrangement and March 1981, a compensatory finance facility) in the early years of the period under review, but it does not appear that these had any specific fiscal reforms attached to them.[8] The first set of reforms over the review period was instituted in 1984. In particular, they centred on tighter controls of expenditure and restructuring of the tax system. It included an expansion of the consumption tax net and an increase in consumption tax rates, along with a general increase in licence fees. In line with this, there was also an increase in the income tax threshold. Other increases included a reduction of the upper end of the tax bracket; a standard deduction of EC$5000; a 5 per cent tax on airline tickets and an increase in a number of licence fees.

In the 1987/88 budget, another set of reforms were introduced but these focused mainly on a corporate income tax on profits earned from exports, which was reduced from 45 per cent to a range of between 25 to 35 per cent.

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7 This section draws heavily on *The Economic History of the ECCB Member Countries*, unpublished, ECCB Mimeo.

8 In 1981 the fiscal authorities awarded a wage increase of 30 per cent over three years.

The tourism sector also benefited from income tax exemptions of 9 to 15 years.

### *(ii) St. Lucia*

The reforms focused on expansion of the consumption tax and the raising of rates, along with an increase in the income tax threshold. This new system was gradually introduced over a three-year period. Other measures included the following:

(a) Corporate tax payments were shifted to a current year basis.

(b) A reduction in corporate tax rates to 33 per cent from 40 per cent for companies in existence before 1988.

(c) A reduction in stamp duties on imports.

(d) The introduction of a customs service charge.

(e) The introduction of a 5 per cent tax on gross earnings from banana (later repealed).

The government generally attempted to keep a tight rein on expenditure throughout the period under review.[9]

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9 A wage agreement covering the period April 1989 to March 1992 was concluded in 1992. This provided for retroactive increases in the following order: 15 per cent 1986 to 1989; 3 per cent between 1989 to 1991/92.

### *(iii) Dominica*

Dominica's reforms were part of two adjustment programmes entered into by the government of the day. In 1980 the government entered into a three-year extended fund facility with the IMF. The main objectives of this programme were to (i) increase public sector savings (ii) foster conditions for foreign investment and aid and (iii) reorient investment efforts to strengthen the balance of payments position. The main fiscal measures implemented under this programme were: an increase in consumption taxes and import duties; the elimination of subsidies to statutory bodies; an incomes policy aimed at restraining the growth of public wages. At the end of this programme the government entered a standby arrangement with the IMF for one year, with the principal aim of further improving central government savings and controlling the growth of external debt. These programmed measures along with good fortune appeared to have been successful during the period under review. During the latter half of the 1980s Dominica undertook a structural adjustment programme. The IMF, the World Bank, the Caribbean Development Bank and USAID supported this programme. Under this programme a complete tax reform was undertaken. The principal aim of this tax reform was the provision of incentives for private sector savings, increasing investment, and generating more revenues by broadening the tax base. The specific measures included the following:

(a) The abolition of export taxes.

(b) The repeal of the foreign exchange tax.

(c) The reduction of corporate tax rates from 45 to 30 percent.

(d) An increase in the threshold on personal income taxes.

(e) The introduction of a development levy on the banana income windfall.

(f) A reduction in the basic consumption tax rate to 20 per cent, with a few exemptions.

(g) The introduction of a 3 per cent sales tax.

(h) The introduction of a customs service charge.

(i) The reduction of the hotel occupancy tax to 10 per cent on the sale of rooms and meals.

(j) The repeal of the bank deposit tax.

(k) The introduction of a tax investment credit scheme. Write-off losses over a three-year period was allowed.

(l) A freeze on employment in the public sector.

***(iv) Grenada***

The main fiscal reform programme was introduced in Grenada in 1986. The main focus of this reform was to assist private sector growth. The basic aim therefore was to shift the economy from one controlled by the state to one based on free enterprise. The government believed that the tax system needed to facilitate an increase in the capacity and aggregate domestic supply in Grenada. Among the measures introduced were the following:

- Personal income tax was abolished;
- A value added tax (VAT) was introduced;
- A modified land value tax was introduced;
- A business levy was introduced;
- A petrol levy was introduced;
- A programme of public sector retrenchment was implemented. This was specifically geared towards the reduction of current expenditure.

This programme encountered significant difficulties on its implementation. In particular, there were frequent adjustments to the business levy and VAT. Due to poor preparatory work and communication with the general public and lack of administrative capacity in the public sector, it created significant fiscal problems for the fiscal authorities. These difficulties eventually caused the repeal of the VAT. The property tax was never introduced. Finally the retrenchment programme was poorly managed and only resulted in the most skilled civil servants leaving the service. As a result of these difficulties, the tax base became severely eroded and the public finances deteriorated. During this period also, the government was forced to pay $25m in arrears of wages and salary to civil servants. With the deterioration in the fiscal situation, the government was forced into a fire sale of some state assets to meet current expenditures, including the sale of the Grenada Telephone company.

In 1991 another round of measures was implemented. A principal measure in this programme was the introduction of a 10 per cent debt service levy on all incomes above $12,000 EC per annum. In addition, the government reduced its expenditure. Finally, to restore fiscal balance the authorities entered a three-year structural adjustment programme (1992-1994). In broad terms the programme aimed to streamline the operations of the public sector; raise tax revenues and control expenditures. In a sense it is reasonable to conclude that the fiscal and economic successes which Grenada is experiencing today rest with the successful fiscal adjustment undertaken through the structural adjustment programme.

### *(v) St. Kitts and Nevis*

The main fiscal reform measures introduced by the government over the period under review included:

(a) The abolition of personal income tax in 1980.

(b) The partial divestiture of the telephone department. This was sold to Cable and Wireless, which formed a joint venture with the government and local private sector call SKANTEL in 1985.

(c) The introduction of an Alien employment levy, a gasoline levy and various other measures in the 1980 to 84 period.

(d) Effective corporate tax rate reduced from 55 per cent to 50 per cent in 1985.

(e) A further reduction in corporate income tax to 45 per cent in 1988 then to 40 per cent in 1989.

(f) Exchange controls on the US dollar (were suspended). Suspension of each controls the US dollar.

(g) Provision of tax exemptions (were provided) on company profits related to interest income – deposits in local banks.

(h) Tax relief on income earned by banks on loans for land, mortgages or construction. The mortgages had to be over 15 years in length.

(i) Abolition of the foreign exchange tax was abolished.

(j) Instead of a social services levy of 4 per cent (was introduced) on wages and salaries.

(k) Introduction of an employment protection levy of 2 per cent (was also introduced).

(l) Increase in consumption taxes (were also increased) along with import duties.

***(vi) Antigua and Barbuda***

The government over the period under review has undertaken no major fiscal reform programme. A number of measures have, however, been implemented from time to time. In the period 1980 to 1984 a new business tax of 25 per cent was introduced. During this period also there were increases in the guest departure, property and consumption taxes. A customs service charge was introduced in 1986, along with hikes in guest service levy, embarkation and telephone taxes. The consumption tax base was also broadened in 1986.

Interestingly, over the period the government awarded sizeable wage and salary increases to civil servants: in particular, 20 per cent in 1987; 15 per cent in 1988; 10 per cent in 1989 and 6.5 per cent in 1990. Importantly also, the government, having graduated from concessional lines of credit, was now forced to borrow on commercial terms for public sector projects.

### *(vii) Montserrat*

The graduation from the grant-in-aid in 1981 apart, there were no significant fiscal reform measures over the review period. Over the period under review, before the volcano crisis, expatriates and also offshore banking activity drove much of the local economic activity. The rules surrounding the operation of the offshore sector were tightened significantly in the mid 1980s, which led to a fall in revenues. Since the volcano crisis, the British government has been forced to provide significant budgetary assistance.

In 1986 the authorities embarked on a particular fiscal strategy aimed at providing tax relief in an effort to provide incentives to the private sector and thereby promote savings and investment. The basic driving force for this new strategy was the distortion effect of the inflationary episode of the 1970s and 1980s on the tax structure. The basic provisions of the new structure included:

- An exemption of up to EC$5000 from taxes.
- Rates chargeable on income ranged from 10 to 30 per cent.
- An EC$15,000 threshold for chargeable income.
- The separate assessment of husbands and wives for income tax purposes. There was, however, to be a standard deduction of EC$5000.

- Mortgages on residential accommodation deductible up to EC$3000 per annum against total annual income.

In addition, all countries have signed on to the Common External Tariff of Caricom (CET), and have proceeded to lower their rates. It is likely that this adjustment on its own would have had a negative impact on government revenues. However, most fiscal authorities made compensating adjustments in other charges, such as the customs service charges. These would, in most cases have nullified the impact of the tariff reductions. A new set of reforms is being discussed at a regional ECCU level by an expert group of tax commissioners, established by the Monetary Council of the ECCB to provide advice on tax reform initiatives to the national governments of the ECCU. Among the issues under active discussion is the feasibility of a transactions based tax, such as the VAT. Another policy initiative is the expenditure review being coordinated by the World Bank. In general, for most of the ECCU countries, public sector investment programmes have emphasised physical infrastructure. In existence and functioning is the Debt Coordination Committee, which seeks to manage and regulate the regional government securities market to ensure that it functions in an orderly manner and that debt policies are in line with the long-term development potential of the market. Finally, all countries have agreed to develop home-grown stabilization programmes, with the assistance of the ECCB and the Caribbean Technical Assistance Centre (CARTAC). The basic aim of this programme is to put the fiscal situation in each country back on an even keel, whilst also providing the necessary training to local technicians.

## 9. Conclusions

This chapter provided several insights. First, it revealed that approximately 75 per cent of the tax revenues for the ECCU is obtained from indirect taxes. More importantly for the ECCU is that approximately 57.5 per cent of all tax revenues is from taxes on international trade. And correspondingly, is the relative insignificance of tax revenues from domestic transactions. With the liberalisation of the world's trading regimes, the fiscal base of these economies, other things being equal, would be severely eroded. Second, there was a trend fall in tax revenues as a per cent of GDP over the period and by implication, the total revenues tax-effort has fallen. This fall in revenues as a proportion of GDP has not generally been matched by a fall in expenditure to GDP. As a result, there has been a corresponding rise in public debt over the period. Third, buoyancy of the tax regime is generally low. This outcome is likely to be the result of the plethora of concessions and exemptions, both programmed and *ad hoc.* These concessions, even the programmed ones, are not generally monitored, which creates opportunities for abuse. Fourth, the capacity within the MOFs of the ECCU countries is generally weak, but particularly so in some countries. As a direct result, the budgetary process is expenditure-driven, within a weak policy framework. Most countries do not possess development plans and in any case, the capital and recurrent budgets are not usually integrated or multi-year in scope. The expenditure management process is input-driven with little or no evaluation of policy results. The information basis for policy formulation and evaluation is generally weak, but particularly so in some countries. This specifically refers to the capabilities of the statistical offices in the member countries of the ECCU. Fifth, the philosophy of the regional governments from time to time has determined the focus of expenditures. In recent times, most governments in the ECCU in their budgetary allocations have shifted significant resources to social expenditures and thereby to certain sectors in the society. Sixth, the main policy lever for adjustment on the expenditure side, given its composition within the ECCU, is personal emoluments. However, in the context of a stagnant private sector, governments have had great difficulty in retrenching significant numbers of workers. Indeed, the government of Antigua and Barbuda has often argued that public sector employment is one of its main policy initiatives as it relates to poverty reduction.

Among the implications for policy is an urgent need for an improvement in the budget policy formulation and monitoring and evaluation framework. A key component of this framework is the improvement in the technical capacity of the MOF. This framework must also fit within an overall medium-term macroeconomic framework for public policy. Secondly, in the adjustment of expenditures cuts ought to be based on none growth-associated expenditures. In this regard, the authorities would be required to provide more resources for health, education and other basic infrastructure. This infrastructure is required by the private sector, if they are to expand the scope of their activities and thereby facilitate more employment and growth possibilities. To achieve this, the fiscal authorities would be required to improve project evaluation and selection processes, so that only high impact growth and employment are undertaken. In addition, the authorities must seek to improve the project implementation ratios. In general, the authorities need to set a number of targets at the micro level to control the entire process. Thirdly, given the imminent reduction of trade tariffs in line with obligations of the WTO and NAFTA, a tax regime which facilitates export competitiveness and integration ought to be adopted with appropriate modifications where required to make it suitable for local circumstances.

Finally, a generalized review of tax policy is suggested. Such a review ought to take into account the impact of taxes on uncertainty and risk-taking by the private sector.

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# 7

# The Sustainability of Fiscal Policy in the ECCU[1]

*Garth Nicholls*

## 1. Introduction and Overview

Fiscal policy is an important instrument which has been used to jumpstart growth and development for all countries. Indeed the growth literature has identified the positive impact of certain government spending for future growth. Fiscal policy, and in particular government borrowing, is also an important anti-cyclical instrument where households face

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1 The ECCU represents the Eastern Caribbean Currency Union, which consists of the following countries; Anguilla (Ang); Antigua and Barbuda (ANT); Dominica (DOM); Grenada (Gda); Montserrat (MON); St. Kitts and Nevis (SKB); St. Lucia (SLU) and St. Vincent and the Grenadines (SVG).

liquidity constraints due to financial market imperfections. In this regard, public sector borrowing is important for tax and consumption smoothing (Barro, 1974). Implicit in this analysis is the need for government to reduce borrowing and debt as the economy develops with a higher permanent income level and a dynamic private sector. These are important issues for less developed countries which seek to jump-start growth and development in an environment characterized by a weak domestic private sector and significant infra-structural bottle necks.

In recent times, however, there has been a rise in the frequency of financial crisis in less developed countries, apparently due to fiscal indiscipline. The recent financial crisis in Argentina and Brazil and before that, in Mexico, are real examples of cases where large fiscal deficits and the resulting growth of public debt have been a principal cause of currency crisis.

High public debt is a central policy concern for several reasons. First, large fiscal deficits and debt have adverse impacts on private sector incentives to save and invest as public sector dissaving is not compensated by the private sector (see Agenor and Montiel, 1999). Therefore, larger fiscal deficits are associated with lower national saving. Moreover, government deficits, at least in the short run, shift resources from the private sector. The rate growth of government debt adversely impacts private sector savings nonlinearly (see Giavazzi *et. al.*, 2002). Hence, other things being equal, excessive public deficits and debt will lower the total productivity of investments, and thereby growth, over the long run. In addition, there are a number of financial risks associated with an unsustainable public debt policy. In particular, the following are regarded as paramount: market risk, interest rate and exchange rate. In addition, commodity price changes can have deleterious impacts on the government budget deficit and roll over risk. High debt can result in difficulty in the private sector agreeing to continue to hold the debt when issued a second time. Other risks associated with excessive public deficits, include liquidity risk, credit risk, settlement risk and operational risks. The conceptual difficulty, therefore, emerges as to what is the permissible deficit and debt levels, sufficient to have a net positive impact on growth and development, without becoming dysfunctional. A further important question in the current international environment is the precise role of the public sector in economic development.

During the 1980s the debt to GDP ratio hardly moved in the ECCU area, despite sizeable deficits on account of rapid growth and the concessional nature of interest rates on public debt. In the late 1990s, with the fall-off in the performance of the export sectors, the graduation of some of the countries from concessional loans by multilateral financial institutions and the increase in commercial borrowing by the public sector, the real interest rate on public debt rose rapidly. Accordingly, the favourable interest rate dynamics and net public debt started to grow. From a low of 44.8 per cent of GDP at the end of 1989, they increased to an estimated 79 per cent of GDP at the end of 2001. In recent years the persistent primary deficits and high interest rates in the ECCU have raised concerns about the sustainability of the public debt dynamics and macro-economic stability. Further delays in the adjustment of the actual to the required primary balances will continue to increase the adjustment needed to stabilise the debt dynamics. A delay in adjustment has two impacts: it shifts the debt path upward and changes its slope, given the increasing interest burden incurred by the growing debt. Therefore the required fiscal adjustment to stabilize the debt dynamics becomes much larger the longer the delay in commencement of the adjustment.

The notion of fiscal sustainability is descriptive of a situation where the government's fiscal programme is consistent with the solvency requirements (Razin 1996). Projected into the indefinite future its fiscal programme should be consistent with sustained growth and not be subject to sudden and abrupt changes even when the economy is hit by a shock. In a broad sense the sustainability of government's fiscal programme depends on the overall macroeconomic policy mix, the expenditure and revenue levels, along with the structure of public debt.

The literature identifies two broad approaches to the measurement of fiscal sustainability. The first is the accounting approach, which essentially judges fiscal sustainability on the basis of whether the debt to GDP ratio remains stable over time. The basic requirements for this are negative interest rate growth differential and fiscal surpluses. In this class are the works of Buiter (1997), Buiter and Petal (1992), Haque and Montiel (1994) and Anand – Wijnbergen (1989). The second approach to sustainability is the present value constraint. This approach requires the discounted value of expected debt to GDP to converge to zero over time. The current debt is offset by the sum of current and expected future discounted surpluses, implying that the budget constraint holds in present value terms. This approach has been applied to test sustainability, essentially in the OECD countries, by Flavin-Hamilton (1986), Trehan-Walsh (1988), Corsetti-Roubiuni (1991), Hakkio-Rush (1991) and Ahmed-Roger (1995). The studies on the ECCU conducted thus far are those by Venner and Williams (1995), Browne (1996) and Marquez (2000) which used a menu of methods including ratios to provide judgements about fiscal sustainability. This paper utilises the accounting approach to measure fiscal and debt sustainability in the ECCU.

The general objective of this paper is to conduct an historical analysis of the fiscal and debt policy strategies to determine how sustainable these policies have been. This paper has three specific objectives. First, to identify the extent and nature of the public debt of the ECCU; second, to determine whether fiscal policy has been sustainable; and third to investigate a fiscal adjustment path to a lower debt to GDP ratio.

Fiscal and debt sustainability discussed in this chapter uses the framework employed by Dihn (1997) and Buiter (1997). In particular, it measures sustainability by defining a path for the primary balance, which would maintain a stable debt to GDP ratio. Therefore the difference between this calculated and the actual path is described as the primary gap.

The outline for the remainder of the paper is as follows. In Section two, some stylised facts about the debt levels and profile in the ECCU and specific countries are highlighted. Section three provides a review of the literature as it relates to the study of fiscal sustainability within the context of the ECCU. A conceptual framework for the analysis of fiscal sustainability is provided in section four, whilst an analysis of fiscal sustainability within the ECCU is done in Section five. Finally, a summary and conclusion are provided in Section six.

## 2. Stylised Facts

### 2.1. Central Government Debt to GDP Ratios

Averaged between 1984 and 2000, there has been a rise in the debt to GDP ratio of the countries of the ECCU, except Grenada, which has witnessed a decline. The largest increase in the central government debt to GDP ratio between the 1980-84 and 1996-2000 period occurred in

St. Kitts and Nevis, and Antigua and Barbuda, rising in both cases by over 35 percentage points. The country with the next highest movement was Dominica, which rose by 19.2 percentage points. Moreover, based on the numbers in Table 1, St. Kitts and Nevis, Dominica, and Antigua and Barbuda are the three most highly indebted countries in the ECCU.

### 2.2. Maturity Structure of the Central Government Public Debt

As at December 2000, approximately 81.2 per cent of external loans were for periods greater than 10 years for the ECCU as a whole, whilst 16 per cent were for periods between 5 to 10 years. St.Vincent and the Grenadines had the highest proportion of maturities over 10 years, followed by Grenada, Montserrat, Dominica and St. Lucia. On the other hand, Anguilla had the lowest at 69.5 per cent of total debt in the 10> maturity structure. Therefore, from an over all perspective, the public debt of central government is substantially long-term debt.

### 2.3. The Economic Classification of the Central Government Public Debt

Four main sectors account for over 80 per cent of the disbursed and outstanding external public sector debt (see Table 3). These sectors are utilities, multisector projects, industrial development and a collection of other projects which include the environment, health and social welfare, rural development, etc. In 1994 the utilities accounted for 24.4 per cent of the debt disbursed and outstanding, whilst tourism-related projects accounted for the second largest share, 17.7 per cent of total loans. In 2000, however, the majority of the loans disbursed and outstanding were for a collection of projects, including energy, environment, health and social welfare, information and tech-

**Table 1: Central Government Debt to GDP Ratios, Period Averages**

| Country | 1980-2000 | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|---|
| Anguilla | 2.5 | N.A. | N.A. | N.A. | N.A. | 2.7 |
| Antigua and Barbuda | 77.3 | 62.4 | 70.4 | 75.3 | 80 | 98.1 |
| Dominica | 73.6 | 57.8 | 65.8 | 71.6 | 84 | 85 |
| Grenada | 60.7 | 63.6 | 75.8 | 68.1 | 51.5 | 47.3 |
| Montserrat | 16.1 | 13 | 11.9 | 8.1 | 18.2 | 27.7 |
| St. Kitts/Nevis | 65.6 | 55.2 | 53.8 | 58.9 | 59.5 | 92.5 |
| St. Lucia | 30 | 46.3 | 26.8 | 19.6 | 25.9 | 32.2 |
| St. Vincent & the Grenadines | 41 | 42.3 | 38.9 | 37.3 | 35.8 | 47.5 |
| **ECCU** | **49.2** | **56.1** | **47.8** | **41.9** | **42.6** | **55.8** |

**Source:** Author's calculations and ECCB *Debt Digest*, various issues.

**Note:** N.A. is not available.

nology and rural development. The second highest allocation (19.9 per cent) went to utilities and 14 per cent was allocated to multi-sector projects. In 2000 tourism-related projects accounted for 10.8 per cent of total loans disbursed and outstanding.

**Table 2: Maturity Structures of the External Debt (In Years)**

| Country | 5-10 | 10> |
|---|---|---|
| Anguilla | 22.0 | 69.5 |
| Antigua and Barbuda | 19.6 | 78.0 |
| Dominica | 15.0 | 83.6 |
| Grenada | 7.2 | 88.1 |
| Montserrat | 14.8 | 85.2 |
| St. Kitts/Nevis | 28.2 | 69.8 |
| St. Lucia | 17.3 | 80.7 |
| St. Vincent & the Grenadines | 4.3 | 93.5 |
| **ECCU** | **16.4** | **81.5** |

**Source:** ECCB *Debt Digest*, various issues.

**Table 3: Outstanding Central Government Debt by Selected Sectors (As a percentage of total disbursed loans)**

| Sector | 1994 | 2000 |
|---|---|---|
| Agriculture | 5.2 | 3.5 |
| Industrial Development | 16.5 | 7.39 |
| Multi-sector projects | 14.7 | 13.96 |
| Other | 4.04 | 28.8 |
| Tourism | 17.7 | 10.75 |
| Utilities | 24.4 | 19.72 |
| Other Sectors | 17.5 | 15.9 |
| **Total** | **100** | **100** |

**Source:** ECCB *Debt Digest*, various issues.

## 2.4. Concessional External Debt of the Central Government

Between 1994 and 2000 the proportion of debt secured on concessional terms has declined to 71 per cent of total debt. In 1994 it was 82.2 per cent of total debt. St.Vincent and the Grenadines had the largest fall in the proportion of loans to central government as concessional, 34.9 percentage points. Grenada suffered a loss of 31.7 percentage points followed by St. Kitts and Nevis, 28.2 percentage points. It was only Antigua and Barbuda and Montserrat which actually increased their share of concessional debt in total debt over the period.

**Table 4: Concessionality of the External Debt of Central Government (In per cent of total debt)**

| Country | 1994 | 2000 |
|---|---|---|
| Anguilla | 76.5 | 64.9 |
| Antigua and Barbuda | 45.5 | 72.1 |
| Dominica | 99.9 | 93.2 |
| Grenada | 94.7 | 63.0 |
| Montserrat | 78.4 | 94.7 |
| St.Kitts/Nevis | 82.7 | 54.4 |
| St.Lucia | 85.4 | 66.7 |
| St.Vincent & The Grenadines | 94.7 | 59.8 |
| **ECCU** | **82.2** | **71.1** |

**Source:** Author's calculations and ECCB *Debt Digest*, various issues.

## 2.5. Debt Service Ratios, etc.

Based on readily available external debt data, the various indicators of external debt showed a slight upward drift. External debt to exports of goods and services, which was 3.57 per cent in 1994, rose to 6.35 per cent by 2000. Also, debt service payments to current revenues rose from 9.4 per cent in 1994 to 14.25 per cent in 2000. Debt service to exports of goods and services ratio was highet. in St.Kitts at 14.2 per cent and lowest in Monsterrat at 0.7 per cent. In terms of debt service to current revenues three countries stand out, Antigua at 15.9 per cent, St.Kitts and Nevis at 21.5 per cent and St.Lucia at 20.6 per cent.

**Table 5: External Debt Service Ratios**
**(cash basis)**

| Countries | Debt Service to Export of Goods and Services | | Debt Service to Current Revenues | |
|---|---|---|---|---|
| | 1994 | 2000 | 1994 | 2000 |
| Anguilla | 1.27 | 1.96 | 5.2 | 4.8 |
| Antigua and Barbuda | 2 | 4.11 | 8.4 | 15.9 |
| Dominica | 7.26 | 5.2 | 14.3 | 9 |
| Grenada | 5.34 | 2.56 | 9.85 | 5.8 |
| Montserrat | 2.2 | 0.7 | 3.8 | 1.55 |
| St. Kitts/Nevis | 5.1 | 14.2 | 12.5 | 21.5 |
| St. Lucia | 3.13 | 9.8 | 8.3 | 20.6 |
| St. Vincent & the Grenadines | 5.7 | 6.1 | 9.3 | 11.1 |
| **ECCU** | **3.57** | **6.38** | **9.4** | **14.3** |

**Source:** Author's Calculations and ECCB *Debt Digest*, various issues.

## 3. Literature Review

A number of studies have been conducted on the question of fiscal and debt sustainability. However, most of these studies have been conducted for developed countries. Only a few have been done for developing countries generally and three for the ECCU in particular. There are two basic approaches used in the literature to the study of fiscal and debt sustainability. The first approach of work uses an accounting approach to sustainability. In the accounting approach to sustainability, the debt to GDP ratio will stablise and the economy will remain solvent if, over time, the expected value of the debt stock tends to zero. This result requires first that the real interest rate on the debt be less than the rate of real GDP growth so that the debt GDP ratio stabilises rather than explodes. Then, the fiscal accounts ought to be in surplus on average, so that the debt burden is ultimately liquidated. The sustainability condition and negative growth-adjusted interest rate ensure that any stable path of the primary government deficit is consistent with a stable public debt to GDP ratio. Thus the government is solvent no matter how large its initial net public debt. The level of public debt may be stablised around a chosen steady-state value by selecting a primary deficit. To obtain the real resource transfers necessary to effectively manage the public debt, the primary balance must on average be in surplus.

The accounting approach has been used to assess the consistency among various macroeconomic policy targets. The accounting approach focuses on steady states and assumes that a fiscal deficit (or surplus) that leads to unchanging debt/GDP ratios over time is sustainable. The accounting approach can also be used to analyse the time path of adjustment in the primary surplus over a period of time which will result in a specified fall in the debt to GDP ratio. In this class are the works of Anand and Wijnbergen

(1989) which used the accounting approach to measure fiscal sustainability in Turkey. Buiter and Patel (1992) also conducted a study on the sustainability of fiscal policy in India. Haque and Montiel (1994) did a similar study for Pakistan. Buiter (1997) analysed the long-term sustainability of fiscal issues faced by transition countries, using the accounting approach to sustainability. A major drawback of the accounting approach is that it assumes that debt can grow in line with GDP, without explicit modelling of the behaviour of the state's creditors. This is important since in the final analysis the debt strategy is sustainable only if the state can secure willing holders of its debt.

The second class of studies utilizes a present value constraint (PVC) approach, which suggests the authorities cannot sustain the debt burden, no matter what sequence of primary deficits are chosen, unless the debt stock itself can be offset by matching the sequence of increasing but discounted primary surplus in the future. For sustainability, it requires that as time goes to infinity the discounted value of the expected debt to GDP ratio converges to zero. That is the government solvency constraint or transversality condition. This implies that a government is solvent if the transversality condition guarantees the non-explosiveness of its public debt and when no ponzi games are allowed. Therefore, current debt is offset by the sum of current and expected future discounted surpluses, implying that the budget constraint holds in present value terms. The PVC approach begins from the premise that the sustainability of fiscal policy ultimately depends on what level of deficit is financiable. This in turn, depends on the behaviour of lenders.

Various methods have been used to test whether the government's fiscal policy packages violate the PVC condition. Favin-Hamilton (1986), using data for the

United States (US) over the period 1960 to 1984, applied the stationary tests on the deficit and debt. Both variables were stationary and they concluded that US fiscal policy was sustainable. Trehan and Walsh (1988) and (1991) also used US data and applied stationarity analysis to test for fiscal sustainability over two separate periods, 1980-86 and 1960-84 respectively. In both periods the variables were found to be stationary and thereby concluded that US fiscal policy was sustainable. Mixed results were, however, reported by Corsetti-Roubiuni (1991) in a wider study of OECD countries. They tested for stationarity of the discounted debt and the existence of a time trend.

Two studies, Hakkio-Rush (1991) and Ahmed-Roger (1995), applied cointegration techniques to test for fiscal sustainability on US and UK data. Hakkio-Rush's study employed US data over the period 1950 to 1988. The cointegration test was done on government revenue and spending inclusive of interest. They obtained different results for different periods. Ahmed-Roger (1995) tested whether US and UK real government tax revenue, expenditure, and real interest payments were cointegrated. The variables were all cointegrated, which implied that fiscal policy was sustainable.

There are three published studies on some aspects of debt and fiscal sustainability in the ECCU. The first study, done by Venner and Williams (1995), analysed the substitution of external debt with domestic debt in the currency union. They essentially analysed the impact of this activity on the budgetary operations, balance of payments position and monetary conditions in the ECCU. This study did not specifically attempt to measure the impact of this operation on the sustainability of the fiscal outcomes. However, the study suggested that as foreign concessional resources declined the authorities would be forced to borrow at commercial terms on the domestic market, and by necessity would be required to increase the productivity of their investments, if they were to avoid running into a fiscal crunch.

Browne (1996) analysed the relationship between debt sustainability and the performance of the export sector. The paper highlighted the vulnerability of ECCU countries to external shocks and their limited capability to absorb such. An inter-disciplinary approach which integrates decisions about borrowing and lending is proposed as the key factor in successful debt management. This study placed great emphasis on the issue of fiscal prudence at the country level and the need for pre-emptive stabilisation programmes, since in most of the debt reduction and relief packages, which exist currently, the members of the currency union do not qualify to receive assistance. Part of the domestic fiscal management practices put forward is the need for tighter controls on debt authorisation, especially for public sector corporations.

Marquez (2000), using a menu of ratios, analysed the sustainability of the debt policies of the member countries in the ECCU. Among the factors considered in the analysis of debt sustainability in the ECCU were the nature of the external debt outstanding, interest rates and the general terms of external debt contracted, the currency composition of the external debt, debt servicing and the accumulation of arrears, rescheduling, the level of concessionality of loans contracted, maturity periods, and finally the exports of goods and services. The main conclusion which emerged from this study was that, based on traditional ratios used to assess debt sustainability, the ECCU countries appeared to have sufficient room for extra external borrowing. However, on a closer analysis of all the considerations of sustainability and the extent of payment arrears, late payments, debt foregiveness and rescheduling already provided to member countries, the debt policies were rapidly approaching a state of unsustainability. Given this conclusion, a number of recommendations were provided, aimed at improving the productivity of government expenditures and debt management and negotiation practices in a consistent macro-economic framework.

In summary, each of these studies on the ECCU hinted at the potential of a fiscal and debt sustainability problem in the ECCU. These papers, however, suffered from two main weaknesses. First, they all focused solely on either domestic or external debt. Therefore, a full view of the sustainability of the fiscal and debt policy packages was not possible. The second shortcoming of these efforts was their static nature. Sustainability of fiscal and debt policies has to be assessed over a period, preferably over a future policy horizon. None of the papers attempted to generate this path for the assessment of fiscal sustainability.

## 4. Conceptual Framework

The notion of fiscal sustainability is descriptive of a situation where the government's fiscal programme is consistent with the solvency requirements( Razin 1996). Therefore, projected into the indefinite future its fiscal programme is consistent with sustained growth and not subject to sudden and abrupt changes even when the economy is hit by a shock. In a broad sense the sustainability of government's fiscal programme depends on the overall macroeconomic policy mix, the expenditure and revenue levels, along with the structure of public debt. In terms of adjustment, the issue is the level and structure of adjustment in expenditure and revenue needed to ensure that a fiscal policy programme becomes sustainable.

Following Dinh (1997) and Buiter (1997) the solvency of the public sector is assessed using the accounting approach. In the long run, at the very least, the fiscal policy strategy for the ECCU must be that the public sector observes its inter-temporal budget constraint, that is, the net present value of its net asset must be equal to or greater than zero.

Let us start with the public sector budget constraint (nominal) given in equation (1),

$$\Delta B_t = -s_t + r_t B_t \tag{1}$$

Where $\Delta$ represents change, $B_t$ – government debt at period *t*, $r_t$ is interest rate on government debt and $s_t$ is the primary balance. To give the level of debt at period *(t)*, equation (1) can be reordered and expressed in percentage of GDP, giving Eq. (2),

$$b_t = \left[\frac{(1+r)}{(1+g)}\right] * b_{t-1} - s_t \tag{2}$$

where $b_t$ is debt to GDP, $s_t$ is the primary balance to GDP, $g$ - growth rate of GDP between *t* and *t-1*. The change in debt/GDP ratio is given as equation (3).

$$\Delta b_t = \left[\frac{(r-g)}{(1+g)}\right] * b_{t-1} - s_t \tag{3}$$

By setting the change in the debt/GDP ratio to zero, equation (3) becomes the condition for **public sector solvency**

$$s_t = \left[ \frac{(r-g)}{(1+g)} \right] * b_t \qquad (4)$$

Equation (4) therefore represents the level of the primary surplus required to keep the debt to GDP ratio constant. In other words, it is to ensure that the government's debt and fiscal policy strategies are sustainable, given the targets for growth and interest rates. A higher $s_t$ for debt service implies fewer resources for other uses. One of the important variables for public sector solvency is the interest rate growth differential $[(r-g)]$. If the $s_t$ is equal to zero, the debt to GDP ratio would evolve according to the growth interest rate differential. If it is positive, then the debt to GDP ratio grows continuously; and conversely if the primary balance is in surplus the debt to GDP ratio will grow slightly slower than the growth interest rate differential. Equation (4) provides a method to assess a country's fiscal position over time. The solvency of the public sector is measured as the difference between the actual primary surplus and the calculated primary balance. If the difference is positive, meaning that the actual surplus is less than the required primary balance, then a fiscal adjustment indicated by the difference is required.[2] The evolution of this indicator over time shows whether a country is moving closer or farther from a fiscal solvency position.

## 5. Data and Analysis of Fiscal Sustainability

The data for this analysis are taken from the ECCB's database on the ECCU economies. In particular, the income

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2 Perhaps even more important than the quantitative fiscal adjustment is the quality of fiscal adjustment.

and expenditure accounts are obtained from the financial programming framework of member countries of the ECCU, whilst the data numbers are derived both from the external debt data base CDRMS programme and checked for consistency within the flow of funds framework. Other aspects of the data base such as average maturity and concessionality of the debt are taken from the ECCB's external debt digest. The interest rates used in this work are based on an average of interest rates observed on external and domestic debts. Finally, the real economic growth rates are obtained from the National Accounts Digest of the ECCB.

### 5.1. Dynamics of Public Debt in the ECCU

Based on Table 6, the ECCU in general has experienced favourable debt dynamics over the last twenty years. Indeed, five countries (Anguilla, Montserrat, St. Kitts-Nevis, St. Lucia and St. Vincent) averaged over the last twenty years, would have reduced their debt. On the other hand, Antigua, Dominica and Grenada, would have added to their debt burdens.

A different picture is painted, however, if the analysis is conducted on the basis of data for the last sub-period 1996 to 2000. Table 7 reveals that in recent times the ECCU has steadily accumulated public debt, approximately 1.2 per cent of GDP per annum between 1996 and 2000.

During the sub-period 1996-2000, only three countries, Grenada, Montserrat and St. Lucia, experienced a favourable public debt dynamics. **In the case of Montserrat, the British Government, precisely because of damage caused by natural events, is servicing their debts. It has also provided substantial budgetary aid to Montserrat reflected in sizeable overall primary**

**Table 6: Public Debt and Debt Dynamics, Period Averages, 1980-2000**

| Country | Real Interest Rate | Real GDP Growth | Primary Balance | Debt/ GDP (1980-2000) | Debt Dynamics |
|---|---|---|---|---|---|
| Anguilla | 2.0 | 7.0 | 1.16 | 2.5 | -1.3 |
| Antigua/Barbuda | 4.0 | 5.0 | -0.6 | 77.0 | 0.2 |
| Dominica | 1.0 | 4.0 | -4.76 | 72.7 | 6.9 |
| Grenada | 3.0 | 5.0 | -4.98 | 60.7 | 6.2 |
| Montserrat | 1.0 | -2.0 | 1.04 | 16.1 | -0.6 |
| St. Kitts/Nevis | 1.0 | 4.0 | -0.77 | 65.5 | -1.2 |
| St.Lucia | 3.0 | 5.0 | 0.65 | 30 | -1.3 |
| St.Vincent & the Grenadines | 2.0 | 5.0 | 2.62 | 41 | -3.9 |
| **ECCU** | **2.0** | **5.0** | **-0.96** | **49.6** | **-0.10** |

**Note:** Debt dynamics or the implied annual change in the debt –to-GDP ratio. The estimate is based on the following formula: $\Delta = d(r-g) - s,$ where $\Delta$ denotes change and the variables are d: government net debt to GDP ratio; s: primary balance to GDP; r: real interest rate; and g: real GDP growth.

**Source:** Author's calculations

**Table 7: Public Debt and Debt Dynamics, Period Averages, 1996-2000**

| Country | Real Interest Rate | Real GDP Growth | Primary Balance | Debt/ GDP (1980-2000) | Debt Dynamics |
|---|---|---|---|---|---|
| Anguilla | 3.0 | 5.0 | -0.84 | 2.7 | -0.79 |
| Antigua/Barbuda | 7.0 | 5.0 | -1.33 | 98.1 | 3.3 |
| Dominica | 3.0 | 2.0 | -1.11 | 85.0 | 1.96 |
| Grenada | 4.0 | 6.0 | -0.85 | 47.3 | -0.10 |
| Montserrat | 1.0 | -15.0 | 5.2 | 27.7 | -0.77 |
| St. Kitts/Nevis | 5.0 | 5.1 | -4.99 | 92.5 | 4.88 |
| St. Lucia | 4.0 | 2.0 | 1.88 | 32.2 | -1.24 |
| St. Vincent & the Grenadines | 4.0 | 3.0 | -0.15 | 47.5 | 0.63 |
| **ECCU** | **4.0** | **3.0** | **-0.61** | **55.8** | **1.2** |

**Source:** Author's calculations.

**surplus.** St. Kitts and Nevis experienced the least favourable debt dynamics, adding approximately 4.9 per cent of GDP per annum to its debt stock over the period under consideration. Part of the story behind the public debt dynamics rests with the growth-adjusted interest rates.

Table 8 provides information on the growth adjusted real interest rates faced by the public sector in the ECCU. In general over the period, it is only in the last two sub-periods, that real interest rates (growth adjusted) were positive. (This indeed was a favourable state of affairs for the countries). In the period 1996 to 2000, apart from Montserrat the country with the least favourable growth adjusted interest rates was Antigua and Barbuda and St. Lucia, both at positive 2 per cent. On the other hand Grenada at negative 2 per cent experienced the most favourable growth adjusted interest rate.

### 5.2 Have the Fiscal Policies of the ECCU Been Sustainable?

Based on the calculations reported in Table 9, on average over the 1980 to 2000 period the ECCU as a whole has pursued marginally sustainable fiscal policy programmes (**negative primary gaps indicate a sustainable fiscal policy stance and conversely for positive primary gaps**). However, this aggregate result masks serious fiscal problems of some of the individual countries. In particular, over the entire period of analysis, there were four countries which, on average, pursued fiscal policies which were unsustainable. The first two were Grenada and Dominica, which generated primary gaps of approximately 3.6 per cent and 3.4 per cent of GDP respectively. The other two countries, Antigua and Barbuda and Montserrat pursued policies which were marginally

**Table 8: Growth Adjusted Real Interest Rates on Public Debt**

| Country | 1980-2000 | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|---|
| Anguilla | -5.0 | | -14.0 | -7.0 | -1.0 | -1.0 |
| Antigua/Barbuda | -0.45 | -3.0 | -7.0 | 0.7 | 2.9 | 2.6 |
| Dominica | -2.0 | -5.0 | -6.0 | -3.0 | -0.2 | 1.0 |
| Grenada | -2.0 | -1.0 | -6.0 | -2.0 | 2.0 | -2.0 |
| Montserrat | 4.0 | -4.0 | -3.0 | -0.4 | 9.0 | 19.0 |
| St. Kitts/Nevis | -3.0 | -2.0 | -8.0 | -3.0 | -1.0 | -0.12 |
| St. Lucia | -1.0 | -2.0 | -5.0 | -3.0 | 3.0 | 2.0 |
| St. Vincent & the Grenadines | -2.0 | -7.0 | -5.0 | -3.0 | 1.0 | 1.0 |
| **ECCU** | **-2.0** | **-4.0** | **-7.0** | **-3.0** | **1.0** | **1.0** |

**Source:** Author's calculations.

**Table 9: Primary Gaps in Per Cent of GDP for the ECCU**

| Country | 1980-2000 | 1980-1984 | 1984-1988 | 1988-1992 | 1992-1996 | 1996-2000 |
|---|---|---|---|---|---|---|
| Anguilla | | | -0.69 | 0.39 | 0.27 | 0.66 |
| Antigua/Barbuda | 0.1 | 0.66 | -4.8 | -0.94 | 0.39 | 3.21 |
| Dominica | 3.39 | 3.49 | 1.83 | 5.6 | 3.1 | 2.3 |
| Grenada | 3.54 | 14.2 | 1.6 | 2.9 | -0.27 | -0.05 |
| Montserrat | 0.03 | 0.09 | 0.63 | -0.12 | -0.23 | -0.59 |
| St. Kitts /Nevis | -0.38 | -1.3 | -5.48 | -1.65 | 0.01 | 5.07 |
| St. Lucia | -0.82 | 1.59 | -2.68 | -2.27 | 0.96 | -1.16 |
| St. Vincent & the Grenadines | -3.24 | -3.1 | -8.55 | -4.32 | -1.49 | 0.69 |
| **ECCU** | **-0.08** | **1.32** | **-3.29** | **-0.72** | **0.45** | **1.11** |

**Source:** Author's calculations.

unsustainable, with primary gaps of 0.1 per cent and 0.03 per cent of GDP respectively.

If the period of analysis is broken up into five-year tranches, through time a different picture emerges of the fiscal sustainability of the ECCU and particular countries. In the first sub-period, 1980 to 1984, the ECCU as a whole had a primary gap of 1.32 per cent of GDP, an unsustainable fiscal policy stance. In respect of the individual countries during this period, only St.Vincent and the Grenadines (SVG) and St. Kitts and Nevis (SKN) were pursuing sustainable fiscal policy stances during this era. Indeed, SVG had a primary margin of approximately 3.1 per cent of GDP, whilst St.Kitts and Nevis had a primary margin of approximately 1.3 per cent of GDP. All other countries were pursuing unsustainable fiscal policy stances. Grenada, with a primary gap of 14.7 per cent of GDP, and Dominica, with a primary gap of 3.5 per cent of GDP, were in need of serious fiscal adjustment.

In the sub-period 1984-1988, the ECCU had a primary margin of approximately 3.3 per cent of GDP, meaning that on aggregate the fiscal policies of the Union were sustainable. This is not surprising, given the favourable economic growth experienced during this period. Five countries had primary margins of varying degrees, as they pursued sustainable fiscal policies. Antigua and Barbuda, St.Kitts and Nevis and SVG, with primary margins of 4.8 per cent, 5.5 per cent and 8.6 per cent of GDP respectively were in reasonably comfortable fiscal positions. Dominica and Grenada, with primary gaps of 1.8 per cent and 1.6 per cent of GDP, were again pursuing unsustainable fiscal policies during this era, with Montserrat marginally so.

In the sub-period 1988-1992, the fiscal policy stance of the ECCU was again sustainable with a primary margin of approximately 0.72 per cent of GDP. Five countries, Antigua and Barbuda, SVG, St. Lucia (SLU), SKN and Montserrat pursued sustainable fiscal policy stances during this era. Dominica and Grenada with primary gaps of 5.6 per cent of GDP and 2.9 per cent of GDP were clearly pursuing unsustainable fiscal policy stances.

In the sub-period 1992-96 the ECCU in aggregate generated a primary gap of approximately 0.45 per cent of GDP, that is, in aggregate, the policies of the ECCU during this period were unsustainable. During this period, it was only, SVG, Montserrat and Grenada which had sustainable fiscal stances. Again, the primary deficit was largest for SVG, at 1.49 per cent of GDP; significant however, was the turn-around in the fiscal fortunes of Grenada, with a small but directionally important primary margin of 0.27 per cent of GDP. All other countries had primary gaps of differing degrees, with Dominica, at 3.1 per cent of GDP, being the largest.

In the final sub-period, 1996-2000, the ECCU in aggregate is again pursuing unsustainable fiscal policy stances, with an overall primary gap of 1.1 per cent of GDP. For the individual countries, it is only St. Lucia, Montserrat and Grenada which have narrow primary margins and have therefore been pursuing sustainable fiscal policy stances during this period. Significantly, this period marks the first time that SVG has generated a primary gap. Of note also is the significant primary gap generated by SKN of 5.6 per cent of GDP, indicating an unsustainable fiscal policy stance. In addition, Antigua and Barbuda and Dominica with primary gaps of 3.2 per cent and 2.3 per cent of GDP continue to pursue unsustainable fiscal policy positions.

Based on the fiscal numbers for 2000, four countries required significant fiscal adjustment, ranging from approximately 2.2 per cent to 14.2 per cent of GDP. **These are in effect the primary gaps, which is the difference between the actual primary balance and the primary balance required for sustainability.** Antigua and Barbuda required the largest adjustment of approximately 14.2 per cent of GDP. This was followed by St.Kitts and Nevis and Dominica, where, based on the 2000 outturn, the required adjustment to achieve a sustainable fiscal dynamic was approximately 9.5 per cent and 9 per cent of GDP respectively. The required adjustment would have obviously been made worse by the further significant deceleration in growth.

There are two key points which emerge from this analysis. First, the impact of the significant slow down of economic growth in the ECCU. Second, the continued rapid accumulation of public debt by the member governments, partly in response to the slow-down, and partly in an attempt to advance the philosophical development plan of the member governments of the ECCU and third, the switch to less concessional debt to finance public goods.

### 5.3. Adjustment to More Prudent Debt Levels

Based on the foregoing analysis, the public debt situation is clearly unsustainable. An important question therefore is, what is a sustainable level of public debt relative to GDP. In the European Union, a ceiling of 60 per cent of GDP has been imposed on countries wishing to join the monetary union. The ECCB has also recommended to member countries that they reduce their debt to GDP ratios to between 40 to 60 per cent of GDP.[3] A low debt to

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3 This recommendation is consistent with benchmark considerations used by international credit rating agencies when assessing a country's debt carrying capacity.

GDP ratio can be supported for several reasons. First, economic management is promoted as it provides an extra degree of freedom for policy action. Second, it reduces roll-over risks and also lowers the incentive for the policy authorities to renege on their low inflation policy or, in the case of the ECCB, its foreign asset rule policy. Finally, a low debt ratio lowers the future potential tax burden of the private sector and thereby promotes, other things being equal, a stable investment environment. Therefore, this particular condition ought to be positive for private sector investment. A lower deficit, and thereby debt to GDP ratio, also directly reduce the competition for resources with the private sector.

The analysis which follows assumes that the debt to GDP ratio is within the range of 40 to 60 per cent of GDP to be achieved over some future time period. This does not mean in any way that we believe this to be the sustainable level of debt. Rather, the analysis is intended to show the implications of adjustment to these different levels of debt. Table 10 provides an indication of the speed and magnitude of the fiscal adjustments which would be required to achieve lower debt to GDP ratios between 2000 and 2007. Given the assumed nominal GDP growth rates and overall fiscal deficits, it is clearly seen in column three that the implied debt to GDP ratios would be very high for most countries. As a preliminary step the debt to GDP ratio of those countries with over 60 per cent are required over time to adjust to 60 per cent. In addition, those countries below that number, but higher than 40 per cent, are required to adjust to 40 per cent. **In the discussion below the overseas territories of Anguilla and Montserrat are not considered since they already have much more stringent fiscal rules to observe – imposed by the British government. In the first instance they are not generally allowed to run current account deficits, and the public debt cannot be more than twenty times the public**

**Table 10: Adjustment to a Lower Central Government Debt to GDP Ratio. As a Percentage of GDP**

| Country | Long-run Real Growth | Overall Balance 2000 Ratio* | Implied Equilibrium Debt to GDP Ratio | Required Primary Surplus | Debt to GDP Ratio 2000+ | Target Debt to GDP | Years to Adjust |
|---|---|---|---|---|---|---|---|
| Antigua & Barbuda | 3.1 | 5.2 | 92.9 | 7.73 | 109.8 | 60 | 7 |
| Dominica | 1.5 | 5.5 | 137.5 | 2.22 | 74.0 | 60 | 7 |
| Grenada | 3.5 | 3.3 | 55.0 | 1.77 | 52.1 | **40** | 7 |
| St.Kitts & Nevis | 4.0 | 14.6 | 224.6 | 4.95 | 93.7 | 60 | 7 |
| St.Vincent & the Grenadines | 3.0 | 2.02 | 36.7 | 2.83 | 59.2 | **40** | 7 |
| **ECCU** | **3.0** | **3.1** | **56.4** | **1.4** | **69.1** | **60** | **7** |

**Notes**: *The implied equilibrium debt to GDP ratio is derived as the overall balance (column (3)) divided by the nominal GDP growth rate (column 2) adjusted for inflation assumed to be approximately 2.5 percent per annum for all countries.

\+ Central government debt. These are sourced from ECCU member country authorities, IMF staff estimates and author's calculations.

**Source**: Author's calculations.

**revenues in any one year. These countries are in effect contingent liabilities of the British government. In the case of St. Lucia, central government debt to GDP ratio is less than 40 per cent.**

An adjustment period of seven years is assumed for all countries. It is assumed that all countries are required to adjust to the 60 per cent debt to GDP ratio by 2007. For the ECCU as a whole a primary surplus of approximately 1.4 per cent of GDP each year over a seven year period would be required. Moreover, based on the results of Table 9, this amounts to an adjustment of 2.5 per cent of GDP in the primary balance. For individual countries, such as Antigua and Barbuda (7.73 per cent of GDP) and St.Kitts and Nevis (4.95 per cent of GDP), the required primary surpluses are larger and consequently the magnitude of adjustment. The magnitude of adjustment in the primary surplus would amount to approximately 10 per cent of GDP for St. Kitts and Nevis and 10.9 per cent of GDP in the case of Antigua and Barbuda. Dominica would require a primary surplus of approximately 2.22 per cent of GDP each year to reduce its debt to GDP ratio to the 60 per cent target. The magnitude of adjustment of the primary surplus would amount to approximately 5.5 per cent of GDP. On the other hand, St.Vincent and the Grenadines over seven years would require a primary surplus of 2.8 per cent to reduce its debt to GDP ratio to 40 per cent.

Table 11 provides an idea of the time path of adjustment in the primary surplus required to yield the precise fall in the debt to GDP ratio for each country to the prescribed target. Required growth rates for each country in the currency union were chosen to be 100 basis points above the assumed interest rates on the debt. For the ECCU as a whole to lower the debt to GDP ratio to 60 per cent without the use of fiscal measures, real growth of approximately 5 per cent per annum for 15 years would be required. For Antigua and Barbuda, it would require growth of approximately 8 per cent per annum, over a period of 65 years, to lower the debt to GDP from 109.8 to 60 per cent. In Dominica real GDP growth of approximately 4 per cent per annum over a period of 22 years would be required to lower the debt to GDP ratio to 60 per cent. On the other hand, St. Kitts and Nevis would require growth of 6 per cent per annum over a period of 47 years to achieve a 60 per cent debt to GDP ratio.

Therefore, based on the results of this Table, it would appear that Antigua and Barbuda, Dominica and St.Kitts and Nevis would require a combination of strong fiscal adjustment and growth. Much of the corrective action for the unsustainable fiscal and debt policy package would be required to come from fiscal adjustment. This is so precisely because the expected GDP growth rates for these countries over the medium term are not likely to be sufficient to raise them out of the potentially unsustainable debt dynamic. Indeed, a simple calculation using the average real growth rates over the last twenty years reveals the extent of the growth gap which such an adjustment on its own would encounter.

## 6. Conclusions

This paper contained three main insights. First, the fall in growth rates in the 1990s has emerged as a key factor in the long-run solvency and short-run sustainability of the public sector's fiscal plans. The deceleration in growth rates is also directly linked to the relatively poor performance in recent times of the main export sectors. Secondly, the non-adjustment of fiscal policy stances after trade performance, and the fall in GDP growth rates, have contributed to a rapid accumulation of public debt. Finally, the rise in real interest rates on public debt as a result of the fall-off in concessional debt contracted by the public

**Table 11: Adjustment to Lower Debt to GDP Ratios, Based on Required Growth. (Results in Percentage of GDP)**

| Country | Required Long-run Real Growth | Real Interest Rate | Overall Balance 2000 | Debt to GDP Ratio 2000 | Target Debt to GDP of GDP | Debt Dynamic in Per-centage | Years to Adjust |
|---|---|---|---|---|---|---|---|
| Antigua & Barbuda | 8.0 | 7.0 | 5.2 | 109.8 | 60 | -0.77 | 65 |
| Dominica | 4.0 | 3.0 | 5.5 | 74.0 | 60 | -0.64 | 22 |
| Grenada | 5.0 | 4.0 | 3.3 | 52.1 | **40** | -0.44 | 28 |
| St.Kitts & Nevis | 6.0 | 5.0 | 14.6 | 93.7 | 60 | -0.72 | 47 |
| St.Vincent & the Grenadines | 5.0 | 4.0 | 2.02 | 59.2 | **40** | -0.47 | 41 |
| **ECCU** | **5.0** | **4.0** | **3.1** | **69.1** | **60** | **-0.62** | **15** |

**Source:** Author's Calculations.

sector has also contributed to an unsustainable fiscal situation.

There are at least three policy implications stemming from the analysis. First, it is important for governments to keep a reign on fiscal policy stance, generally. As a rule the fiscal policy stance ought not to be more expansionary than trade performance, otherwise significant debt accumulation will result. Second, a focused approach is required on the redevelopment of the foreign exchange-earning sectors. A well-articulated programme for increasing the competitiveness of domestic industries must guide such a policy. The aspect of quality rather than price competitiveness ought to be the focus of policy in this programme. Finally, the public policy authorities must resist the temptation to borrow resources on non-concessional terms to fund social projects, without compensating adjustment in other taxes or expenditures.

This paper can be extended in at least three directions. First, there is the need to identify the component causes of the public sector deficits, that is, what proportion can be explained by the slow down in economic growth and what proportion is explained by expansionary fiscal policy on the part of the fiscal authorities. Second, there is need for an analysis of fiscal policy rules and its potential impact in an individual country *vis a vis* currency union context. Finally, the analysis of fiscal and debt sustainability ought to be extended to embrace the entire public sector. This is important as in some countries it is the statutory bodies which have caused significant debt accumulation. In addition, if rules based fiscal regimes are to result in real adjustment in the public sector's solvency, then all liabilities and obligations of the public sector ought to be included in the analysis.

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# 8

# Economic Perfomance and Public Finance in Belize

*Ramesh Ramsaran*

## Introduction

The rapid growth in Belize's external debt in recent years in the context of a persistent deficit in the public accounts, and pressure on the exchange rate, has raised a number of questions about economic policies and management, notwithstanding impressive export and GDP growth rates in the last few years. In the late 1980s the country also experienced a period of high growth, but this was accompanied by a high savings rate and large inflows of private capital. The Belizean economy is a highly open one and external factors exert a significant influence on the level of economic activity, but domestic policies can also worsen or enhance the effects of external developments. Vulnerability also comes from an economy that is highly agricultural-based and from the country's exposure to hurricanes which in the past have taken a heavy toll on the country's infrastructure and production capacity. Frequent fluctuations in production and revenue in a democratic system put the government under constant pressure, and the availability of a limited range of levers to stabilize income levels can sometimes trigger short-run responses that create long-term problems. Decisions at the margin (e.g. tampering with the tax system, privatising state enterprises, etc.) may not only have a limited or temporary effect, but can divert attention from the more fundamental policy issues bearing on savings, investment, efficiency, competitiveness and diversification.

Belize is a small country (area: 22,960 $km^2$) with a population of around 250,000 and a highly open economy. Exports of goods and services amount to more than 50% of GDP, while imports are generally over 60%. Belize is an underdeveloped country, relying heavily on export agriculture and tourism. It has been classified by the UNDP as a country with 'medium human development,' having an HDI of 0.784, and was ranked 58 among 123 countries in the year 2000. In 2000, per capita GDP in current dollars was US$2,600 (PPP US$5,606). Life expectancy is 75 years and the adult literacy rate is 93.2%.[1]

This paper discusses Belize's economic performance in recent years with emphasis on the state of public finance and the debt situation. The first section describes trends in major economic indices and the evolution of the economic structure. The second examines the state of the public finances, and this is followed by a discussion on

1 This is taken from the UNDP *Human Development Report 2002.* The IMF Country Report (No.01/151) uses a much lower figure, 75.5%.

the external public debt. The final part offers some concluding observations.

**Recent Economic Performance**

There were periods when the economy was able to grow at relatively high growth rates (e.g. the late 1980s and the late 1990s), but over the last two decades economic performance has not been consistent. Since 1980 real GDP has grown at an average rate of around 4.5% per year, while real per capita income has increased by about 1.8% per year. Per capita income in 2001 was 50% higher than the level in 1980. In current dollars, per capita GDP in 2001 was estimated to be around US$2,700. The inflation rate has traditionally been low and in the last decade has averaged below 3% per annum. The unemployment rate seems to have fallen slightly since the 1980s, and is now estimated to be around 12-14%.

Though services account for over 50% of GDP, the economy remains heavily dependent on agriculture whose contribution to GDP has hardly changed since 1980, averaging around 15% of real GDP (see Table 2). In 2000, sugar, seafood products, bananas and citrus concentrates accounted for 75% of total domestic exports. Between 1990 and 2000, sugar production increased by 20%, while banana production more than doubled. Citrus production has also been increasing. During the period 1995 to 2002 the value of merchandise exports increased by 5.2% per year, despite the fact that the average export price for sugar declined by 33% during the period.[2] Non-traditional exports have been growing at almost three times the rate

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2 IMF Country Report No. 01/151, August 2001.

**Table 1: Selected Economic Indicators, 1980-2001**

| Year | Real GDP Growth[1] % | Real Per Capita GDP[1] | | Unem-ployment Rate % | Inflation Ratio % | Per Capita GDP Current f.c. US$ | Import Ratio[2] % | Export Ratio[2] % |
|---|---|---|---|---|---|---|---|---|
| | | B$ | % Change | | | | | |
| 1980 | .. | 2,516 | .. | 14.2 | 7.1 | 1,198 | 69 | 56 |
| 1981 | 2.0 | 2,500 | -0.7 | .. | 13.0 | 1,134 | 75 | 53 |
| 1982 | -0.5 | 2,420 | -3.2 | .. | 6.8 | 1,035 | 98 | 66 |
| 1983 | -1.6 | 2,321 | -4.1 | 14.2 | 5.7 | 1,056 | 65 | 49 |
| 1984 | 1.8 | 2,300 | -0.9 | 14.0 | 3.3 | 1,147 | 70 | 62 |
| 1985 | 0.3 | 2,249 | -2.2 | 15.1 | 3.8 | 1,103 | 61 | 48 |
| 1986 | 2.9 | 2,257 | 0.3 | 15.1 | 0.8 | 1,091 | 58 | 55 |
| 1987 | 12.0 | 2,456 | 8.8 | 15.0 | 2.0 | 1,369 | 63 | 60 |
| 1988 | 7.0 | 2,545 | 3.6 | 15.0 | 3.2 | 1,476 | 68 | 62 |
| 1989 | 12.4 | 2,807 | 7.0 | 15.0 | 2.1 | 1,167 | 69 | 58 |
| 1990 | 10.3 | 3,011 | 10.2 | .. | 4.0 | 1,792 | 61 | 60 |
| 1991 | 3.1 | 3,027 | 0.5 | .. | 3.1 | 1,874 | 67 | 57 |
| 1992 | 9.5 | 3,229 | 6.7 | .. | 2.4 | 2,061 | 67 | 59 |
| 1993 | 4.3 | 3,278 | 1.5 | 9.8 | 1.4 | 2,203 | 65 | 53 |
| 1994 | 1.3 | 3,261 | -0.5 | 9.0 | 2.6 | 2,204 | 58 | 52 |
| 1995 | 4.1 | 3,273 | 0.3 | 12.5 | 2.9 | 2,286 | 54 | 51 |
| 1996 | 1.5 | 3,241 | -1.0 | 13.8 | 6.4 | 2,294 | 53 | 51 |
| 1997 | 4.2 | 3,261 | 0.6 | 12.7 | 1.0 | 2,270 | 61 | 54 |
| 1998 | 1.7 | 3,192 | -2.2 | 14.3 | (0.8) | 2,207 | 62 | 53 |
| 1999 | 6.6 | 3,345 | 4.8 | 12.8 | (1.2) | 2,412 | 71 | 61 |
| 2000 | 10.8 | 3,602 | 7.7 | 11.5 | 0.6 | 2,638 | 78 | 58 |
| 2001 | 4.6 | 3,767 | 4.6 | .. | 1.1 | 2,706 | 74 | 55 |

1. Factor cost (1984 prices)
2. Goods and services as a % of GDP

.. Not available

**Source:** Central Bank of Belize, *Statistical Digest*, Various Issues; Caribbean Development Bank.

of total exports. The tourist industry has also been growing impressively (over 16% per year in the period 1995-2000). Tourists' spending in 2001 amounted to US$121 million or more than 70% of the value of domestic exports.

Belize tends to import more goods than it exports, and as a result the trade balance is consistently negative. While the services account balance tends to be positive, it is not always sufficient to offset the negative trade balance deficits, and the current account balance is often negative (see Table 3). As a result of capital inflows net official reserves, though fluctuating from year to year, have been equivalent to about two to three months' imports in recent years. The inflows of foreign savings have allowed gross investment ratio to greatly exceed the gross savings ratio which on average has been less than 20% of GDP (see Table 4). It appears that the savings rate has declined since the early 1990s. Net direct investment inflows since the mid-1980s have averaged around 3% of GDP.

**Aspects of Public Finance**

In current terms, current revenue grew by an average of 7.4% between 1980 and 2000 as compared to 7.9% for current expenditure. In the absence of significant current account savings, the government has had to borrow to finance its capital programme which since 1980 has averaged almost 10% of GDP. The overall position has generally been in deficit (see Table 5).

**Table 2: Composition of Real GDP (at factor cost), 1980-2001**
**(Percentage)**

| Sectors | 1980 | 1985 | 1990 | 1995 | 2001 |
|---|---|---|---|---|---|
| *Primary Activities* | *20.7* | *21.1* | *19.1* | *20.1* | *23.4* |
| Agriculture | 15.4 | 15.6 | 13.9 | 13.9 | 14.3 |
| Forestry & Logging | 2.3 | 1.8 | 2.2 | 2.2 | 1.2 |
| Fishing | 2.8 | 3.3 | 2.3 | 3.2 | 7.2 |
| Mining | 0.2 | 0.3 | 0.6 | 0.7 | 0.7 |
| *Secondary Activities* | *28.4* | *26.7* | *26.1* | *25.4* | *24.3* |
| Manufacturing | 21.5 | 19.7 | 17.2 | 17.0 | 16.2 |
| Electricity & Water | 1.3 | 1.8 | 1.8 | 2.0 | 1.6 |
| Construction | 5.5 | 5.1 | 7.1 | 6.3 | 6.5 |
| *Services* | *54.7* | *55.7* | *58.4* | *57.8* | *55.7* |
| Trade, Restaurant, Hotels | 20.4 | 14.5 | 19.2 | 18.0 | 19.5 |
| Transport & Communication | 6.0 | 8.9 | 12.6 | 14.8 | 13.5 |
| Finance & Insurance | 5.3 | 4.9 | 5.1 | 4.8 | 5.0 |
| Real Estate & Business Services | 5.8 | 5.8 | 5.1 | 5.0 | 5.3 |
| Public Administration | 8.2 | 11.4 | 8.8 | 8.1 | 6.3 |
| Commerce & Other Services | 8.9 | 10.0 | 7.5 | 6.9 | 6.1 |
| Less Imputed Bank Service Charges | -3.8 | -3.5 | -3.6 | -3.3 | -3.9 |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

**Source:** Central Bank of Belize, *Statistical Digest*, Various Issues.

**Table 3: External Account Indicators**

| Year | B$ Per[1] 1 US$ | Exchange Rate: Real Effective 1995-100 | Exchange Rate: Real Effective % Change | Balance of Payments: Current Balance as a Percentage of GDP | Balance of Payments: Overall Balance as a Percentage of GDP | Tourism Expenditure US$ mn | Net Official Researves: B$ | Net Official Researves: In Months' Imports |
|---|---|---|---|---|---|---|---|---|
| 1980 | 2.00 | 102.7 | .. | .. | .. | 7.0 | 26.5 | 1.3 |
| 1981 | 2.00 | 111.4 | 8.5 | .. | .. | 7.5 | 22.2 | 1.1 |
| 1982 | 2.00 | 118.6 | 6.5 | .. | .. | 8.9 | 21.9 | 1.4 |
| 1983 | 2.00 | 125.2 | 5.6 | .. | .. | 9.3 | 13.7 | 0.8 |
| 1984 | 2.00 | 130.3 | 4.1 | -2.5 | -3.3 | 10.7 | (0.2) | .. |
| 1985 | 2.00 | 138.3 | 6.1 | -4.0 | 2.3 | .. | 9.7 | 0.6 |
| 1986 | 2.00 | 123.7 | -10.6 | 5.6 | 5.1 | 41.0 | 33.1 | 2.1 |
| 1987 | 2.00 | 114.7 | -7.3 | 6.5 | 3.7 | 47.3 | 53.7 | 2.9 |
| 1988 | 2.00 | 113.5 | -1.0 | -1.5 | 6.0 | 48.0 | 91.0 | 3.4 |
| 1989 | 2.00 | 111.7 | -1.6 | -5.2 | 3.3 | 78.9 | 115.0 | 3.5 |
| 1990 | 2.00 | 104.8 | -6.2 | 5.4 | 3.1 | 91.4 | 143.2 | 4.6 |
| 1991 | 2.00 | 103.3 | -1.4 | -6.2 | -4.8 | 94.5 | 108.7 | 2.9 |
| 1992 | 2.00 | 100.7 | -0.7 | -6.0 | -0.3 | 64.7 | 110.8 | 2.7 |
| 1993 | 2.00 | 106.6 | 5.8 | -9.2 | -3.6 | 70.0 | 71.8 | 1.7 |
| 1994 | 2.00 | 102.3 | -4.0 | -4.5 | -0.7 | 71.4 | 63.1 | 1.6 |
| 1995 | 2.00 | 100.0 | -2.2 | 1.3 | 0.5 | 77.6 | 69.9 | 1.8 |
| 1996 | 2.00 | 105.3 | 5.3 | 0.4 | 3.4 | 93.1 | 113.0 | 2.6 |
| 1997 | 2.00 | 108.6 | 3.1 | -2.7 | 0.2 | 96.5 | 111.4 | 2.1 |
| 1998 | 2.00 | 108.2 | -0.4 | 6.3 | -2.4 | 101.0 | 84.6 | 1.5 |
| 1999 | 2.00 | 105.6 | -2.5 | -9.5 | 4.0 | 103.7 | 140.2 | 2.2 |
| 2000 | 2.00 | 107.1 | 1.4 | -16.6 | 6.7 | 121.1 | 243.9 | 3.2 |
| 2001 | 2.00 | 109.2 | 2.0 | .. | .. | .. | 221.7 | 3.0 |

1. End of period; .. Not available.

**Source:** IMF, *International Financial Statistics*, Various Issues, Central Bank of Belize.

**Table 4: Savings and Investment Ratios, 1980-2001**

| Year | Gross Savings Ratio | Gross Investment Ratio | Foreign Capital Flows as a % of GDP | | |
|---|---|---|---|---|---|
| | | | Direct Investment (net) | Other Private (net) | Official (net) |
| 1980 | 10.8 | 24.2 | .. | .. | .. |
| 1981 | 4.1 | 26.0 | .. | .. | .. |
| 1982 | -2.9 | 20.6 | .. | .. | .. |
| 1983 | 4.2 | 20.1 | .. | .. | .. |
| 1984 | 15.9 | 23.4 | -1.7 | -0.2 | 1.8 |
| 1985 | 8.9 | 21.6 | 0.9 | -1.4 | 7.1 |
| 1986 | 17.8 | 20.3 | 2.0 | -3.3 | 1.6 |
| 1987 | 19.7 | 21.9 | 2.5 | -0.3 | 0.2 |
| 1988 | 19.4 | 25.4 | 4.1 | 2.1 | 3.0 |
| 1989 | 19.3 | 30.3 | 5.3 | -1.6 | 3.8 |
| 1990 | 25.1 | 26.1 | 4.2 | 0.0 | 1.1 |
| 1991 | 20.2 | 30.4 | 3.1 | -2.2 | 4.1 |
| 1992 | 19.8 | 28.5 | 3.2 | 0.2 | 2.5 |
| 1993 | 18.8 | 30.0 | 2.2 | 1.6 | 4.3 |
| 1994 | 17.6 | 23.0 | 3.4 | 2.6 | 1.5 |
| 1995 | 18.9 | 22.0 | 3.1 | -5.1 | -0.3 |
| 1996 | 20.6 | 22.6 | 1.8 | -0.7 | 2.1 |
| 1997 | 16.5 | 23.5 | 1.3 | 3.0 | 2.2 |
| 1998 | 15.1 | 24.3 | 2.1 | 0.9 | 1.1 |
| 1999 | 19.5 | 29.6 | 7.2 | 0.9 | 4.9 |
| 2000 | 12.3 | 32.5 | 2.5 | -2.1 | 13.6 |
| 2001 | 12.8 | 31.8 | 5.0 | .. | .. |

.. Not available.

**Sources:** Computed from official data.

**Table 5: Revenue and Expenditure of Central Government (As a % of GDP)[1]**

| Year | Tax Revenue (1) | Current Revenue (2) | Current Expen-diture (3) | Current Balance (4) | Capital Expen-diture (5) | Overall Balance (6) |
|---|---|---|---|---|---|---|
| 1980 | 19.0 | 20.9 | 16.6 | 4.2 | 9.7 | -2.1 |
| 1981 | 19.0 | 21.5 | 19.6 | 1.8 | 8.9 | -3.5 |
| 1982 | 18.9 | 21.9 | 24.2 | -2.4 | 10.2 | -9.0 |
| 1983 | 17.9 | 20.5 | 23.9 | -3.4 | 7.3 | -7.2 |
| 1984 | 19.4 | 21.6 | 22.1 | -0.5 | 6.7 | -5.5 |
| 1985 | 19.9 | 23.6 | 23.7 | -0.0 | 9.6 | -9.3 |
| 1986 | 21.0 | 24.6 | 22.6 | 2.0 | 7.4 | -4.5 |
| 1987 | 21.3 | 24.6 | 23.0 | 1.6 | 3.2 | -0.3 |
| 1988 | .. | 25.3 | 18.2 | 7.1 | 5.5 | 8.5 |
| 1989 | .. | 25.4 | 17.5 | 7.9 | 9.5 | 0.2 |
| 1990 | 21.8 | 26.0 | 17.0 | 9.0 | 10.6 | 0.2 |
| 1991 | 21.4 | 25.2 | 17.9 | 7.3 | 15.9 | -4.7 |
| 1992 | 21.3 | 25.4 | 19.6 | 5.7 | 14.9 | -5.5 |
| 1993 | 20.6 | 23.6 | 20.6 | 2.9 | 10.7 | -6.3 |
| 1994 | 20.6 | 23.8 | 21.7 | 2.1 | 10.1 | -6.4 |
| 1995 | 20.0 | 22.0 | 19.8 | 2.2 | 6.6 | -3.4 |
| 1996 | 19.8 | 23.4 | 20.0 | 3.4 | 6.6 | -0.8 |
| 1997 | 19.7 | 23.3 | 20.5 | 2.8 | 6.3 | -1.4 |
| 1998 | 19.8 | 24.1 | 21.0 | 3.1 | 9.6 | -1.4 |
| 1999 | 17.4 | 24.5 | 21.1 | 3.3 | 14.3 | -4.8 |
| 2000 | 17.9 | 21.9 | 19.1 | 2.7 | 15.4 | -6.5 |

.. Not available
1. At market prices

**Source:** Central Bank of Belize, *Statistical Digest*, Various Issues.

Both total revenue and tax revenue as a percentage of GDP has been falling since the early 1990s. The tax ratio declined from about 22% in 1990 to 18% in 2000, reflecting an inelastic tax system. The tax take has been growing at a slower rate than GDP. The buoyancy coefficient for the period 1980-2000 was estimated to be 0.98. While the respective shares of income tax and taxes on international trade (the largest contributors) in total revenue have been growing, the share of taxes on goods and services has been falling. While income tax as a percentage of GDP has averaged around 4.4% in recent years, the ratio for taxes on goods and services has been falling, reaching 5.5% in 2000. Taxes on international trade has remained around 7%.

Wages and salaries plus pensions account for close to 60% of current expenditure and goods and services for 6 to 7%. In 2000, interest payments on the public debt took 13.7% of current expenditure as compared to 9.6% in 1996. Subsidies and current transfers account for about 10% of current expenditure. With privatisation of some state enterprises, subsidies have declined.

Given the small size of the local market, exports represent a major source of growth for the Belizean economy. With the loss of protection in foreign markets for traditional exports, issues of competitiveness must rank high among the goals of macro-economic management. Government has a key role to play in not only upgrading the country's infrastructure, but in providing a policy framework conducive to export and tourism development. It has been estimated that in the period 1995-2000 real wages in the Belizean private sector declined at an average rate of 1.3% per year, but the real effective rate of the Belizean dollar appreciated by about 7% in the period.[3]

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3 *Ibid.*

This, however, was partly negated by improvements in productivity mainly resulting from investment in infrastructure.

It has been observed that Belize's competitiveness is affected by a trade regime that is more restrictive than that of its neighbours, an unsatisfied demand for foreign exchange by the private sector, higher fuel prices, electricity tariffs, and telephone rates.[4] Although the maximum tariffs have come down to 20% in accordance with the CARICOM Agreement, quantitative import restrictions still apply to about 29 product categories, including food items.

The heavy reliance of the tax regime on fuel and telephone services taxes is reportedly having a negative influence on the country's competitiveness. "Import duties and other taxes on fuel account for about 48 per cent of the retail price of gasoline, and as a result retail gasoline prices are about 12 per cent higher in Belize than in other countries in the region."[5] Telephone rates in Belize are also significantly higher than in other countries.

## The External Debt

In 1981 when Belize achieved its political independence, the outstanding public external debt was less than US$60 million (less than 30% of GDP). The debt service ratio was less than 5%. By 1984 Belize had difficulty meeting its debt service obligations, and in 1985 adopted

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4 *Ibid.*

5 *Ibid.*

an IMF stabilisation programme.[6] Between 1986 and 1992 the outstanding external debt increased by 41%, but with the expansion of the economy and increased foreign earnings, the debt to GDP ratio fell from 47% to 31%, while the debt service ratio declined from 16% in 1985 to 5% in 1992 (see Table 6). Between 1992 and 1998, the debt increased steadily, crossing 40% of GDP in 1998. By 1998 the debt service ratio was still under 10%, but debt service payments as a % of current revenue increased from 12% in 1992 to 22% in 1998. In the last few years, though the economy has grown fairly impressively, this has corresponded with sharp increases in foreign borrowing. Between 1998 and 2000 the outstanding debt (including the guaranteed) increased by over 100%, with the debt/GDP ratio moving from 41% to 71%, the debt service ratio from 9.7% to 12.9% and the debt service/current revenue ratio from 21.7% to 30.5%.

With the increase in borrowing, there has been a shift from multilateral and official bilateral sources to commercial debt and publicly guaranteed debt. As late as 1998 multilateral and bilateral debt accounted for almost 80% of the outstanding debt as compared to 22% for commercial. By 2000, however, the share of multilateral and bilateral had fallen to 59% while the commercial share had risen to 38.5% and the publicly guaranteed (privatized state enterprises) to 24%. Included in the 2000 figure is US$42 million borrowed by the Central Bank in 2000 from foreign commercial banks and onlent to the DFC. The Central Bank borrowed a further US$25 million in March

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6 See M. Robinson and M. Palacio, "Implications of Belize's Indebtedness for Sustained Economic Growth." Paper presented at the XXXIII Annual Monetary Studies Conference, Belize, 2001.

**Table 6: Growth of the Public External Debt,[1] 1980-2001**

| Year | (1) External Debt Outstanding | | (2) (1) as a Percentage of GDP | (3) Debt Service Ratio | (4) External Debt Service as a Percentage of Current Revenue |
|---|---|---|---|---|---|
| | B$ mn | US$ mn | | | |
| 1980 | 89.2 | 44.6 | 22.9 | .. | 3.8 |
| 1981 | 102.2 | 51.6 | 28.8 | .. | 3.6 |
| 1982 | 120.8 | 60.4 | 35.9 | .. | 5.7 |
| 1983 | 140.4 | 70.2 | 37.1 | .. | 15.4 |
| 1984 | 152.0 | 76.0 | 36.0 | .. | 19.2 |
| 1985 | 196.8 | 98.4 | 47.1 | 15.7 | 31.5 |
| 1986 | 212.6 | 106.3 | 46.7 | 10.5 | 23.8 |
| 1987 | 229.9 | 115.0 | 41.6 | 8.8 | 21.3 |
| 1988 | 248.3 | 124.1 | 39.4 | 6.6 | 19.6 |
| 1989 | 255.6 | 127.8 | 35.2 | 6.7 | 15.9 |
| 1990 | 265.5 | 132.7 | 32.8 | 6.5 | 16.0 |
| 1991 | 285.6 | 142.8 | 33.1 | 6.0 | 13.6 |
| 1992 | 299.5 | 149.7 | 30.9 | 4.9 | 12.0 |
| 1993 | 335.7 | 167.8 | 31.7 | 5.5 | 12.5 |
| 1994 | 368.0 | 184.0 | 33.3 | 8.2 | 19.9 |
| 1995 | 368.7 | 184.4 | 31.4 | 10.0 | 23.9 |
| 1996 | 439.7 | 219.8 | 36.3 | 9.8 | 21.3 |
| 1997 | 482.2 | 241.1 | 39.0 | 9.0 | 21.4 |
| 1998 | 521.4 | 260.7 | 41.4 | 9.7 | 21.7 |
| 1999 | 718.8 | 359.4 | 52.2 | 9.2 | 21.3 |
| 2000 | 1,105.4 | 552.7 | 71.5 | 12.9 | 30.5 |
| 2001[e] | 1,140.6 | 570.3 | 70.8 | 15.3 | .. |

1: Including publicly guaranteed debt.
e: Estimate.
.. Not available.

**Source:** Central Bank of Belize.

2001. "Commercial bank borrowing was mainly used to finance specific projects, including the construction of a new city (La Democracia), the construction of new schools and purchases of real maintenance equipment, while multilateral borrowing was used to finance hurricane construction *(sic)*, public disaster management, and basic social and physical infrastructure."[7] With respect to the maturity structure of the total debt stock, "payments have become skewed, with shorter maturity debt payments now dominating. By the end of 2001, 17.7% ... will be maturing in 1-5 years. One-third of this will fall due four years from now with a single bullet payment for the whole amount. Payments are now bunched up to the point where 58.1% of amounts now owed will be due and payable over the next 10 years."[8] Another feature of the debt is the increasing share subject to variable interest rates, which increased from 3.1% in 1997 to 5.5% in 2000.[9]

The debt service ratio in 2001 was estimated to be over 15% as compared to 5% in 1992. The allocation of borrowed funds helps to explain the increasing burden of servicing the foreign debt. "Housing construction was the centrepiece of the government's investment strategy and as a result, the country's capacity to transfer the increased output into hard currency for debt servicing was not increased while demand for hard currency rose, given the high import content of the construction industry."[10] This can be expressed another way. "Contributing to the wide

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7 IMF, *Country Report*, No. 01/151, p. 37.

8 Robinson and Palacio, *Op. Cit.*

9 *Ibid.*

10 *Ibid.*

disparity in the debt service growth *vis á vis* exports has been the direction of loans into the non-tradable sector and difficulty in raising the national capacity to generate more hard currency earnings in the short term."[11] A debt service ratio of 15% may not appear particularly high, but, given the nature of Belize's exports and the high percentage of loans with variable interest rates, this ratio could increase unexpectedly to more burdensome levels.

**Concluding Remarks**

Between 1999 and 2001 real GDP grew by an average of over 7% per year. Output has partially recovered from the damage of Hurricane Iris in late 2001, but fluctuation in the prices of major agricultural exports may still adversely affect the outurn in 2002. Despite the favourable growth rate of recent years, the economy faces serious problems. The current account deficit of the balance of payments has averaged 12% of GDP since 1999 and has added to the pressure on the exchange rate. The overall deficit in the public accounts has been widening since 1998 in the context of a worsening external debt situation. The government has staved off cutting expenditure or raising taxes by borrowing, leading to a rapid increase in the debt service ratio and the share of revenue taken by debt service. The structure of the debt and the use of loan resources raise serious questions of the management of the public debt. In late July 2002 Standard and Poors downgraded Belize's long-term foreign currency debt ratio to BB- while in August of the same year Moody's Investors Service revised its equivalent rating to Ba2-.[12]

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11 *Ibid.*

12 EIU *Country Report,* October 2002, p. 34.

In the 1985-1980 Macro-economic Development Plan, a major objective was to promote diversified export-led growth primarily in agriculture, agro-industry, tourism and manufacturing. In the early 1980s, food products accounted for over 80% of Belize's domestic exports. By 2000, that position had not changed, though there were significant increases in bananas and citrus production. Tourism receipts have also been growing at over 15% per year. Production of these exports are not only susceptible to internal and external shocks but survival hinges on their becoming increasingly competitive. To this end economic management and the development of the country's infrastructure have crucial roles to play. Domestic savings ought to play a larger role in the country's development and the use of both internal and external resources need to be guided by principles which can enhance and diversify the productive base.

# Section 2:
# Thematic Fiscal Issues and Problems

9

# Fiscal Policy and Exchange Rate Management

*Karl M. Bennett*

## Introduction

This study is concerned with an assessment of the fiscal policy implications of adhering to a fixed or managed exchange rate regime in the CARICOM context, based on the experiences of Barbados and Jamaica during the decade of the nineties. In that period, Barbados operated under a fixed exchange rate regime, while Jamaica operated under a managed float.

The study will be organised as follows. In the first section there will be a review of the theoretical arguments of the potential relationship between the choice of exchange rate regime and the conduct of fiscal policy. This will be followed by a review of the fiscal performance of the respective countries during the reference period. In the third section, attention will be directed to an examination of the policy instruments employed in managing the exchange rate in the respective countries. In the fourth section, there will be an assessment of how the differences in the use of management instruments might have affected fiscal performance. In the final section, there will be an exploration of some of the possible links between the exchange rate regime, fiscal policy and the overall performance of the respective economies.

## The Exchange Rate Regime and Fiscal Policy

The potential impact of the choice of an exchange rate regime on the conduct of fiscal policy is often centred on the link between the regime and discipline in the conduct of fiscal policy. For example, under a fixed exchange rate regime, the impact on aggregate demand of expansionary fiscal policy would lead to a weakening in the country's balance of payments position and a run on reserves. This would likely force a government to abandon the peg. It is argued that a government which is forced to devalue the currency is unlikely to survive in office (Collins, 1996; Edwards, 1996). Recognition of their limited ability to support the rate along with a desire to avoid the political costs associated with a devaluation, would encourage governments to exercise a greater measure of restraint in their conduct of policy. A fixed exchange rate is then seen as providing the appropriate nominal anchor for promoting a greater measure of discipline in the conduct of fiscal policy (Corden, 1994). The adoption of a fixed peg, by establishing a direct link between the domestic rate of inflation and that of the country to which the currency is linked, is seen as providing evidence of a commitment to a future rate of inflation. Alternatively, it is argued that a flexible exchange rate regime, by providing the authorities with the possibility of opting for fiscal deficits and higher rates of inflation, results in less discipline in the conduct of policy (DeKock and Grilli, 1993). At the same time, since it bears no direct responsibility for the external value of the currency, the government could avoid the political costs of the inevitable currency depreciation.

On the other hand, there are those who argue that a government's decision to adopt a fixed exchange rate regime at a particular point in time does not preclude the possibility of subsequent adjustments in the rate. This line of argument is based on the contingent nature of a government's policy decisions. A policy decision will normally be taken after assessing the costs associated with various policy options. For example, a decision might be taken to devalue the currency if it is believed that it would be less costly than pursuing policy alternatives necessary to support the fixed parity. At the same time, concern about the potential political costs of a devaluation is likely to delay the devaluation decision. Consequently, a fixed exchange rate regime, rather than promoting discipline in the conduct of fiscal policy, is as likely to result in a succession of financial crises, followed by devaluations (Aghveli, Khan and Montiel, 1991).

Although Barbados operates under a fixed exchange rate regime and Jamaica under a managed exchange rate, there has been no fundamental difference in the perception on the part of the respective governments of the importance of maintaining exchange rate stability. This arises from the fact that given the degree of openness of the respective economies, exchange rate stability is essential in ensuring a reasonable level of price stability. Accordingly, governments in both countries have been highly conscious of the need to exercise fiscal restraint.

## Review of Fiscal Performance in Barbados and Jamaica

In this section an attempt will be made to ascertain whether there were any noticeable differences in the approach to fiscal management arising from the fact that the two countries operated under different exchange rate regimes. This will be carried out with reference to a set of standard indicators often used in the assessment of fiscal performance, such as levels and trends in the overall debt and deficits.

The fiscal indicators for Barbados are summarized in Table 1. There was a moderate increase in the overall level of indebtedness for the country over the course of the decade. This was due to an increase in the level of domestic borrowing, as there was a decrease in external debt. As shown in the table, the internal debt to GDP ratio rose from under 40 percent to slightly in excess of 50 percent, while the external debt ratio declined from 29 percent to less than 20 percent between 1991 and 1999. The overall level of indebtedness was quite close to the target indicator, a debt/GDP ratio of 60 percent, conventionally deemed to be reflective of the exercise of fiscal prudence.

Total government expenditure as a share of GDP remained fairly stable over the period. This stability was also reflected in the amounts allocated to current and capital expenditure. The maintenance of capital expenditure resulted in the occurrence of annual fiscal deficits in all but one year, over the course of the decade. Nevertheless, on only two occasions did the deficit/GDP ratio exceed the conventionally acceptable target of 3 percent of GDP. In summary, the government of Barbados appeared to have exercised discipline in its fiscal management over the decade.

The fiscal indicators for Jamaica are summarized in Table 2. In the first half of the decade, Jamaica operated with an overall fiscal surplus. This was a period, as indicated in the Table, when there was a significant

**Table 1: Barbados: Fiscal Indicators**
**Percent of GDP**

| Year | Internal Debt | Extermal Debt | Total Debt | Deficit/ Surplus | Total Expenditure | Current | Capital |
|---|---|---|---|---|---|---|---|
| 1991 | 38.4 | 28.8 | 67.3 | - 2.3 | 37.5 | 31.9 | 5.4 |
| 1992 | 45.7 | 27.9 | 73.6 | - 1.2 | 37.6 | 33.7 | 3.4 |
| 1993 | 57.8 | 25.2 | 82.9 | - 3.1 | 39.6 | 35.7 | 3.7 |
| 1994 | 60.6 | 24.3 | 84.9 | - 2.8 | 37.4 | 32.6 | 4.2 |
| 1995 | 55.8 | 22.7 | 78.5 | 0.9 | 35.2 | 32.2 | 3.4 |
| 1996 | 57.8 | 21.2 | 79.1 | - 3.8 | 38.9 | 33.6 | 5.3 |
| 1997 | 56.1 | 19.2 | 75.6 | - 1.1 | 40.3 | 33.1 | 7.1 |
| 1998 | 54.7 | 17.5 | 72.2 | - 1.0 | 40.0 | 33.7 | 6.4 |
| 1999 | 50.9 | 19.0 | 69.9 | - 2.8 | 40.1 | 33.7 | 6.4 |
| 2000 | 51.1 | 23.7 | 74.3 | - 1.8 | 41.1 | 34.6 | 6.5 |

**Source:** Central Bank of Barbados, *Annual Statistical Digest*, 2001.

decrease in the debt burden as evidenced in a decline of approximately 50 percent in the debt/GDP ratio. This was, in large measure, due to a major reduction in the external debt burden. External debt as a share of GDP, as shown in the table, fell by more than 50 percent over this period. There was a major reversal in the situation in the last half of the decade. Although the external debt burden continued to decline, there was a dramatic increase in the level of internal debt. The ratio of internal debt to GDP more than doubled over the last five fiscal years of the period, resulting in the overall debt/GDP ratio returning to more than 100 percent by the end of the period. In light of these developments, there were very large fiscal deficits in this period. The deficit/GDP ratio, as shown in the table, exceeded by a substantial margin the usual prudential target of 3 percent.

The developments in the latter part of the decade were in large part due to the financial obligations assumed by the government arising from the insolvency of several firms in the financial sector. As a result, the relative stability in current expenditures early in the decade was not sustained in the latter period. This was, in part, due to the increase in allocations for interest payments. The burden imposed by interest payments was compounded by the very high interest rates, which prevailed throughout the period. As indicated in Table 3, expenditure on interest payments rose from 9 to 15 percent of GDP over the last five fiscal years of the decade. If interest payments were excluded from current expenditure, the country operated with a primary surplus over the course of the decade. In addition, there were also significant increases in the amounts allocated to wages and salaries. This made it more difficult for the Jamaican government to contain current expenditure in the manner of the Barbadian government. Current government expenditure as a percentage of GDP increased by 30 percent over the last four fiscal years of

Table 2: Jamaica: Fiscal Indicators
Percent of GDP

| Fiscal Year | Internal Debt | External Debt | Total Debt | Deficit/ Surplus | Ttoal Expenditure | Current | Capital |
|---|---|---|---|---|---|---|---|
| 1991/92 | 18.1 | 123.0 | 141.1 | 3.7 | 23.1 | 18.9 | 4.2 |
| 1992/93 | 21.9 | 62.1 | 84.0 | 3.7 | 23.5 | 18.8 | 4.7 |
| 1993/94 | 21.4 | 74.6 | 96.0 | 3.1 | 25.4 | 21.5 | 3.9 |
| 1994/95 | 34.2 | 60.1 | 94.3 | 3.1 | 25.6 | 22.2 | 3.8 |
| 1995/96 | 31.6 | 56.6 | 88.2 | 2.0 | 28.6 | 23.2 | 4.1 |
| 1996/97 | 38.4 | 41.1 | 79.5 | - 6.7 | 35.2 | 28.9 | 5.0 |
| 1997/98 | 42.3 | 42.2 | 84.5 | - 8.3 | 36.0 | 30.1 | 5.0 |
| 1998/99 | 54.8 | 43.3 | 93.1 | - 7.5 | 36.6 | 33.2 | 2.7 |
| 1999/00 | 63.6 | 44.0 | 107.6 | - 4.6 | 37.3 | 33.8 | 3.0 |

**Source:** Bank of Jamaica, *Statistical Digest*, Monthly.

**Table 3: Barbados & Jamaica: Recurrent Expenditure of Central Government**
**Percent of GDP**

| Fiscal Year | Barbados Total | Barbados Wages | Barbados Interest | Jamaica Total | Jamaica Wages | Jamaica Interest |
|---|---|---|---|---|---|---|
| 1991/92 | 32.3 | 14.1 | 5.7 | 18.9 | 6.9 | 7.4 |
| 1992/93 | 34.5 | 13.5 | 6.0 | 18.8 | 4.6 | 7.9 |
| 1993/94 | 33.7 | 14.2 | 5.1 | 21.5 | 8.7 | 8.4 |
| 1994/95 | 33.1 | 13.7 | 5.5 | 22.2 | 7.2 | 9.7 |
| 1995/96 | 32.9 | 13.5 | 5.9 | 23.2 | 8.3 | 9.4 |
| 1996/97 | 32.8 | 13.4 | 5.8 | 28.9 | 10.8 | 12.3 |
| 1997/98 | 33.9 | 13.6 | 5.5 | 30.1 | 12.1 | 10.2 |
| 1998/99 | 33.6 | 13.4 | 5.5 | 33.3 | 12.6 | 13.5 |
| 1999/00 | 33.6 | 13.9 | 5.4 | 33.8 | 11.6 | 15.2 |

**Source:** As per Tables 1 & 2.

the decade. On the other hand, current expenditure by the Barbadian government remained relatively stable over the period.

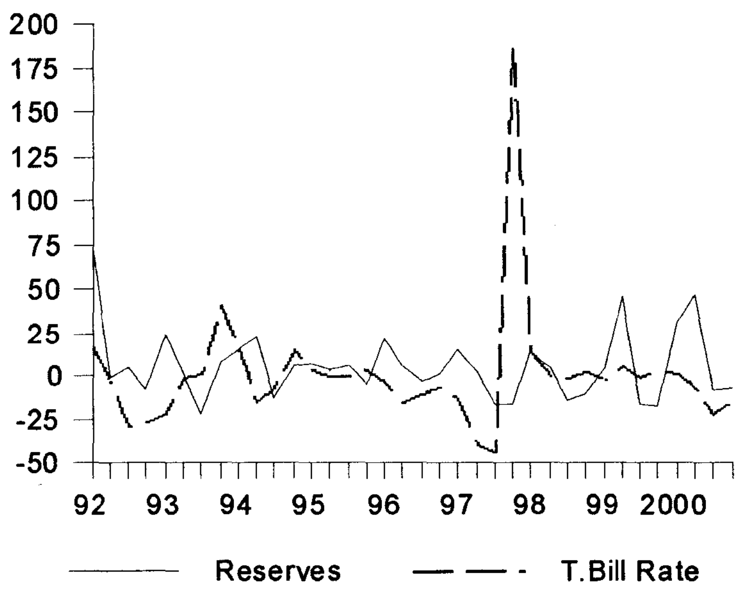
The difference in the Jamaican fiscal performance seems more related to the government response to the problems in the financial sector than to the differences in the exchange rate regime. Indeed, an empirical investigation of the relationship between the exchange rate regime and prudence in the conduct of fiscal policy by countries in the region found no systematic differences in fiscal discipline performance across regime types (Seerattan, 2000). However, although differences in the exchange regime might not be revealed in differences in overall debt and deficit ratios, there may be implications for expenditure items, such as interest and wages and salaries. For example, the pressures on overall expenditure arising from these items might force a government to cut back on capital expenditure in order to contain the deficit. Whereas the Barbadian government increased its outlays on capital expenditures in the latter part of the decade, the Jamaican government reduced its outlays.

## Exchange Rate Management

The need for active exchange rate management, over any time period, will depend on the frequency and severity of the shocks to which the economy has been subjected. This, in turn, will have an impact on the overall performance of the economy. For example, governments usually intervene in the foreign exchange market to offset pressure on the exchange rate arising from internal and external shocks. The intervention in the market might be direct, taking the form of foreign currency sales or purchases. Such direct intervention in the foreign exchange market by the central bank would have a direct impact on the money supply, unless accompanied by sterilization initiatives. These money supply changes, by influencing the availability and cost of loans could be seen as complementing the direct intervention efforts. Alternatively, the intervention might be indirect. This most commonly will be in the form of interest rate adjustments geared towards influencing currency flows in the market. Raising domestic interest rates relative to foreign interest rates will help to attract capital inflows and reverse outflows. In addition, the potential dampening impact on aggregate demand of higher interest rates will work to reduce the demand for foreign currency. In this section, there will be an assessment of the ways in which the governments of Barbados and Jamaica have used these policy instruments in managing the exchange rate.

The Barbadian economy went through a protracted period of decline in the early years of the decade. The period since 1994 has been associated with growth rates fluctuating between 2.3 to 4.5 percent. Throughout the period the country maintained an unchanged exchange rate parity. Given the variations in the performance of the economy, the central bank would have had to take action from time to time to maintain the exchange rate. In an effort to derive evidence of direct intervention in the market, estimates were made of quarterly changes in foreign exchange holdings of the central bank, covering a period from the first quarter of 1992 through to the fourth quarter of 2000. A quarter over quarter change of more than 2 percent was taken as being indicative of active intervention in the foreign exchange market by the central bank. As shown in Figure 1, in 33 of 36 quarters the change exceeded this benchmark. Of these 33, 20 were increases and 13 were decreases. The average percentage quarter over quarter increase or decrease was 15 percent. There were 20 quarters in which the central bank was a net buyer of foreign currency and 13 quarters in which it was a net seller. This suggests that there was a great deal of active direct intervention on the part of the central bank in the foreign exchange market. At the same time the bank did not allow these interventions to have a major impact on the money supply. On only 8 occasions did the quarterly change in the money supply exceed 10 percent.

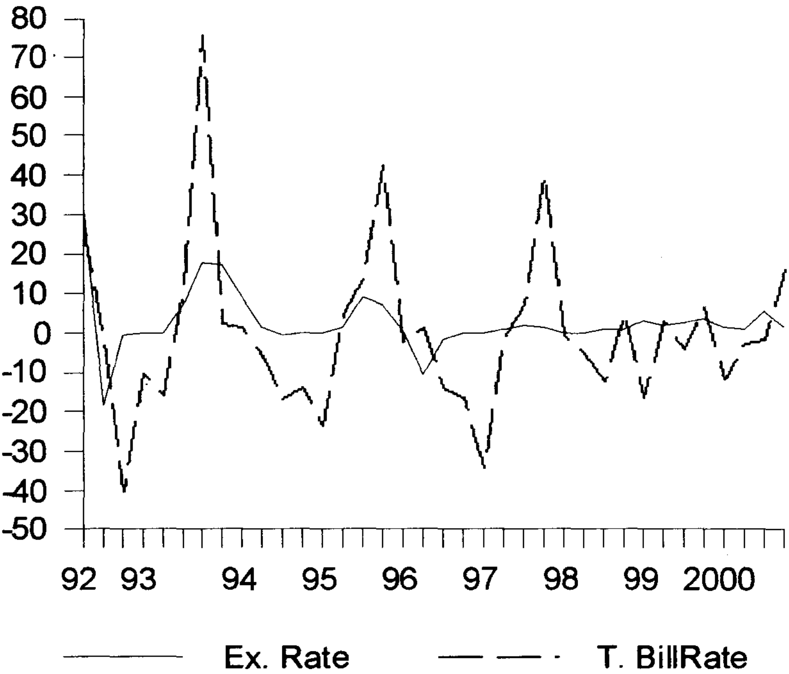
**Figure 1: Barbados: Percentage Change in International Reserves and T. Bill Rate 1992 Q1 to 2000 QIV**




Let us turn our attention now to the use of the interest rate as a management instrument. One might associate use of this instrument for this purpose when, for example, shifts in reserve holdings seem to be associated with interest rate movements. Estimates were derived of quarter over quarter changes in the 90 day treasury bill rate over the same period used in assessing changes in official reserves. The rate for the most part fluctuated within a range of 5 to 9 percent. In 22 of the 36 quarters there were decreases or no change in the rate. There were only three occasions on which there were significant increases in the rate following a quarter in which there had been significant reserve losses. The estimated correlation coefficients of changes in reserves and changes in current and lagged changes in interest rates were - 0.066 and -0.28, respectively, underscoring the lack of any significant relationship.

The Jamaican economy performed poorly over the course of the decade. On only two occasions did the annual real rate of growth exceed 2 percent. There were annual negative growth rates in the post 1995 period. In light of these developments one would expect active intervention on the part of the central bank to stabilize the exchange rate. In light of the importance attached to controlling the rate of inflation, one would expect the central bank to act more aggressively to limit the rate of currency depreciation in the short-term and to be less concerned about an appreciation of the currency. There was a significant nominal depreciation in the external value of the Jamaican dollar over the course of the decade. Nevertheless, the central bank appeared to have realized a fair measure of success in limiting the magnitude of short-term depreciations in the exchange rate. In the 37 quarters following the move to a managed rate regime in the fourth quarter of 1991, there were only three quarters over the rest of the decade, as can be seen in Figure 2, where the rate of depreciation exceeded 10 percent and five other occasions when it exceeded 5 percent.

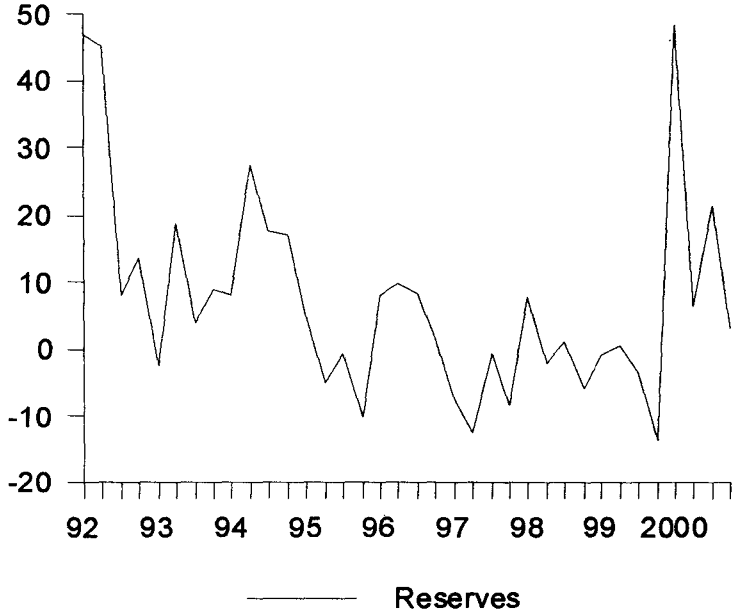
**Figure 2: Jamaica: Percentage Change in Exchange Rate & T. Bill Rate 1992 Q1 to 2000 Q IV**




It would appear that limited reliance was placed on direct intervention in the foreign exchange market to limit the rate of depreciation in the exchange rate. Over the 36 quarters, there were only thirteen occasions, as indicated in Figure 3, when there was a decline in reserve holdings. Moreover, there were only five occasions on which the decline exceeded 5 percent.

The Bank of Jamaica appeared to rely more on the interest rate mechanism as its primary management instrument. The strong link between changes in the exchange rate and interest rate, as reflected in changes in the 90 day Treasury bill rate, can be seen in Figure 2. The

**Figure 3: Jamaica: Percentage Change in International Reserves 1992 Q1 to 2000 QIV**




estimated correlation coefficient between quarterly changes in the exchange rate and the treasury bill rate for the period was 0.49. Interest rates were maintained at very high levels in nominal and real terms and there were frequent significant adjustments in rates. The objective was to relieve pressure on the exchange rate by encouraging the repatriation and retention in the country of foreign currency holdings of residents, as well as limiting surges in aggregate demand.

In order to derive further insights into the extent to which interest rate policy was driven by concerns about exchange rate stability the following model was employed.

$$\Delta I_{nt} = \alpha o + \alpha_1 EX_t - \alpha_2 R_{t-1}$$

where $\Delta I_{nt}$ is the percentage change in interest rates represented by the 90 day treasury bill rate, $EX_t$ the percentage change in the exchange rate, measured as the number of Jamaican dollars per US dollar and $R_{t-1}$ the percentage change in reserve holdings by the Bank of Jamaica, lagged one period.

It is assumed that there would be a direct relationship between changes in the exchange rate and interest rates. At the same time reductions / increases in reserves in a particular quarter would be a signal of potential pressure in the foreign exchange market leading to depreciation / appreciation in the rate. Interest rate changes would respond to changes in reserves with a lag. Accordingly, one would expect an inverse relationship between changes in reserves and interest rates. The model was estimated by ordinary least squares using quarterly data covering the period from the first quarter of 1992 through the fourth quarter of 2000. The results are reported below.

$$\Delta I_{nt} = -0.187 + 2.55 EX_1 - 0.617 R_{t-1}$$
$$(-0602) \quad (4.75) \quad (-3.59)$$

$$R^2 = 0.52; R^2{}_{adj} = 0.49; \text{Durbin} - \text{Watson} = 2.26$$

The $t$ values are in parentheses.

The coefficients for the exchange rate variable and international reserves were both highly significant and had the correct signs. There was a strong direct relationship between changes in the exchange rate and the Treasury

Bill rate. It also appears that interest rate changes were sensitive to changes in holdings of international reserves.

**Exchange Rate Management Instruments and Fiscal Performance**

In this section attention is directed to the issue as to ways in which the choice of instruments for exchange rate management might affect fiscal performance. One might ask whether the difference in emphasis placed on direct intervention in the foreign exchange market in the two countries noted in the previous section might have been due to differences in reserve adequacy. The ability to intervene directly in the foreign exchange market in an effective manner to offset the impact of negative shocks on the exchange rate depends on whether the central bank has at its disposal adequate holdings of foreign reserves. Reserve adequacy will be determined by the size of reserve holdings relative to the size and frequency of the external deficits with which the country has to cope. There would clearly be an inverse relationship between the level of reserve holdings deemed adequate and the size and frequency of external deficits.

In the context of CARICOM economies, such as Barbados and Jamaica, the size of the deficit on balance on current account is usually indicative of the potential magnitude of the intervention required in the foreign exchange market. This is due to the fact that their limited integration in international capital markets results in portfolio flows not being of major significance. Specifically, the current account deficit, as a percentage of GDP, would be a useful indicator of the magnitude of the external shock calling for intervention in the foreign exchange market.

Barbados operated with current account surpluses from 1992 through 1996. The surpluses, as shown in Table 4, were significant, averaging over 6 percent of GDP, ranging from a low of 2.8 percent to a high of 10.6 percent. These surpluses were reflected in overall surpluses in the balance of payments. There were annual deficits on the current account balance from 1997 to 2000, ranging from 3 to 7 percent of GDP. The country clearly did not experience frequent or protracted negative external shocks.

Jamaica, on the other hand, experienced current account deficits in all but two years between 1992 and 2000. Annual deficits on current account averaged, approximately, 4 percent of GDP. On the basis of this criterion, it would appear that the Bank of Jamaica would have been required to intervene more frequently in the foreign exchange market in support of the exchange rate.

**Table 4: Balance on Current Account as a Percentage of GDP**

| Year | Barbados | Jamaica |
|---|---|---|
| 1992 | 10.6 | 0.03 |
| 1993 | 5.0 | -5.2 |
| 1994 | 9.2 | 0.03 |
| 1995 | 2.8 | - 4.2 |
| 1996 | 4.2 | - 2.3 |
| 1997 | - 2.7 | - 4.7 |
| 1998 | - 3.2 | - 3.8 |
| 1999 | - 7.1 | - 3.1 |
| 2000 | - 6.7 | - 4.2 |

**Source:** Central Bank of Barbados, *Annual Statistical Digest;* Bank of Jamaica, *Statistical Digest,* Monthly.

Given the size of the deficit/GDP ratio, further insights into the adequacy of reserves might be garnered from an indication of the number of weeks of imports which could be financed out of reserve holdings by the central bank. Such information for Barbados and Jamaica is set out in Table 5. The level of reserve holdings, on average, provided cover for approximately 15 weeks of imports for Barbados and 10 weeks for Jamaica, over the course of the decade. This suggests that the ability of the central bank to intervene directly in the market would not have been severely constrained by inadequacy of reserves.

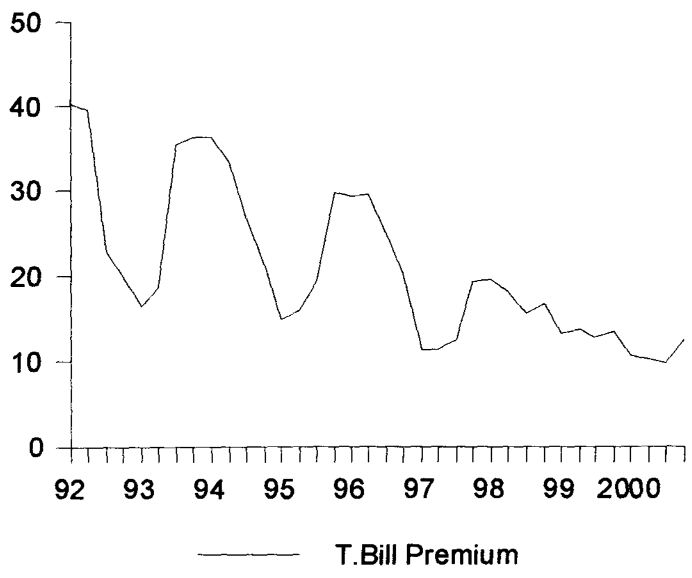
**Table 5: Number of Weeks of Imports Covered by Central Bank Reserves**

| Year | Barbados | Jamaica |
|---|---|---|
| 1992 | 14.0 | 7.0 |
| 1993 | 14.0 | 8.0 |
| 1994 | 16.0 | 13.0 |
| 1995 | 14.0 | 12.0 |
| 1996 | 17.0 | 13.0 |
| 1997 | 15.0 | 11.0 |
| 1998 | 12.0 | 11.0 |
| 1999 | 12.0 | 10.0 |
| 2000 | 17.0 | 14.0 |

**Source:** Same as for Table 4.

Jamaica, as has been stated, operated with high nominal and real rates of interest throughout the decade. The authorities' position was based on the conventional notion that a country like Jamaica had to provide a premium on savings to attract and retain funds which might normally be held in the major financial centres, to compensate for the greater risk associated with holding funds in the country. The premium would be linked to the potential exchange risk associated with converting foreign currency into domestic currency assets. Using the rate on the 90 day Treasury Bill as a benchmark, the Jamaican premium was estimated on the basis of the differential between the Jamaican rate and the equivalent US rate, covering the period from the first quarter of 1992 to the fourth quarter of 2000. The differential, as shown in Figure 4, ranged from a high of 40 percent in the first two quarters of 1992, to a low of 10 percent in the second and third quarters of 2000. From the third quarter of 1992 through the fourth quarter of 1996, the premium never fell below 15 percent. These premiums seem excessive in light of the fact that the rate of currency depreciation in any quarter never exceeded 2 percent.

**Figure 4: Jamaica: Interest Premium on 90 day Treasury Bills 1992 Q 1 to 2000 Q IV**



The maintenance of high interest rates was also seen as a means of offsetting the potential pressures on the balance of payments and the exchange rate arising from the high degree of liquidity in the economy. The fact of the matter is that providing such high rates of return on short-term liquid assets, such as treasury bills, worked to enhance the level of liquidity in the economy.

The fact that a significant share of government expenditure was locked in to meet interest payments meant that a severe constraint would be imposed on a government concerned with maintaining a reasonable balance between public expenditure and revenue. Interest payments in Jamaica, as shown in Table 6, absorbed, on average, more than 30 percent of total government revenue for most of the decade and surpassed the 40 percent level in four of the last five fiscal years. It absorbed a slightly lower share of total government expenditure. In Barbados, by comparison, interest payments accounted for no more than 16 percent of total revenue and expenditure for the same period

Allocations for interest payments along with wages and salaries in the last three fiscal years of the decade accounted for over 70 percent of total government expenditure and over 80 percent of tax revenue in Jamaica. The comparative values for Barbados were in the 50 percent range. This high portion of revenue committed to meet these obligations in Jamaica forced the government to economize in spending on other areas of social and economic infrastructure.

## Exchange Rate Management and Economic Performance

It was argued that differences in the exchange regimes under which Barbados and Jamaica operated during the

Table 6: Interest, Wages and Salaries as a Percent of Expenditure and Revenue

| Year | Barbados | | | | Jamaica | | | |
|---|---|---|---|---|---|---|---|---|
| | Expenditure | | Revenue | | Expenditure | | Revenue | |
| | Interest | Wages | Interest | Wages | Interest | Wages | Interest | Wages |
| 1991/92 | 15.6 | 38.4 | 16.5 | 40.4 | 31.8 | 29.9 | 27.5 | 25.8 |
| 1992/93 | 15.6 | 35.0 | 16.4 | 36.8 | 33.7 | 19.6 | 29.2 | 16.9 |
| 1993/94 | 13.4 | 37.3 | 14.3 | 39.9 | 32.9 | 34.3 | 29.4 | 30.6 |
| 1994/95 | 14.9 | 37.2 | 15.4 | 38.5 | 37.7 | 28.0 | 33.7 | 25.0 |
| 1995/96 | 15.9 | 36.5 | 16.2 | 37.4 | 32.8 | 28.9 | 30.7 | 27.0 |
| 1996/97 | 14.7 | 34.1 | 16.3 | 37.6 | 35.0 | 30.8 | 43.2 | 38.1 |
| 1997/98 | 13.4 | 33.3 | 13.8 | 34.5 | 28.4 | 33.6 | 36.9 | 43.7 |
| 1998/99 | 13.8 | 33.6 | 14.2 | 34.3 | 36.9 | 34.3 | 46.4 | 43.1 |
| 1999/00 | 13.5 | 34.6 | 14.1 | 36.2 | 40.6 | 31.0 | 46.2 | 35.3 |
| 2000/01 | 12.4 | 33.1 | 13.1 | 35.0 | 41.2 | 33.8 | 42.5 | 34.8 |

**Source:** Same as for Table 4.

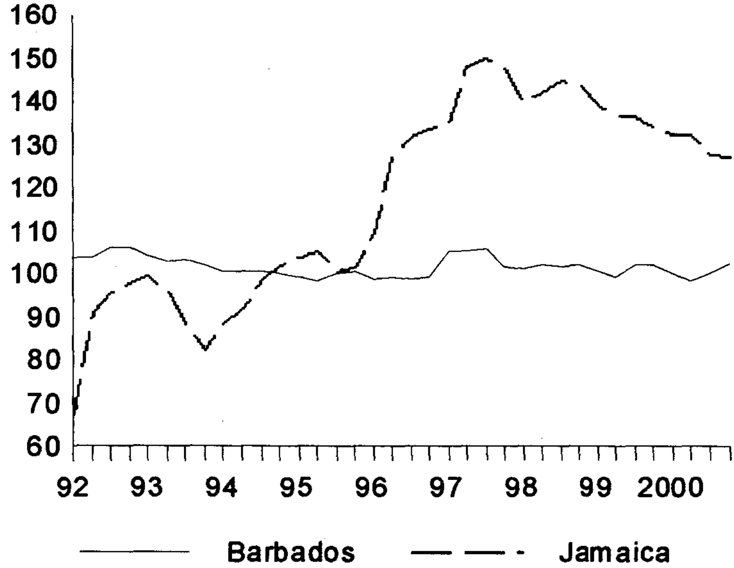
decade of the nineties did not appear to lead to major differences in the overall conduct of fiscal policy. Specifically, the differences in outcomes, as reflected in such measures as the ratio of debt and deficit to GDP in the latter part of the decade could be explained by the major internal shock, the crisis in the financial sector experienced by Jamaica. There are, however, a number of ways in which the difference in the choice of exchange rate regime and instruments used in managing the exchange rate may have had an impact on specific aspects of fiscal management, as well as on the overall performance of the respective economies. This stems from the impact on government spending priorities, the cost of borrowing on private sector investment decisions, and the ability to control the inflation rate.

It has been argued that, had Jamaica operated under a fixed exchange rate regime, the Bank of Jamaica might have been obliged to place more emphasis on control of the rate of growth of the money supply and availability of credit to the private sector, as compared with reliance on interest rates in its approach to exchange rate management (Bennett, 2000). Reference was made earlier to the success realized by the Central Bank of Barbados in exercising control over the rate of growth of the money supply, with the quarterly growth rate exceeding 10 percent on only 8 occasions in the 36 quarters from 1992 to 2000. In Jamaica, on the other hand, there was an almost fourfold increase in the money supply, M1, between the first quarter of 1992 and the fourth quarter of 1996. The combination of growth in the money supply, high interest rates and exchange rate depreciation was shown to be major contributors to the high rates of inflation experienced by Jamaica in this period (Bennett, 2000).

The high interest rates, given the increase in the level of external debt, starting in the middle of the decade, made it difficult for the Jamaican government to contain recurrent expenditure. Furthermore, the combined impact of growth in recurrent expenditure, along with expansion of credit to the private sector, offset any potential anti-inflationary impact of high interest rates. The result was that although some success was realized in limiting short-term depreciation in the exchange rate there was a trend toward an appreciation in the real exchange rate. Barbados, on the other hand, by realizing more success in combatting inflation was able to achieve a far greater measure of stability in the real effective exchange rate. Figure 5 shows trends in the bi-lateral real effective exchange rate of the two countries, with their major trading partner the United States, from the first quarter of 1992 through the fourth quarter of 2000. The rate for Barbados fluctuated within a narrow range of 5 percent. There was a major appreciation in the Jamaican rate, following the managed nominal appreciation of the currency at the beginning of the second quarter of 1992. The rate appreciated by over 60 percent from that time through the third quarter of 1997. Since that time there has been a modest depreciation but it has retained a substantial real premium.

The poor performance of the Jamaican economy was, in part, related to its failure to achieve success in reducing its reliance on traditional primary exports and increasing exports of manufactured products. There was a sharp reduction in exports of manufactured products in the post-1995 period. This was in large part due to the loss of markets for garments in the United States. The failure to adjust to the loss of what had emerged as a major product market was made more difficult by appreciation in the real effective exchange rate. The combined effect of real exchange rate appreciation and low labour productivity was found to have had a major negative impact on the performance of the manufacturing export sector (Bennett, 2001).

**Figure 5: Barbados and Jamaica: Bi-Lateral Real Exchange Rate Indices Q1 1992 to Q IV 2000. 1990 = 100**




**Note:** An increase represents a real appreciation.

This was in large part due to the loss of markets for garments in the United States. The failure to adjust to the loss of what had emerged as a major product market was made more difficult by the appreciation in the real effective exchange rate. The combined effect of real exchange rate appreciation and low labour productivity was found to have had a major negative impact on the performance of the manufacturing export sector (Bennett, 2001).

## Conclusions

The study suggests that there are potential important implications for fiscal policy arising from the choice of exchange rate regime, even in the absence of direct evidence of a link between regime choice and fiscal discipline. It was pointed out that the Central Bank of Barbados, in defence of the fixed exchange rate, had to exercise a greater measure of control over the rate of growth of the money supply. On the other hand, the flexible exchange rate regime allowed the Bank of Jamaica more flexibility in its approach to controlling the money supply, since the objective was to limit movements in the rate, rather than maintain an unchanged parity. It placed more emphasis on use of the interest rate as its primary tool of monetary management for the greater part of the decade. Interest rate adjustments were used as a means of containing aggregate demand and, in this indirect manner, pressure on the exchange rate.

The heavy reliance on the interest rate as the instrument of choice for monetary management in Jamaica led to a situation where the fiscal policy options were far more constrained than was the case in Barbados. This arose from the fact that the combination of high interest rates and high levels of public debt meant that a major share of government revenue had to be committed to debt service. Given the need to try to contain the level of public indebtedness within reasonable limits, sacrifices had to be made in other areas of public expenditure. This was reflected in the deterioration in important areas of social and economic infrastructure, such as education, health and the road system.

It was also shown that there were some important indirect consequences of the choice of the exchange rate regime not only for fiscal policy, but for the overall performance of the respective economies. The Bank of Jamaica strategy of high interest rates combined with relatively lax control on the rate of growth of the money supply in the first half of the decade made it difficult to contain the rate of inflation. Persistent inflation made it difficult to reduce interest rates. At the same time, the inability to control inflation contributed to a major appreciation in the real exchange rate. In Barbados, by comparison, in realizing a greater measure of success in containing inflation, interest rates were maintained at much lower levels and the real exchange rate remained relatively stable.

The combination of high interest rates and real exchange rate appreciation in Jamaica undermined the competitive position of those engaged in the production of non-traditional exports, mainly manufactured products. The weakness in export performance helped to perpetuate the economic stagnation of the economy over the decade.

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# 10

# The Standard Approach to Stabilisation and its Implications for Small Economies

*Esteban Pérez**

## Introduction

The last two decades of the twentieth century will be remembered, from most accounts, as decades of economic adjustment and reform. Against a background of macroeconomic disequilibria and an external debt crisis, Latin American and Caribbean countries adopted market-based policies featuring

* ECLAC. Economic Affairs Officer (Trinidad and Tobago, Sub-regional Headquarters for the Caribbean). The opinions expressed here are the responsibility of the author and may not coincide with those of ECLAC. The rest of the usual caveats also apply.

monetary restraint and fiscal contraction, trade liberalisation and institutional reform.

Underlying this policy orientation was a uniform vision termed the 'Washington Consensus.'[1] The market was perceived as a benevolent regulator and acted as a catalyst for optimal resource allocation and growth. The specifics of this vision incorporated a determinate hypothesis regarding the behaviour and functioning of the labour, capital (asset) and goods markets, and a sequential order of market liberalisation.[2] In a nutshell, this working hypothesis included rational economic agent behaviour, relative prices as reflecting relative scarcities, price flexibility and market clearing. Most important to the consensus was the belief that efficiency was promoted by

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1 The 'Washington Consensus' is used here for didactic purposes but is not understood to have a 'fixed meaning' or interpretation. The meaning of 'Washington Consensus' moved from providing a 'list of policy reforms to be implemented' to 'a policy prescription advocating the allocation of resources through market mechanisms and government intervention to provide the legal and institutional framework for the workings of market-based policies.' See Williamson (1990 and 2000). Williamson (2000) argues that the 'Washington consensus' was geographically and historically specific and provided a lowest common denominator for policies being implemented in Latin American countries during the decade of the 90s.

2 See, for example, McKinnon (1991) on the financial order of economic liberalization. According to Hallwood and MacDonald (1994, p.346) the order of liberalization accepted by "some economists" is the following: "reduce fiscal deficit -> financial liberalization and trade reform->reform the exchange rate->reform the capital account."

real forces, productivity, thrift and the like, and that money was simply 'a veil.'[3]

At a formal level, the Monetary Approach of the Balance of Payments gave one of the most coherent formulations of this vision. This approach viewed the balance of payments as a monetary phenomenon, emphasised stock over flow equilibrium, and assumed full employment as the long-run norm of market economies. In its simplest formulation, prices and interest rates were determined exogenously and the adjustment was brought about by variations in quantities rather than in relative prices. The model postulated that balance of payments disequilibria were the result of an excess of absorption over income and that absorption was driven by domestic credit and, in particular, by credit to the public sector.[4]

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3 Friedman and Shcwartz (1971, p.696) write: "Money is a veil. The 'real forces' are the capacities of the people, their industry and ingenuity, the resources they command, their mode of economic and political organization, and the like."

4 The most basic income accounting identity states that income *(Y)* is by definition equal to the sum of consumption *(C)*, investment *(I)*, government spending *(G)* minus taxes, and net exports (exports *(X)* minus imports *(M)*).

$$\begin{aligned} Y &= C + I + (G - T) + (X - M) \Leftrightarrow \\ (S - I) &= (G - T) + (X - M) \end{aligned} \tag{1}$$

A causal relationship is postulated running from government spending to external and internal balance. An excess of government expenditure (excess of absorption over income, $G>T$) results in an excess of imports over exports $(M>X)$. As a result, when government expenditures exceed taxes, investment exceeds savings $(I>S)$. See as an example the IMF Balance of Payments Manual (1995), Appendix V.

The restoration of equilibrium needed a monetary policy to keep absorption in line with income. Due to the assumption of full employment, which provided the underpinnings for the separation of the real from the monetary sphere, this policy was not perceived as affecting the level of real variables (such as GDP), nor their composition. As a corollary, policy makers believed that this policy would be able to remove the distortions imposed by the excessive and unbalanced growth of nominal variables without significant alterations to the patterns of development and productive specialization.

In the 1980s and 1990s, the Monetary Approach of the Balance of Payments became the main tool for economic policy stabilisation in Latin America and the Caribbean and was particularly suited to deal with the external disequilibrium affecting these economies. While in fact the initial conditions of the countries were different, the application of the economic principles underlying this market-oriented approach was remarkably homogeneous throughout the cases involved.

In addition, the coexistence of economic stagnation and inflation (i.e., stagflation) following the first oil shock legitimised the use of the Monetary Approach. The event exposed the weak foundations of the current approach to stabilisation based on a discretionary mix of fiscal and monetary policies. The intellectual climate was ripe for a change in the orientation of stabilisation policies.

Drawing on Latin American and Caribbean experiences, the paper analyzes theoretical and empirical issues of stabilisation policies.[5] The focus of the paper is on the conceptual underpinnings of the Monetary Approach of the Balance of Payments, its application in selected Latin American and Caribbean economies and its economic consequences.

The paper is divided into seven sections. The first traces the history of stabilisation policies from the Keynesian Revolution to the adoption and implementation of the Monetary Approach of the Balance of Payments. This section provides the historical context for the rest of the paper.

The second section describes the basic features of the Monetary Approach of the Balance of Payments. The third section sets the algebraic formulation of the simple Monetary Approach of the Balance of Payments model. The fourth and fifth sections develop that model in growth rates and introduce endogenous prices and output.

The sixth section describes the implementation of the Monetary Approach in selected Latin American and Caribbean cases. The cases included are resource based economies (Guyana and Nicaragua), a reversed commodity boom economy (Trinidad and Tobago), services based

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5 Analyses of economic stabilization are also found in Taylor (1988 and 1993). With the exception of Nicaragua, the countries-cases presented in this paper are not analyzed in Taylor *(op.cit)*. A three-gap model provides the framework for the analysis of country cases. Other stabilization studies include Bruno *et. al.* (1988 and 1991) although both deal specifically with inflation stabilization.

economies (Barbados and the Dominican Republic) and a more industrialised economy (Argentina).

The seventh section combines the theoretical aspects of the Monetary Approach and the empirical features of the country cases in order to trace the economic consequences of economic stabilisation. The final reflections are found in the conclusion.

## 1. A Brief Sketch of Stabilisation Policy History

Following World War II, the Keynesian revolution ruled the roost. It consisted of two ideas. The first, known as the principle of effective demand, asserted that investment determines output, employment and savings. The second stated that the price level is determined by nominal wages rising above productivity. The policy recommendations followed accordingly. Investment policies were geared to promote high levels of employment. Public investment was thought to be complementary to private investment and focussed mainly on infrastructure.

The price for high employment levels was inflation, as reflected in money wages rising above productivity. At the same time that unemployment was declining to reach an all time low in developed economies, inflation began to accelerate.[6] The recommended tool to deal with inflation was an incomes policy. This responded to the view that

6 During 1950-1973, the average unemployment rate and the inflation rate for developed countries were 2.6% and 4.2% respectively (Maddison, 1991).

inflation was not an economic but, in essence, a political problem (Keynes, 1943).[7]

In practice, rather than providing an institutional solution to the problem of combining low levels of unemployment with high growth, the dilemma was solved through the appropriate mix of fiscal and monetary policies. This responded, in part, to a belief in the economics profession that macroeconomic performance should reflect microeconomic behaviour.

Indeed, monetary and fiscal policies could be appropriately combined to restore and validate the principles of pre-Keynesian theory. As put by Samuelson (1970, p.348):

> ... we end with the reasoned prospect that appropriate monetary and fiscal policies can ensure an economic environment which will *validate* the verities of microeconomics – that society has to choose among its alternative high-employment production possibilities, that paradoxes of thrift and fallacies of composition will not be permitted to create cleavages between private and social virtues or private and public vices. By means of appropriately reinforcing monetary and fiscal policies, a mixed economy can avoid the excesses of boom and slump and can look forward to healthy progressive growth. The broad cleavage between microeconomics and macroeconomics has been closed by active public use of fiscal and monetary policy.

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7 Keynes (1943 (1980, p.38), CW, Vol. XXVI states: " The task of keeping efficiency wages reasonably stable ...is a political rather than an economic problem."

These precepts became ultimately embedded in the IS-LM model for a closed economy and its extension to an open economy in the guise of the Mundell-Fleming model.[8] These models in conjunction with the Phillips curve, which provided the missing price equation, provided the basis for stabilisation policies throughout the Golden Age of Capitalism (1950-1970).[9]

As it turned out, the adoption of a monetary and fiscal mix to address the problems of inflation and unemployment forced governments into a straightjacket: the political economy of the trade-cycle (Kalecki, 1944).[10] Unemployment became an important fetter to the success of govern-

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8 The Mundell-Fleming model was used in particular to analyse the effectiveness of monetary and fiscal policies with flexible and fixed exchange rate regimes and different degrees of capital mobility. The basic model asserted that in a small open economy with unemployed resources, an elastic aggregate supply curve, static exchange rate expectations and perfect capital mobility and flexible exchange rates, fiscal policy is imponent and monetary policy is all-effective. See, Fleming (1962) and Mundell (1963) for the original contributions. On the origins of the model see Boughton (2002). Boughton (p.7) states that: "Fleming presented his model as an extension of the Hicks-Hansen IS-LM model." On the development of the IS-LM model see Young (1987).

9 During 1950-1973, GDP growth for developed and developing economies (excluding Eastern and Central Europe and the former Soviet Union) was 5.9% and 5.5% respectively. (See Davidson (2000), p.159).

10 See also J. Robinson CW Vol. III (1965), pp.103-112 and p.112-124; and CW. Vol. V (1980), pp.1-31; pp.168-177; and pp. 178-183.

ments democratically elected but at the same time low levels of unemployment meant high levels of inflation, which in turn had negative effects on the productive and *rentier* classes. Maintaining the social and economic balance and stability thus meant adopting stop and go policies as a means of alternating between regimes of high and low unemployment. Thus, despite the claim of using stabilisation policies 'to close the cleavage' between macro and microeconomics, stabilisation policies themselves had a weak foundation in economic theory.[11] They were, rather, the outcome of a political compromise.

The basis for a trade-off between unemployment and inflation was removed once stagflation (economic stagnation and high rates of inflation) became an international problem following the 1974-1975 recession.[12] Unemploy-

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11 Skidelski (1992, p.613) explains the acceptance of Hicks interpretation of Keynes' General Theory in an IS-LM format in the following way: "The lack of the 'mathematically elegant' approach was due to the fact that working economists did not know how to digest the *General Theory* until Hicks's diagram told them how to see it, and also that Hicks's model 'was the conceptual manifestation of the quest for continuity and certainty....' Hicks, or perhaps ultimately Keynes, reconciled revolution and orthodoxy in a double sense: in terms of the discipline of economics, and in terms **of the continuity of political and social institutions.**" (bold font added by the author of this paper).

12 The international 1974-1975 crisis also coincides with the abandonment of the Bretton Woods System following the United States' decision to abandon the gold standard in 1971. To what extent the dismantling of the current international 'rules of the game' contributed to the recession is a debatable question that has become important in light of the proposals for a new international monetary order.

ment and inflation coexisted and this removed the political basis for a social compromise that led to the adoption of stop-and-go economic cycles. Stagflation set the stage for an attack on stabilisation policies, and through them on the ability of a government to steer the course of an economy.

The foundations of the attack were outlined by Milton Friedman in his presidential address of 1968.[13] These can be summarised as follows. Economies have a natural rate of unemployment corresponding to a natural rate of output determined by real factors (preferences, technology, and endowments). The natural rate of unemployment is conceived as the dividing line between monetary and real factors, the former being independent of the latter. No economic agent possesses sufficient knowledge to ascertain the level of the natural rate of unemployment. As a result, no agent can determine to what extent the actual rate of unemployment coincides or deviates from the natural rate.

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13 See Friedman (1968) and (1984). The weaknesses of the fiscal-monetary mix approach to economic stabilization became clear during the debate between Monetarists and Keynesians as they realized that their underlying theory was the same. In the IS-LM format it all boiled down to the different shapes in the slopes of the IS and LM curves. Friedman discredited the foundations of the fiscal-monetary mix approach to economic stabilization by pointing out that economic agents are not blind to economic events and in fact incorporate these into the formation of their expectations. In his presidential address (1968) he considered, nothwithstanding economic illusion on the part of workers, obtaining a short-run downsloping Phillips curve and a vertical long-run Phillips curve.

Government intervention should thus be limited to removing the obstacles impeding the actual rate from trending to the natural rate and/or to implementing policies to change the natural rate of unemployment. The former implies the removal of constraints to the functioning of markets (labour, capital, commodities and money) and the latter the need to articulate supply-side policies. Within this framework, monetary policies could only affect the rate of unemployment transitorily due to the existence of market imperfections. In the 'long run', the rate of unemployment will be independent of monetary factors and determined by 'real forces' (thrift, productivity and the like).

The separation of the real and monetary sides of the economy was fully completed by the New Classical Macroeconomics (NCM, hereafter).[14] This school of thought emerged in the 1980's and posited jointly a market-clearing approach to economic analysis and the assumption that

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14 The rational expectations hypothesis stated formally that

$$E(\pi/I_{t-1}) = \pi^* \text{ and } \pi - \pi^* = \pi - E(\pi/I_{t-1}) = \nu \qquad (2)$$

where $\nu$ is a random variable and $E(n)=0$; $E$ is the mathetical expectations operator; $\pi, \pi^* =$ are the expected and actual values of a given relevant economic variable denoted by '$\pi$' and $I_t$ = refers to the information set available to economic agents at time $t$. The rational expectations hypothesis was originally formulated by Muth (1961). According to Sargent (1973) it states: "...amounts to supposing that the public's expectations depend, in the proper way, on the things that economic theory says they ought to." The main articles of the NCM are included in Rational Expectations and Econometric Practice (1981).

economic agents make 'on average' correct forecasts of the relevant economic variables (i.e., rational expectations). According to the NCM proponents, monetary factors were independent of real factors, both in the short and long run. In other words, the Phillips curve was always vertical in the inflation-unemployment rate loci.

This development had an important bearing on stabilisation policies. Stabilisation policies were removed from the sphere of the real economy and unemployment and re-directed to act exclusively on the monetary sphere. The aim of stabilisation policies was to achieve price stability. Within this vision, unemployment was not a requirement for the maintenance of the value of money as implied by Keynesian economics. It was a temporary effect of monetary policies caused by market imperfections, whether these were embodied in expectations or institutional arrangements.

This monetarist approach was easily extended to the open economy by viewing the balance of payments in terms of the international reserve position of a country. Since by definition the money supply equals domestic net assets (i.e., credit to the private and public sector) and international reserves, the analysis of its components should also be cast in monetary terms. This approach was termed the Monetary Approach of the Balance of Payments (MABP, hereafter).

## 2. The MABP: A Prose Description

The MABP is the offspring of an empirical fact and an economic tradition. The empirical fact is the 1967 devaluation of the pound by British authorities, leading to wage inflation and deflationary measures to improve the position of the balance of payments. Intellectually the MABP owes its development to the Chicago School of economics (Mundell, Johnson) and to Dutch economists Koopmans and Polak (Johnson, 1972, 1980).[15]

The MABP defines the balance of payments as the "net resultant inflow or outflow of international reserves" (Johnson, 1980, p.263). It is, thus, a result of a disequilibrium in the money market and hence a monetary phenomenon. This view is contrasted to the 'Keynesian' or 'popular' type theories of the balance of payments that focus on the real side. Adjustment in these theories comes through relative prices and interest rates. On the other hand, according to the MABP, the adjustment comes through the interplay of the demand for money and changes in international reserves. As an example, if a domestic expansion of credit leads to an increase in real cash balances for a given price level, absorption increases relative to output, inducing a deficit in the balance of payments. As a result, the stock of foreign reserves decreases, driving with it the supply of money. This translates into a reduction of absorption until it conforms to the level of output. Within this framework, the relevant control variable is the rate of growth of credit rather than the rate of growth of the money supply. The practical application is a rule focusing on the rate of growth of credit relative to that of output replacing the usual Friedmanite money supply rule (Mundell, 1980, p.87).

The assumptions underlying the MABP are first that the world is an integrated capital and commodity market.

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15 See Polak (1957) for an early treatment. Taylor (1988, p.154) states that Polak rivals Keynes in his influence on macroeconomic policy: "Certainly in terms of the number of countries and people it has affected, Polak's work is the most important piece of Macroeconomics since Keynes." See also Polak's (1997), "The IMF Monetary Model at Forty."

Second, within this setting national price levels conform through competition to a one-world price level. Any country's price level is pegged to the world price level and moves rigidly in line with it. This assumption rules out adjustment through relative prices. This is justified by positing for infinite elasticities of substitution among industrial products of advanced economies or by arguing that changes in relative national price levels are "transitory concomitants of the process of stock adjustment to monetary disequilibrium." (Johnson, 1980, p.154). Finally, the MABP assumes full employment, arguing that this is the norm rather than the exception for the world economy in the post WWII era.[16]

The MABP has important implications for economic policy. First, the world rate of inflation is determined by the world money supply. As long as countries maintain pegged or fixed exchange rates they cannot avoid conforming over time to the world price level.

Second, since the model assumes an integrated world capital and commodity markets, fiscal and monetary policies do not have any effect on real aggregate output. Fiscal policy can only change the composition of government expenditure and the proportion financed by debt. For its part monetary policy has no control over the money supply; it is an endogenous variable (the public adjusts the nominal supply of money to its demand by exporting or importing money via the balance of payments). Monetary policy can only determine the composition of

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16 See Hahn (1983) for a critique of this assumption.

the money supply between net domestic assets and international reserves.

Third, contrary to the conclusion of the Keynesian balance-of-payments theory, international reserve growth is positively related to domestic growth and the income elasticity of demand for money. Growth does not deplete reserves *via* an increase in imports. On the contrary, it leads to an increase in its stock *via* its positive effect on the demand for money. The effect will be all the more positive, the greater the income elasticity of demand for real cash balances.

Finally, the effects of a devaluation are akin to those of a deflationary policy stance. A devaluation of the currency increases domestic prices, *ipso facto*, through the law of one price, and translates into a decrease in real cash balances. Economic agents' restoration of their desired level of real cash balances leads to an increase in lacking (to use the Robertsonian term) and a lower level of expenditure. Since a devaluation merely restores a desired level of real cash balances its effects are transitory. As stated by Johnson (1971, p.92): " A continuing balance-of-payments surplus requires either repeated devaluation or continuing restraint on the rate of growth of domestic credit."

The explosion of the international debt crisis in 1982, which dried up the supply of external funds and forced debtor developing countries to adjust in order to avoid unsustainable external positions, provided the ideal setting for the implementation of the MABP. In fact, it became the main vehicle for formulating stabilisation policies in Latin America and the Caribbean during the 1980's and 1990's. In correspondence with the methodological principles of orthodox economic theory, it was applied irrespective of the particular position and condition or structural features of the country.[17] The adjustment consisted in restoring macroeconomic equilibrium and the adoption of policies aimed at imposing the discipline of the free market on the different spheres of economic activity (trade, financial and capital market and eventually the labour market).

The following two sections provide the formulation of the MABP model in its algebraic form, first in levels and in growth rates. In a subsequent step, inflation and the rate of growth of output are endogenized. Endogenizing prices allows solving an important contradiction within the standard model (prices cannot be determined simultaneously by the money supply and by foreign factors through the law of one price). At the same time, all of these extensions to the basic model make the MAPB more applicable and amenable to the conditions of developing economies without affecting the main policy conclusions of the MABP in its standard form.

## 3. The Algebraic Formulation of the MABP

The model starts with an identity of the consolidated balance sheet of the banking system stating that money supply *(Ms)* equals the change in international net reserves *(IR)* plus the change in domestic bank credit *(DBC)*,

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17 These principles are laid out in Dow and Lawson (1997). Allais (1970, p.1156) provides a clear statement of these principles in his analysis of hyperinflation: "The results show that human societies placed in very different circumstances, ranging from normal situations to hyperinflations..., today or half a century ago, react accordingly to one and the same law (maximization of utility)...The similarity in behaviour should be interpreted as corresponding to the invariance of human psychology in space and over time, at least in its collective aspect."

$$\Delta Ms = \Delta IR + \Delta DBC \qquad (1)$$

where $\Delta$ = increment.

Assuming equilibrium in the money market, money supply *(Ms)* equals money demand *(Md)*,

$$\Delta IR = \Delta Md - \Delta DBC \qquad (2)$$

$$Md = Pf(y,r) \Leftrightarrow Md = P * y / V \qquad (3)$$

The balance of payments balance equals the sum of the current account balance *(CA)* and the financial and capital balance *(BK)*,

$$BP = CA + BK \qquad (4)$$

By definition, the current account balance equals the difference between aggregate expenditure or absorption and disposable income. In turn, this is equivalent to expressing the current account balance as the difference between the change in international reserves and the surplus in the capital and/or financial account.

$$CA = Y - ABS \Leftrightarrow CA = \Delta IR - K \qquad (5)$$

Substituting (2) and (4) into equation (5) we get,

$$ABS - Y = \Delta DBC + K - \Delta Md \qquad (6)$$

Equation (6) states that, for a given position of the capital and financial account of the balance of payments, if absorption is greater than income *(ABS>Y)* then the increase in credit creation has to be greater than the increase in money demand $(\Delta DBC - \Delta Md > 0)$. As a result, the current account will be in deficit (Eq.5) and the level of reserves will decrease (Eq.2)

Though domestic credit refers to both public and private credit ($DBC_{pr}, DBC_{pu}$ respectively) the onus of the adjustment is placed, in general, on credit to the public sector. This permits the transformation of these identities into causal relationships. The posited causality is going from public spending to a balance of payments disequilibrium and a consequent loss of international reserves. Avoiding this situation involves imposing a restrictive monetary policy to make absorption conform to income so that the economy in question will not lose reserves, avoiding in turn a balance-of-payments constraint.

Within this simple MABP framework, fiscal policy can be analyzed by introducing a government constraint. Since this framework operates with identities, a budget constraint is in accordance with the spirit of the model and merely provides an additional analytical dimension, that of fiscal policy.

The government constraint states that its operational deficit (the primary deficit *(Gs -Gr)* and the interest payments on its debt *(rB)*) is financed with an increase in its bond issues $(B_{pu})$ and commercial bank credit $(\Delta DBC_{pu})$. Formally,

$$dDBC_{pu}/dt + dB/dt = Gs - Gr + rB \qquad (7)$$

where

$B$ = stock of government debt.
$Gs$ = government expenditure.
$Gr$ = government revenue.
$r$ = rate of interest.

Insofar as a budget deficit implies credit creation by the monetary authorities, a fiscal disequilibrium will translate into a balance of payments deficit and a loss of foreign reserves. The fiscal policy recommendations also point to a restrictive stance on the part of the authorities for a given level of output, which at this stage is exogenous.

## 4. The MABP in a Growth Context

One of the key assertions of MABP proponents is that the model is not static and can be expressed in a growth context. The procedure starts with a demand for money homogenous of degree one in prices and expressed as a function of real output *(y)* and the rate of interest *(r)*. Formally,

$$Md = P\,f(y, r) \qquad (8)$$

Using the representation of functions by means of elasticities, the growth rate of money demand can be expressed as a function of the rate of inflation ($\pi$), the rate of growth of real output *(gy)* weighted by the income elasticity of real cash balances (($\eta y$), and the interest rate weighted by its respective elasticity ($r$ and $\eta r$ respectively). Formally,

$$gmd = \pi + \eta y y + r\,\eta r \qquad (9)$$

The rate of growth of the money supply can be expressed as the rate of growth of reserves *(gr)* and that of domestic credit *(gd)* weighted by the proportion of reserves and deposits to total money supply *(R/R+D and D/R+D).* Formally,

$$gms = R/(R+D)\ gr + \ D/(R+D)\ gd \tag{10}$$

where

$R$ = reserves and $D$ = deposits.

Assuming equilibrium in the money market, the rate of growth of reserves can be expressed as a function of inflation ($\pi$), real output growth *(gy)* and the rate of growth of domestic credit *(gd)*.

$$\begin{aligned} &gms = gmd \Leftrightarrow (R/R+D)\ \ gr + \\ &(D/r+D)gd = \eta + gy\eta y + r\eta r \Leftrightarrow gr = \\ &(R+D)/R[\pi + gy\ \eta y + r\eta r] - (D/R)gd \end{aligned} \tag{11}$$

According to Eq. (11) the growth of international reserves is positively related to inflation, the income elasticity of the demand for real cash balances, output growth, domestic interest rate, the elasticity of domestic interest rates and negatively related to domestic credit.

Assuming that inflation is stable and excluding variations in the rate of interest on account of the assumption of the degree of integration of capital and goods market, the rate of growth of reserves will be equal to zero, or will be positive or negative according to whether output growth and the income elasticity of real cash balances are equal to, greater, or smaller than the growth of credit creation weighted by the proportion of credit in total money supply. Formally,

$$gr = 0 \Leftrightarrow (R + D) / R \ ((gy\eta y) - (D / R)gd =$$
$$0 \Leftrightarrow 1 / R \ (gy\eta y) - (D / Ms) fd) = \qquad (12)$$
$$0 \Leftrightarrow \ (gy\eta y) = (D / Ms)gd$$

This conclusion expressed in a growth context is very similar to the one derived from Eq. (6) above, namely, credit creation has to be greater (smaller) than money demand for the rate of growth of reserves to be negative (positive).

At this stage expressing in growth terms the budget constraint in Eq.(7) completes the model. Appropriate manipulation of Eq. (7) yields,

$$(Gr/Y - Gs/Y) + gb = (r - gy) \ B/Y + gd \qquad (13)$$

where $gb$ = rate of growth of government debt.

The budget constraint can always be modified to include external debt. If, as the MABP presumes, there is perfect capital mobility in the sense that the domestic rate of interest equals the international rate of interest $(r = r^*)$, then Eq. (13) above becomes

$$(Gr/Y - Gs/Y) + gb =$$
$$(r^* - gy) \ (B + eB^*)/Y + gd \qquad (14)$$

Where, $e$ = nominal exchange rate and $r^*$ = international rate of interest.

The implications for economic policy of the MABP approach developed in the previous section remain valid when the model is formulated in growth rates. A budget deficit, other things remaining equal, implies credit creation by the monetary authorities and an increase in absorption above output. This results in a loss of foreign exchange reserves.

This conclusion is further strengthened when the price level and the rate of inflation are endogenized. Rather than assuming that the rate of inflation is determined exclusively through the law of one price, it can be viewed as a function of two variables, the external rate of inflation and domestic expenditure.[18] In this case, credit creation can worsen a balance of payments position through increased imports (income effect), and by undermining the competitiveness of exports *via higher* domestic prices (price effect).

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18 It should be pointed out that endogenizing prices has a logical function within the MABP model. This springs from the over-determination of prices implicit in the standard model (Taylor, 1988). According to Eq. (3) above, the price level is determined by the quantity theory of money. That is,

$$Md = P\,y/V, \text{since } Ms = Md \Leftrightarrow P = Ms * V/y \qquad (3)$$

At the same time $P$ is determined through the law of one price, that is by foreign factors. Thus in the model prices are determined by two conditions simultaneously. The price level is over-determinate. A way to overcome this over-determination is to use a tradable-non-tradable model to obtain prices and at the same time permit prices in part to be determined by monetary and external conditions.

The incorporation of endogenous prices, however, requires the modification of Eq. (11). This is due to the fact that an increase in prices has two opposite effects on the growth of reserves.

On the one hand, a price increase (ruling out hyper-inflation cases) leads, other things being equal, to a decline in real cash balances and a consequent decline in expenditure and absorption (increase in nominal money demand) as agents seek to restore their initial level of real cash balances. In this situation, reserves increase. On the other hand, an increase in prices leads to a decline in exports and, depending on the balance of payments outcome, to a reduction in the stock of international reserves. The final result will depend on the relative strength of each of these effects, which can only be determined empirically. To capture this effect and due to the fact its sign is unknown a priori, an additional parameter with an interrogation mark $(\gamma(?))$ is added to Eq. (11), so that it becomes

$$gr = (R+D)/R\,[\gamma(?)\pi + gy\eta y + r\eta r] - (D/R)gd \qquad (15)$$

At a formal level the derivation of the price equation proceeds in the following way. Let the overall price level (Pt) depend on the price levels of tradables $(P_T)$ and non-tradables $(P_{NT})$,

$$P_t = P_{NT}{}^{\alpha} P_T{}^{(1-\alpha)} \text{and } \alpha < 1 \qquad (16)$$

Assume that the price level of tradables follows the law of one price,

$$P_T = eP^* \qquad (17)$$

where

$e$ = exchange rate
$P^*$ = external price level

This price formulation assumes that wages and the nominal rate of exchange are determined by past price levels, that is,

$$W_t = P^{\rho}{}_{t-1} \tag{18}$$

$$e_t = P^{\varpi}{}_{t-1} \tag{19}$$

Finally, it is assumed that there exists a proportional relationship between the ratio of absorption to income and that of the supply to the demand of non-tradables. The supply of non-tradables depends on the cost of production and the demand for non-tradables on the relative price ratio of both goods.

$$A/Y = S_n(W, P_{NT})/D_n(P_{NT}, P_T) \tag{20}$$

Eq. (20) can be expressed in terms of the price level of non-tradables. Then, taking logarithms and differentiating Eqs, (16-20), the rate of inflation can be expressed as a weighted average of the rates of the external rate of inflation, the rate of change of the exchange rate and the difference in the rate of growth of absorption over income,

$$\begin{aligned}\pi_t = 1/(\varepsilon-\eta)[(\alpha\varepsilon-\eta)(e_t+\pi_T{}^*)+ \\ (1-\alpha)(\varepsilon\pi_{t-1})-(1-\alpha)(ga-gy)]\end{aligned} \tag{21}$$

where

$\varepsilon$ = elasticity of supply of non-tradables with respect to the real wage and $\varepsilon < 0$.

$\eta$ = cross elasticity of demand of the non-tradables with respect to the terms of trade and $\eta > 0$.

The introduction of endogenous prices makes the case for restrictive policies more pressing since, in general, $(\alpha\varepsilon - \eta) < (1 - \alpha)$. In other words, the weight assigned to the exchange rate and external inflation in the determination of domestic inflation is smaller than the weight assigned to the difference in the rate of growth of absorption relative to income.

## 5. The Incorporation of Endogenous Growth within the MABP Framework

The rate of output growth can be endogenized using the two basic pillars of the modern endogenous growth theory. These are the intertemporal utility function and the production function. The rate of growth of output is then seen to depend on the elasticity of substitution, the marginal product of capital and consumers' choice of intertemporal preferences.

To commence, assume an immortal representative agent that maximizes an intertemporal utility function over an infinite horizon. Formally,

$$U = e^{\rho} U(c) \qquad (22)$$

where $\rho > 0$ *and* $u' > 0$; $u'' < 0$.

$\rho$ = parameter reflecting intertemporal preferences.
$U$ = well behaved utility function with a constant elasticity of substitution.

Assume furthermore a well-behaved production function satisfying the Inada (1960) conditions in its most general form,

$$Y(t) = F[A(t), K(t), B(t), L(t)], \qquad (23)$$

where

$A(t)$ = index of the quality of capital
$K(t)$ = capital stock
$B(t)$ = index of the quality of labour
$L(t)$ = labour

The steady state rate of growth of output can be obtained from the particular specification of the utility and production functions. That is, the steady state rate of growth depends on the state of technology, the elasticity of substitution in the utility function and consumer preferences. That is,

$$gy = 1/\varphi(f' - \delta - \rho) \qquad (24)$$

where

$gy$ = steady state rate of growth of output.
$\varphi$ = constant elasticity of substitution.
$f'$ = first derivative of the production function.
$\delta$ = depreciation of the capital stock.
$\rho$ = parameter reflecting intertemporal preferences.

If in this model preferences are assumed to be constant or stable, the steady state rate of output growth will depend exclusively on the specification of the production function. If $f'<0$ then the production function will exhibit decreasing marginal returns. If $f'>0$, the equation easily incorporates increasing returns to scale and it is compatible with endogenous growth theory. This particular framework can incorporate fiscal policy in such a way as to affect the long-run value of the steady state growth of output and is thus compatible with the Monetary Approach of the Balance of Payments. Following Rebelo (1991) let the production function equal,

$$Y = AK \tag{25}$$

Replacing the first derivative in Eq. (24), we obtain

$$gy = 1/\varphi(f' - \rho) = 1/\varphi(A - \rho). \tag{26}$$

In this model the introduction of a tax on consumption and investment modifies equation (26) to yield

$$gy = 1/\varphi[(A/(1+\tau)) - \rho] \tag{27}$$

where

$\tau$ = tax on investment.

According to Eq. (27) a tax on investment decreases the steady rate of growth of output. Another type of model (Barro, 1990) assumes that output is a function of capital and public services. The model has two main hypotheses. First, the production function exhibits constant returns to scale in capital and public spending jointly. Second, public services act as an input to private production, that is, public services are not a substitute of private ones. This assumes that public services do not have rivalry and are non-excluding.

$$gy = Ag^{\beta}k^{1-\beta} \tag{28}$$

where

$gy$ = government expenditure.

If government expenditure is financed through a proportional tax on income ($g = \tau y$) then Eq. (28) becomes,

$$gy = Ag^{\beta}k^{1-\beta} \tag{29}$$

Replacing Eq. (29) in Eq. (26) we obtain

$$gy = 1/\varphi[((1-\beta)A/(\tau y/k)^{\beta}(1-\tau))-\rho] \tag{30}$$

In this model fiscal policy has two effects. On the one hand, taxes reduce the rate of growth since they reduce the marginal productivity of capital. On the other hand, fiscal policy has a positive effect on growth since government expenditure is viewed as an input into the production of private goods.

The research within endogenous growth theory has important implications for the role that fiscal policy can play within stabilisation policy context. From the earnings side, an increase in taxes has a negative effect on growth when these affect the factors of production, in particular capital, and government expenditure. Thus capital or profit taxation does not encourage growth. By the same reasoning, taxation schemes that affect the income of factor production owners, wage earners and entrepreneurs have a similar effect. In short, this analysis favours indirect over direct taxation. This is consistent with some of the country cases presented in Section 6 where the introduction of a VAT tax was a key pillar of fiscal reform.

From the expenditure side, government spending may help to raise an economy's long-term growth as long as its expenditure does not crowd-out and is complementary to the production of private goods. Government investment must be confined to spheres where it does not compete with private initiative. Thus the extent to which activities are incorporated under the private enterprise system sets the limits to government intervention. The greater the number of activities that fall under the private system, the less scope and rationale there will be for government intervention. If government intervention is confined to infrastructure (say roads, housing and the like) but these spheres of economic activity are overtaken by the private sector, the public sector must re-direct its expenditure to activities that do not compete with profit-seeking capital.

## 6. Stabilization Policies in Practice: Selected Latin American and Caribbean Experiences

This section presents the practice of stabilization policy in selected country cases. It is not meant to provide a comprehensive overview but to extract the main features of stabilization policies in countries with different productive and specialization patterns. Countries are classified into resource-based economies, service-based economies, and the more industrialized economies.

Within the resource-based category, two sub-categories can be distinguished. These are the primary product exporters and countries that were confronted with 'foreign bonanzas' and eventually the Dutch Disease. The countries included here in the first sub-category are Nicaragua, Guyana and Suriname. Examples of the latter are Colombia, Mexico, and Trinidad and Tobago. Service-based economies comprise mostly the economies from the Caribbean such as Barbados, countries belonging to the

Organization of Eastern Caribbean States and the Dominican Republic. The last category refers to the Latin America southern cone economies (Argentina, Brazil and Chile).

Following the above classification of economies, this section briefly discusses the main features of stabilization programmes in some of these countries; these are Nicaragua and Guyana; Trinidad and Tobago; Barbados and the Dominican Republic; and lastly Argentina.

### 6.1. Resource-Based Economies (Primary Product Exporters): Nicaragua and Guyana

In the 1990's, Nicaragua and Guyana implemented orthodox stabilization policies following socialist experiments that eventually led, in conjunction with other factors to unsustainable macroeconomic imbalances.

In Nicaragua, the socialist-oriented Frente Sandisnita de Liberación Nacional took power (1979) after a civil war against the U.S. backed dictator Anastasio Somoza Debayle. The initial macroeconomic conditions were favourable to the new regime (see Table 1). A mixed economy strategy rather than a populist approach to economic policy characterized the Sandinista approach to economic policy. While production was transferred to the government and the state, distribution remained in private hands (Gibson, 1988). The Sandinista experiment followed three phases. The first one (1979-1981) was characterized by favourable initial conditions, the recovery of agricultural exports, and foreign aid that helped to soften the external constraint and facilitated income and wealth redistribution policies. The main adjustment mechanism was government changes in prices, and import controls helping to maintain absorption in line with output.

In the second phase (1981-1983), Nicaragua was faced with the Contra invasion and an international context that was not as favourable as during the first phase. Import and foreign exchange transaction controls remained in place but the lever of prices as an adjustment mechanism gave way to fiscal restraint. However, this policy was undermined by a mounting disequilibrium in the current account deficit which, coupled with a decline in foreign exchange inflows and uncompetitive exports, led to mounting levels of external debt. The external constraint hardened the fiscal constraint. Ultimately the government resorted to financing its expenditures via the inflation tax. High inflation and high levels of indebtedness led to an increasing discount on Nicaragua's exchange rate.

The last phase (1983-1990) is portrayed as a war economy with increasing pressure to finance the war effort, high levels of liquidity and inflation, low productivity, and high unemployment. The government undertook several devaluations of the currency, which fed into inflation through cost of production and fiscal channels, increasing the pressure for further devaluations of the currency. The conditions of an inflation-exchange rate spiral were thus defined. During this time several unsuccessful attempts were made at stabilization. In the last two years of the Sandinista government, as a consequence mostly of exchange rate depreciation, the economy had entered a hyperinflationary phase.

In 1991, the new government implemented a stabilization package that included the introduction of a new currency (the Córdoba Oro), a fixed exchange rate regime that evolved slowly towards a managed float, a wage freeze, and fiscal and monetary restraint. These were accompanied by fiscal reform. This fiscal reform consisted in reducing government expenditure through the decline in public employment, privatization, the enhancement of administrative efficiency and closing loopholes in the tax system. The reforms were expanded to include financial and trade liberalization. Financial liberalization comprised the privatization of state banks, the strengthening of the private banking system and interest rate liberalization. Trade liberalization included the elimination of import restrictions and tariff reductions to conform to the tariff system of the Central American Common External Market.

Guyana's stabilization history is similar to that of Nicaragua, except that Guyana followed more closely the principles of a socialist regime. In 1970, the People's National Congress declared Guyana a Cooperative Socialist Republic. This meant the control of the economy by the government. The guidelines for development included the nationalization of the means of production and distribution, including the sugar and bauxite industries, the adoption of a basic needs strategy (food, housing and clothing)[19] and the subjugation of the financial system to the needs of the real sector. These guidelines were accompanied by controls on interest rates, and on import and foreign exchange transactions.

In the first stages the implementation of the government's policies was facilitated by international high sugar prices, softening in this way the external and fiscal constraints. However, the lack of export dynamism and the persistent granting of subsidies to finance public enterprises and the fiscal stance of the government helped to reduce reserves. According to Howard (1992) the net foreign reserves which peaked in 1975 (G$197 million) became negative throughout the 1980s reaching G$–13 442mn in 1989.

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19 Thomas (1993), p.137.

The economy experienced a period of recession and the attempts to redress the macroeconomic situation through fiscal restraint were thwarted by the second oil crisis of the 1979-1981 period (Hilaire, 2000). The oil crisis provoked a rise in government expenditure that could not be sustained by revenues, causing the fiscal deficit to increase to unprecedented levels and sending the external debt to an all-time high. Other attempts at stabilization guided by the devaluation of the exchange rate were unable to improve the situation.

In 1987, the current account deficit represented 46% of GDP, the public sector deficit reached 34% of GDP, GDP growth was negative (-1.4%), and the stock of external debt was 330% of GDP (see Table 1).

As in Nicaragua, at the beginning of the 1990's, the Guyanese authorities embarked on a stabilization programme. The stabilization programme consisted in monetary restraint accompanied by fiscal reform. Monetary restraint was based on direct instruments of monetary control such as increasing reserve requirements (9% in 1991, 16% in 1994 and 12% in 1999). The reserve requirement conditions were extended to include all depository institutions (Ganga, 2000).

The nature of the fiscal reform was coloured by the extent of the country's external indebtedness. The reform consisted in the reduction of government expenditure and increases in taxes. Public employment was reduced (the civil service was reduced by one half between 1991 and 1998), state-owned assets were sold to finance fiscal operations, the tax base was widened to include public firms, the tax structure simplified and the consumption tax introduced.

**Table 1: Guyana and Nicaragua Basic Macroeconomic Indicators**

| | Guyana | | Nicaragua | |
|---|---|---|---|---|
| | **Initial conditions 1987** | **A decade later** | **Initial conditions 1990** | **A decade later** |
| GDP growth a/ | -1.4 | 5.0 | -1.0 | 5.5 |
| Unemployment | ... | ... | ... | 9.8 |
| Inflation | 28.7 | 1.5 | 13 49.0 | 9.9 |
| Money growth | 46.3 | 11 | ... | 0.1 |
| Fiscal deficit | -34.0 | -9.6 | 12.3 | 11.5 |
| Current account balance | -45.5 | -15.5 | 357.5 b/ | 35.0 |
| External debt | 333.0 | 169.3 | ... | 274.8 |
| International reserves c/ | 1.7 | .... | ... | 3.6 |
| Rate of interest | -10.6 | 16.2 | ... | 8.3 |

**Source:** Gibson (1993); Hilaire (2000); ECLAC (2002).

**Note:** a/ refers to the period 1980-1987 for Guyana and 1980-1990 for Nicaragua. b/ expressed in US dollars multiplied by $10^{-6}$. c/ International reserves are expressed in months of imports.In this section the fiscal deficit, the current account balance and the external debt are expressed as percentages of GDP unless otherwise noted.

The monetary and fiscal stabilization was complemented with commercial and financial liberalization. The CARICOM external tariff rates were reduced as well as import quotas, and import surcharges were applied on a temporary basis. On the financial front, measures included removing restrictions on interest rates, credit and foreign exchange transactions. Financial liberalization measures were also accompanied by measures to strengthen financial supervision.[20] (Ganga, 1997 and 2000).

In line with these developments, exchange controls were removed (1991), the exchange rate regime progressed from a pegged based to a flexible exchange rate regime and capital controls were abolished in 1996.

### 6.2. Resource-Based Economies. Stabilization in a Reversed Commodity Boom: The Case of Trinidad and Tobago

Trinidad and Tobago's economy is largely dependent on the fortunes of oil. Oil not only provides foreign exchange and capital to satisfy import consumption and the requirements of domestic investment, but is also an important source of fiscal revenue and distribution to other sectors of the economy. Foreign companies' exports of oil, which represent in part ex-ante surplus earnings, are taxed to finance the state's activities in other areas of economic activities. Oil is a linkage between the balance of payments and the fiscal accounts and between the petroleum sector

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20 In 1995, the Financial Institutions Act was enacted. The Act enables the Central Bank to be the ultimate supervisory institution. A similar arrangement was implemented in the Dominican Republic following its structural adjustment programme in 1990.

and the other productive and distribution sectors. The oil sector is currently in decline although it still represented 26% of GDP in 2001.. The authorities are turning to natural gas as a substitution for oil as the motor of the economy.

The oil shocks of 1973 and 1979 increased the price of crude oil, improving the terms of trade for Trinidad and Tobago. The net barter terms of trade increased from 154 in 1973 to 223 in 1981 (Central Bank of Trinidad and Tobago, 1998). The favourable movement of the terms of trade strengthened the position of the oil-producing sector in GDP. In 1970 the petroleum industry represented 21% of GDP, 46% in 1975 following the first oil shock and 36% in 1981 following the second oil shock. At the same time these events led to a favourable position in the balance of payments. The value of exports increased and so did the volume due to the fact that petroleum has a low price elasticity of demand. In addition, a profitable resource as petroleum attracted capital inflows. These factors facilitated the accumulation of international reserves. Finally, the oil-price hike led to an increase in the government's revenue.

When prices collapsed in 1981-1988, the value of exports declined (due to both a decrease in its price and its quantity), capital inflows exhibited a downward tendency and government revenues were also negatively affected. As a result, reserves declined. The economy was faced with a double constraint: balance-of-payments and fiscal constraints. Both effects had a negative impact on growth that was compounded by the linkage between oil and domestic investment (see Table 2).

**Table 2: Trinidad and Tobago Basic Macroeconomic Indicators**

| | Initial conditions 1987 | After a decade 2000 |
|---|---|---|
| GDP growth (%) a/ | -1.1 | 3.6 |
| Unemployment (%) | 22.3 | 12.8 |
| Inflation (%) | 13.4 | 3.6 |
| Money growth (%) | 3.5 | 11.6 |
| Fiscal deficit (% of GDP) | -7.1 | 1.2 |
| Current account balance (% of GDP) | -4.7 | 1.0 |
| External debt (% of GDP) | 47.5 | 21 |
| International reserves b/ | 7.7 | 5.8 |
| Rate of interest (%) c/ | 0.6 | 12.9 |

**Source:** Central Bank of Trinidad and Tobago (2002); ECLAC (2002); Hilaire (2000).

**Note:** a/ refers to the periods 1980-1987 and 1991-2000.
b/ expressed in months of imports.
c/ real rate of interest.

The drain in foreign exchange reserves forced the government to adopt a stabilization package.[21] The aims of the program included a devaluation (the TT dollar was devalued from TT$3.60 to TT$4.25 per US dollar on August 1988) and monetary and fiscal restraint and the management of liquidity through direct instruments, i.e., high reserve requirements. The programme established

21 In practice the government adopted two successive stabilization packages in 1989 and 1990. For expository purposes this section refers to the stabilization package which encompasses both the 1989 and 1990 programmes.

ceilings on the net domestic assets of the Central Bank. The programme contemplated the decrease in the budget deficit from 7% of GDP in 1988 to 4% in 1989 and 1% in 1991. The deficit was reduced first by reducing capital expenditures and then by the decline in current expenditures (i.e., the wage bill). Public wages and employment were reduced.[22] On the revenue side public assets were sold to the private sector and tariffs were increased.[23] The tax system was simplified, and the value -added tax was introduced to replace an array of different taxes.[24] Finally, credit ceilings were imposed on the borrowing requirements of the public sector.

Trade liberalization measures included the decrease in the common external tariff rates and reduction in import restrictions. As in the case of Guyana, temporary import surcharges were also applied. Export diversification measures were encouraged to widen the productive base and develop non-oil exports. In line with this framework the exchange rate was progressively liberalized to reach a floating exchange rate regime and the capital account of the balance of payments was liberalized in 1993.

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22 Public wages were reduced by 10% (Howard, 1992 and Hilaire, 2000).

23 According to Howard, *op. cit.*, p. 77: "transfers to public utilities, state enterprises, and statutory bodies were reduced by 0.5% of GDP...state enterprises were reduced by 1 100 employeed in 1989...as it was estimated that there would be a further reduction of 3 200 employees in 1990."

24 The value-added tax rate was set at 15%.

## 6.3. Stabilization in Service-Based Economies: The Case of Barbados and the Dominican Republic

Barbados and the Dominican Republic adopted stabilization plans to correct growing balance of payments and fiscal deficits. The twin deficits were partly a product of expansionary policies aimed at increasing the level of capital expenditure and of unfavourable external economic conditions.

Barbados' resort to stabilization at the start of the 1980's and the 1990s, was the result of a continued expansionary fiscal policy dating from the mid-1960's coupled with a decline in the economy's key economic sector: tourism. The tourism sector is an important source of foreign exchange, and tax earnings and due to its linkages with the other sectors acts as a catalyst for their development.

Barbados' expansionary fiscal policy led to a deficit that was mainly financed from domestic sources. However, by the end of the decade of the 1970s the government was borrowing on the external market. During this time the ratio of the total debt to national income increased from 32% to 49%. For its part, tourism experienced a significant decline as a consequence of a general decline in external demand. Tourism earnings dropped in 1981 by 20% below their 1979 level and this contributed to the widening of the current account deficit (Anyadike-Danes, 1996).

Thus Barbados found itself with twin deficits (fiscal and balance of payments deficits) at a time when the external debt crisis in developing countries exploded (see Table 3). The decline in reserves forced the authorities to adopt an unsuccessful stabilization programme in 1982.

**Table 3: Barbados and the Dominican Republic Basic Macroeconomic Indicators**

| | Barbados | | The Dominican Republic | |
|---|---|---|---|---|
| | Initial conditions 1987 | A decade later 2000 | Initial conditions 1990 | A decade later 2000 |
| GDP growth (%) a/ | 1.3 | 0.8 | 2.3 | 7.3 |
| Unemployment (%) | 17.9 | 9.2 | 22 | 15 |
| Inflation (%) | 3.6 | 3.8 | 79.2 | 9.0 |
| Money growth (%) | 14.3 | 8.6 | 35.0 | 13.3 |
| Fiscal deficit (% of GDP) | -5.9 | -1.5 | -5.0 | 1.1 |
| Current account balance (% of GDP) | -1.3 | -5.6 | -5.0 | -5.0 |
| External debt (% of GDP) | 40.2 | 26.1 | 61b/ | 19.2 |
| International reserves (US$mn) | 14.6 | 5.3 | -474c/ | 0.1 |
| Rate of interest (%) | 5.8 | 8.1 | -4 | 17.5 |

**Source:** Gibson (1993); Hilaire (2000); ECLAC (2002).

**Note:** a/ refers to 1980-1987 and 1990-2000 in the case of Barbados.
b/ this is a proximate percentage. The stock of outstanding external debt was $4,613million (US$) in 1990.
c/ In 1990 the Dominican Republic experienced a loss of reserves equivalent to US$474 million.

The programme floundered on the unchanging monetary and fiscal policies of the government and a world economic recession. In 1991 another stabilization package was adopted centred on restraining the growth of aggregate demand in order to reduce the pressure on the balance of payments. Demand was curbed by monetary and fiscal means.

Direct instruments (i.e., reserve requirements) of monetary management were adopted and interest rates were increased. On the fiscal expenditure side nominal wages were cut and frozen and public employment reduced. On the revenue side a surtax termed the "stabilization tax" was introduced in addition to consumption taxes and levies and at the same time the authorities reduced the rate of CARICOM's common external tariff. In 1997 the value-added tax was introduced. The authorities decided to maintain a pegged exchange rate regime sustained in part by capital controls on outflows (Hilaire, 2000; Williams, 2001).

In the Dominican Republic, the country embarked in 1986 on an economic policy based on aggregate demand and public works expansion whose end result was an economic and financial crisis. After four years, the economic situation of the Dominican Republic was precarious. GDP and GDP per capita exhibited negative growth rates (–6% and –7% respectively). This contraction was reflected in the performance of consumption and investment (–11% and –16%). The exchange rate depreciated significantly and the rate of inflation reached an overall high of 80%. Finally, the government sector and the consolidated public sector yielded deficits of 5% of GDP and international reserves decreased by 474 million dollars (see Table 3).

Within this context, a stabilisation package, termed the New Economic Programme (NEP, hereafter) was launched at the end of 1990. The main objective was to bring down the rate of inflation through the curtailment of government expenditure and a unified exchange rate regime.

The implementation of the programme necessitated on the one hand ensuring regular foreign capital flows to the Dominican Republic. This, in turn, required macroeconomic stability without imposing monetary or currency restrictions that could hamper the attraction of foreign capital. Capital account liberalisation, trade liberalisation, abolition of currency restrictions for selected economic activities, free trade zone and foreign investment laws, and selective policies for tourism provided the framework for the needed capital flows while allowing the market rate not to deviate significantly from the official rate, thus maintaining macroeconomic stability. [25]

On the other hand, fiscal discipline was required to avoid domestic credit creation that could create an external disequilibrium. Both requirements were met by a dual exchange rate system anchored in the official exchange rate and by a policy of fiscal and monetary restriction.

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25 The previous investment laws dated from 1978 and 1983. The Free Trade Zone law, which modified the current legislation, was passed in 1990. A new foreign investment law was passed in 1995. It allowed the access of foreign capital to key sectors of the Dominican Republic, equalised the treatment for national and foreign investors and lifted the restrictions on the repatriation of capital and profits.

Monetary restriction was achieved by controlling the reserve requirement ratio, and fiscal discipline by the contraction of fiscal expenditure. This policy stance was also complemented by a series of structural reforms namely, tariff, tax and financial reforms. The tariff reform (September, 1990) aimed at reducing tariff rates and their dispersion as well as the average effective rate of protection.[26] The tax reform (June, 1992) sought to increase tax collection and its efficiency. [27]

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26 The 1990 tariff reform was intended to rationalise and simplify the tariff structure as well as to make it more progressive. It established a new tariff structure with seven initial *ad-valorem* tax rates within the range 5%-35%. This meant a decrease in the ceiling rate by 165 percentage points. Prior to the 1990 reform the tariff rate structure was within the range 0%-200%. Also, most import quotas, permits and licences as well as export were eliminated between 1990 and 1992.

27 In 1992 the government implemented a fiscal reform programme whose basic aim was fiscal equilibrium. The reform tried to adopt simpler fiscal laws to increase the amount of revenue and the efficiency of tax collection. To this end the fiscal reform modified personal and corporate taxes, the value added and excise taxes on consumption. As part of the reform the value added tax rate was increased from 6% to 8%. The application of this tax was extended to cover services. All exports as well as some nationally produced and imported goods are exempted. The excise tax on consumption, which was a specific tax, became an *ad-valorem* tax. Further fiscal and tariff reforms were undertaken in 2000, increasing even more the value-added tax rate while tariff rates were reduced. These reforms will be discussed in more detail in the next section.

### 6.4. Stabilization in the More Industrialized Countries: The Case of Argentina

Following very high price surges sold to the public as "a hyperinflation episode," Argentina chose to implement in 1991 a variant of a unilateral currency arrangement with the United States, known as a currency board.

The events that led to the adoption of the currency board are well known. Following a military dictatorship in the 1970's, a democratically elected government took office in 1983 and identified the control of inflation as its main priority. Inflation which was running at 400% per annum was confronted with the standard orthodox measure, namely, demand restraint. The failure of these policies led the government to the adoption of a stabilization plan termed the Austral Plan (1985-1987). It combined wage, price and exchange freezes with fiscal and monetary reforms. Despite an early success of the Austral Plan and the implementation of three other stabilization plans, inflation could not be brought under control. The monthly rate of inflation reached 38% in August 1988, 200% in July 1989 and an average of 79% in the first trimester of 1990.[28] These high rates of inflation were accompanied by the deterioration of public finances, external disequilibrium, and capital flight. Moreover, the shift in the composition of agent's portfolio from peso denominated

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28 These stabilization plans are the Primavera (1988), the Bunge and Born (1989), and the Bonex Plans (1990). Bunge and Born were two executives of a multinational corporation and the Bonex plan was masterminded by the Economics Minister Erman González (December 1989 to March 1990) of the Menem government.

to dollar denominated assets due to currency depreciation endangered the stability of the financial system (see Table 4).

Within this context, the newly appointed Finance Minister of the Carlos Menem government who took office in 1990, Domingo Cavallo, introduced the Convertibility Plan in April 1990. The plan fixed the exchange rate at one peso per dollar, provided full foreign currency convertibility for the money supply, and thus made it illegal for the authorities to issue currency without foreign exchange backing and transformed the central bank into a quasi monetary monetary board.[29] Also the convertibility law forbade the central bank from lending to the government.

The convertibility plan was supported by a set of key measures, which were meant to reflect changes in 'fundamentals'. These measures responded to the so-called 'necessary preconditions' for adopting a currency board: fiscal discipline and a financial system that would allow the government to defend the currency.

The government imposed tax increases and decreases in government expenditure. Public sector employment was downsized by 20%, and public sector wages were frozen. The government also proceeded with the sale of state-owned enterprises. The privatization of state owned assets

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29 Unlike the Argentine currency boards, the more orthodox currency boards normally do not have a central bank and leave no room for disretionary monetary policy. Moreover, the Argentinian central bank is also allowed to hold national bonds as a backing for the money supply rather than only foreign currency.

**Table 4: Argentina**
**Basic Macroeconomic Indicators**

| | Initial conditions 1990 | After a decade 2000 |
|---|---|---|
| GDP growth (%) a/ | -0.5 | -0.8 |
| Unemployment (%) | 7.4 | 15.1 |
| Inflation (%) | 2,316 | -0.7 |
| Money growth (%) | ... | -6.2 |
| Fiscal deficit (% of GDP) | -2.7 | -1.6 |
| Current account balance (% of GDP) | 3.3 | -3.3 |
| External debt (% of GDP) | ... | 51 |
| International reserves (US$bn) | 3.8 | ... |
| Rate of interest (%) | ... | 11.7 |

**Source:** ECLAC (2002).

**Note:** a/ GDP growth refers to the years 1990 and 2000 respectively.
... Not Available

began in 1990 with the sale of the national telephone company (ENTEL) and the national airline (Aerolineas Argentinas). As a result, between 1988 and 1991 government revenues increased by 5.3 billion dollars while expenditures decreased by a billion dollars, eliminating the budget deficit and turning it into a surplus.

The government also liberalized the financial system allowing since 1994 foreign financial institutions to compete with Argentine ones. The share of foreign bank deposits in total deposits increased during 1994-1998 from 26% to 41% of total deposits.

## 7. The Economic Consequences of Stabilization

This section traces the logical results of stabilization policies, using the main features of stabilization policies outlined in the previous section and four behavioral relationships, which capture the essence of the MABP model with endogenous prices and growth. These relationships (reproduced below) include an equation for the rate of growth of reserves, the government's budget constraint, the rate of inflation expressed as a function of the rate of exchange, external prices and the rate of growth of absorption and the most simple equation derived from endogenous growth theory explaining the rate of growth of output. These relationships are not expressed in a model but rather in a format allowing a didactic understanding of the basic consequences of the MABP policies.

$$gr = (R+D)/R[\gamma\pi(?) + \eta ygy + r\eta r] - (D/R)gd \tag{15}$$

$$(Gr/Y - Gs/Y) + gb = (r - gy)(B/Y + eB^*/Y) + gd \tag{14}$$

$$\pi_t = 1/(\varepsilon - \eta)\ [(\alpha\varepsilon - \eta)\ (e_t + \pi_T{}^*) + (1-\alpha)\ (\varepsilon\pi_{t-1}) - (1-\alpha)\ (ga - gy)] \tag{21}$$

$$gy = 1/\varphi(f' - \rho) \tag{24}$$

Although the MABP only considers monetary variables and tends to dichotomize between real and monetary sectors, the country-case examples given in the previous section show that stabilization policies affect real magnitudes. The main variable linking the monetary and the real sectors is the interest rate.

In the formulation of the MABP, the rate of interest is, for all purposes, exogenous and equal to the international rate of interest so that a country cannot change its real rate of interest. In practice, however, this is not the case. The analysis in this section focuses on the effects of stabilization on the balance of payments, interest rates, the growth and composition of output and the fiscal accounts. The results derived from the logical application of the model and selected stabilization policies are illustrated with empirical evidence for Latin America and the Caribbean.

The starting point is a situation of external disequilibrium that is reflected in a decline in the rate of growth of international reserves $(g_r)$. The monetary authorities respond to the current situation by restricting the creation of domestic net assets. In practice, authorities use direct monetary instruments. More specifically, they decide to raise the reserve requirement for the banking system.

The increase in the reserve requirement forces banks to increase the nominal-lending rate of interest to maintain profitability.[30] This is facilitated by the existence of

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30 This follows directly from balance sheet accounting of commercial banks. Following Dick, (1999) the lending rate of interest is equal to

$$rl = R(rl) + OC / D + LL / D + P / D - NI / D + \mu rd$$

where,

| | | |
|---|---|---|
| $rl$ | = | lending rate of interest |
| $R$ | = | required reserve ratio |
| D | = | deposits |
| $OC$ | = | operating costs |
| $LL$ | = | loan losses |
| P | = | profits |
| $NI$ | = | non-interest income |
| $\mu$ | = | mark-up |

imperfect capital mobility. The extent of the increase in the lending rate will depend on the banks' position in the money market. This will also determine the interest-rate spread.[31] The increase in the nominal rate of interest raises the cost of borrowing funds. The demand for credit subsides, slowing its rate of growth. This in turn reduces the rate of growth of absorption, translating into a fall in the rate of inflation (see Eq. (21) above). Given the fact that $(\alpha\varepsilon - \eta) < (1 - \alpha)$, the effect of the contraction in the rate of growth of absorption is deemed to be significant. Lower inflation and higher nominal interest rates result in higher real interest rates.

The decline in inflation makes domestic exports more competitive. By reducing absorption the decrease in the rate of growth of credit will lower import growth. The expected result, according to the MABP, is an increase in the rate of growth of reserves. However, the available evidence indicates that the removal of trade barriers that accompanies stabilization policies stimulates import growth. This factor is mainly due to the high income-elasticity of imports, which tends to be especially high for small open developing economies (see Table 5 below and Table 9 in the Appendix). Exports respond to trade liberalization, albeit at a much slower pace.

The overall result is an increase in export growth that is overpowered by import growth (again this is shown in Table 5 below, where the rate of growth of imports increased from 0.2% to 7.7% between 1980 and 2000) and a tightening of the balance of payments constraint. In order to overcome this constraint authorities have opted for two solutions.

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31 This is captured by the term $m$ in footnote 17. See, Rousseas (1992) on this point for the developed economies.

**Table 5: GDP, Export and Import Growth, 1950-2000**

| Rates of Growth | 1950-1980 | 1980-1990 | 1990-2000 |
|---|---|---|---|
| GDP | | | |
| Latin America | 5.47 | 1.16 | 3.27 |
| Large economies | 5.91 | 1.22 | 3.18 |
| Medium-sized economies | 4.51 | 0.82 | 3.57 |
| Small economies of LA | 4.57 | 1.12 | 3.54 |
| CARICOM economies | .... | 2.70 | 1.80 |
| | | | |
| Exports | | | |
| Latin America | 3.76 | 5.26 | 9.12 |
| Large economies | 4.94 | 7.12 | 10.43 |
| Medium-sized economies | 2.36 | 3.22 | 6.98 |
| Small economies LA | 4.94 | 2.29 | 6.12 |
| CARICOM economies | .... | .... | .... |
| | | | |
| Imports | | | |
| Latin America | 5.10 | -0.02 | 10.68 |
| Large economies | 5.12 | 0.73 | 11.74 |
| Medium-sized economies | 4.68 | -1.99 | 9.59 |
| Small economies LA | 5.72 | 0.15 | 7.65 |
| CARICOM economies | .... | .... | .... |

**Source:** Moreno-Brid (2001); ECLAC (2002).

**Note:** The author follows the ECLAC methodology of dividing Latin American economies into large (Argentina, Brazil, and Mexico), medium-sized and ( Colombia, Chile, Peru, Venezuela) and smaller-sized economies (Bolivia, Costa Rica, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, Panama, Paraguay, Dominican Republic and Uruguay).

The first involves granting special fiscal treatment for export activities. This has been the case of Central American countries, the Dominican Republic, and some CARICOM economies, which have granted fiscal exemptions in the case of free trade zones and export-oriented activities. The exemptions include exoneration from the obligation to pay income taxes which, depending on the cases, may be granted for a specific period of time or may be granted for an indefinite period (see Table 10 in Appendix 1).[32] The other option is to prolong the need for restrictive policies, leading to a higher plateau in the term structure of interest rates.

Either of these options has important effects on growth, output composition and fiscal finances. The fiscal effects have, in turn, merely reinforced the initial impact on growth and output composition.

Fiscal subsidies have been granted to investors in free trade zones. Free trade zones are export enclaves without strong linkages to the rest of the economic

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32 The World Trade Organization considers this preferential fiscal treatment an export subsidy and according to the WTO-GATT texts forbids it under Articles 1 and 3 of the Agreement on Subsidies and Countervailing Measures (WTO, 1999, pp.231-233 and pp.265-267). However, due to the granting of longer periods for implementing obligations to developing countries, these had until the year 2003 to dismantle these subsidies. The exception was the group of countries whose GNP was below US$1,000 per capita (see, the Agreement on Subsidies and Countervailing Measures, Annex VII, WTO, 1999, p. 274). The Doha Ministerial Conference (November, 2001) extended the time derogations and the per capita threshold. These developments indicate the degree to which developing countries have become dependent on this foreign exchange earning activity. In fact, it is market-based policies at the national level that ultimately create and accentuate this dependency while at the same time their implementation at the international level demand their banishment in order to comply with WTO free trade rules.

sectors.[33] Production activities are labour-intensive, requiring low-skilled labour. Inputs are for the most part imported and transactions are carried out in foreign currency.

In the same vein as fiscal subsidies, high rates of interest also constitute a profitable outlet for foreign capital. Short-run capital inflows respond immediately to variations in interest rates but long-term capital inflows also respond to higher margins of profitability.[34]

Yet at the same time productive enclaves contribute little to output or growth. The little value-added they contribute to production and output comes from wages. At the same time, higher interest rates discourage domestic investment.[35]

Thus while foreign direct investment inflows have increased, gross domestic investment as a percentage of GDP for the economies of the Caribbean have remained

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33 Initially free trade zone legislation defined a specific geographic area for their activity. However, there has been a recent tendency to increase their degree of flexibility in their operations. The notion of industrial park has tended to disappear, allowing free trade zone operations in any geographical location of a national territory. Honduras and Nicaragua are cases in point.

34 In addition the interest rate differential more than compensates for exchange rate risk.

35 When, as for some Caribbean countries, consumption represents more than 40% of imports, MABP policies, in effect, stimulate private consumption at the expense of investment.

unchanged at the regional level and in many country cases this ratio has decreased (see Tables 6 and 7 for Caribbean countries). This may provide an indication that, contrary to common belief, foreign investment might not have acted as a catalyst for growth. In fact, it may simply act as a substitute for domestic investment. In other words, foreign investment might have crowded-out domestic investment.[36]

This revealed preference for foreign over domestic investment, encouraged by national economic policy, has underpinned a pattern of productive specialization that, in some cases, is reflected in the change in the composition of GDP. This change is often viewed, perhaps erroneously, as a process of structural change brought about by globalization when in fact it is a result of the policy options implemented.

The case is most evident for Caribbean countries where the manufacturing sector during the 1990s virtually stagnated. On the other hand service and natural resource-based activities have increased their contribution to GDP significantly. As shown in Table 8 below, the contribution of the manufacturing sector has remained during the decade of the 90's at 12% while tourism has risen from 39% to 47%.

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36 In the standard literature foreign investment is presented as a key component of a long-run growth strategy. It can be hypothesized that foreign investment, when accompanied by a decline in real wages, can act as a motor for growth. Preliminary evidence in this direction is available in the case of Mexico (see, Table 11 in the appendix).

**Table 6: Gross Domestic Investment (As percentages of GDP)**
**The Caribbean and Central America, 1980 – 2000**

| Country | 1981-1990 | 1991-2000 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Antigua and Barbuda | 33.8 | 33.6 | 32.4 | 32.8 | 29.9 |
| Barbados | 18.6 | 15.2 | 18.5 | 19.4 | 18.1 |
| Belize | 23.6 | 25 9 | 25.8 | 26.1 | 31.6 |
| Dominica | 31.1 | 29.0 | 27.0 | 28.5 | 29.3 |
| Dominican Republic | 22.4 | 22.1 | 23.4 | 24.2 | 23.7 |
| Grenada | 34.0 | 34.9 | 37.4 | 35.7 | 38.6 |
| Guyana | 28.0 | 31.3 | 28.8 | 24.5 | 22.3 |
| Haiti | 15.2 | 7.5 | 10.7 | 11.0 | 10.7 |
| Jamaica | 23.1 | 28.1 | 27.2 | 25.6 | 26.8 |
| St. Kitts and Nevis | 37.7 | 42.6 | 43.0 | 37.4 | 45.0 |
| St. Lucia | 26.8 | 23.6 | 23.8 | 25.8 | 24.5 |
| St. Vincent and the Grenadines | 28.9 | 28.7 | 31.8 | 32.6 | 28.0 |
| Suriname | 19.9 | 16.4 | 18.1 | 15.6 | 11.0 |
| Trinidad and Tobago | 20.3 | 20.7 | 27.9 | 21.4 | 19.1 |
| Costa Rica | 24.9 | 27.9 | 20.5 | 17.1 | 16.6 |
| Guatemala | 14.9 | 15.81 | 18.8 | 18.0 | 17.9 |
| El Salvador | 12.8 | 19.4 | 18.9 | 17.3 | 17.3 |
| Honduras | 20.7 | 31.6 | 28.6 | 31.3 | 31.8 |
| Nicaragua | 22.3 | 22.3 | 30.6 | 39.6 | 34.1 |

**Source:** World Bank (2002); ECLAC (2002).

## Table 7: Foreign Direct Investment Flows, 1990-2001
## (US$ MN)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| Anguilla | 10.7 | 6.3 | 15.5 | 6.6 | 11.1 | 17.7 |
| Antigua and Barbuda | 60.4 | 54.5 | 19.5 | 15.2 | 24.7 | 31.4 |
| The Bahamas | -8.0 | 9.0 | 3.0 | 42.2 | 42.9 | 27.0 |
| Barbados | 19.9 | 33.8 | 26.3 | 1.2 | 40.9 | -5.4 |
| Belize | 20.7 | 23.9 | 40.0 | 84.8 | 127.7 | 82.7 |
| Dominica | 12.8 | 15.2 | 20.5 | 13.1 | 22.5 | 53.9 |
| Grenada | 12.8 | 15.2 | 22.5 | 20.2 | 19.2 | 19.9 |
| Guyana | 16.4 | 28.0 | 137.9 | 63.3 | 46.8 | 53.4 |
| Haiti | 0.0 | -1.8 | -2.2 | -2.8 | 0.0 | 7.4 |
| Jamaica | 291.7 | 51.4 | 336.3 | 309.1 | 446.6 | 285.0 |
| Montserrat | 9.6 | 8.0 | 4.6 | 4.8 | 7.2 | 3.0 |
| St. Kitts and Nevis | 9.6 | 8.0 | 4.6 | 13.7 | 15.3 | 20.4 |
| St. Lucia | 44.6 | 8.0 | 4.6 | 34.0 | 32.4 | 32.6 |
| St. Vincent and the Grenadines | 7.6 | 8.8 | 14.8 | 31.3 | 47.1 | 30.5 |
| Trinidad and Tobago | 554.0 | 144.1 | 171.0 | 372.6 | 521.0 | 295.7 |
| Costa Rica | 162.5 | 178.4 | 226.0 | 246.7 | 297.6 | 337.0 |
| El Salvador | 25.2 | 15.3 | 16.4 | ... | ... | 38.0 |
| Guatemala | 47.6 | 90.7 | 94.1 | 142.5 | 65.2 | 75.0 |
| Honduras | 43.5 | 52.1 | 47.6 | 52.1 | 41.5 | 50.0 |
| Nicaragua | ... | 42.0 | 42.0 | 40.0 | 40.0 | 75.0 |

**Source:** ECLAC (2002) and on the basis of official data.

**Table 7: Foreign Direct Investment Flows, 1990-2001 - Concluded**
**(US$ MN)**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| Anguilla | 33.2 | 21.0 | 28.0 | 38.0 | 39.1 | 27.3 |
| Antigua and Barbuda | 19.3 | 22.9 | 27.3 | 36.4 | 33.0 | 53.5 |
| The Bahamas | 88.2 | 209.6 | 146.4 | 149.1 | 249.6 | 70.9 |
| Barbados | 23.5 | 31.7 | 16.7 | 54.1 | 155.7 | 93.4 |
| Belize | 115.1 | 249.7 | 240.2 | 151.4 | 76.1 | 96.3 |
| Dominica | 17.7 | 21.0 | 6.5 | 17.9 | 10.8 | 14.1 |
| Grenada | 19.3 | 33.4 | 48.5 | 41.4 | 35.6 | 34.2 |
| Guyana | 59.0 | 52.0 | 44.0 | 46.0 | 67.1 | 56.0 |
| Haiti | 4.1 | 7.0 | 10.8 | 30.0 | 0.0 | 0.0 |
| Jamaica | 476.6 | -7.3 | 135.9 | -3.8 | 422.0 | 880.3 |
| Montserrat | -0.3 | 2.5 | 2.5 | 8.2 | 3.4 | 3.5 |
| St. Kitts and Nevis | 35.1 | 19.6 | 31.8 | 57.5 | 95.9 | 82.6 |
| St. Lucia | 18.3 | 47.6 | 83.1 | 82.8 | 48.8 | 50.7 |
| St. Vincent and the Grenadines | 42.5 | 92.1 | 88.6 | 55.9 | 28.1 | 35.5 |
| Trinidad and Tobago | 356.3 | 999.6 | 731.9 | 379.2 | 654.3 | 554.0 |
| Costa Rica | 427.0 | 408.0 | 613.0 | 669.0 | 400.0 | 447.0 |
| El Salvador | -5.0 | 59.0 | 1104.0 | 231.0 | 185.0 | 198.0 |
| Guatemala | 77.0 | 84.0 | 673.0 | 155.0 | 228.0 | 440.0 |
| Honduras | 91.0 | 122.0 | 9.0 | 237.0 | 282.0 | 186.0 |
| Nicaragua | 97.0 | 173.0 | 184.0 | 300.0 | 254.0 | 180.0 |

**Source:** ECLAC (2002) and on the basis of official data.

**Table 8: Weighted Sectoral Share of Output, 1990 and 2000**
**(Percentages)**

| Country | Agriculture | | Mining | | Manufacturing | |
|---|---|---|---|---|---|---|
| | 1990 | 2000 | 1990 | 2000 | 1990 | 2000 |
| Antigua and Barbuda | 4.2 | 4.9 | 2.0 | 2.2 | 3.4 | 2.8 |
| Barbados | 7.3 | 6.1 | 0.8 | 0.9 | 10.0 | 9.3 |
| Belize | 18.4 | 21.0 | 0.7 | 0.8 | 17.2 | 17.2 |
| Dominica | 25.0 | 18.2 | 0.8 | 0.8 | 7.1 | 7.2 |
| Grenada | 13.4 | 10.1 | 0.4 | 0.6 | 6.6 | 9.9 |
| Guyana | 23.6 | 35.4 | 9.5 | 10.9 | 11.1 | 11.7 |
| Jamaica | 6.2 | 7.1 | 8.7 | 9.1 | 21.1 | 15.8 |
| St Kitts and Nevis | 6.5 | 3.8 | 0.4 | 0.5 | 12.9 | 14.3 |
| St. Lucia | 14.6 | 7.7 | 0.4 | 0.5 | 8.2 | 5.9 |
| St. Vincent and the Grenadines | 21.1 | 12.0 | 0.3 | 0.3 | 8.5 | 5.8 |
| Suriname | 9.3 | 11.1 | 9.1 | 17.8 | 13.0 | 10.6 |
| Trinidad and Tobago | 1.9 | 1.8 | 57.7 | 56.5 | 4.5 | 6.0 |
| Weighted average a/ | 17.2 | 18.6 | 39.4 | 36.8 | 12.7 | 11.6 |
| (excluding Guyana) | 13.5 | 9.5 | ... | ... | ... | ... |

**Source**: Selected Statistical Indicators of Caribbean Countries (LC/car/G.666). Vol.XIV 2001. ECLAC.
**Note:** "Other services" includes communications and transport.
a/ The weighted average was estimated for agriculture, manufacturing and the service sector as a whole.

**Table 8: Weighted Sectoral Share of Output, 1990 and 2000 - Concluded**
**(Percentages)**

| Country | Tourism | | Financial services | | Other services | |
|---|---|---|---|---|---|---|
| | 1990 | 2000 | 1990 | 2000 | 1990 | 2000 |
| Antigua and Barbuda | 14.4 | 14.4 | 7.2 | 11.2 | 18.9 | 25.1 |
| Barbados | 13.9 | 15.0 | 0.0 | 0.0 | 7.8 | 8.3 |
| Belize | 19.2 | 19.8 | 5.1 | 5.2 | 25.2 | 24.8 |
| Dominica | 2.1 | 2.4 | 11.3 | 13.2 | 16.2 | 20.9 |
| Grenada | 5.8 | 11.8 | 7.8 | 12.9 | 20.1 | 30.5 |
| Guyana | | | 6.0 | 5.7 | 8.7 | 8.5 |
| Jamaica | 9.4 | 16.9 | 9.2 | 14.9 | …… | …… |
| St. Kitts and Nevis | 7.6 | 9.0 | 8.0 | 19.3 | 15.0 | 17.6 |
| St. Lucia | 9.6 | 13.3 | 7.3 | 10.6 | 16.8 | 20.0 |
| St. Vincent and the Grenadines | 2.2 | 2.5 | 7.6 | 9.6 | 20.5 | 25.2 |
| Suriname | 12.1 | 10.6 | 17.8 | 9.3 | 5.4 | 8.9 |
| Trinidad and Tobago | 5.7 | 7.3 | 5.0 | 4.7 | 5.9 | 6.2 |
| Weighted average a/ | 39.1[a] | 47.2[a/] | … | … | … | … |
| Weighted average for agriculture (excluding Guyana) | … | … | … | … | … | … |

**Source**: Selected Statistical Indicators of Caribbean Countries (LC/car/G.666). Vol.XIV 2001. ECLAC.
**Note:** "Other services" includes communications and transport.
a/ The weighted average was estimated for agriculture, manufacturing and the service sector as a whole.

The magnitude and direction of the effects of this stabilization policy framework on government finances depend (for a given stock of internal and external debt) on the differences between the rate of interest and the rate of growth of output (i.e., *(r-y)*) and between government earnings and expenditures *(Gr – Gs)/Y* (See Eq. 14 above).

In practice, stabilization measures, by increasing the rate of interest (nominal and real) and generating foregone revenues, which are an economic cost of export subsidies, tighten the budget constraint. Ultimately MABP policies widen the difference between r and y and that between Gr and Gs.

The net result can always be said to depend on the effect of the stabilization policy on the rate of output growth. Increases in output growth will reduce *(r-y)* and for a given structure of tax elasticities, increase Gr. The evidence, however, indicates that the rate of growth of output never equals the rate of interest and is always below it and that tax elasticities are not exceedingly high.[37]

Thus stabilization policies force the government to deepen its fiscal adjustment. Due to the fact that current expenditures are rigid downwards, fiscal adjustment is generally achieved by contracting capital expenditures. This policy stance reinforces the negative effect of the

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37 Tax elasticity coefficients computed for OECS economies for 1987-1997 are less than one for most taxes and higher than one only for taxes on property and on income and profits (See, ECLAC, 1999). For Barbados, Williams (2001, p.74) obtains tax elasticities which are greater than one for levies and stamp duties.

policies described on domestic investment. Moreover, it rules out, *de facto*, the type of public policy described in Section 5 and captured in Eq. (24), which would be compatible with the MABP approach (the incorporation of endogenous growth within the MABP framework) whereby government expenditure can increase output growth by being complementary to private investment.

A government can always forego the required adjustment by increasing its debt. But it can do so only up to a point. It has to respect ultimately a debt sustainability criterion. Sustainability requires that the rate of growth of debt be equal to zero. This implies that the difference between government revenue and expenditure is equal to the difference between the rate of interest and the growth rate of output. Formally,

$$\begin{aligned} db = 0 \Leftrightarrow (Gr/Y - Gs/Y) = \\ (r - gy)B/Y + dg \end{aligned} \tag{31}$$

According to Eq. (28), sustainability requires that if the rate of interest on government debt exceeds the rate of growth of output, provided the government does not resort to the printing press to avoid a resort drain, it must ensure a sufficiently high surplus to respect its budget constraint.

Thus the logic of the standard approach to stabilization requires fiscal policy to respond to monetary policy in the same direction. It must, to avoid an unsustainable situation, behave pro-cyclically. In practice, this means that a monetary stabilization package necessitates a fiscal reform in order to avoid a debt-trap. Fiscal policy is subsumed and subjugated to the needs of monetary policy.[38] In addition, by using domestic capital expenditures as the adjustment lever, it reinforces the effects mentioned above of stabilization policies on the composition of output and employment.

**Conclusion**

The MABP is the standard macroeconomic tool for the design of stabilization policies and the basis for granting IMF conditionality. Its policy measures consist in restoring macroeconomic equilibrium and creating the required institutional background through trade, financial and capital account liberalization for market forces to operate. These changes were eventually complemented with a new wave of reforms, the 'second generation reforms.'

For the MABP, the balance-of-payments is a monetary phenomenon and the analysis focuses on its result, namely the rate of growth of international reserves. The rate of growth of international reserves is determined by the difference between the rate of growth of absorption over output (income). In turn, the rate of growth of absorption is driven by the behaviour of domestic credit. The policy recommendations consist in making absorption conform to output (income).

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38 Historically this view is not new. It was fully developed and articulated by a pionneer of monetarism, Clark Warburton (1896-1979). Warburton viewed fiscal policy through its monetary aspects. See, C. Warburton. "The Monetary Theory of Deficit Spending" *The Review of Economic Statistics*, 1945-1946, XXVII and XXVIII, No2. 92-94.

The assumption of full-employment facilitates the separation of monetary variables from real ones. In addition, it provides the basis for the implicit claim that a process of adjustment can be carried out by monetary means without affecting real magnitudes. In practice, MABP proponents recognize that an adjustment process can have contractionary effects on output. However, these effects are short-lived and their intensity can be mitigated by careful and planned policy implementation.

More importantly, a closer look at the empirical evidence, at least a decade old, shows that stabilization policies can have significant effects on the composition of output, on specialization and on the pattern of development. The combination of high interest rates, and relatively high import elasticities of income induced by MABP policies, foster a pattern of development that is biased towards sectors of economic activity that are highly dependent on foreign capital, but detrimental to the more traditional sectors (agriculture and non-export or domestic manufacturing).

The former sectors are the most dynamic. They attract the bulk of foreign capital flows but have limited scope for economic growth because of their weak linkages to the rest of the economy. The more traditional sectors (i.e., the laggard sectors) depend on internal demand, which has, with a few exceptions, a narrow base for expansion. Both sectors receive a gamut of special concessions from the more developed economies, which have failed, in part due to the characteristics of the sectors, to stimulate their growth and diversification.

This pattern of dependent-duality is reinforced by fiscal policy. The fiscal stance can seldom deviate from monetary policy and fiscal performance is affected, in part, by credit restriction and foregone revenues resulting from the subsidies to dynamic sectors. Current expenditure rigidities force capital expenditures to bear the brunt of the adjustment, thus ruling out 'counter-cyclical fiscality.'

The effects of stabilization policies are not confined to the short run. Stabilization affects the long run course of economies because it changes the way in which economies grow. The current growth patterns, particularly in the smaller economies of Latin America and the Caribbean, point to a growing divide between dynamic and laggard sectors, which may widen and render the current development model unsustainable. Duality, divergence, and dependency may actually re-emerge from oblivion as key concepts in understanding patterns of development in the present century.

# Appendix 1: Tables 9 – 13

**Table 9: Rolling OLS Estimates of the Income Elasticity of Imports and Observed and Estimated Rates of Growth for Latin America Countries During and Following Import Substitution, 1950-1997**

| Country | 1950-1975 | | | 1976-1997 | | |
|---|---|---|---|---|---|---|
| | $\xi$ | $gy_a$ | $gy_e$ | $\xi$ | $gy_a$ | $gy_e$ |
| Chile | 1.02 | 1.3 | 4.9 | 2.96 | 5.2 | 5.4 |
| Mexico | 3.10 | 6.4 | 2.1 | 3.00 | 3.1 | 3.7 |
| Costa Rica | 1.07 | 5.6 | 3.6 | 1.66 | 3.2 | 3.7 |
| Guatemala | 1.23 | 5.1 | 3.1 | 4.1 | 2.7 | 0.30 |
| Nicaragua | 2.04 | 5.1 | 3.7 | 1.67 | 3.1 | -1.8 |
| Argentina | 2.74 | 3.5 | 0.80 | 4.32 | 1.77 | 1.7 |
| Brazil | 1.32 | 6.8 | 5.0 | 1.76 | 3.3 | 3.4 |
| El Salvador | 1.50 | 5.2 | 4.5 | 0.73 | 1.6 | 4.1 |
| Honduras | 0.60 | 3.8 | 7.5 | 0.84 | 3.7 | 3.6 |
| Panama | 1.16 | 6.3 | 5.0 | 1.76 | 5.9 | 2.3 |
| Paraguay | 0.076 | 4.7 | .... | 2.45 | 4.4 | 3.9 |
| Peru | 2.46 | 4.9 | 1.2 | 3.57 | 2.0 | 1.2 |
| Uruguay | 3.03 | 1.2 | 0.5 | 1.50 | 2.2 | 4.0 |
| Venezuela | 2.08 | 4.2 | 3.5 | 3.89 | 1.6 | 0.74 |
| Dominican Republic | 2.69 | 5.8 | 1.4 | 1.03 | 2.9 | 7.6 |
| Colombia | 6.45 | 5.0 | 0.60 | 2.40 | 4.1 | 2.4 |
| Ecuador | 1.11 | 6.6 | 5.8 | 2.01 | 3.4 | 2.8 |
| Haiti | 1.40 | 1.3 | 1.4 | 0.47 | -2.8 | -6.0 |

**Source:** Moreno-Brid and Pérez (2000).

**Note:** $\xi$ denotes the income elasticity of imports.

$gy_e$ and $gy_a$ denote the estimated and actual rates of growth of output consistent with balance-of-payments equilibrium. For the second sub-period the estimations for Haiti were undertaken for the period 1992-1997.

**Table 10: Latin America and the Caribbean: Income Tax Exemption for Firms Operating in Free Trade Zones (2000)**

| Country | Percentage of Income Tax Exoneration | Years of Exemption |
|---|---|---|
| Costa Rica | 100/50 | 8-12/4-6 |
| El Salvador | 100 | Indefinite |
| Guatemala | 100 | 5-15 |
| Honduras | 100 | Indefinite |
| Nicaragua | 100/60 | 10/11 |
| Dominican Republic | 100 | 15-20 |
| Brasil | 100 | 3-10 |
| Chile | 0 | 0 |
| Mexico | 0 | 0 |

**Source:** ECLAC (2001).

**Table 11: The Manufacturing Sector in Mexico Foreign Direct Investment, Productivity and Real Wages, 1990 – 2000**

| Year | Employment 1993=100 | Average productivity per worker 1993=100 | Unit real labour cost 1993=100 | Share of manufacturing in total direct foreign investment to Mexico |
|---|---|---|---|---|
| 1990 | ... | 83 | 100 | ... |
| 1991 | ... | 88 | 100 | ... |
| 1992 | ... | 93 | 103 | ... |
| 1993 | 100 | 100 | 100 | ... |
| 1994 | 97 | 109 | 95 | 57.9 |
| 1995 | 88 | 114 | 80 | 57.8 |
| 1996 | 90 | 125 | 65 | 61.1 |
| 1997 | 95 | 131 | 62 | 61.2 |
| 1998 | 98 | 136 | 61 | 64.4 |
| 1999 | 99 | 140 | 61 | 72.4 |
| 2000 | 100 | 146 | 62 | 61.3 |

**Source:** WTO (2002).

**Table 12: Net Financial Flows**
**OECS Economies (US$ million), 1990 – 2000**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Total net financial flows | 237.2 | 215.3 | 185.9 | 251.4 | 256.4 | 363.1 | 330.9 | 374.3 | 530.4 | 520.7 | 468.7 |
| Total net long term | 234.5 | 214.3 | 183.2 | 203.4 | 274.6 | 354.1 | 310.8 | 374.8 | 443.4 | 558.3 | 461.3 |
| Official flows | 68.4 | 67.5 | 77.8 | 67.2 | 83.8 | 149.7 | 129.7 | 83.9 | 98 | 62.9 | 60.7 |
| Grants | 29.6 | 41.4 | 38.6 | 45.3 | 64.9 | 139.4 | 96.9 | 37.2 | 75.3 | 53.6 | 41.9 |
| Loans | 38.8 | 26.1 | 39.2 | 21.9 | 18.9 | 10.3 | 32.8 | 46.7 | 22.7 | 9.3 | 18.8 |
| Private flows | 166.1 | 146.8 | 105.4 | 136.2 | 190.8 | 204.4 | 181.1 | 290.9 | 345.4 | 495.4 | 400.6 |
| Debt flows | -2 | 22.8 | -1.2 | -2.8 | 11.4 | -5 | -4 | 30.6 | 28.9 | 157.4 | 106 |
| Commercial bank loans | -1 | -1.1 | -0.8 | -0.4 | 4.7 | -0.1 | -0.1 | 16.4 | 7.1 | 80.4 | 56.5 |
| Other | -1 | 23.9 | -0.4 | -2.4 | 6.7 | -4.9 | -3.9 | 14.2 | 21.8 | 77 | 49.5 |
| Foreign direct investment | 168.1 | 124.0 | 106.6 | 139.0 | 179.4 | 209.4 | 185.1 | 260.3 | 316.5 | 338.0 | 294.6 |
| Short-term debt flows | 2.7 | 1 | 2.7 | 48 | -18.2 | 9 | 20.1 | -0.5 | 87 | -37.6 | 7.4 |

**Table 13: Net Financial Flows**
**Larger Caribbean Economies (US$ million), 1990 – 2000**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Total net financial flows | 641.0 | 654.2 | 879.0 | 998.2 | 1064.2 | 989.4 | 657.4 | 1795.5 | 1206.7 | 850.2 | 2056.5 |
| Total net long term | 518.4 | 721.6 | 785.2 | 1078.0 | 1094.8 | 621.0 | 963.1 | 1202.2 | 1385.6 | 446.1 | 2063.8 |
| Official flows | 451.9 | 736.3 | 233.4 | 422.4 | 112.3 | 168.1 | 14.2 | 42.3 | 135.3 | 31.2 | 99.5 |
| Grants | 267.9 | 516.1 | 179 | 396.1 | 208 | 186.7 | 157.9 | 312.1 | 284.2 | 184.6 | 78.3 |
| Loans | 184 | 220.2 | 54.4 | 26.3 | -95.7 | -18.6 | -143.7 | -269.8 | -148.9 | -153.4 | 21.2 |
| Private flows | 66.5 | -14.7 | 551.8 | 655.6 | 982.5 | 452.9 | 948.9 | 1159.9 | 1250.3 | 414.9 | 1964.3 |
| Debt flows | -371.7 | -262.1 | -133.4 | -174.2 | -159.6 | -263.9 | -58.1 | -134.1 | 98.3 | -157.9 | 744.8 |
| Commercial bank loans | -105 | -8.6 | -42.5 | -22.9 | -48.3 | -84.5 | -81.6 | -69.8 | -53.8 | -144.2 | 69.6 |
| Bonds | -52 | -52.1 | 1.2 | 14.4 | 95 | 12.5 | 177.5 | 50 | 250 | 165 | 668.6 |
| Other | -214.7 | -253.5 | -90.9 | -151.3 | -111.3 | -179.4 | 23.5 | -64.3 | 152.1 | -13.7 | 675.2 |
| Foreign direct investment | 438.2 | 247.4 | 685.2 | 829.8 | 1142.1 | 716.8 | 1007.0 | 1294.0 | 1152.0 | 572.8 | 1219.5 |
| Short-term debt flows | 122.6 | -67.4 | 93.8 | -79.8 | -30.6 | 368.4 | -305.7 | 593.3 | -178.9 | 404.1 | -7.3 |

**Source:** World Bank (2002) and national data.

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# 11

# Government Spending and Economic Growth in Latin America and the Caribbean

*Rudolph C. Matthias & Anthony Birchwood*

## Introduction

An important issue in development economics concerns the role governments[1] should play in the economy. There are two main views on the role of government. One view is that a smaller role for government will be less distortionary and therefore governments should limit their roles to some core

1 In this study, we define government to include central and local governments.

functions.[2] This view is associated with the neo-classicals and has gained orthodoxy in recent times. For them the market is the supreme mechanism for the distribution and allocation of resources. Hence they see government intervention as being distortionary. One of the major concerns of those advocating less government intervention and a smaller role for government is the tendency for "big" governments to run large and persistent fiscal deficits, generate high inflation and accumulate large public debt, which usually generate marginal welfare gains at the cost of creating disincentives for private sector investment.

Proponents of public spending, on the other hand, argue that downsizing as an ultimate policy goal makes little sense since governments can play a pivotal role in the economy, through both the size and allocation of their expenditure.[3] For example, Musgrave (1997) argues that public finances are needed (a) to provide services where externalities cause market failure, (b) to address issues of distribution, and (c) to share in the conduct of macro-economic policy. Governments may also play a meaningful role in the economy by spending on maintaining law and order to help provide an environment conducive to private investment, and by spending on education and health to raise the productivity of labour.

Hall and Jones (1997) support the latter view of the role of government. They view government activity,

2 These core functions might include redistributing income, helping to stabilise the economy at full employment levels and addressing issues of market failure and externalities.

3 Here we refer to the amount of government spending as well as the purposes to which the government chooses to allocate its limited resources.

together with the laws and institutions, as an important and integral part of the infrastructure or the economic environment of an economy. They argue that

> ...differences in levels of economic success across countries are driven primarily by institutions and government policies that frame the economic environment in which people produce and transact.[4]

This paper examines the impact of government spending on economic growth in 18 Latin American and Caribbean countries over the last three decades, 1970 to 1997. The study attempts to establish which, if any, components of government spending are positively related to economic growth in these countries and can therefore be encouraged, and which components, from the point of view of social welfare, can be cut with minimal growth costs when fiscal austerity demands. We approach the issue by first looking at the impact of overall government spending on economic growth and then by segregating government spending into four parts to see whether spending on certain social indicators is welfare and growth enhancing.

## A Brief Discussion on Growth Theory and Evidence

The differing views on the role of government in the economy are partly fuelled by the fact that economic theory does not clearly delineate the impact of government spending on economic growth. The orthodox neo-classical theory, for instance, does not explicitly account for the impact of government activity and size on economic growth

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4 See Hall and Jones (1997, p. 173).

and development.[5] From the preponderance of neo-classical growth models developed over the years, two central themes have emerged from this literature. The first is that in the absence of continuing improvements in technology, per capita growth will eventually cease. Underlying this prediction is the assumption of diminishing returns to capital,[6] which includes human capital. The other central theme for these models, the conditional convergence theory, is that the lower the starting level of per capita gross domestic product of a particular country, the higher is its predicted growth rate, holding other factors constant. There is a large body of cross-country evidence which supports the conditional convergence theory. However, unlike the predictions of the neo-classical theory, most of these studies also provide evidence that countries continue to achieve positive rates of per capita growth over the long term and that these growth rates have no clear tendency to decline. Endogenous growth theories attempt to explain this divergence between the empirical results and the neo-classical theory. The central theme in these competing theories is that growth occurs from the creation of new ideas — technical progress — a crucial missing link in neo-classical theory.[7] According to the endogenous growth theories, long-term growth depends not only on technological progress, but also on government policies.

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5 Since the new endogenous growth theory, neo-classical models have been extended to include government.

6 For a discussion of some of these later neo-classical models, see, for example, Lucas (1988), Rebelo (1991), Mulligan and Sala-i-Martin (1993), Barro and Sala-i-Martin (1995).

7 See, for example, Romer, (1990), Aghion and Howitt (1992) and Grossman and Helpman (1991).

On the other hand, structuralists argue that because developing countries are, in most cases, primary exporting countries, which tend to face declining terms of trade, government intervention is needed to change the structure of production in these economies.[8] Policy involving the protection of "infant industry" through the erection of trade barriers, the imposition of foreign exchange controls, the maintenance of overvalued exchange rate and the provision of cheap credit and labour are considered important policy measures to promote industrialisation. These theories also view government investment as complementary to private investment.

The empirical evidence is not clear-cut, one way or the other, as the evidence from cross-country studies of government spending on growth still lacks consensus. Using a sample of 115 advanced and developing countries over the period 1960 to 1980, Ram (1986, p. 202), for example, argues that "it is difficult not to conclude that government size has a positive effect on economic performance and growth." His study found that government spending had a positive externality effect on the rest of the economy, and perhaps more interestingly, that government spending in the 1960s had higher relative factor productivity than the rest of the economy. Kormendi and Meguire (1985) also found supporting results.

In contrast, using a sample of 86 countries, Landau (1983) found that the larger the size of the government sector in the economy, the lower the rates of economic growth. This finding was for the most part, corroborated by his later study [Landau (1986)], which undertook a more

8 This view is associated with the early work of Raul Prebisch (1962 ), and more lately Lance Taylor (1990).

comprehensive examination of the impact of various components of government spending on economic growth in developing countries. Evidence in support of a negative effect of government expenditures on growth was also provided by Barro (1991), who studied a sample of 98 countries.

One of the factors that account for the differences in these empirical results is the way in which government activity is measured. While some studies focus on the overall size of government spending (Landau, 1993), some focus on components of government spending (Barro, 1991; Landau, 1986), while others focus on the change in government spending (Ram, 1986). The complexity of the problem involved in the empirical studies in this area is underscored by the work of Levine and Renelt (1992). This study investigates whether the links between growth and economic, political, and institutional factors are robust to small changes in the information set. They find that apart from investment and measures of international trade, almost all the variables used to explain cross-country growth rates are not robustly related to growth. In contrast, Sala-i-Martin (1997) adds to this debate by showing that there are a substantial number of institutional, economic and political variables that are robust. In the next section, we discuss the framework within which we re-examine these issues.

## Government Spending and Growth: The Analytical Framework

The framework we employ for analysing the role of government spending in relation to economic growth is a synthesis of the Barro (1996) and Tanzi and Schuknecht (1997) models. The Barro (1996) framework is an extended version of the neoclassical model to include variables designed to account for differences in institutional factors across countries. The model can be represented as:

$$dy = f(y, y^*), \qquad (1)$$

where *dy* is the growth rate of per capita output, y is the current level of per capita output and $y^*$ is the long-run or steady-state level of per capita output. The target variable, $y^*$, depends on an array of choice and environmental variables. Equation 1 suggests that for any given level of initial per capita income, *y*, an increase in the steady state income, $y^*$, raises per capita income, *dy*. Within this extended neoclassical framework, the private sector has to make decisions about savings and labour fertility among other things, while the government faces different types of spending and revenue options, market distortions, property rights, rule of law and political freedoms. Terms of trade issues are also likely to be important in the case of open economies.

Within this framework, governments have significant potential to influence the long-term (steady state) growth rate of the economy. For example, if the government creates a climate that is conducive to business investment by, say, maintaining the rule of law and reducing corruption and "red tape", the steady-state growth rate, $y^*$, can increase over a transitional interval. As the growth rate rises, diminishing returns push it back to its steady-state level which is determined by the rate of technological progress. However, because the transitional period can be fairly long, the growth effects from shifts in government policy can persist for a very long time.

The endogenous growth theories show how research and development can lead to technological progress, and how, once there is no tendency to run out of ideas, technical progress can generate positive growth rates over the long-term. However, the rate of growth and underlying amount of inventive activity in any economy tend not to be Pareto optimal because of distortions relating to the creation of new goods and production methods (Barro, 1996). It is for this reason that government policy relating to taxation, maintenance of law and order, infrastructure, protection of intellectual property rights, and regulation of international trade, among other things, becomes important in helping to achieve the potential long-term rate of growth of the economy.

Tanzi and Schuknecht (1997) have also shed some light on the role of government policy in economic development. Their analysis attempts to establish whether there is a continuous positive relationship between higher government spending and higher social welfare or whether there are diminishing returns in terms of welfare gains to such spending. In addressing this complex issue, they model social welfare, $\gamma$, as a function of several indicators, $\lambda$, as:

$$\gamma = f(\lambda_1, \lambda_2, \ldots. \lambda_n)$$

such that,
$$\Delta\gamma = \sum_{i=1}^{n} \frac{\partial f}{\partial \lambda_i} \Delta\lambda_i$$

Within this framework, governments can influence social welfare through its spending and other policies in that the greater the positive effect of public spending on these indicators, the greater the improvement in social welfare. Changes in a wide range of socio-economic indicators may provide evidence of changes in social welfare.

Tanzi and Schuknecht (1997) themselves point out some of the obvious limitations implicit in this model. First, more public spending often generates an opportunity cost in terms of private spending forgone, either because government collects higher taxes to finance its spending or because government borrowing crowds out private investment. Secondly, it is difficult, if not impossible, to consider all the different social areas on which governments may choose to spend. In essence, the model attempts to assess whether public spending is associated with positive improvements in indicators that are assumed to influence social welfare without considering the opportunity costs, and without applying weights to capture the importance of such indicators.

In spite of the obvious limitations of the Tanzi and Schuknecht (1997) model, we can combine this with the Barro (1996) type extended neoclassical model to evaluate the impact of government spending on economic growth by examining spending on various socioeconomic indicators. In this study, we focus on government spending on social indicators such as: (a) defence which – captures the government policy on national security and defence against threats from internal and external sources, and the general maintenance of law and order; and (b) education and health – which together capture government's contribution to raising labour productivity.

## Model and Data Description

Using the analytical framework discussed above, we attempt to explain the determinants of growth for 18 Latin America and Caribbean countries, over the period 1970 to 1997. The variables in our model are computed over the following six periods: 1970-74, 1975-79, 1980-84, 1985-89, 1990-94 and 1995-97. Most variables are calculated as averages over each period, while the others are recovered from the first year for each of the six periods. For example, the birth rate is observed only once in five years and hence the value for Birth for 1970-1974 is the value in 1970, the only year in this period when the variable was measured. Our dependent variable is the growth rate of gross national product per-capita (GNY), averaged over each period.

Apart from the main variables capturing government spending in our model, the other explanatory variables are similar to those used in Barro (1996) and other similar cross-country studies. We include the initial level of real per-capita GDP (GDP70) calculated as per capita GDP using the purchasing power parity method averaged over the first five-year period, 1970-74, and denominated in US dollars, (GDP70). The coefficient's magnitude indicates the rate at which the economy approaches its long-term position when the other variables are held constant.

In addition to the initial level of income, there are three other social variables included in our model. The first is the crude birth rate per 1,000 people (Birth), used as a crude proxy for the growth rate of the labour force, which should correlate positively with growth. The second is life expectancy at birth (Life) expressed in number of years, to proxy for health and more generally, quality of life, and is expected to correlate positively with growth. The final social indicator is the dependency ratio (DEPEN), calculated as the age dependency of young and old to the working age population. High dependence ratios imply that there is a sizeable proportion of the population that does not work and hence does not contribute to output growth. We therefore expect a negative relationship between dependence and per capita growth rates.

Besides government spending, there are three economic variables in the model. We include the annual rate of inflation (INFL) calculated as the percentage change in the GDP deflator. This variable should capture the negative effects on growth of expansionary monetary policies and external price shocks. The investment to GDP ratio (GDI)[9] is included to account for the positive effects of savings and investment on output growth. And the ratio of the value of export of goods and services to GDP (EXPORT) is included to account for the positive impact of international trade on the growth rate of the open economies in our sample.

Our model can therefore be written in a general form as:

$\delta y = f$ (social indicators, economic indicators, indicators of government spending).

We estimate two regression equations, each of which contains the four social and three economic variables just defined. In addition to these seven variables, we include in the first equation general government consumption to GDP (GOVC), which is our main focus in this equation. General government consumption includes all current expenditures for the purchase of goods and services by all levels of government and capital expenditure on national defence and security but excludes spending by most government enterprises. Landau (1983, 1986) and Barro (1996) use a similar measure of government to account for the effects of government size on growth.

In the second equation, we also include the seven social and economic variables as well as the four com-

9 Investment here is gross domestic investment.

ponents of government spending: defence (DEFEXP), education (EDUEXP), health (HEALTHEXP) and other government expenditure (OTHGOVEXP). Other government expenditure is calculated as total government expenditure minus amounts allocated to defence, education and health. Each of these four variables is scaled by total government expenditure. We include both linear and squared terms for the first three government-spending variables. The squared terms are supposed to account for non-linear effects.

The three categories – defence, education and health – are the components of public spending that we believe are associated with positive improvements in social welfare. If government outlays on defence, education and health are also growth-enhancing, we expect them to correlate positively with growth. Having removed spending on these social indicators, we do not expect other government outlays to enhance productivity and therefore we expect this component to correlate negatively with economic growth.

In the next section, we present the empirical evidence. First, we present some evidence on the size of government across the globe, looking at size by region and countries, and by income groupings. After this, we present some evidence to show the relationship between government spending and changes in several indicators of social welfare in Latin America and the Caribbean. In the final section, we present the econometric results from our two models that relate changes in growth rates to the social, economic and government spending indicators.

## Empirical Evidence

### *Government Size Across the Globe*

Before we focus on the Latin American and Caribbean area, it is useful to put into context government size in this region by showing how it compares with that of the other regions of the world.[10] This information is presented in Table 1, which shows average government consumption to GDP over six time periods, for the World, and deviations from the world's average for various regions and countries. The results suggest that government consumption to GDP averages 14.9 per cent around the world and appears to have risen slightly from 13.7 per cent of GDP in the early 1970s to about 15.0 per cent in the late 1990s.

On average, government size is bigger in the richer regions and countries of the world. For instance, the size of governments in South Asia (-4.9%), East Asia and the Pacific (-3.6%) and Latin America and the Caribbean (-3.7%) is below world average, whereas Canada (7.1%), the United Kingdom (5.9%) and the United States (2.4%) are above the world's average. Canada has the biggest government in the sample; compared to the size of government in Latin America and the Caribbean, Canada's is twice as large.

A similar picture emerges when we look at government consumption by income groups. Table 2 is similar to Table 1 in that it shows the average government consumption to GDP for the average income group and deviations from this average for each income group. These results suggest a *positive* relationship between government consumption

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10 These regions are based on the World Bank's classification.

**Table 1: Government Consumption to GDP Averaged Over Five-Year Periods for Regions**

This table shows government consumption to GDP ratios for the World, various regions and countries. The world column gives the government consumption to GDP, while the observations for regions and countries are deviations from the world average. The Grand average is the average over the six time periods.

| | Latin America and the Caribbean | East Asia and Pacific | South Asia | Sub-Saharan Africa | Middle East | Canada | United Kingdom | United States | World |
|---|---|---|---|---|---|---|---|---|---|
| 1970-74 | -3.3 | -4.7 | -4.6 | -1.0 | 3.3 | 6.9 | 5.1 | 4.0 | 13.7 |
| 1975-79 | -4.2 | -3.9 | -5.5 | -0.1 | 6.3 | 7.4 | 6.5 | 2.6 | 14.6 |
| 1980-84 | -5.1 | -1.7 | -5.7 | -0.2 | 6.3 | 7.0 | 6.8 | 2.2 | 15.3 |
| 1985-89 | -4.5 | -3.1 | -3.6 | 1.5 | 7.7 | 6.6 | 5.4 | 2.7 | 15.1 |
| 1990-94 | -2.6 | -4.0 | -4.8 | 2.3 | 4.2 | 7.9 | 5.9 | 1.5 | 15.7 |
| 1995-97 | -1.6 | -4.5 | -5.1 | 1.6 | 2.7 | 6.0 | 5.9 | 0.6 | 15.2 |
| Grand Average | -3.7 | -3.6 | -4.9 | 0.6 | 5.4 | 7.1 | 5.9 | 2.4 | 14.9 |

**Source:** World Bank Development Indicators.

**Table 2: Government Consumption to GDP Averaged Over Five-Year Periods by Income Groups**

This table shows government consumption to GDP ratios for the World, various regions and countries. The world column gives the government consumption to GDP, while the observations for regions and countries are deviations from the world average. The Grand average is the average over the six time periods.

| Year | Low Income | Low Middle Income | Lower Middle Income | Middle Income | Upper Middle Income | High Income: Non-OECD | High Income: OECD | Average for all Income Groups |
|---|---|---|---|---|---|---|---|---|
| 1970-74 | -1.9 | -1.2 | -1.8 | -1.2 | -0.7 | 4.2 | 2.6 | 11.7 |
| 1975-79 | -2.4 | -1.0 | -0.8 | -0.8 | -0.8 | 3.0 | 2.7 | 12.6 |
| 1980-84 | -2.6 | -1.0 | 0.2 | -0.8 | -1.6 | 3.2 | 2.6 | 13.3 |
| 1985-89 | -1.1 | -1.0 | -0.9 | -0.9 | -1.0 | 2.6 | 2.3 | 13.4 |
| 1990-94 | -2.5 | -0.5 | -1.5 | -0.3 | 0.8 | 2.5 | 1.5 | 14.5 |
| 1995-97 | -3.1 | -0.4 | -1.7 | 0.0 | 1.4 | 1.8 | 1.9 | 13.7 |
| Grand Average | -2.2 | -0.9 | -1.0 | -0.7 | -0.4 | 2.9 | 2.3 | 13.2 |

**Source:** World Bank Development Indicators.

and wealth. Countries in the low to upper middle-income groups have lower government consumption to GDP ratios than the overall average and lower than those in the high-income groups. The results in this table lend support to those in Table 1, which show that government size in Canada, the United Kingdom and the United States is bigger than that in Latin American and the Caribbean and other poorer regions of the world. The difference between government spending to GDP of poor (low income) and rich (high-income OECD) is about 5.5 percentage points, in favour of rich countries.

The size of government in the richest countries of the world suggests that public expenditure increases with the level of development. This positive relationship between public spending and development — measured by income levels — suggests that public spending is a superior good. A recent study by ECLAC (1998)[11] notes that the high level of public spending in rich countries is strongly associated with the development of social security, which is reflected by the increasing proportion of the public spending allocated to transfers and subsidies, and health. In contrast, Agénor and Montiel (1996) present evidence to show that compared to their industrial counterparts, developing countries devote a much larger fraction of their spending directly on production of goods and services.

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11 ECLAC is an acronym for the Economic Commission for Latin America and the Caribbean.

### *Government Spending and Social Welfare in Latin America and the Caribbean*

We can examine the efficiency and quality[12] of government spending by looking at selected indicators for 18 countries in Latin America and the Caribbean over the period 1970 to 1997. Table 3 reports a number of indicators which suggest that the countries are a diverse group. For instance, the average per-capita income in the 1970-74 period ranges from US$1,400 to US$4,100. Over the period, the growth rates in these countries range from –1.2 per cent to 3.1 per cent. Moreover, there are large variations across countries in terms of government size and spending on defence, education, and health.

Table 4 and Figures 1 and 2 shed further light on the indicators over time for our sample countries. As the table shows, when we take cross-sectional averages, the components of government spending on defence, education and health grow relatively slowly over the years. As an example, spending on education has been quite stable, deviating from the mean of 15.3 percent (expressed as a percentage of total expenditure) by only ±1.4 per cent over time.

Figure 1 suggests that government consumption and investment have also been stable over the years, with government consumption averaging around 12 per cent of GDP and investment 21 per cent of GDP (Table 4).

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12 When we talk about the quality of government expenditure, we consider things such as the productivity gained by spending on management that is efficient and results-oriented, spending on projects that are sustainable, and decentralising the management of government spending and projects.

**Table 3: Country Averages for Variables Used in Regression Equations for 18 Latin American and Caribbean Countries Over Five-Year Periods Between 1970 and 1997**

GNY is the growth rate of gross national product (GNP) per capita. BIRTH is the crude birth rate per 1,000 people; DEPEN is the dependency ratio, calculated as the age dependency of young and old to the working age population. LIFE is the life expectancy at birth expressed in number of years. GDP70 is the per capita GDP average over 1970-74 using the purchasing power parity method and expressed in US dollars. INFL is the annual inflation rate calculated as the percentage change in the GDP deflator. GDI is gross domestic investment to GDP. EXPORT is the ratio of the value of export of goods and services to GDP. GOVC is government consumption divided by GDP. General government consumption includes all current expenditures for purchases of goods and services by all levels of government, excluding most government enterprises. It also includes capital expenditure on national defence and security. DEFEXP is defence expenditure calculated as the percentage of total government expenditure on defence. EDUEXP is education expenditure to total government expenditure; HEALTHEXP is expenditure on health as proportion of total government expenditure. OTHGOVEXP is other government expenditure, the sum of total government expenditure minus expenditure on defence, education and health to total government expenditure.

| Country | GNY | BIRTH | DEPEN | LIFE | GDP70 | INFL | GDI | EXPORT | GOVC | DEFEXP | EDUEXP | HEALTHEXP | OTHGOVEXP |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Argentina | 1.0 | 0.62 | 22.4 | 70.3 | 4,146 | 305.7 | 21.3 | 8.1 | 6.6 | 7.3 | 8.5 | 4.3 | 79.9 |
| Barbados | 1.2 | 0.65 | 16.8 | 73.1 | 3,928 | 7.1 | 20.0 | 57.2 | 16.9 | 1.8 | 21.4 | 12.6 | 64.2 |
| Belize | 2.7 | 0.99 | 36.3 | 70.2 | 1,226 | 4.9 | 24.2 | 54.0 | 17.4 | 4.7 | 16.4 | 9.1 | 69.7 |
| Brazil | 2.4 | 0.71 | 27.7 | 63.6 | 2,508 | 394.9 | 21.5 | 8.6 | 13.1 | 5.1 | 4.5 | 6.7 | 83.6 |
| Chile | 2.8 | 0.65 | 23.2 | 70.4 | 2,666 | 77.7 | 20.6 | 24.9 | 12.3 | 10.1 | 13.5 | 8.8 | 67.5 |
| Colombia | 2.1 | 0.77 | 29.5 | 66.5 | 2,114 | 22.3 | 19.4 | 15.5 | 11.0 | 8.6 | 21.4 | 6.9 | 63.0 |
| Costa Rica | 1.4 | 0.76 | 28.4 | 73.1 | 2,636 | 19.5 | 25.1 | 35.2 | 15.8 | 2.7 | 22.8 | 16.7 | 59.0 |
| Dom. Rep. | 3.1 | 0.80 | 31.7 | 65.8 | 1,544 | 14.7 | 22.9 | 29.0 | 6.9 | 7.0 | 12.1 | 10.3 | 70.7 |
| Ecuador | 2.2 | 0.83 | 33.2 | 64.9 | 1,946 | 27.3 | 21.4 | 26.0 | 11.6 | 14.1 | 25.9 | 8.2 | 51.8 |
| El Salvador | 0.4 | 0.89 | 34.5 | 61.9 | 1,392 | 11.4 | 16.4 | 24.8 | 11.7 | 11.9 | 18.4 | 8.5 | 61.2 |

**Table 3: Country Averages for Variables Used in Regression Equations for 18 Latin American and Caribbean Countries Over Five-Year Periods Between 1970 and 1997 - Concluded**

GNY is the growth rate of gross national product (GNP) per capita. BIRTH is the crude birth rate per 1,000 people; DEPEN is the dependency ratio, calculated as the age dependency of young and old to the working age population. LIFE is the life expectancy at birth expressed in number of years. GDP70 is the per capita GDP average over 1970-74 using the purchasing power parity method and expressed in US dollars. INFL is the annual inflation rate calculated as the percentage change in the GDP deflator. GDI is gross domestic investment to GDP. EXPORT is the ratio of the value of export of goods and services to GDP. GOVC is government consumption divided by GDP. General government consumption includes all current expenditures for purchases of goods and services by all levels of government, excluding most government enterprises. It also includes capital expenditure on national defence and security. DEFEXP is defence expenditure calculated as the percentage of total government expenditure on defence. EDUEXP is education expenditure to total government expenditure; HEALTHEXP is expenditure on health as proportion of total government expenditure. OTHGOVEXP is other government expenditure, the sum of total government expenditure minus expenditure on defence, education and health to total government expenditure.

| Country | GNY | BIRTH | DEPEN | LIFE | GDP70 | INFL | GDI | EXPORT | GOVC | DEFEXP | EDUEXP | HEALTHEXP | OTHGOVEXP |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Guatemala | 1.0 | 0.94 | 40.9 | 58.8 | 1,800 | 12.2 | 15.0 | 18.3 | 6.8 | 13.1 | 15.9 | 8.8 | 62.2 |
| Mexico | 1.5 | 0.87 | 32.5 | 67.9 | 3,098 | 35.3 | 22.1 | 15.8 | 9.2 | 6.8 | 17.3 | 2.6 | 73.3 |
| Nicaragua | -1.2 | 0.98 | 41.5 | 61.1 | 1,662 | 973.6 | 20.6 | 26.5 | 19.1 | 15.4 | 14.4 | 10.4 | 59.8 |
| Paraguay | 2.3 | 0.89 | 35.5 | 67.5 | 1,382 | 16.9 | 22.9 | 19.4 | 7.5 | 13.0 | 12.2 | 3.9 | 71.0 |
| Peru | 0.8 | 0.80 | 33.2 | 62.2 | 2,132 | 372.0 | 22.2 | 14.8 | 10.1 | 14.3 | 18.1 | 5.2 | 62.4 |
| T&T | 3.0 | 0.69 | 24.2 | 69.3 | 2,830 | 9.2 | 22.5 | 44.3 | 14.9 | 1.7 | 12.5 | 7.1 | 78.7 |
| Uruguay | 1.7 | 0.60 | 18.9 | 71.3 | 3,112 | 55.4 | 15.9 | 20.0 | 13.8 | 9.3 | 10.2 | 4.1 | 76.4 |
| Venezuela | -0.2 | 0.78 | 30.9 | 69.4 | 4,776 | 29.2 | 24.3 | 26.9 | 10.0 | 6.5 | 17.1 | 7.1 | 69.5 |

**Sources:** *World Bank Development Indicators* on CDROM. Government spending on defence, education and health came from *Government Finance Statistics Yearbook*, IMF, various years.

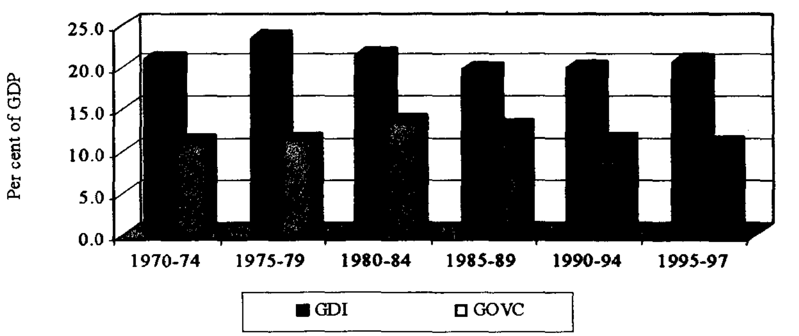
**Table 4: Averages Over Five-Year Periods for Variables Used in Regressions for 18 Latin American and Caribbean Countries**

| Year | GNY | BIRTH | DEPEN | LIFE | INFL | GDI | EXPORT | GOVC | DEFEXP | EDUEXP | HEALTHEXP | OTHGOVEXP |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1970-74 | 3.8 | 0.90 | 35.2 | 61.8 | 29.3 | 20.9 | 21.9 | 11.0 | 8.3 | 16.6 | 7.2 | 68.0 |
| 1975-79 | 2.4 | 0.86 | 33.3 | 64.3 | 38.5 | 23.4 | 24.0 | 11.3 | 9.0 | 16.4 | 6.0 | 68.6 |
| 1980-84 | -1.9 | 0.81 | 31.3 | 66.2 | 44.1 | 21.4 | 24.7 | 13.5 | 8.8 | 15.5 | 8.8 | 66.8 |
| 1985-89 | 0.7 | 0.77 | 29.0 | 68.5 | 354.0 | 19.7 | 26.0 | 12.8 | 8.6 | 13.8 | 6.2 | 71.5 |
| 1990-94 | 1.8 | 0.71 | 27.1 | 69.8 | 314.6 | 19.9 | 26.8 | 11.3 | 11.1 | 14.1 | 9.0 | 67.5 |
| 1995-97 | 2.5 | 0.67 | 24.3 | 71.4 | 15.9 | 20.6 | 28.1 | 10.9 | 5.9 | 15.2 | 10.5 | 69.5 |
| Grand Average | 1.57 | 0.79 | 30.01 | 67.04 | 132.73 | 20.96 | 25.26 | 11.82 | 8.74 | 15.28 | 7.87 | 68.57 |

**Source:** *World Bank Development Indicators* on CDROM and Government Finance Statistics Yearbooks.

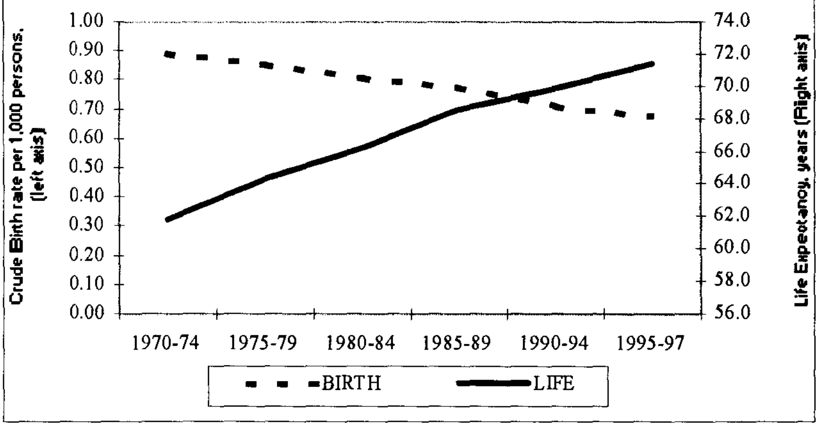
However, the figure also exhibits a weak negative relationship between these two indicators: in periods when investment spending is comparatively high (1975-79 and 1995-97), government consumption is comparatively low; when the latter is relatively high in 1985-89, the former is comparatively low. This could be interpreted in several ways. One possible explanation is that government spending might be playing the role of automatic stabiliser in the recession period in the 1980's (see Figure 1) when government consumption appears comparatively high. It might also be, as ECLAC (1998) argues, that public spending in the region emphasizes size rather than the quality of spending, hence public spending crowds out private investment rather than create conditions for higher private spending.

**Figure 1: Investment and Government Spending**




The evidence nonetheless indicates some welfare gains from government spending over the years. Figure 2 shows that over the last two decades, there were improvements in life expectancy (or quality of life) and lower rates of fertility, which Barro and Lee (1994) argue is a measure of prosperity and a sign of higher levels of primary

**Figure 2: Birth Rate and Life Expectancy**




education, especially among females. To get some idea of whether there are significant welfare gains associated with higher income (wealth) and government spending in the Latin American and Caribbean countries in our study, we conduct difference of means tests, the results of which are reported in Table 5.

The approach taken in testing the significance in the differences of means is to create two groups, based on the lower and upper extremities in certain parameters, to see whether there are significant differences with respect to various indicators between the two groups. In the first panel of the table, our two groups are segmented on initial per capita income levels (GDP70). Comparing the groups of high and low per-capita income, the results suggest that the average dependency ratio and the crude birth rate are both lower and life expectancy is significantly higher for countries in the high per-capita income group compared to those in the low-income group. These results are consistent with the significantly higher levels of public

**Table 5: Difference of Means Test Based on GDP70, GNY and GOVC for Latin American and Caribbean**

| | GHY | BIRTH | DEPEN | LIFE | GDP70 | INFL | GDI | EXPORT | GOVC | DEFEXP | EDUEXP | HEALTHEXP | OTHGOVEXP |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Mean, Low GDP75 | 1.49 | 0.87 | 35.1 | 64.2 | 1,689 | 161.7 | 20.4 | 24.3 | 11.1 | 11.2 | 16.8 | 8.2 | 63.8 |
| Mean, High GDP75 | 1.65 | 0.70 | 25.0 | 69.8 | 3,300 | 103.8 | 21.5 | 26.2 | 12.5 | 6.4 | 13.8 | 7.6 | 73.2 |
| Significance level | | * | * | * | * | | | | | * | ** | | * |
| Mean, Low growth | 0.65 | 0.81 | 31.2 | 66.4 | 2,841 | 196.2 | 20.8 | 24.7 | 11.8 | 9.0 | 16.8 | 8.4 | 66.6 |
| Mean, High growth | 2.49 | 0.76 | 28.8 | 67.7 | 2,148 | 69.2 | 21.1 | 25.8 | 11.9 | 8.5 | 13.6 | 7.3 | 70.6 |
| Significance level | * | | | | * | | | | | | ** | | *** |
| Mean, Low GOVC | 1.54 | 0.81 | 32.2 | 65.9 | 2,549 | 92.8 | 21.3 | 19.3 | 8.9 | 9.7 | 15.7 | 6.4 | 68.1 |
| Mean, High GOVC | 1.60 | 0.76 | 27.8 | 68.2 | 2,440 | 172.6 | 20.6 | 31.5 | 14.9 | 7.8 | 14.9 | 9.2 | 69.0 |
| Significance level | | | * | ** | | | | * | * | | | * | |

**Source:** *World Bank Development Indicators* on CDROM and Government Finance Statistics Yearbooks.

spending on education, but probably not defence, by the higher income group than by the lower income group. Several of the other indictors for the high-income group appear to be better, although the difference is not statistically significant.

In the second panel of Table 5, we segment the countries based on per-capita growth rates. These results show that countries with high growth rates over the period 1970 to 1997 also had lower income levels in 1970-74, supporting the neo-classical convergence hypothesis. Surprisingly, however, high growth countries spent significantly less on education than low growth countries, but are not any worse off on many of the indicators of social development. What these two sets of findings suggest is that although wealth (measured by per-capita income) helps predict social development levels, the level of social development in each country changes very slowly. It does not vary significantly with contemporaneous growth rates.

In the third segment of Table 5, we show two groups based on government consumption spending. These results suggest that countries with high government consumption have higher life expectancy and lower dependency ratios. Countries with high government spending also spent significantly more on health care, which might explain their better health status. It is not clear to us, however, why countries with higher government consumption also have higher export ratios. One possible explanation is that a sizeable proportion of government consumption in these countries could have been used to provide greater incentives and subsidies to the private sector to encourage exports. This might also explain their higher per capita growth rates, which however, are not statistically significant, given the positive impact of higher exports on growth.

In summary, this section presents evidence to suggest that in Latin America and the Caribbean, the richer countries and those with higher public spending tend to have higher rates of social development, measured by higher life expectancy, lower birth rates and dependency ratios, and high rates of per capita and export growth over the period 1970 to 1997.

### *Regression Results*

In this section, we evaluate the results from our two regression models. Before doing so, it is useful to first examine the simple correlation between the dependent and explanatory variables used in our models. These correlation coefficients are presented in Table 6 which shows some fairly strong correlation between per-capita growth and investment, inflation and government consumption respectively. However, there does not appear to be any strong correlation between output growth and any of the four components of government spending, even though the relationship between growth and total government consumption seems relatively strong (0.24). One can also see this in the scatter plots presented in Figure 3. The graphs in this figure show the relatively weak negative relationships between output growth and government consumption and output growth and government spending on defence, education and health, respectively.

The regression results using these variables in our two models are presented in Tables 7 and 8. The results are derived from panel data analysis for 18 Latin America and Caribbean countries using data from six five-year periods between 1970 and 1997.[13] Our data set is un-

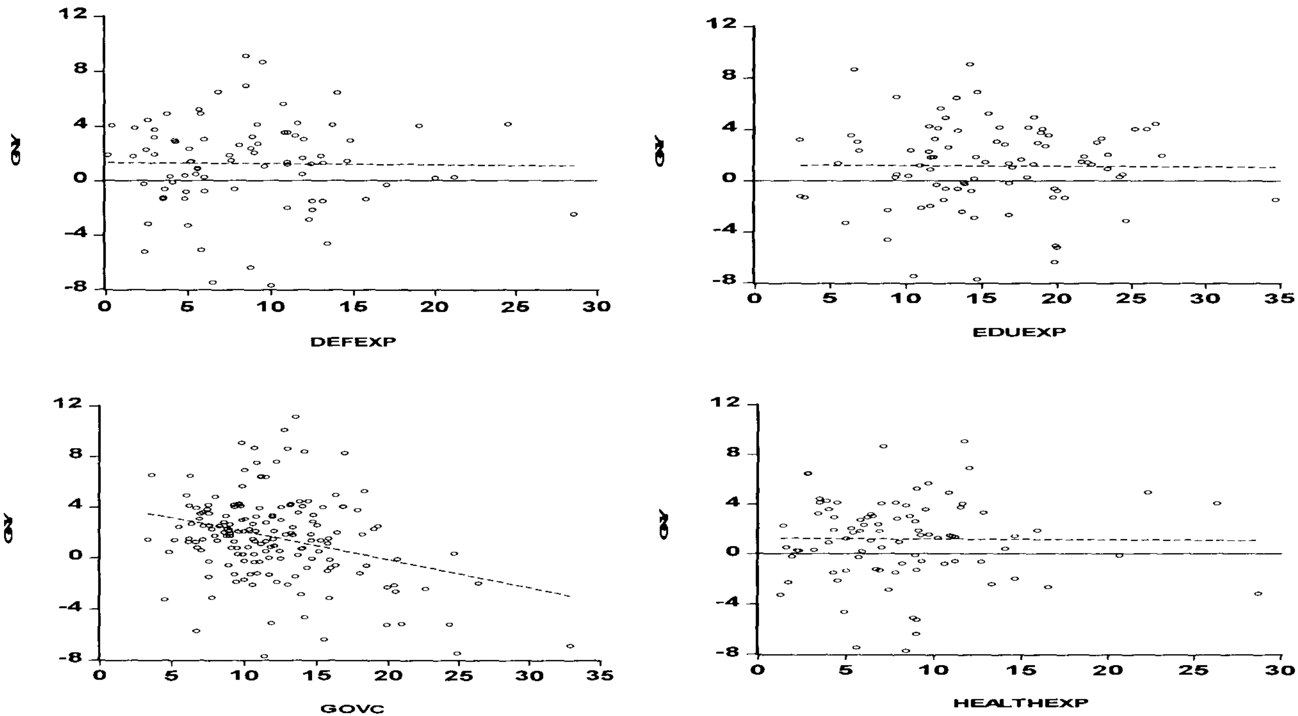
13 The last period uses data from 1995 to 1997.

**Table 6: Correlation Coefficients for Variables Used in Regression Equations for 18 Latin America and Caribbean Countries, 1970-1997**

| | GNY | BIRTH | DEPEN | LIFE | GDP75 | INFL | GDI | EXPORT | GOVC | DEFEXP | EDUEXP | HEALTHEXP |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GNY | 1.00 | | | | | | | | | | | |
| BIRTH | 0.01 | 1.00 | | | | | | | | | | |
| DEPEN | -0.06 | 0.90 | 1.00 | | | | | | | | | |
| LIFE | 0.06 | -0.68 | -0.80 | 1.00 | | | | | | | | |
| GDP75 | -0.08 | -0.51 | -0.56 | 0.43 | 1.00 | | | | | | | |
| INFL | -0.29 | 0.04 | 0.05 | -0.08 | -0.04 | 1.00 | | | | | | |
| GDI | 0.24 | 0.05 | 0.08 | 0.17 | 0.11 | -0.03 | 1.00 | | | | | |
| EXPORT | 0.08 | -0.05 | -0.23 | 0.41 | 0.01 | -0.20 | 0.19 | 1.00 | | | | |
| GOVC | -0.29 | -0.01 | -0.11 | 0.14 | -0.01 | 0.40 | 0.08 | 0.33 | 1.00 | | | |
| DEFEXP | -0.07 | 0.29 | 0.37 | -0.37 | -0.34 | 0.18 | -0.23 | -0.36 | -0.05 | 1.00 | | |
| EDUEXP | -0.04 | 0.29 | 0.23 | -0.06 | -0.11 | -0.31 | 0.08 | 0.38 | 0.22 | 0.03 | 1.00 | |
| HEALTHEXP | -0.04 | -0.02 | 0.00 | 0.17 | -0.14 | -0.04 | 0.09 | 0.46 | 0.28 | -0.13 | 0.24 | 1.00 |
| OTHGOVEXP | 0.10 | -0.38 | -0.39 | 0.24 | 0.34 | 0.10 | 0.09 | -0.23 | -0.20 | -0.53 | -0.76 | -0.51 |

**Figure 3: Scatter Plots of the Growth Rate of GNP Per Capita on Government Consumption to GDP, Government Spending on Defence, Education and Health for Five-Year Periods 1970 to 1997 in Latin America and the Caribbean Countries**

In each graph, the per capita GNP (GNY) is plotted on the y axis. GNY is plotted against government consumption (GOVC), defence expenditure (DEFEXP), education expenditure (EDUEXP), and health expenditure (HEALTHEXP) in the four graphs.



balanced, with, at most, 103 observations on each variable in the model. Both tables present six different sets of coefficient estimates for each model. The first two columns of the tables present ordinary least squares (OLS) estimates in levels and first differences. Modelling the problem in this way ignores differences in the intercept over time and between countries. In effect, we are running ordinary least squares on the pooled sample, with a common intercept and slope.

The next two columns in the tables report fixed effects estimates. The first fixed effects estimator uses the least squares dummy variable approach (LSDV),[14] while the second is generated by a *within* effects transformation.[15] The fixed effects approach used here allows us to take advantage of the country specific effects, or to put it another way, it allows us to control for the cross-sectional dimensions in the data. Another way of accounting for country effects is to generate random effects estimators (GLS), reported in the final two columns of the tables. The random effects estimators are weighted least squares estimators. The first uses weights from *within* and *between*

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14 The LSDV approach involves introducing dummies to take account of the country effects. This means that, compared to the other regression estimates, we are losing at least 17 degrees of freedom – one less than the 18 countries in our study.

15 The *within* transformation is another fixed effects estimator. In generating estimates using this approach, the country effects are "swept" out of the model in the transformation process. This *within* estimator therefore does not estimate country effects.

transformations, while the other uses weights from the OLS residuals.[16]

We note that the fixed effects, but not the random effects estimators remain unbiased even if our assumption that the country effects are uncorrelated with the error term does not hold. This assumption is critical; if there is any systematic correlation between the error term and effects included in the model, the estimator cannot determine how much of the change in the dependent variable associated with an increase in the included effects to assign to the coefficient, versus how much to attribute to the unknown country effects. For this reason, while Tables 7 and 8 present results of six estimators, we focus on the fixed effects results from the LSDV approach.[17]

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16 The fixed effects (LSDV and Within) and random effects (GLS) estimators differ in terms of their efficiency and consistency. To estimate these effects, we have to make one of two assumptions about the distribution of the cross sectional units. The fixed effects estimators are based on the assumption that these cross-sectional effects have no distribution, in which case we treat them as fixed quantities to be estimated. Inferences from this model are therefore restricted to the behaviour of the particular countries, over the specific time period observed, that is, the model is analysed conditional on the effects that are present in the sample. In contrast, the random effects estimator assumes that the country effects are random and the model is to be analysed unconditionally.

17 The results from the fixed effects estimator using the *within* transformation are similar to those of the LSDV, but because there is little variation over time for some of the variables of interest, they are *swept* out of the model and hence do not have an estimate. That is why we ignore the results of the *within* transformation.

Table 7 reports results from the first model, which includes the seven social and economic indicators, and the government consumption variable, on which we focus. Most of the seven social and economic variables have the correct signs, based on the theory and earlier empirical findings, but are not statistically significant at conventional levels. Investment is found to be positively and significantly related to growth, a finding consistent with other empirical work in this area.[18] We also find, as expected, that inflation, dependency ratio, and the initial level of income correlate negatively with output growth. In addition, exports, life expectancy and birth rate correlate positively with growth. However, in our preferred model (LSDV), only the coefficients on investment and birth rate are statistically significant at conventional levels.

Our main interest in estimating these equations is, of course, to observe the impact of government spending on economic growth. The results from this model indicate that government spending correlates negatively and significantly with growth.[19] This is the case not only in our

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18 See Levine and Renelt (1997) for a review of empirical findings in studies of determinants of cross-sectional growth.

19 It was pointed out to us that if we were to divide government consumption into current and capital spending, we might have observed a positive relationship between growth and capital expenditure and a negative relationship between growth and current expenditure. This suggests that government capital spending to enhance the basic infrastructure in the country should correlate positively with growth. This is interesting and debatable, but is not the central issue in this paper. We intend to address this issue in our next paper on the subject.

**Table 7: Model 1 Panel Data Results Regressing the Per-Capita Growth Rate of GNP on Seven Socio-Economic Variables and Government Consumption for Latin America and the Caribbean, 1970-1997**

The dependent variable in each equation is the growth rate of gross national product (GNP) per capita. The sample is a panel dataset for 18 Latin American and Caribbean countries over the period 1970 to 1997. The dependent and independent variables in the regressions are computed over the five-year periods, beginning in 1970-74, 1975-79...1995-97. There are, at most, 6 observations on each variable. The variables are as defined in Table 3. Country effects are estimated for some equations but not reported. The asterisks represent significance levels for the t-test. They are to be interpreted as * significant at the 0.01 level, ** significant at the 0.05 level, and *** significant at the 0.10 level. T-statistics are in ellipses. Standard errors are robust standard errors.

| | OLS Coefficient | OLS[a] Coefficient | LSDV Coefficient | Within Coefficient | GLS[b] Coefficient | GLS[c] Coefficient |
|---|---|---|---|---|---|---|
| Birth Rate | 10.9624* | 13.6471*** | 15.4947** | 15.4947** | 7.5108*** | 10.9624** |
| | (2.600) | (1.750) | (2.060) | (2.060) | (1.770) | (2.310) |
| Dependency Ratio | -0.3688* | -0.3849 | -0.1642 | -0.1642 | -0.3196* | -0.3688* |
| | (-3.46) | (-1.560) | (-0.863) | (-0.863) | (-3.610) | (-3.430) |
| Life Expectancy | -0.1199 | 0.1545 | 0.1896 | 0.1896 | -0.1078 | -0.1199 |
| | (-1.16) | (0.332) | (0.690) | (0.690) | (-1.610) | (-1.190) |
| GDP per capita, 1970-74 | -0.0008* | .... | -0.0051 | .... | -0.0009* | -0.0008** |
| | (-3.09) | .... | (-0.863) | .... | (-4.150) | (-2.280) |
| Inflation | -0.0012* | -0.0016** | -0.0010 | -0.0010 | -0.0014** | -0.0012*** |
| | (-3.32) | (-2.410) | (-1.580) | (-1.580) | (-2.080) | (-1.690) |
| Gross Domestic Investment | 0.2790* | 0.3585* | 0.2903** | 0.2903** | 0.2498* | 0.2790* |
| | (2.82) | (2.960) | (2.210) | (2.210) | (4.110) | (3.780) |

**Table 7: Model 1 Panel Data Results Regressing the Per-Capita Growth Rate of GNP on Seven Socio-Economic Variables and Government Consumption for Latin America and the Caribbean, 1970-1997 - Concluded**

The dependent variable in each equation is the growth rate of gross national product (GNP) per capita. The sample is a panel dataset for 18 Latin American and Caribbean countries over the period 1970 to 1997. The dependent and independent variables in the regressions are computed over the five-year periods, beginning in 1970-74, 1975-79...1995-97. There are, at most, 6 observations on each variable. The variables are as defined in Table 3. Country effects are estimated for some equations but not reported. The asterisks represent significance levels for the t-test. They are to be interpreted as * significant at the 0.01 level, ** significant at the 0.05 level, and *** significant at the 0.10 level. T-statistics are in ellipses. Standard errors are robust standard errors.

| | OLS Coefficient | OLS[a] Coefficient | LSDV Coefficient | Within Coefficient | GLS[b] Coefficient | GLS[c] Coefficient |
|---|---|---|---|---|---|---|
| Exports | -0.0013 | -0.0149 | 0.0006 | 0.0006 | -0.0049 | -0.0013 |
| | (-0.06) | (-0.130) | (0.008) | (0.008) | (-0.252) | (-0.047) |
| Government Consumption | -0.2035* | -0.2907*** | -0.3169** | -0.3169** | -0.1412** | -0.2035* |
| | (-3.36) | (-1.700) | (-2.480) | (-2.480) | (-2.340) | (-2.640) |
| Constant | 10.9337 | -0.7542 | .... | .... | 11.5433** | 10.9337 |
| | (1.54) | (-1.060) | .... | .... | (2.320) | (1.320) |
| R-squared | 0.288 | 0.258 | 0.365 | 0.285 | 0.380 | 0.288 |
| No of observations | 103 | 85 | 103 | 103 | 103 | 103 |
| F-test | 2.4*** | 102.0*** | 167.6*** | 164.2*** | 55.7*** | 38.1*** |

In Table 7, the following applies: OLS is ordinary least squares estimator, LSDV is least squares dummy variable estimator, GLS is Generalized least squares estimator, Within is the *within* transformation estimator. Also: [a] OLS regression on the first difference of each variable; [b] Generalized least Squares weighted by between and within estimates; [c] Generalized least squares weighted by OLS residuals.

chosen model, but also in all of the other five equations, which indicates the robustness of the results. Our results are also consistent with those of Barro (1996), Landau (1983, 1986), and Summers and Heston (1988), among others, who find an inverse relationship between government size (measured by government consumption to GDP) and economic growth.

Table 8 presents estimates for model 2 for the seven social and economic variables and the four components of government spending. Again, our primary focus is on the LSDV results. These results show that investment and the birth rate remain positively related to growth, while inflation remains negative, but now becomes significant. Apart from the initial level of income, none of the other variables enter the model significantly. Indeed, in most cases, their standard error is larger than the estimate, which leaves little room for confidence in the estimate. Interestingly, however, the initial level of wealth becomes positive and significant in this model. This is inconsistent with our explanation of convergence from the results in Table 7.

The results for government spending in Table 8 support our decision to model both linear and non-linear effects of government spending on growth. The results suggest that low levels of government spending on defence is negatively correlated with output growth, mainly because of the opportunity cost of such spending. However, higher levels of spending appear to generate a positive impact, but this effect does not seem large enough to offset the negative effects of spending on the military at the lower levels. Spending on health care also seems to generate some negative influence on growth, whether this spending is at a low or high level. On the other hand, government spending on education at low levels seems to have a positive influence on growth, but this effect seems to turn negative at higher levels of spending. Finally, as we expect, other government spending is significantly negatively correlated with per capita growth.

While it is clear from Model 2 that other government spending has a negative effect on growth, it might not be so clear what impact the other three components of government spending has on growth, given the inclusion of linear and non-linear terms in the model. To get some sense of the quality (net effect on growth) of government spending on defence, education and health, we can evaluate the estimates in Model 2 at their sample means. To do this, we take the partial derivative of per capita growth, y, with respect to government spending on defence (Defexp), education (Eduexp), and health (healthexp). These partial derivatives are as follows:

$$\text{Evaluating defence spending :} \qquad (1)$$
$$\delta Y / \delta(\text{Defexp}) = \beta_{\text{Defexp}} + 2\beta_{\text{Defexpsq}}\text{Defexp},$$

$$\text{Evaluating education spending :} \qquad (2)$$
$$\delta y / \delta(\text{Eduexp}) = \beta_{\text{Eduexp}} + 2\beta_{\text{Eduexpsq}}\text{Eduexp},$$

$$\text{Evaluating health spending :}$$
$$\delta y / \delta(\text{Healthexp}) = \beta_{\text{Healthexp}} + 2\beta_{\text{Healthespsq}}\text{Healthexp}. \qquad (3)$$

Evaluating each component of government spending at the sample mean produces the results in Table 9. These results suggest that government spending, in all forms, has a negative influence on growth. As one would expect, spending on education seems to have the smallest negative

**Table 8: Model 2 Panel Data Results Regressing the Per-Capita Growth Rate of GNP on Seven Socio-Economic and Four Government Spending Variables for Latin America and the Caribbean, 1970 - 1997**

The dependent variable in each equation is the growth rate of gross national product (GNP) per capita. The sample is a panel dataset for 18 Latin American and Caribbean countries over the period 1970 to 1997. The dependent and independent variables in the regressions are computed over the five-year periods, beginning in 1970-74, 1975-79...1995-97. Hence, there are, at most, 6 observations on each variable. The dependent variables are as defined in Table 3. Country effects are estimated for some equations but not reported. The asterisks represent significance levels for a t-test. They are to be interpreted as * significant at the 0.01 level, ** significant at the 0.05 level, and *** significant at the 0.10 level. Standard errors are robust standard errors.

| | OLS Coefficient | OLS[a] Coefficient | LSDV Coefficient | Within Coefficient | GLS[b] Coefficient | GLS[c] Coefficient |
|---|---|---|---|---|---|---|
| Birth Rate | 9.522 | 19.340** | 18.119** | 18.119** | 9.908*** | 9.522 |
| | (1.580) | (2.440) | (2.130) | (2.130) | (1.830) | (1.640) |
| Dependency Ratio | -0.333*** | -0.236 | 0.009 | 0.009 | -0.350** | -0.333** |
| | (-1.890) | (-0.958) | (0.040) | 0.040) | (-2.640) | (-2.340) |
| Life Expectancy | -0.040 | 0.669 | 0.429 | 0.429 | -0.036 | -0.040 |
| | (-0.332) | (1.510) | (1.350) | (1.350) | (-0.335) | (-0.315) |
| GDP per capita, 1970-74 | -0.001** | ... | 0.004** | ... | -0.001* | -0.001** |
| | (-2.640) | | (2.330) | | (-3.040) | (-2.350) |
| Inflation | -0.003* | -0.003*** | -0.002*** | -0.002*** | -0.003*** | -0.003 |
| | (-3.830) | (-1.810) | (-1.800) | -1.800) | (-1.730) | (-1.570) |
| Gross Domestic Investment | 0.237** | 0.372* | 0.248** | 0.248** | 0.223** | 0.237** |
| | (2.410) | (2.870) | (2.180) | 2.180) | (2.420) | (2.500) |

**Table 8: Model 2 Panel Data Results Regressing the Per-Capita Growth Rate of GNP on Seven Socio-Economic and Four Government Spending Variables for Latin America and the Caribbean, 1970 - 1997 - Cont'd**

The dependent variable in each equation is the growth rate of gross national product (GNP) per capita. The sample is a panel dataset for 18 Latin American and Caribbean countries over the period 1970 to 1997. The dependent and independent variables in the regressions are computed over the five-year periods, beginning in 1970-74, 1975-79...1995-97. Hence, there are, at most, 6 observations on each variable. The dependent variables are as defined in Table 3. Country effects are estimated for some equations but not reported. The asterisks represent significance levels for a t-test. They are to be interpreted as * significant at the 0.01 level, ** significant at the 0.05 level, and *** significant at the 0.10 level. Standard errors are robust standard errors.

| | OLS Coefficient | OLS[a] Coefficient | LSDV Coefficient | Within Coefficient | GLS[b] Coefficient | GLS[c] Coefficient |
|---|---|---|---|---|---|---|
| Exports | -0.070* | -0.020 | 0.010 | 0.010 | -0.069*** | -0.070 |
| | (-3.200) | (-0.178) | (0.142) | 0.142) | (-1.760) | (-1.610) |
| Defence Expenditure | -0.148 | 0.000 | -1.144** | -1.436* | -0.171 | -0.148 |
| | (-0.839) | (0.000) | (-2.400) | -3.670) | (-0.712) | (-0.570) |
| Defence Expend. Squared | 0.006 | 0.013 | 0.018 | 0.018 | 0.007 | 0.006 |
| | (1.160) | (1.080) | (1.560) | 1.560) | (0.772) | (0.629) |
| Education Expenditure | 0.239 | 1.144** | 0.293 | ... | 0.205 | 0.239 |
| | (1.030) | (2.210) | (0.796) | ... | (0.746) | (0.799) |
| Education Expend. Squared | -0.006 | -0.017** | -0.023* | -0.023* | -0.005 | -0.006 |
| | (-1.430) | (-2.480) | (-4.930) | (-4.930) | (-0.693) | (-0.800) |
| Health Expenditure | 0.375* | 0.517 | -0.333 | -0.626** | 0.365*** | 0.375 |
| | (3.580) | (1.460) | (-0.766) | (-2.130) | (1.720) | (1.610) |

**Table 8: Model 2 Panel Data Results Regressing the Per-Capita Growth Rate of GNP on Seven Socio-Economic and Four Government Spending Variables for Latin America and the Caribbean, 1970 - 1997 - Concluded**

The dependent variable in each equation is the growth rate of gross national product (GNP) per capita. The sample is a panel dataset for 18 Latin American and Caribbean countries over the period 1970 to 1997. The dependent and independent variables in the regressions are computed over the five-year periods, beginning in 1970-74, 1975-79...1995-97. Hence, there are, at most, 6 observations on each variable. The dependent variables are as defined in Table 3. Country effects are estimated for some equations but not reported. The asterisks represent significance levels for a t-test. They are to be interpreted as * significant at the 0.01 level, ** significant at the 0.05 level, and *** significant at the 0.10 level. Standard errors are robust standard errors.

| | OLS Coefficient | OLS[a] Coefficient | LSDV Coefficient | Within Coefficient | GLS[b] Coefficient | GLS[c] Coefficient |
|---|---|---|---|---|---|---|
| Health Expend. Squared | -0.015* | -0.010 | -0.018** | -0.018** | -0.014 | -0.015 |
| | (-3.500) | (-1.210) | (-2.350) | (-2.350) | (-1.620) | (-1.580) |
| Other Govt. Expend. | 0.048 | 0.377 | -0.680** | -0.972* | 0.061 | 0.048 |
| | (0.531) | (1.130) | (-2.150) | (-4.770) | (0.699) | (0.457) |
| Constant | ... | -1.197 | ... | ... | ... | ... |
| | ... | (-1.560) | ... | ... | ... | ... |
| R squared | 0.23 | 0.27 | 0.44 | 0.30 | 0.29 | 0.23 |
| Number of observations | 78 | 60 | 78 | 78 | 78 | 78 |
| F-statistics | 6,145.0 | 1,334.0 | 1,457.0 | 1,601.0 | 46.6 | 34.4 |

**Notes:** The following applies: OLS is ordinary least squares estimator, LSDV is least squares dummy variable estimator, GLS is Generalized least squares estimator, Within is the *within* transformation estimator. Also: [a] OLS regression on the first difference of each variable; [b] Generalized least Squares weighted by between and within estimates; [c] Generalized least squares weighted by OLS residuals.

impact on growth while spending on defence seems to generate the largest opportunity cost. These findings support those who argue that because the public sector does not respond to market signals, its spending can be inefficient and tends to crowd out more efficient private sector activity, thus generating a negative effect on the growth rate. Although, as we show above, government spending contributes to social development, such as longer life expectancy and lower fertility rates, because public spending tends to be inefficient, larger governments generate higher opportunity costs to the economy in terms of private sector activity forgone. This seems to have implications for economic efficiency and the rates of growth achieved by the economy.

**Table 9: Net Impact on Growth as Evaluated at Sample Mean for Components of Government Spending**

| | Sample Mean | Effect on Growth |
|---|---|---|
| DEFEXP | 8.74 | -0.83 |
| EDUEXP | 15.28 | -0.41 |
| HEALTHEXP | 7.87 | -0.62 |
| OTHGOVEXP | 68.11 | -0.68 |

## Conclusion and Policy Implications

This paper examines the impact of government spending on economic growth in eighteen Latin America and Caribbean countries over the period 1970 to 1997. One of the key questions that this study attempts to address is whether countries with higher government consumption and spending on defence, education and health tend to have higher rates of social development and economic growth or whether there are diminishing returns in terms of growth and other welfare gains to higher government spending. We approach the issue in several ways. First, we examine the relationship between government consumption across income groups and regions across the globe; secondly, we examine the relationships between government spending and several indicators of social development; and finally, we examine the impact of overall government spending on economic growth and then segregate government spending into four parts to see whether certain components of government spending are growth enhancing while others are not.

We find that while government spending is associated with improvements in certain social indicators, government spending in all forms has a negative influence on the rates of economic growth. There are several ways of looking at these results. The mainstream might argue that they indicate a need for scaling down the size of government or the extent to which the state taxes and spends. Consistent with this view, one might argue that governments should ensure that current public spending does not burden future generations. Consequently, current outlays should, as far as possible, be paid for currently. To the extent that government spending retards growth, one can only make weak arguments for capital expenditure to be financed by debt, which becomes a tax on future generations. What all this suggests is that increasing the size of government may not necessarily lead to greater growth in Latin America and the Caribbean.

On the other hand, we have also shown above that government spending on education and health is associated with longer life expectancy and fertility rates are lower when females are more educated. The evidence suggests that there is a role for government in society and this implies a certain quantum of government spending. For instance, governments have a responsibility to promote social equity, which they can do through their spending on social programmes in education, health and in reducing unemployment levels. Human resource development through investments in education can play a meaningful role, not only in raising the productivity of each worker, but also in providing greater skills, which can lead to a higher income. Indeed, social expenditure is a major means by which governments can influence income distribution. On the basis of this, we conclude that there is a social developmental role for government, but also that governments should restrict their spending to the core purposes of facilitating income redistribution, raising the productivity of labour, addressing issues of market failure and other externalities, and providing for law and order in the country.

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# 12

# The Caricom Common External Tariff (CET): Development and Fiscal Implications

*Roger Hosein*[1]

## Introduction

Sir Arthur Lewis was perhaps foremost among West Indian intellectuals in recognizing the need for West Indian integration. He explicitly argued in his 1950 article, "*The Industrialization of the British West Indies,*" that before the islands of the Caribbean area engaged in any form of industrialization, they

1 I would like to acknowledge the guidance of Professor Ramesh Ramsaran and the research assistance of Ms. Denise Hosein.

should form a customs union.[2] Not all economists agreed with Lewis' perspective on the structure of a regional trade agreement, and Brewster and Thomas (1967) provided their variant. The basic argument made by Brewster and Thomas was that the Caribbean region already had the relevant raw materials base necessary for economic development and that a pooling of resources in the context of a well laid out regional integration plan could lead to a broadening of the productive base.

The development of the CARICOM agreement stemmed from the Caribbean Free Trade Agreement (CARIFTA), which was signed by 12 countries of the English speaking Caribbean on the 1st May 1968.[3] The latter agreement had no significant developmental effect on the export performance of the 12 countries and as such the larger countries, especially Jamaica and Trinidad and Tobago (T&T), called for a deepening of the process.

The Treaty of Chaguaramas established the Caribbean Common Market (CARICOM) on the 4th July 1973 for the purpose of facilitating the economic and social development of its member states, and as a movement towards greater integration in the Caribbean. The initial signatories were Barbados, Guyana, Jamaica and Trinidad

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2 However, although Lewis argued in favour of a customs union, he also noted that the Caribbean region was too small to act as a sustained export platform and should only be used as an export launching pad in the short-run.

3 One economist, William Demas, pointed out in 1971 that CARIFTA marked the start of serious attempts to use Caribbean policies and instruments to help Caribbean countries after years of foreign reliance.

and Tobago. The Treaty came into force on the 1st August 1973. Belize, Dominica, Grenada, Montserrat, St. Lucia and St. Vincent became members of the Community and Common Market in April 1974, and Antigua and St. Kitts/ Nevis and Anguilla in July 1974. On July 4th, 1983, the Bahamas became the 13th Member State of the Caribbean Community. The British Virgin Islands and the Turks and Caicos Islands became associated members of CARICOM in July 1991. Several other members of the Commonwealth Caribbean and some Latin American countries now enjoy observer status in CARICOM.[4] On July 14th, 1995, Suriname became the 14th member of CARICOM. Haiti was granted full membership in CARICOM in July 1999.[5] Within the definitions of Article 4 of the Treaty of Chaguaramas, the Bahamas, Barbados, Guyana, Jamaica, Suriname and Trinidad and Tobago are referred to as the More Developed Countries (MDCs), while the remaining member countries are referred to as the Less Developed Countries (LDCs).

The CARICOM Agreement has the following objectives:

(i) improved standards of living and work;

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4 The following countries enjoy observer status in CARICOM: Aruba, Bermuda, the Cayman Islands, Columbia, Dominican Republic, Mexico, Netherlands Antilles, Puerto Rico, and Venezuela.

5 The Bahamas and Haiti, even though members of the Caribbean Community, are not members of the Caribbean Common Market, and as such, do not participate in the deliberations of the Common Market.

(ii) full employment of labour and other factors of production;

(iii) accelerated, coordinated and sustained economic development and convergence;

(iv) expansion of trade and economic relations with third states;

(v) enhanced levels of international competitiveness;

(vi) organization for increased production and productivity;

(vii) the achievement of a greater measure of economic leverage and effectiveness of member states in dealing with third states and group of states;

(viii) enhancing coordination of member states and foreign economic policies; and

(ix) enhanced functional co-operation, including:

   (a) more efficient operation of common services and activities for the benefit of its peoples;

   (b) accelerated promotion of greater understanding among its peoples and the advancement of their social, cultural and technological development; and

   (c) intensified activities in areas such as health, education, transportation and telecommunications (CARICOM Secretariat, 2001).

CARICOM's basic trading rule allows for the completely unrestricted flow of goods that originate from within the body of members to other members within the body. According to Article 15 of the Annex to the agreement, application of import duties by Member States on goods that are of Common Market origin is prohibited. Article 21 prohibits the application of quantitative restrictions on such goods. However, these general provisions are subject to a number of exceptions, which are set down in the Annex, *inter alia*, in Articles 28, 29 and 56. Article 14 defines 'Common Market origin,' and the detailed rules regarding the application of that Article are set out in Schedule II of the Annex.

It is the drive towards closer economic integration that has created the need for the development of a Common Market. Article 3 of the Annex to the Treaty of Chaguaramas identifies the following objectives of the Common Market:

- the strengthening, coordination and regulation of the economic and trade relations among Member States to promote their accelerated harmonious and balanced development;

- the sustained expansion and continuing integration of economic activities, the benefits of which shall be equally shared;

- the achievement of a greater measure of economic independence and effectiveness of its Member States (CARICOM Secretariat, 1991).

The Common Market Council was given the responsibility, under the Common Market Annex to the Treaty, for the efficient operation and development of the Common Market. The Council may make changes to the system in furtherance of the objectives of the Common

Market. The detailed provisions of the system and any changes to the system agreed by the Council are given effect in the member states through the enactment of domestic legislation or the adoption of other appropriate measures to be implemented nationally.[6]

This paper focuses on the Caricom Common External Tariff and the rest of it is developed as follows. Part 1 below discusses some of the economic characteristics of Caricom countries and reviews the path taken by Caricom member states in their integration thrust. The second part of the document discusses the purpose of a CET both in a general context and in the particular case of Caricom. This section also discusses the background to the Caricom CET. The next part of the paper discusses the structure of the Caricom CET in more detail, focusing in particular on its objectives and Rules of Origin criteria. Section four of the paper discusses some of the fiscal and protectionary issues that arise with the Caricom CET, whilst Section 5 provides a critique of the CET in the context of regional and global developments. The paper then concludes.

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6 One of the scarcest resources for a small state is the administrative capacity required to engage in bilateral, regional and multilateral issues. Some authors, however, e.g. Schiff (2002), have alluded to the success of CARICOM, especially in terms of its negotiations with extra-regional countries or trade blocs. In particular, CARICOM negotiators have been involved in the following: ACP-EU, GATT/WTO, UNCTAD and UNCLOS (UN Conference on the Laws of the Seas) negotiations. There have also been joint councils with Canada, Cuba, Japan, the US, the FTAA, the OAS, the G3 (Mexico, Venezuela, Columbia) and many more (Schiff, 2002).

## PART 1: CARIBBEAN ECONOMIES AND THE APPROACH TO INTEGRATION

Almost all the members of CARICOM are island states with narrow resource bases and have a number of other features in common. Most of these states are former colonies of Britain and share the legacy of colonialism in their legal and political systems. English is the predominant language, particularly amongst the initial signatories. As it stands, two of the newer signatories, Haiti and Suriname, are the only two non-English speaking members. Some basic economic indicators of the CARICOM countries are posted in Table 1 below.

Only Jamaica and Trinidad and Tobago had a GDP in excess of US$6bn in 1998, with all of the remaining member states except the Bahamas (US$3.7bn) and Barbados (US$2.3bn) having a level of GDP less than US$1bn. These countries have relatively low rates of inflation ranging (in 1998) from –0.4% in Dominica to 6.7% in T&T. For the period 1990-1998, all the member states experienced positive growth in their GNP except the Bahamas, which contracted by –0.9%.[7] Guyana experienced a rapid average annual growth rate of 8.9%

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7 This is in contrast to the 1980s, which for many CARICOM countries was a 'lost decade' in terms of economic growth. Declining output was principally due to adverse changes in the extra-regional sphere and was heightened in most instances by poor management in the respective member states. The period of the 1980s was thus characterized by high (and in some cases rising) unemployment, falling real income and excessive government involvement. Structural Adjustment Programmes were implemented in some member states and encouraged a return to real positive growth rates.

**Table 1: Some Macroeconomic Indicators of CARICOM Member Countries**

| Country | GDP (US$ billions 1998) | Average Annual Rate of Inflation (1998) | GNP Per Capita Annual Growth Rate (1990-1998) | Total Popula-tion (Millions) 1998 | Agri-culture (as a % of GDP) 1998 | Industry (as a % of GDP) 1998* | Service (as a % of GDP) 1998 | Human Develop-ment Index (HDI) 1998 |
|---|---|---|---|---|---|---|---|---|
| Antigua/Barbuda | 0.6 | 2.8 | 3.5 | 0.1 | 4.0 | 18.9 | 77.1 | 0.833 |
| Bahamas | 3.7a | ... | -0.9 | 0.3 | ... | ... | ... | 0.844 |
| Barbados | 2.3 | 3.8 | 0.7 | 0.3 | 6.6 | 20.0 | 73.4 | 0.858 |
| Belize | 0.7 | 0.9 | 0.5 | 0.2 | 18.7 | 25.5 | 55.8 | 0.777 |
| Dominica | 0.2 | -0.4 | 1.4 | 0.1 | 20.2 | 22.5 | 57.3 | 0.793 |
| Grenada | 0.3 | 3.6 | 2.2 | 0.1 | 8.4 | 22.2 | 69.4 | 0.785 |
| Guyana | 0.7 | 3.2 | 8.9 | 0.8 | 34.7 | 32.5 | 32.8 | 0.709 |
| Jamaica | 6.4 | 5 | 0.6 | 2.5 | 8.0 | 33.7 | 58.4 | 0.735 |
| St.Kitts/ Nevis | 0.3 | 3.3 | 4.5 | ... | 4.6 | 24.3 | 71.1 | 0.798 |
| St. Lucia | 0.6 | 2 | 1.4 | 0.2 | 8.1 | 18.9 | 72.9 | 0.728 |
| St. Vincent | 0.3 | 2.3 | 2.6 | 0.1 | 10.9 | 26.9 | 62.2 | 0.738 |
| T&T | 6.4 | 6.7 | 2.1 | 1.3 | 1.8 | 47.5 | 50.7 | 0.793 |
| Suriname | 0.3b | ... | 0.5 | 0.4 | ... | ... | ... | 0.766 |

**Source:** Human Development Report (2001).

a: Data refer to 1995,
b: Data refer to 1996,
... Means not available,
*: Source did not explicitly specify exactly what industry means.

during the same time interval. In terms of population, only Jamaica and T&T have populations in excess of 1 million people. The total population of CARICOM (excluding Haiti) is 7.2 million people. Only in T&T and Jamaica is there an industrial base that accounts for more than one third of GDP. In particular, Jamaica's industrial sector accounted for 33.7% of GDP in 1998 whilst that of T&T accounted for 47.5%. Guyana and T&T are the only two member states in which the service sector contributes less than 51% to GDP. According to the United Nations Development Program's Human Development Report (2000), CARICOM member countries experience medium to high standards of living as reflected in Human Development Index (HDI) scores ranging from 0.709 in Guyana to 0.858 in Barbados (see Table 1).

For the data period 1990-1998, only T&T has been able to generate a consistent surplus on its intra-regional trade balance. More specifically, although the trade balances of the more developed CARICOM countries increased from EC$307.6mn in 1990 to EC$834.3mn in 1998, this was predominantly because T&T's intra-CARICOM trade balance increased from EC$500.5m in 1990 to EC$1,704.4mn in 1998.[8] In 1998, the only other CARICOM member country besides T&T to record a trade surplus intra-regionally was St. Vincent with EC$2.1mn. In 1973, intra-regional imports were a mere 8% of total imports, increasing only marginally to 9% in 1998.

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8 Exports by T&T to the intra-regional market were principally petroleum and petroleum products. In 1990, CARICOM accounted for 13% of T&T's exports, although by 1998 this would have increased by 19 percentage points to 32%.

In general though, the depth and breadth of trade in the CARICOM region are extremely restrictive. In a recent study, Hamilton and Associates (2002) identified the following features regarding the structure of intra-regional exports:

(i) The structure of intra-regional trade is monopolistic with many member states having national monopolies.

(ii) Some of the main commodities traded are produced by regional monopolies, e.g. cement or flat-coated zinc corrugated sheets produced by a single owner in several CARICOM countries. The cotton box industry in the OECS also has a monopolist owner from St. Lucia; and within the OECS, wheat flour from St. Vincent and the Grenadines, a major traded commodity, has monopoly status in the OECS under Article 56.

(iii) The main intra-regionally traded commodities fall into the category of Ineligible for Conditional Duty Exemptions. This means that these countries enjoy the highest category of protection in terms of the CET and the Rules of Origin regime.

Hamilton and Associates (2002) also found that the commodities (except building materials) which are most heavily protected within CARICOM are the ones which experienced the most significant declines in intra-regional exports for the period 1998-2000. In contrast, the more competitive segments of industry and intra-regional trade have recorded the fastest growth rate amongst commodities traded within CARICOM. T&T was found to have the most competitive intra-regional structure of exports (indicated by its 5 top exports accounting for only 20% of the total value of its intra-regional exports). T&T currently supplies as much as 75% of the intra-regional exports and it is also the most frequent user of the CET suspension mechanism.

Caribbean economies are characterized by distortions in both their product and factor markets. Further, these economies are typified by high levels of unemployment, narrow export baskets concentrated mainly in the primary goods sector, high debt levels, foreign exchange shortages and imperfect markets with heavy Multinational Corporations (MNC) presence in many cases.[9] As a consequence of narrow production bases, the tax base is itself narrow. It is these characteristics which have encouraged the movement towards greater integration.

## The Integration Experience and Factors Leading up to the Decision to Form the Caricom Single Market and Economy (CSME) and Implications for the CET

By the end of the 1970s up through the 1980s, it was evident that CARICOM was not living up to its early promises. The region did not experience significant changes in its structure of production and there were no major changes in the pattern of intra-regional trade. At this stage Caricom governments seemed incapable of making the type of 'hard' decisions to put in place the infrastructure necessary for a joint intra-regional production platform. It was also commonplace for some member countries to enter into trade and economic agreements with non-members without proper consultation with CARICOM partners.

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9 See Demas (1965, 1997), Ferguson (1990) and Worrel (1992).

Recognizing these deficiencies, the CARICOM Heads of Governments, in 1989, agreed to advance the integration movement in the Caribbean area.[10] At this meeting, it was identified that several functions of importance for the formation of a Caribbean community had thus far remained unattended to and the proposal for a CARICOM Single Market and Economy involving the following trade integration issues were put forward:[11]

(i) Free Movement of Goods and Services: for this trade integration objective to be attained, it was agreed that all intra-regional barriers to the trade should be eliminated.

(ii) Free Movement of Labour: Intra-regionally, labour services should be allowed to move freely. It was acknowledged that free movement of labour services would require the introduction of a proper framework for evaluating similarity in terms of quality of the various qualifications attained in different member states. It would also require that adequate

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10 This decision was later endorsed (October 1991) by a special ministerial sitting and reaffirmation was made in June 1996.

11 The conversion of the Common Market to the CSME is set out via nine protocols, which revise the 1973 Treaty of Chaguaramas. These are: the Institutions and Organs of CARICOM; Rights of Establishment, Provision of Services and Movement of Capital; Industrial Policy; Trade Policy; Agriculture Policy; Transportation Policy; Disadvantaged Countries, Regions and Sectors; Competition Policy, Consumer Protection, Dumping and Subsidies and Dispute Settlement.

facilities be established to allow remittance transfers and further, the harmonization of social security measures.

(iii) Designing an effective structure for the Common External Tariff (CET): This would require a simplification of the structure of the CET and a well-defined time period for the systematic reduction of the tariff.[12]

(iv) Reform of Institutions and the Creation of New Rules for the Conduct of Economic Policy: this would require the designing of new institutions intra-regionally and a revision of the Treaty of Chaguaramas (Nicholls, 2000).

## PART 2: THE PURPOSE OF A CET IN GENERAL: THE BACKGROUND OF THE CARICOM CET

The tariff is the most common and well-known barrier to trade. A tariff operates in the same way as a tax by artificially inflating the price of the foreign product as it enters the domestic economy above that which would have prevailed in free trade. CETs are imposed by members of an integration unit to facilitate the development of intra-regional production via trade creation. Trade creation refers to the substitution within the regional trade agreement of

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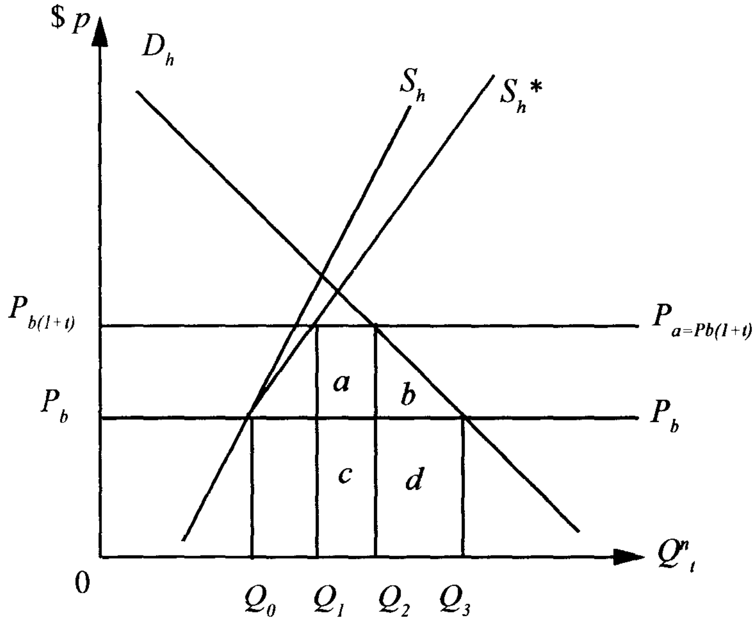
12 One of the main measures to ensure the functioning of a single market is free trade. Free trade, when combined with a common external tariff (CET) and a common trade policy of member states with respect to third countries, equates to a customs union. A custom union is a prerequisite for the formation of a single market and economy.

a higher-cost producer for a lower-cost producer. Trade diversion occurs when a higher cost intra-regional producer replaces a lower cost extra-regional producer. To illustrate how a common external tariff operates, we shall assume that two small countries (international price takers) form an economic union. Prior to the formation of a customs union, $D_h$ and $S_h$ represent the pre-union demand and supply curves for commodity *n* respectively in the home country (see Figure 1 below).

In the pre-union environment, the home country can purchase any amount of the commodity n at the price level $P_b$. With an international price of $P_b$, $Q_0$ is produced domestically and $Q_3 - Q_0$ is imported. With the imposition of a tariff upon the formation of a customs union, the supply curve shifts to $S_h$*. Intra-regional production increases to $Q_1$ and imports fall to $Q_2 - Q_1$. The horizontal line $P_b(1+t)$ is the new tariff-inclusive foreign supply curve of the commodity *n* for the small home country. The consumption effect (reduction in consumption) of the tariff is $Q_3$-$Q_2$. The production effect of the tariff, which refers to the expansion of domestic production that results from the implementation of the tariff, is $Q_1$-$Q_0$. The tariff also has a trade effect, which in this case is the sum of the production and consumption effects and is $(Q_3-Q_0) - (Q_2-Q_1)$. The effect on government revenues would be $(\Delta P)*(Q_2-Q_1) = abcd$.

**Fig 1: Partial Equilibrium Effect of CET**




While it is acknowledged that there are substantial gains from trade to be made when a country participates in a free trade area, there are also substantial losses that can accrue from trade diversion.[13] The welfare effect of the imposition of a CET would require determination of the

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13 Nicholls (1999) outlined several weaknesses of the model proposed by Jacob Viner as concerns customs union theory. One of the main weaknesses of neo-classical theory is the limited attention paid to the whole issue of distribution. For the small member states of CARICOM, the notion of distribution is relevant for, as noted above, the formation of a trade agreement can lead to a loss of fiscal revenues for members.

net gains and losses of the imposition of a tariff (Viner, 1950).

### *Background of the CARICOM CET*

It is the Annex to the Treaty of Chaguaramas that established the Caribbean Common Market, and Article 4 of the Treaty which advocated the implementation of the CET.[14] In the CARICOM context, the common external tariff is a regime of customs tariffs which are placed on goods that are imported, either from third countries or from member-states in the CARICOM Market, which does not meet the qualifying conditions within the Common Market Rules of Origin. Article 31 of the Annex discusses the establishment of the CET, while Articles 32 and 33 provide for the workings of the CET. Article 34 demonstrates the commitment of member states to seek progressive co-ordination and expansion of their trade relations with extra-regional parties.[15]

Initially, the Treaty had set August 1981 as the period of time by which member states would fully adjust for the implementation of the CET with respect to the importation of commodities into CARICOM from extra-regional sources. However, this deadline was never attained by most of the

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14 Articles 31 to 34 outline the commitment of member states to the establishment of a Common Protective Policy. This, it was felt, would serve to enhance the regional integration process by creating a larger more assured target market (CARICOM Secretariat, 2001).

15 Importantly though, members of CARICOM are still allowed to pursue trade policies, independently of CARICOM, with non-members, providing they submit to the CARICOM Secretariat the relevant information.

members (only Guyana, Jamaica and Trinidad and Tobago had implemented the CET by 1976 and Barbados in 1981). By 1990, the CET was still not in place, although there was agreement on a set of arrangements to have the CET implemented by 1st January 1991. As at 1991, however, there were in existence four distinct tariff schedules pertaining to CARICOM trade with extra-regional countries, these being:

(1) the Montserrat tariff,
(2) the Belize tariff,
(3) the CET applied by MDCs, and
(4) OECS tariff (excluding Montserrat).

However, by 1991, all member countries still had not implemented the CET and as a consequence the CARICOM Heads of Government ordered a full revision of the CET in 1992. The decision by the CARICOM Heads of Government to review the CET was intended to facilitate greater attention to the international trends in trade liberalization, regional trade blocs and a general phasing out of preferential trading agreements (CARICOM Secretariat, 2000). This new rate structure of the CARICOM CET was influenced by several factors including the competitiveness of CARICOM products, revenue collection by member states fiscally dependent on international trade taxes, the cost of living and the economic conditions in the OECS and Belize. This review resulted in the following sequential process for the implementation and lowering of the tariff schedule over a five-year period between 1993-1998.

**Table 2: Proposed Implementation and Reduction of the Caricom CET**

| Period of Application | Period Allowed to Effect Implementation | Rate Structure | |
|---|---|---|---|
| | | MDC% | LDC% |
| 1 January 1993 to 31 December 1994 | 1 January 1993 to 30 June 1993 | 5 to 30/35 | 0-5 to 30/35 |
| 1 January 1995 to 31 December 1996 | 1 January 1995 to 30 June 1995 | 5 to 25/30 | 0-5 to 25/30 |
| 1 January 1997 to 31 December 1997 | 1 January 1997 to 30 June 1997 | 5 to 20/25 | 0-5 to 20/25 |
| 1 January 1998 onwards | 1 January 1998 to 30 June 1998 | 5 to 20 | 0-5 to 20 |

**Source:** CARICOM Secretariat (2000).

The tariff structure for both MDCs and LDCs within the region was to be progressively reduced to 20% by 30th June 1998. Some authors have argued that progressive reductions in the level of the CET from the 1993 level constitute perhaps the single most important policy shift amongst member states of CARICOM during the last decade (Antoine *et. al.*, 2001).

As mentioned previously, CARICOM members agreed on a relatively simple rate structure, as well as a programme that would allow for the gradual reduction of the rate over a five-year period, subdivided into 4 phases. This was to commence on 1st January 1993 and conclude on 30th June 1998. The targeted outcome was that, by the date of completion, a maximum tariff of 40% and 20% would be applied to 'agricultural products' and 'all other products' respectively. Even though there were significant delays in the implementation process, most countries were able to implement the first three phases as at the end of 1997. Only St. Vincent and the Grenadines and Trinidad and Tobago were able to implement the fourth phase by the end of the scheduled time period for completion, although by 1st January 2001, Antigua and Barbuda, Montserrat, St. Kitts and Nevis and Suriname were the only countries which had not implemented the fourth phase.[16] Some countries, especially Montserrat and St. Kitts and Nevis, expressed the concern that reducing the rate in Phase 4 would adversely and significantly affect their fiscal accounts. (See the table below for a detailed list of which countries implemented the various phased reductions of the CET within CARICOM).

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16 One author, Arjoon (1993), has highlighted that slow implementation in the early stages of the CET may have been on account of bottlenecks in the dissemination of information on the trading mechanism.

**Table 3: Implementation of Phases I to IV of the Scheduled Reduction of the CET, the Revised Structure of the CET, and Schedule II Based on the 1996 Harmonized System (HS) - Cont'd**

| Member State | First Phase | Second Phase | Third Phase | Fourth Phase | Revised Structure CET Based on 1996 HS | Schedule 11 of Article 14 | Comments |
|---|---|---|---|---|---|---|---|
| Antigua & Barbuda | Jan. 2, 1995 | - | - | Not Implemented | Not Implemented | Not Implemented | Will Implement on February 1, 2002 |
| Barbados | April 1, 1993 | April 1, 1995 | April 1, 1997 | April 1, 1998 | Implemented | Implemented | - |
| Belize | - | April 1, 1997 | April 1, 1998 | April 1, 2000 | Implemented | Implemented | - |
| Dominica | Sept. 1, 1993 | Oct. 1, 1995 | Jan. 1999 | July 1, 2001 | Implemented | Implemented | - |
| Grenada | July 1, 1993 | June 20, 1995 | July 1, 1997 | Jan. 1, 2000 | Implemented | Implemented | - |
| Guyana | Jan. 14, 1994 | Sept. 5, 1995 | Nov. 1, 1997 | April 13, 1999 | Implemented | Implemented | - |
| Jamaica | April 1, 1993 | Jan. 1, 1995 | - | Jan. 1, 1999 | Implemented | Implemented | - |
| Montserrat | N/A | N/A | N/A | Not Implemented | Not Implemented | Not Implemented | The Conference had agreed that Montserrat would implement the Fourth Phase tariff levels with certain differences in light of the trade and other concerns of Montserrat |

**Table 3: Implementation of Phases I to IV of the Scheduled Reduction of the CET, the Revised Structure of the CET, and Schedule II Based on the 1996 Harmonized System (HS) - Concluded**

| Member State | First Phase | Second Phase | Third Phase | Fourth Phase | Revised Structure CET Based on 1996 HS | Schedule 11 of Article 14 | Comments |
|---|---|---|---|---|---|---|---|
| St. Kitts & Nevis | July 5, 1993 | Jan. 1, 1995 | - | Not Implemented | Implemented | Implemented | Fiscal constraints delaying implementation of Final Phase by St. Kitts & Nevis |
| St. Lucia | July 1, 1993 | July 27, 1997 | - | Jan. 1, 2001 | Implemented | Implemented | - |
| St. Vincent and The Grenadines | April 2, 1993 | Jan. 1, 1996 | Jan 1, 1997 | Jan 1, 1998 | Implemented | Implemented | - |
| Suriname | - | July 1, 1998 | July 1, 1997 | Not Implemented | Not Implemented | Not Implemented | - |
| Trinidad & Tobago | Jan. 1, 1993 | Jan.1, 1996 | Jan. 1, 1997 | July 1, 1998 | Implemented | Implemented | - |

**Source:** CARICOM Secretariat (2000) and author's additions.

## PART 3: THE STRUCTURE OF THE CARICOM CET: OBJECTIVE AND RULES OF ORIGIN CRITERIA

The structure of CARICOM's CET can be described as follows. Basically, 4500 distinct commodities are identified, each one having a 7-digit code in the harmonized system (HS) classification of commodities. The structure of the tariff rate is classified on the "economic use of goods" which is subdivided into inputs and final goods.

The new rate structure of the CARICOM CET was influenced by a number of factors including the competitiveness of CARICOM products. With the revised CET, a further distinction is made between competing and non-competing commodities. The classifications 'competing' and 'non-competing' are of the following nature: goods produced within the CARICOM region would constitute the "competing" category, and all other goods produced internationally would constitute the "non-competing" category. The table below illustrates the rate structure of both inputs and final goods in the categories of competing and non-competing goods and the relevant time frames for the phased reduction in tariff rates.

The revised version of the CET was based on a phased reduction process during the time interval 1993 – 1997. In 1993, the members of CARICOM started the systematic reduction of their external tariff with a targeted maximum rate of 20%. A number of exemptions have been allowed by the Common Market Council to meet the concerns of some member states; these include items that are heavily weighted in the calculation of the cost of living and those goods that are traditionally important for revenue raising purposes.

**Table 4: Rate Structure and Tariff Reduction Schedule of the CARICOM CET**

| Product Categories | Rate Treatment and Period of Application | | | | | | |
|---|---|---|---|---|---|---|---|
| | Competing | | | | Non-Competing | | |
| | 1.1.93-31.12.94 | 1.1.95-31.12.96 | 1.1.97-31.12.97 | From 1.1.98 | 1.1.93-31.12.94 | 1.1.95-31.12.961 | 1.1.97-31/12/97 |
| **Inputs** | | | | | | | |
| • Primary | 20% | 15% | 10% | 10% | 5% | 5% | 5% |
| • Intermediate | 25% | 20% | 15% | 15% | 5% | 5% | 5% |
| • Capital | 20% | 15% | 10% | 10% | 5% | 5% | 5% |
| Final Goods | 30-35% | 25-30% | 20-25% | 20% | 25% | 20-25% | 20% |

**Source:** CARICOM Secretariat (2002).

Table 5 below provides an indication of the structure of the CARICOM tariff across the various member countries. One point which emerges clearly from the data is that the agricultural sector has higher tariffs than all of the other sectors (except arms and munitions), i.e. agriculture is still very much protected from extra-regional competition.[17] Belize has the highest overall tariff amongst CARICOM countries whilst Montserrat has the lowest.

Although there has been some dismantling of the CARICOM CET, the average tariff rate today is still high by international standards, especially as compared to some of the regional integration schemes in Latin America, e.g. the Central American Common Market (CACM). In particular, the CARICOM CET as it concerns Live Animals/ Products, Vegetable products, Animal/Vegetable Fats, Processing Foods/Tobacco, Precious and Semi-precious metals, Arms/Munitions and Arts/Antiques is higher in CARICOM as compared to the CACM. Additionally, one should note that because some CARICOM members apply other import taxes apart from the CET, the actual level of import protection would be higher than listed in the table.

### *Objectives of the CARICOM CET*

In establishing the tariff rates, several concerns had to be considered. If the rates were too protective, there would be X-inefficiency, since these protected firms would now operate in an artificial monopoly environment. It was,

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17 On 28-29 October 1992, a special meeting of the Conference of the Heads of Government was convened in Port of Spain, Trinidad and Tobago. At this meeting, it was argued that the highest level of protection be offered to the agricultural sector because of the extent of subsidies deployed by other countries to boost their agricultural sectors.

**Table 5: CARICOM Tariffs in 1998 – by Sections of the Harmonized System 1996**
**(Average Most Favoured Nation Applied Tariff)**

| | AB | Ba | Be | D | Gr | Gu | J |
|---|---|---|---|---|---|---|---|
| Live Animal/Products | 19.2 | 21.1 | 27.4 | 20.2 | 22.9 | 26.1 | 24.2 |
| Vegetable products | 16.2 | 18.9 | 18.8 | 19.2 | 18.7 | 19 | 18.9 |
| Animal/Vegetable | 32.2 | 24.7 | 22.5 | 24.7 | 24.7 | 24.7 | 24.7 |
| Processing Foods/Tobacco | 16.2 | 15.2 | 19.5 | 19.9 | 17.3 | 24.2 | 16.6 |
| Mineral Products | 4.7 | 5.1 | 5.1 | 5.2 | 5.3 | 5.8 | 5.3 |
| Animal Hides/Skin | 8.6 | 8.6 | 8.6 | 8.6 | 8.6 | 0.6 | 8.6 |
| Wood/ Wood Articles | 8.6 | 8.6 | 9.5 | 8 | 8.6 | 8.6 | 8.6 |
| Paper/Cellulose Material | 6.8 | 6.8 | 6.8 | 6.8 | 6.8 | 6.8 | 6.8 |
| Chemical/Industrial Products | 5.2 | 5.1 | 5 | 5.4 | 5.1 | 5.1 | 5.1 |
| Plastic/Rubber | 7.8 | 7.8 | 7.6 | 7.7 | 7.6 | 7.7 | 7.9 |
| Textiles | 11 | 9.9 | 14.7 | 11.1 | 9.9 | 9.9 | 9.9 |
| Footwear/Miscellaneous Articles | 16.5 | 15.8 | 18 | 16.5 | 15.8 | 15.8 | 15.8 |
| Stone/Glassware | 8.9 | 9 | 9.2 | 8.8 | 8.6 | 9 | 8.7 |
| Precious/Semiprecious Material | 17 | 29.7 | 29.7 | 19.7 | 19.6 | 29.7 | 17 |
| Base Metals | 5.7 | 5.5 | 5.8 | 5.6 | 5.5 | 5.5 | 5.5 |
| Machinery/Electrical Equipment | 6.4 | 5.9 | 6 | 5.9 | 6.1 | 0.9 | 5.8 |
| Motor Vehicles/Vessels | 9.6 | 0.9 | 8.9 | 8.6 | 8.3 | 8.9 | 7.6 |
| Precision Instruments | 9.5 | 12.4 | 12.5 | 10.1 | 10.2 | 12.7 | 10 |
| Arms/ Munitions | 41.4 | 41.4 | 41.4 | 28.9 | 23.9 | 41.4 | 21.4 |
| Misc. Manufactured Articles | 15.4 | 14.9 | 15.6 | 15.2 | 14.9 | 14.9 | 14.9 |
| Art/Antiques | 17.5 | 20 | 18.1 | 20.8 | 20 | 20 | 20 |
| Overall | 9.7 | 9.8 | 11.2 | 10.1 | 9.8 | 10.6 | 9.7 |

**Table 5: CARICOM Tariffs in 1998 – by Sections of the Harmonized System 1996 – Concluded (average Most Favoured Nation Applied Tariff)**

| | M | SK | SL | SV | S | T&T | CARICOM |
|---|---|---|---|---|---|---|---|
| Live Animal/Products | 20.4 | 15.8 | 19.9 | 19.5 | 22.5 | 23.7 | 21.8 |
| Vegetable products | 18.8 | 15.7 | 19.1 | 19 | 18.7 | 18.6 | 18.4 |
| Animal/Vegetable | 24.7 | 23.2 | 24.7 | 24.7 | 24.7 | 24.7 | 24.3 |
| Processing Foods/Tobacco | 15.9 | 15.8 | 19.1 | 16.6 | 18.9 | 15.7 | 17.7 |
| Mineral Products | 3.9 | 5.1 | 5 | 4.9 | 4.7 | 7.3 | 5.2 |
| Animal Hides/Skin | 8.6 | 8.5 | 8.6 | 8.6 | 8.6 | 8.6 | 8.6 |
| Wood/ Wood Articles | 8.6 | 8.5 | 8.6 | 8.6 | 8.6 | 8.5 | 8.6 |
| Paper/Cellulose Material | 6.7 | 6.9 | 6.9 | 6.9 | 6.8 | 6.8 | 6.8 |
| Chemical/Industrial Products | 5.2 | 4.9 | 5.5 | 5.1 | 5.1 | 5.1 | 5.1 |
| Plastic/Rubber | 7.6 | 7.9 | 7.8 | 7.6 | 7.6 | 7.9 | 7.7 |
| Textiles | 9.9 | 11.9 | 12.2 | 9.9 | 9.9 | 9.9 | 10.8 |
| Footwear/Miscellaneous Articles | 15.8 | 17.4 | 18.4 | 15.8 | 15.8 | 15.8 | 16.4 |
| Stone/Glassware | 7.7 | 9.1 | 0 | 8.6 | 8.1 | 9 | 8.7 |
| Precious/Semiprecious Material | 19.7 | 16.8 | 17 | 14.4 | 22.4 | 19.7 | 21 |
| Base Metals | 5.5 | 5.7 | 5.7 | 5.5 | 5.5 | 5.5 | 5.6 |
| Machinery/Electrical Equipment | 5.8 | 6.3 | 6.2 | 5.9 | 5.6 | 6.1 | 6 |
| Motor Vehicles/Vessels | 5.5 | 11.2 | 9.7 | 8.3 | 6.3 | 8.5 | 8.5 |
| Precision Instruments | 9 | 9.7 | 9.5 | 10.2 | 10 | 10.8 | 10.5 |
| Arms/ Munitions | 21.4 | 41.1 | 41.4 | 23.9 | 18.9 | 23.9 | 31.6 |
| Misc. Manufactured Articles | 14.9 | 15 | 15.3 | 14.9 | 14.9 | 14.9 | 15.1 |
| Art/Antiques | 20 | 20.6 | 20.6 | 20 | 20 | 20 | 19.8 |
| Overall | 9.3 | 9.6 | 10.3 | 9.5 | 9.7 | 9.8 | 9.9 |

**Source:** Jessen and Rodriguez (1999).AB: Antigua and Barbuda, Ba: Barbados, Be: Belize, D: Dominica, Gr: Grenada, Gu: Guyana, J: Jamaica, M: Montserrat, SK: St. Kitts, SL: St. Lucia, SV: St. Vincent and the Grenadines, S: Suriname, T&T: Trinidad and Tobago.

**Table 6: Comparison of 1998 Common External Tariffs in CARICOM and CACM by sectors of the Harmonized System 1996 (Average Most Favoured Nation Tariff Applied)**

| | CARICOM | CACM |
|---|---|---|
| Live Animal/Product | 21.77 | 14.06 |
| Vegetable products | 18.43 | 12.77 |
| Animal/Vegetable Fats | 24.31 | 11.24 |
| Processing Foods/Tobacco | 17.75 | 15.98 |
| Mineral Products | 5.19 | 3.96 |
| Chemical/Industrial Products | 5.15 | 3.14 |
| Plastic/Rubber | 7.70 | 6.04 |
| Animal Hides/Skin | 8.63 | 12.58 |
| Wood/ Wood Articles | 8.64 | 11.34 |
| Paper/Cellulose Material | 6.80 | 6.61 |
| Textiles | 10.79 | 18.22 |
| Footwear/Misc. Articles | 16.39 | 18.10 |
| Stone/Glassware | 8.74 | 9.18 |
| Precious/Semiprec. Mat | 20.96 | 9.13 |
| Base Metals | 5.57 | 4.40 |
| Machinery/Electrical Equip. | 6.00 | 3.94 |
| Motor Vehicles/Vessels | 8.47 | 4.21 |
| Precision Instruments | 10.49 | 5.02 |
| Arms/Munitions | 31.57 | n.a |
| Misc. Manufactured Articles | 15.07 | 14.06 |
| Art/Antiques | 19.81 | n.a |
| Overall | 9.93 | 8.74 |

**Source:** Jessen and Rodriguez (1999).

however, understood that the rates set should assist in the development and sustenance of CARICOM export competition on the international market.

The CET was supposed to act as an umbrella to the regional grouping, offering some degree of shelter to encourage regional import substitution. Within this protective umbrella, it was perceived that there would be an expansion in regional trade. More technically, the CET is supposed to enhance regional trade by diverting imports from extra-regional avenues to intra-regional ones. Through the use of the regional tariff, firms in the Caribbean region are expected to realize an improvement in their efficiency, generate higher output levels and in the long-run achieve international price and quality competitiveness (Arjoon, 1993).

The Common Market Council also felt the need to take into consideration the different revenue needs of Member States. The lowest rates were applied to a number of products that were usually taxed (i.e. tax-generating products) and Member States were given the power to set their respective rates, even at rates higher than the minimum. It was also noted that applied rates could either be of a flat or ad-valorem nature, once these rates were not lower than the minimum set by the Common Market Council. Note that Member States could obtain additional funds through internal tax regimes, once this did not discriminate in favour of domestic production in the member state in which they were applied.

### *CET and the Rules of Origin*

In order to provide a more rigorous understanding of the CET, some reference has to be made to the Rules of Origin and other ancillary arrangements. Caricom's Rules of Origin operate alongside the CET and are an important aspect of the Common Market. In designing the Rules of Origin, an important influence was the extent of dependence of Member States on the imports of raw material for industrial purposes and the explicit need to relocate dependence on such raw materials away from extra-regional markets and towards intra-regional ones. In order to try to stimulate the amount of value added in the output of manufactured goods from Member States, a deliberate and direct attempt was made to encourage the use of intra-regional production by allowing goods originating from any Member State duty-free entry.

A commodity is granted free intra-regional movement and is treated as a product of the Common Market if it is:

1. Entirely produced within the Common Market;

2. The result of a substantial transformation of materials, intra-regionally.

In the Rules of Origin discussions, it was concluded that if regional production or the present productive capacity was able to satisfy seventy-five per cent of consumer demand and consumption, then the same goods that were produced internationally could be considered "competing." Furthermore, where a commodity was not being produced regionally, but there was sufficient demand, and resources could be easily shifted into productive means to satisfy this demand, it was established that preferential treatment should be extended to the commodity so as to develop its production. It should be noted, though, that if member countries realize difficulty in obtaining a particular competing commodity from an intra-regional producer, then they can apply to the Common Market Council to have the tariff waived on the commodity, if it is now to be sourced extra-regionally (this is the suspension mechanism).

Many industries have argued that CARICOM authorities had overestimated intra-regional supply capabilities, resulting in a large number of petitions to have the CET waived or reduced. Antoine (2001) lists the following reasons why petitions were made:

- The regional supply capacity of the product was non-existent or incapable of meeting the ongoing requirement of intra-regional demand.
- The quality of the intra-regionally supplied good was dubious or fluctuated so that additional costs were incurred at production points where in-house adjustments had to be quickly made before the input was used.
- The regional input was not price competitive.[18]

Antoine (2001) goes on to argue that in granting a suspension for a particular commodity, CARICOM authorities should ensure that intra-regional suppliers were aware of and genuinely unable to meet the requirements of intra-regional demand. In particular, Antoine notes:

> The operation of the rate suspension process appears too far removed from the producers (if not the users) of the products in question. In several instances, potential suppliers argue that in the course of the petition process, they are neither consulted nor informed about enquiries regarding the availability of regional supplies (Antoine, 2001, p. 51).

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18 Antoine (2001), cites T&T and Jamaica as the two main petitioners but notes that all member states make requests in varying degrees.

A reduction in the level of the CET would certainly impact on the fiscal position of CARICOM member countries, especially the smaller ones. The extent of the impact depends on:

1. The magnitude of the reduction in the tariff;

2. The response of imports to the reduction in the tax rate;

3. The extent of fiscal dependence on import taxes;

4. The response of other tax bases to the reduction in the level of the CET and the consequential impact of these other tax bases on total revenue;

5. The number of items below and above the tariff line;

6. The initial value of the tariff; and

7. The magnitude of the imported goods that are subjected to the tariff as a proportion of total imports (Caricom Secretariat, 2002).

One author, Ebrill (1999), has identified several conditions in which the tax revenues collected can either improve or, at worst, be only marginally affected by a reduction in taxes. These include the initial tax revenue position being highly restrictive, or situations of trade liberalization, which involves the replacement of qualitative restrictions by tariff, or the auctioning of import licences. Similar effects on revenues can also be achieved by reform measures such as a reduction in tariff dispersion, or the introduction of a minimum tariff or the removal of exemptions.

## PART 4: FISCAL AND PROTECTIONIST ISSUES ASSOCIATED WITH THE CARICOM CET

What is the fiscal position of CARICOM countries? As the data in Table 7 show, virtually all of the Caricom countries run fiscal deficits on a consistent basis. In Guyana, the magnitude of the fiscal deficit was as much as 50% of GDP in 1987, although this had declined substantially to 3.3% in 1996. Whilst the OECS countries have, in general, avoided large fiscal deficits, the fiscal deficit in Jamaica deteriorated sharply from a position of surplus in 1987 (7.1% of GDP) to a position of deficit by 1996 (24.6%). In the context of the overall fiscal position of Caribbean countries, an ever-present fear is that a greater thrust towards trade liberalization may lead to a fall-off in fiscal revenues collected *via* border taxes. This raises a whole range of fiscal issues that have not been properly addressed and is a major reason why the CET has been so difficult to dismantle.

Many CARICOM member states are heavily dependent on international trade taxes for their fiscal revenues.[19] The table below provides data on three main indicators that reflect fiscal dependence on import taxes: the ratio of import taxes to tax revenue, import taxes to current revenue and import taxes to current GDP. The distinct pattern which emerges with respect to the ratio of import taxes to total tax revenues is that the MDCs (Barbados, Guyana, Jamaica and T&T) are less dependent on trade taxes for their tax revenues than the other CARICOM countries. The conclusion remains basically the same when we look at import taxes as a proportion of current revenues,

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19 Nicholls *et. al.* (1999) have outlined various measures that show how fiscally dependent a country is on trade taxes.

**Table 7: Fiscal (Overall) Balance as a Percent of GDP, 1987-99, at Current Prices**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Antigua & Barbuda | 1.2 | -1.9 | -0.5 | -1.4 | -2.8 | -2.9 | -3 | -4 | -4 | -2.5 | -2.2 | n.a. |
| Bahamas | n.a. | n.a. | n.a. | n.a. | n.a. | -1 | -0.9 | -3 | -1 | -0.3 | 0.4 | -0.8 |
| Barbados | -8.4 | -1.8 | -1.9 | -2.5 | -1.2 | -0.9 | -3.8 | -1 | -1 | -2.3 | -1.5 | -3.5 |
| Belize | 0.3 | -5 | -7.5 | -9.1 | -7.6 | -4.3 | -0.4 | -2 | -2 | -2.1 | -9 | -11 |
| Dominica | -10 | -3.3 | -5.7 | -0.3 | -4.8 | -5.7 | -1.9 | -2 | -1 | -9.9 | -5.5 | n.a. |
| Grenada | -15 | -4.8 | -0.6 | -0.9 | -1.9 | 0.3 | -2.7 | -2 | -3 | -2.8 | -3.4 | n.a. |
| Guyana | -25 | -27 | -20 | -8.1 | -1.8 | 0 | -1.6 | -7 | -7 | -5.7 | -6.6 | -8.3 |
| Jamaica | 4.8 | -5.6 | -6.6 | -2.7 | -11 | -5.4 | -24.6 | -8 | -8 | -6.1 | -0.3 | -6.9 |
| St. Kitts-Nevis | -0.3 | -2.3 | -1.2 | -1.4 | -3 | -6.6 | -3.8 | -3 | -6 | -11 | -14.2 | n.a. |
| St. Lucia | 1 | 0.7 | -1.8 | -0.7 | -0.8 | -1.2 | -2.2 | n.a. | n.a. | n.a. | n.a. | n.a. |
| St. Vincent & the Grenadines | -0.8 | -0.2 | -4.3 | -4.8 | -0.3 | -2.4 | 0.6 | -4 | -3 | -1.5 | -5.8 | n.a. |
| Suriname | n.a. | n.a. | -8.7 | -9.4 | 5.1 | 4.3 | 0.8 | n.a. | n.a. | n.a. | n.a. | n.a. |
| Trinidad | -1.2 | -0.2 | -2.7 | -0.2 | 0 | 0.2 | 0.5 | 0.1 | -2 | -3.2 | 1.6 | -0.4 |

N.A.: Not Available.

**Source:** UNECLAC (2002).

or import taxes as a proportion of current GDP. In this regard, Bourne *et. al.* (1999) have classified all CARICOM member countries except Guyana, Barbados and T&T as being highly dependent on import taxes. Jamaica is listed as moderately dependent.[20]

The data used by Bourne *et. al.* focused on one year, 1997. To provide an idea of the evolving fiscal dependence of CARICOM countries on international trade taxes, consider the data in the table below. The fiscal dependence (import taxes as a percent of fiscal revenues) of all the listed CARICOM member countries shows a trend decline between the snapshot years 1991 and 1999. However, this would have been counterbalanced in most countries by an increase in the amount of tax revenues collected from other sources, e.g. consumption taxes.[21]

Associated with the reduction in the total level of the CET would be gains and losses. On the positive side, the

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20 Bourne *et. al.* (1999) used the following classification for fiscal dependence on trade taxes (import duties as a percentage of total tax receipts). A low level of dependence prevailed with a ratio of 0-15%, a moderate level existed between 15-30%, and a high dependence occurred above 30%.

21 The tax structure within CARICOM varies from country to country and in addition to the CET, a number of other taxes are levied on imports. These taxes include consumption taxes (CT) and/or value added taxes (VAT), customs surcharges (CSC), stamp duty, Revenue Replacement Duty and an Excise Equalization Tax. Antoine (2001) shows that the amount of tax revenues collected from the VAT in Caricom member states as a whole, for example, increased from US$18.5m in 1996 to US$41.3m in 1997.

**Table 8. The Fiscal Dependence of Some Caricom Member States on Trade Taxes (%), 1997**

| Country | Ratio: Import Taxes to Tax Revenue | Ratio: Import Taxes to Current Revenue | Ratio: Import Taxes to Current GDP | Level of Dependence |
|---|---|---|---|---|
| Antigua & Barbuda | 66.6 | 57.2 | 32.1 | High |
| The Bahamas | 50.5 | 45.5 | 10.5 | High |
| Barbados | 9.3 | 8.8 | 2.9 | Low |
| Dominica | 54.2 | 46.0 | 14.4 | High |
| Grenada | 64.6 | 58.3 | 13.7 | High |
| Guyana | 11.7 | 10.9 | 3.5 | Low |
| Jamaica | 26.8 | 24.3 | 6.7 | Moderate |
| Montserrat | 47.2 | 42.5 | 10.8 | High |
| St. Kitts & Nevis | 53.3 | 39.3 | 12.0 | High |
| St. Lucia | 57.9 | 51.6 | 12.7 | High |
| St. Vincent & Grenadines | 50.8 | 42.2 | 12.3 | High |
| Trinidad & Tobago | 7.5 | 6.2 | 1.6 | Low |
| OECS | 60.6 | 51.7 | 17.8 | High |

**Source:** Bourne *et. al.* (1999).

**Table 9: Import Taxes as a Percentage of Fiscal Revenues, 1990-1999**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|---|---|---|
| Antigua & Barbuda | 52.08 | 54.84 | 54.75 | 54.12 | 51.48 | 51.83 | 51.08 | 49.7 | 50.36 | 48.08 |
| Anguilla | n.a | 65.97 | 67.84 | 48.33 | 54.92 | 53.23 | 58.25 | 57.04 | 65.57 | 63.18 |
| Bahamas | 65.94 | 62.23 | 55.62 | 54.97 | 53.65 | 52.62 | 52.77 | 52.1 | 49.79 | 52.67 |
| Barbados | 13.21 | 9.44 | 8.08 | 8.08 | 8.63 | 8.61 | 8.08 | 9.26 | 9.35 | 9.57 |
| Belize | 51.54 | 51.86 | 47.82 | 49.2 | 49.7 | 52.97 | 34.41 | 31.6 | 33.5 | 34.8 |
| Dominica | 17.8 | 18.2 | 17.4 | 17.6 | 14.7 | 14.3 | 14.0 | 15.0 | 13.5 | 14.6 |
| Guyana | 11.4 | 10.2 | 9.5 | 12.6 | 12.8 | 11.6 | 11.7 | 11.8 | 12.1 | na |
| Jamaica | na | 13.4 | 13.7 | 13.6 | 10.9 | 11.9 | 10.8 | 11.3 | 10.6 | 10.4 |
| St. Kitts/ Nevis | 53.5 | 50.3 | 48.3 | 26.2 | 49.1 | 45.6 | 45.3 | 44.2 | 42 | 43.5 |
| St. Lucia | 51.9 | 50.5 | 50.01 | 50.6 | 48.3 | 48.0 | 47.9 | 44.7 | 48.6 | 47.1 |
| St. Vincent & the Grenadines | 51.1 | 49.6 | 48.7 | 47.6 | 45.9 | 48.9 | 43.6 | 44.9 | 42.7 | 43.3 |
| Trinidad & Tobago | 8.2 | 8.1 | 9.4 | 9.4 | 7.7 | 5.8 | 5.2 | 6.3 | 7.2 | 7.2 |

**Source:** UNELAC (2002).

reduction in the CET would no doubt expand the amount of tourism activity. In particular, because of the heavy import content of the tourism sector, a fall in the CET would imply a fall in per unit costs in this sector so that pricing policies can become even more competitive.[22] Further, one would also need to consider the impact of trade liberalization (falling CET rates) on the substitution of extra-regional supply sources for intra-regional sources (Caricom Secretariat, 2002).

Naturally, one would expect that the biggest losers from a reduction in the CET would be those countries whose trade taxes constitute the greater proportion of their fiscal revenues. Certainly, dismantling the CET would raise issues as to where and how these countries would obtain their tax revenues.[23]

A natural candidate for a substitute source of fiscal revenues for Caricom countries is a value added tax (VAT) or a sales tax. However, value added taxes and sales taxes (ST) do not only impact on the amount of revenues collected; they also affect the allocation of resources. Barbados and Trinidad and Tobago have been able to successfully implement VAT systems and the indication is that other Caricom member states can do the same. VATs, however, are by nature regressive and so an appropriate list of exempted goods should be established in order to minimize the burden on the poor. In the context

22 Imports in the tourism sector range from bed linens to airplanes to service air routes between CARICOM countries and major tourist-originating countries.

23 CARICOM Secretariat (2000) describes the financing of the process of economic development as 'the soft underbelly of the transformation process in the Caribbean' (p. 309).

of regional integration, fiscal harmonization of the indirect tax measures of member states would also ensure easier overall administration.

Other authors, e.g. Itam *et. al.* (2000) have suggested that what is required is an extension of the existing tax machinery into untapped areas such as the self-employed and parallel economy, both of which currently contribute very little to tax revenues. It will not be easy to extend taxes into those untapped areas but from both an efficiency and equity perspective, it needs to be done. As Itam *et. al.* notes:

> In the absence of effective taxation, an excessive amount of economic activity takes place in these sectors and the formal sectors' perceived inequity in bearing the burden of taxation undermines overall compliance. Sometimes presumptive or other simplified forms of tax can be used to collect revenues from these sectors of the economy. (Itam, 2000, p. 26)

Woodward and Rolfe (1993) have noted that the islands of the Caribbean offer a very large number of tax-related incentives for foreign investors. Higher tax revenues in other sectors of the economy buttress these tax incentives. Even more, tax incentives offered to foreign investors increase the complexity of the tax system and make it less transparent. These tax incentives also tend to favour *hit and run* types of investments rather than the type of longer-term stable investments that Caricom countries as a whole require.

A further means of raising revenues in Caricom countries can be obtained by implementing user charges at public institutions. For example, user charges could be implemented at hospitals for certain types of secondary and tertiary level health care. The user charge need not be aimed initially at full cost recovery, although this should eventually be the objective.[24] Itam *et. al.* (2000) also point out that there is a greater need to reduce the amount of transfers governments make to loss-making public firms. Governments in some member states have found it difficult to implement changes in loss-making public firms but if the CET has to be dismantled and the lifeblood of tax revenue collections for many member states slowly dries up, then governments would be forced to make these types of hard decisions.

Many Caricom countries have weak property taxation instruments in place and as a result, these taxes contribute very little to total tax revenues.[25] If greater efforts were made to improve the database with respect to the ownership structure of properties and their respective worth, then tax collections from this avenue might be higher.

Altogether a reformation of the tax structure in those CARICOM countries that are fiscally dependent on trade taxes require:

> ...a new level of sophistication, new, more efficient methods of tax collection and administration and a search for alternative tax bases, ... .. .... Many Member States have already started this process and this must

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24 On the expenditure side, Caricom member states, especially those heavily dependent on the CET, would have to be much more wary when making lump sum expenditures and more rigorous economic analysis should be implemented before any investment choices are made.

25 I am grateful to Dr. Anthony Gonzales, Director of the Institute of International Relations, UWI, St Augustine, for this point.

> be an ongoing one. ( CARICOM Secretariat, 2002, p. 9)

Antoine (2001), in a detailed assessment of the CARICOM CET, found that the amount of revenues collected from the CET has fallen far short of expectations. Some of the possible reasons for this, he noted, may be due the number of inconsistencies that exist both in terms of the application of the CET and Rules of Origin arrangements. In the first instance, an important facet of the CET regime is the provision that allows the tariff rate to be reduced or altogether remitted if the imports are used for certain predefined purposes. The Common Market Council of Ministers has the authority to suspend or alter any of the CET rates. To provide flexibility in the system, however, national governments can grant a certain number of tariff concessions in accordance with established rules that govern the implementation of conditional duty exemptions. However, national governments are not allowed to grant conditional exemptions on those commodities which are part of the list of commodities Ineligible for Conditional Duty Exemptions.

It is reasonable to assume that the framing of the CARICOM Treaty Provisions was such that it anticipated that on occasions member states would require alterations or suspensions of the CET on a small scale. As mentioned previously, what happens in practice, however, is a large number of petitions are made for alterations or suspensions, particularly, for intermediate goods. Even more than this, these petitions are not one-off but are repeated, hinting that regional production of the relevant intermediate good was limited. Further, as Antoine (2001) notes, these petitions were not only concerned with the availability of a particular product but questioned other salient aspects of the commodity itself, including price, quality and technical specifications.

As mentioned earlier, the CET and the CARICOM Rules of Origin have a common objective in that they are designed to facilitate a greater degree of intra-regional product development. In this regard, there is in existence a list of commodities for which competing rates have been assigned. In accordance with the objective under which competing rates have been established for various commodities, specific conditions have been included in the Rules of Origin arrangements, which allow a specified list of commodities that would be permissible for Caricom duty-free treatment, providing the finished commodity is produced from prescribed regional materials, particularly from the agricultural sector. In some cases, member states have made requests for derogation from the Rules of Origin criteria on the grounds that some of the available regional raw materials were either unsuitable or altogether unavailable.

Once a derogation in terms of the Rules of Origin has been permitted, then the relevant applying Member State is free to waive the CET on the imported substitute, providing it is not on the list of ineligibles. However, as Antoine (2001) clearly notes:

> The derogation actually results in a loss to the regional economy of added value in addition to the import duty foregone (p. 53).

## The Protectionist Implications

Some researchers have started questioning the level of the CET in a vigorous way. Using specialization indices which can help to show the extent of diversification in a country's export basket, Hosein (2002) found that T&T's intra-regional export portfolio was less concentrated (more diversified) than its extra-regional export portfolio.[26] Whilst this may appear encouraging, it may also be reflective of a greater element of domestic inefficiency as firms can supply within the boundaries of the CET but not beyond. Indeed, Hosein (2002) has shown that the export of sitc0, sitc1, sitc2, sitc4, sitc7 and sitc8 remain biased towards the intra-regional market, and so, the current CET level may be helping to create a zone of comfort for some Caribbean exporters.[27]

Additionally, CARICOM countries must square up to the fact that the preferences on offer from former metropoles may be coming to an end. The consequences of such a trend especially for the smaller CARICOM countries are dismal, pointing to the need for urgent action. Already, the preferential access by CARICOM countries to the European Union (EU) in bananas has been challenged

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26 A specialization index may be calculated as follows:

$$S_j = \sum_{i=0}^{9} (Xsitc_{ij} / X_j)^2, i = 0,....,9$$

Where: $Xsitc_{ij}$: the exports of sitc$_i$: (i equals the 0... 9 single digit export sectors) and $j = 1$ or 2, (1 represents intra-CARICOM exports and 2 represents extra-regional exports).

27 The single digit sitcs are: **sitc0**: food and live animals, **sitc1**: beverages and tobacco, **sitc2**: crude materials and inedible oils except fuels, **sitc3**: minerals, fuels, lubricants and related materials, **sitc4**: animals and vegetable oils and fats, **sitc5**: chemicals, **sitc6**: manufactured goods classified by materials, **sitc7**: machinery and transport equipment, **sitc8**: miscellaneous manufactured articles, **sitc9**: miscellaneous transactions and commodities.

and the same situation seems to be on the way for sugar as Brazil prepares to challenge the EU in the international court.[28] Even in those instances where there is not an absolute removal of preferences, there is a relative removal as is clearly illustrated with NAFTA, which while preserving CARICOM member countries' access to the USA and Canada, has also granted similar privileged access to Mexico, an arguably larger and more efficient producer in most of the productive areas which CARICOM countries embrace.[29]

In 1950, Sir Arthur Lewis, the first West Indian Nobel laureate, argued that there was a need for greater West Indian integration. Lewis noted that the markets of the Caribbean region would be unable to sustain an import substitution agenda and that regional producers should look beyond the intra-regional markets. However, proponents of the more radical New World Group, especially Brewster and Thomas (1967), were inclined to encourage an import substituting industrialization programme centred on the resource base of the region. In contrast to Lewis, Brewster and Thomas encouraged a stronger focus on intra-regional markets as compared to

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28 As one author notes: "Indeed, the rest of the world no longer sees the Caribbean as a special or unique case deserving of special treatment and assistance. Our search for empathy or goodwill, as we seek stays of execution in carrying out actions arising from our international commitments, which can have painful consequences for the survival of Caribbean societies is now perceived as yet another set of rearguard actions, not dissimilar to other such actions on our part over the last three hundred years" (Arthur, 2001, p. 624).

29 This type of trend is becoming more and more common as countries globally prepare to reduce multilateral tariffs in concordance with WTO arrangements.

extra-regional markets. In part, strategies that have stressed import substitution instead of export promotion may have encouraged intra-regional production functions that are weak by international standards. In this context, we should also mention the work of Tybout (1992) which highlights that

> ...new processes diffuse through an industry as managers learn about them and older vintage machines depreciate. This means that there is no single production function, and it is a mistake to think of productivity growth as an orderly shift in technology. Rather, the processes of learning, innovation, investment, entry and exit are what matter (Tybout, 1992, p. 191).

Tybout's argument implies, in part, that a CET may facilitate firms operating with a single technologically weak production function.[30]

The majority of requests for suspension of CET rates were made for products used as factor inputs in the productive process. Some factor inputs fall into the category of competing goods and are thus confronted with the higher bracket of the CET in order to encourage their use intra-regionally. However, it may be argued that input

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30 Vamvakidis (1998) examined the economic impact of five Regional Trading Agreements (RTAs) (including the European Union) on the economic performance of its members. Apart from the EU, Vamvakidis found no significant evidence of a positive relationship between membership of the RTA and the economic growth performance of their member countries and concluded that economic integration amongst small LDCs are unlikely to have a positive impact on economic growth within these LDCs. See also Panagariya (1997) and Schiff (1997).

costs above the best minimum available anywhere would have an adverse effect on the competitiveness of the final products of affected CARICOM firms. In a rapidly globalizing and liberalizing world where price competitiveness is a key factor for the survival of any firm, the employment of correspondingly high CET rates can be harmful to intra-CARICOM business dynamism.

## PART 5: CRITIQUE OF THE CET IN THE CONTEXT OF REGIONAL AND GLOBAL DEVELOPMENTS

Economic activity in the CARICOM area has existed for many years under various forms of protectionist measures and preferential trading arrangements. Since the 1980's, the world economy has experienced a progressive trend towards globalization and CARICOM countries are being increasingly asked to enter into more transparent multilateral free trading arrangements with characteristics of reciprocity. Within CARICOM, some member states, notably T&T, Guyana, Jamaica and Barbados, have begun to liberalize their economies as part of the conditionalities attached to their borrowing arrangements with the multilateral lending agencies. In recent times, the global economy has also witnessed the collapse of the former Soviet empire and the establishment of the World Trade Organization (WTO), which is subscribed to by all CARICOM members except Barbados and Montserrat. The rules governing international trade are themselves also undergoing continual change. The World Trade Organization, for example, requires all countries to remove non-tariff barriers to trade and to engage in a continued liberalization of trade in goods and services. By 2004, CARICOM member states will be expected to conform to the WTO trading arrangements. In no small way then, the global economy has changed since the inception of CARICOM and the very survival of CARICOM member countries would depend greatly on how they adjust to these wider changes.

As early as 1864, Sir Alexander List introduced the infant industry argument. Basically, the infant industry argument proposed that new industries cannot enter into serious competition with existing mature (cost effective) suppliers unless they are offered a reasonable period of time to grow behind protectionary barriers. In this context, the CET offers indigenous firms of the Caribbean region the opportunity to strive behind the protective veil of the CET.[31]

But do the small highly open developing countries of CARICOM still need protection? The agricultural sector of the USA, some members of the European Union and many other countries are heavily subsidized by their respective governments (or, in the case of the EU, an agricultural body). To offset these subsidies, CARICOM countries can obviously implement countervailing duties or anti-dumping legislation.[32] Countervailing duties would require an

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31 In the CARICOM context, there are no tariff restrictions to intra-regional trade; consequentially firms may actually be producing with technically inefficient production functions since they have a protected export market. Were the CET to fall to zero, many firms would go out of existence since they would not be able to compete at an international level with their inefficient cost structures. In the context of globalization and trade liberalization, productive inefficiency is one of the more serious problems in the Caribbean area and indigenous firms would need to restructure their production functions if they are to operate successfully in the global environment.

32 Article 116 spells out the conditions under which a member state could impose countervailing duties.

assessment of the context of the subsidy that, say, a milk producer in Europe receives. But many of the subsidies granted by industrialized countries are implicit in that they are targeted at infrastructure etc. This means that it would be difficult to certify the exact level of the subsidy and, by extension, the requisite countervailing duty. It is also well known that many firms dump some of their produce in the CARICOM market. Appropriate anti-dumping legislation is expensive and also takes a considerable period of time before it can be implemented.[33] In this regard, the CET remains a valuable option available to CARICOM firms to protect them from open subsidization elsewhere or blatant dumping.

In a parallel vein of reasoning, many of the islands inherited labour-intensive production platforms and these sectors employ a considerable proportion of the labour force. In many instances, some of these labour-intensive production opportunities are subsidized by the state. The brutal reality, however, is that in the context of the limited capital endowments of these countries, it would be difficult to restructure the production base even into the meso period. In this context, the shelter from the CET is welcome. However, that shelter period now needs to be well defined and a mechanism for structural transformation of the

33 A good recent example of the difficulties attached to the implementation of antidumping legislation can be found with Trinidad Cement Limited (TCL). When TCL realized in November 1998 that a T&T importer was bringing in cement from Thailand at prices below the normal value in Thailand, a complaint was made to the Antidumping Authority of the Ministry of Trade in December 1998. It was not until March 2000, however, that any action taken.

existing productive sectors has to be called into play.[34] In this sense, although a phased reduction of the CET is therefore very definitely on the agenda, some protection may still be required in labour-intensive sectors so that positive externalities attached to employment and production opportunities in specific areas of production are not missed. In particular, Caricom and member state governments would need to consider that although a particular industry may be a net loss-making one in the accounting sense, from a broad economic perspective, when externalities are considered, it may not be prudent to close down certain industries.

These questions and issues concerning the CARICOM CET have not gone unnoticed and recognizing the need for a deepening and widening of CARICOM, a decision was taken at the level of the CARICOM Heads of Government in 1989 where it was agreed that the regional agreement should move forward to form a Single Market and Economy. A West Indian Commission was formed and in 1992 they submitted the 'Time for Action' document. One of the clear directives of the West Indian Commission was the need to widen CARICOM. In this regard, CARICOM has entered into a series of important trade agreements during the

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34 Whilst it is fashionable and indeed necessary to engage in discussions about changing the production base of CARICOM member countries, it may not always be possible. As an example, consider bananas in the Windward Islands. A banana tree bears fruit all year round and banana is a crop which can be cultivated to produce an income on a weekly basis so that the small farmer can gain income. Given that some Caribbean islands are in the hurricane belt, the banana plant stands out as a good option, which can produce again within months of destruction by storm/ hurricane.

last two decades (See Table 10 below). Some of these agreements are non-reciprocal whilst others are reciprocal. A widening of the preferential market of CARICOM countries with reciprocation offers an important stepping stone opportunity for CARICOM countries to improve their competitiveness. Thus, whilst the CET may still provide protection from First World producers, these new trade agreements would allow CARICOM countries to interface with competitors from other LDCs, some of whom would no doubt be more efficient. This, in turn, would facilitate an overall improvement in productive efficiency and prepare the region more robustly for globalization.[35]

One of the most cogent arguments in favour of a rapid dismantling of the CARICOM CET comes from no less a place than the nineteenth Meeting of the Conference of Heads of Government of the Caribbean Community. At this meeting, one of the discussion papers noted:

> The idea of keeping some defensible margin of preference for local producers in the form of a tariff is no longer tenable for a small CARICOM market seeking to link trade and production with the rest of the hemisphere and region. While such a policy can

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35 As an indication of how favourable a move this is, in terms of encouraging productive efficiency, one only has to consider the following statistics. The Dominican Republic, Mexico and Venezuela have a combined population of approximately 130mn people with an aggregate GDP of US$760bn in 2000. The growth of GDP in these three countries in 2000 was 8.0%, 6.9% and 3.1% respectively. Except in Venezuela, which had an inflation rate of 16.1% in 2000, these economies appear macroeconomically stable as reflected in inflation rates of 7.1% for the Dominican Republic and 9.5% for Mexico.

**Table 10: List of Important Trade Agreements Between CARICOM and Other States**

| Parties to Agreement | Agreement | Preferential/ non-Preferential | Year Signed | Date Entered into Force | Status at at December 1999 |
|---|---|---|---|---|---|
| ACP-EU | Lomé IV Convention | Non-Reciprocal | 1995 | 1996 | Renegotiated |
| CARICOM-Argentina | Agreement on Joint Commission on Consultation, Cooperation and Coordination | - | 1998 | - | Inactive |
| CARICOM-Canada | Trade and Investment Agreement | Non-Reciprocal | 1985 | 1986 | Active |
| CARICOM-Central America | Framework Cooperation Programme | - | 1996 | - | Inactive |
| CARICOM-Chile | Agreement on Scientific Technology | - | | | Inactive |
| CARICOM-Columbia | Trade, Economic and Technical Cooperation | Non-Reciprocal (1998) | 1994 | 1995 | Active |
| CARICOM-Dominican Republic | Agreement on Technical Cooperation | Reciprocal | 1998 | 1999 | Under discussion |
| CARICOM-Mexico | Trade, Economic and Technical Cooperation | - | 1990 | 1990 | Active |
| CARICOM-United States | Free Trade Agreement | Non reciprocal | 1983 | 1984 | Active |
| CARICOM-Venezuela | Agreement on Technical Cooperation and Trade Promotion | Non reciprocal | 1992 | 1993 | Active |

*Source:* Nicholls *et al.* (2000).

> still bring creation gains for large schemes such as Mercosur and even reconcile regional trade protection with universal liberalization if it bears a low tariff, it is counterproductive for CARICOM (Gonzales, 1998, p. 6).

The imminent Free Trade Area of Americas (FTAA) would force CARICOM countries to reconsider the high level of tariff it has historically imposed on the imports of manufactured goods, as ultimately the aim is an elimination of tariffs on all commodities traded within Member States of the FTAA.[36] How would this change in tariff rates be felt by Caricom member states? In the first instance, Caribbean producers would have to adopt more efficient production platforms for their manufactured and semi-manufactured goods if they are to survive the competition from more efficient producers outside the region. Towards this end, one possibility is the formation of mergers and acquisitions amongst firms within the region in an effort to boost their efficiency and restructure their production processes.

Just as importantly, though, the formation of the FTAA would coerce some Caricom countries to take a closer look at their tax regimes. As the discussion earlier in the paper revealed, however, most Caribbean countries are heavily dependent on import taxes to finance public expenditures and so, the formation of the FTAA is likely to

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36 An important part of the agenda established by the FTAA is the progressive dismantling and eventually, elimination of tariffs and other protectionary barriers amongst the members of the trading agreement. In accordance with the Uruguay Round Understanding on Article XXIV, FTAA would have to eliminate tariffs within the trade bloc within 10 years of 'substantially all' members.

have a significant impact on their economies. In the context of the trade liberalization which the FTAA will bring onstream, CARICOM countries will need to devise measures to assist those who lose.[37]

Member States of CARICOM are also engaged in aggressive competition to attract foreign direct investment inflows. This has encouraged excessively generous incentive structures including tax holidays, etc. which eventually compromise the amount of revenues accruing from corporate taxes. In this direction, CARICOM member states need to make a greater effort at harmonizing their fiscal incentive regime.[38] Such a move, if successfully implemented, would help to offset some of the pressure

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37 Some authors, e.g. Worrel (2001), have argued that too much attention is attributed to "tariffs and other measures affecting visible trade, which have little effect on the structure of economic relationships either within the Caribbean or between the Caribbean and the wider world. Intra-regional trade is unlikely to assume major proportions, and it will continue to be dictated by relative prices and transport costs, notwithstanding the level of tariffs and trade regulations. Inevitably trade will be mainly with the rest of the world, its patterns and growth determined by skills, investment, productivity and the rate at which the region adopts new techniques, the critical factors in international competitiveness" (Worrel, 2001, p. 435).

38 In order to accomplish the task of tax harmonization within the region, an adequate package of instruments will be necessary. The Council of Finance and Planning (COFAP) is the relevant council to oversee regional tax issues. However, COFAP as a regional council charged with the coordination of regional fiscal matters is still in its infancy and much more resources would have to be made available before it can realize its designated goal.

that would arise if the CET rate is lowered as public savings expand (CARICOM Secretariat, 2002). Intra- regionally, tax harmonization would

> ...remove the incentive of capital to move due to differences in tax rates......Capital in a harmonious world would be allocated to its best use as signaled by relative prices determined by the interaction of demand and supply. Other factors ... will also determine the movement of capital, but for all intents and purposes, tax incentives are intended to remove distortions to the relative price structure that will signal the direction in which capital should flow (Caricom Secretariat, 2001, p. 10).[39]

Tax harmonization would need to focus on the length of tax holidays, the amount of tax credits, investment allowances and the rate of depreciation etc. offered by the various member countries.

The problem of the reduction of the CET must not be underrated. CARICOM countries are open and are typically large importers of both consumer and capital goods. The export base of these countries is concentrated in a narrow range of commodities and as a consequence, the islands are more susceptible to fiscal tragedy. In this regard, the CARICOM Secretariat (2002) is careful to note:

> Solutions, therefore, lie not only in tax reform but in a longer-term structural reform (p. 8).

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39 The implementation of the CSME will result in free intra-regional flows of commodities and factors of production as established in Protocols II and IV.

In general, as the work of Vamvakidis (1998) and other authors have shown, the experience of economic integration amongst developing countries have led to unsatisfactory results in terms of the economic growth of member countries. The solution, however, whilst including the removal or lowering of non-tariff barriers (NTBs) and tariffs does not end there.[40] The policies which would significantly impact upon the deepening of integration and which could promote intra-regional efficiency are the removal of barriers to the free movement of capital and labour, the harmonization of tax rates and the unification of the currencies of the region. Further, a case can be made for an active industrial policy that gives some margins of preference to domestic producers, particularly in order to narrow the technological gap and promote high-skill and knowledge-intensive industries as the way forward (Gonzales, 2001).

## Conclusion

CARICOM was founded in 1973 in a world where protection was widely accepted. With CARICOM came the associated CARICOM external tariff which itself has gone through a series of changes. The global economy today, however, is substantially different from the period in which CARICOM was formed. As a consequence of some of these changes, the CET has come under greater scrutiny and there have been repeated calls for its systematic elimination. The contentious issue, which arises in this context, is how would CARICOM countries expect to raise revenues if they are forced to dismantle the CET and other

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40 Tariffs are not the best way of giving a margin of preference even if it is established that such margins are necessary (Gonzalves, 2001).

import taxes in the context of the WTO, FTAA and other arrangements. Notwithstanding this, CARICOM exists in a world economy that is no longer prepared to support uncompetitive exports. Instead, CARICOM nations are being asked increasingly to reciprocate in external trade relations. Urgent need therefore, arises for the progressive reform, if not dismantling, of the current CET. This must not be done, however, on an *ad hoc* basis.

Perhaps the time has come once more for CARICOM countries to reconsider implementing broad aspects of the Industrialization by Invitation (IBI) strategy outlined by Sir Arthur Lewis (1950). Basically, CARICOM today is still capital starved, entrepreneurially deficient (note massive brain drain) and perhaps as technologically backward as the members were in the 1950s. The brute fact of globalization and the removal of protection is that we no longer have preferred access to safe and secure export markets. Basically, an IBI strategy would require a process of wooing and fawning upon foreign capitalists to set up production facilities in the region. The reason for calling for a modified version of Lewis' initial IBI as compared to a wholesale application of Lewis' initial propositions is that we are now more conscious of the practices and operations of the transnational corporations. Foreign entrepreneurs can bring with them foreign capital, entrepreneurial talent, technology and very importantly, markets, but the terms of entry have to be very carefully negotiated.

Progressive dismantling of the CET is not an option; it is a necessity. The world will not stand by and wait for an economically insignificant block of countries such as CARICOM to become more competitive. If urgent and drastic short-run action is not taken, the Caribbean is likely to fall even further behind with serious consequences in the long-term.

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# 13

# 'Fiscal Rigidities and the Social Welfare': An Analysis of the Structure of Government Revenues and Expenditure in Trinidad and Tobago

*Dhanayshar Mahabir*

## 1. Introduction

Much debate currently exists on the management of the public finances in Trinidad and Tobago. It is now generally accepted that the Government is on the verge of a boom in revenues on account of the expected earnings in the natural gas sector and on new oil finds which are about to be developed. However, this does not necessarily imply that there is little need for a significant restructuring of the fiscal operations of the Government of Trinidad and Tobago. For one, revenue collections have always been felt to be less than efficient, so that the new revenue stream will simply allow an unsatisfactory situation to persist without improving the efficiency of the collections machinery. In addition, expenditures are rigid in that Government has little by way of flexibility in its spending. This lack of flexibility immediately suggests that Government may be hard-pressed to fully discharge its social welfare obligations and hence, the new revenue stream must be carefully managed if Government is to create room within which it can manoeuvre. Generating flexibility is, however, not easy, as the structure of Government is such that it has embedded within it considerable pressure to spend to satisfy many vested interest groups in the society. Accordingly, these claims impose obligations which make fiscal deficits a salient feature of the public finances, the public debt a growing economic menace and the addressing of social concerns a low priority item on account of resource scarcity. Consequently, it is possible that the growing economy will result in a situation where most actors in the economy will be advancing materially, but at the same time, a failure of Government to effectively manage its fiscal operations will result in its inability to initiate social welfare programmes so vital to reducing poverty and incorporating more of the formerly excluded individuals into the economic mainstream.

This paper explores the current structure of the fiscal accounts in Trinidad and Tobago and offers explanations to account for its characteristics. It also focuses on the policy measures which are necessary in order to enable the state to generate flexibility in its fiscal operations so necessary for a smooth transition from a position of growth to that of social equity.

## 2. The Revenue Base of the Government of Trinidad and Tobago

The Government raises its revenues from a number of sources. These include taxes and royalties *(T)*, profits of state enterprises $(\prod)$ sale of capital assets *(Cs)*, domestic borrowing either from the Central Bank or domestic financial institutions $(B_D)$, foreign borrowing $(B_F)$ and grants or aid $(A_F)$. This revenue base can be expressed as follows:

$$G = T + \prod + C_S + B_D + B_F + A_F \qquad (1)$$

where $G$ represents the Government's budget constraint. In general, sale of assets $C_S$ and grants $A_F$ do not comprise a significant share of annual revenues. Hence, the budget constraint, $G$, may be expressed as

$$G = T + \prod + C_S + B_D + B_F \qquad (2)$$

The profits $\prod$, earned from institutions (such as the National Lotteries Control Board), do contribute a non-trivial amount to the revenue flow. However, given Government's divestment thrust, it is expected that such flows will assume reduced significance in the future.

Consequently, for our purposes the constraint may be further compressed to

$$G = T + B_D + B_F \qquad (3)$$

where $T$ now includes all receipts which do not imply any future obligations to repay.

From the simplified equation (3) above, if total spending is $G - T$, then borrowing is by definition zero and the budget is said to be balanced. If, however, $G - T > 0$, then $B_D + B_F$ is necessarily positive, which implies that the Government must borrow to finance all spending in excess of tax revenues. Similarly if $G - T < 0$, then $B_D + B_F$ must also be negative. This situation of fiscal surplus will result in a fall in the value of outstanding Government debt.

The analysis thus implies that the Government's deficit must be financed by borrowing, and fiscal surpluses must be reflected in a falling debt stock. The implications of the deficit and the debt for fiscal flexibility need to be scrutinized because of claims on future revenues.

***Deficit Financing***

The financing of a fiscal deficit necessitates borrowing. Domestic borrowing can involve either Central Bank advances or borrowing from the domestic financial sector. Since Central Bank borrowing expands the monetary base, reliance on this source naturally has to be limited as increasing the stock of high powered money will usually result in domestic inflation (assuming the classical stable demand for money function). Since inflation also causes the real exchange rate to appreciate, a sustained inflation will lead to foreign reserve losses in a fixed exchange rate regime, which will then precipitate a currency devaluation or, alternatively, result in currency depreciation in a floating rate regime. Such an undesirable outcome is mitigated in Trinidad and Tobago by the imposition of a statutory limit on the advances made by the Central Bank to Government. An important current question therefore is whether this limit should be raised or lowered and what would be the consequent impact on inflation and the real exchange rate. In any event it appears that the stability of the TT$ in relation to foreign currencies since 1993, and the level of foreign reserves which have been accumulated to date are due, in some measure, to the inability of the Government to borrow from the Central Bank beyond the stipulated limit, thus controlling the growth of the domestic money stock.

In addition to Central Bank borrowing, Government can also borrow from the domestic financial institutions. Such borrowing does not increase the stock of high-powered money although the money supply can rise, if banks previously held idle reserves. Furthermore, when Government utilizes this source, it competes with the private sector for finance and bids up the interest rate. Naturally, in a scenario where the Central Bank cannot increase its lending to Government, and where defending the exchange rate requires tight monetary policy which is reflected in a high reserve requirement ratio and open market sales of securities, the domestic borrowing requirements of Government will put upward pressure on interest rates. This has indeed been the case from 1995 to 2001. The high interest rates which prevailed during this period would no doubt have served to reduce some private sector investment. This reduction in private domestic investment was, however, counteracted with the significant inflow of foreign direct investment so that the private sector capital stock continued to rise. In addition, consequent upon trade liberalization, the manufacturing sector's contribution to GDP actually increased and the special arrangements for mortgage finance prevented the interest rate from adversely affecting residential construction. During 2002 the interest rate fell. This subsequent fall can clearly be linked to the fact that Government cannot engage in much more domestic borrowing on account of having almost reached its limit on borrowing from the private market as determined by statute. [This in addition to the statutory limits on Central

Bank borrowing previously mentioned]. There is, incidentally, no limit imposed on the quantum of foreign borrowing which Government can undertake, a possibility which can lead to an increase in the outstanding liabilities in this area given the recent improvements in the international credit worthiness of the country's bonds to investment grade status by the major rating agencies, Moody's and Standard and Poors. Given the existence of a limit on domestic borrowing, debate must now focus on whether these limits must be amended in any way. Furthermore, debate must now begin on whether a limit to Government's foreign borrowing must also be instituted to assist in the goal of macro stability.

**Revenue-Raising Measures**

Taxes on income and profit (at $7.4 billion) accounted for around 50% of all revenues collected in 2000/01. Three items accounted for the bulk of taxes. They included taxes on oil companies ($2.7 billion), taxes on individuals ($2.3 billion) and corporate income taxes ($1.9 billion). The scope for increasing revenues seems to lie in the first item, namely, revising the regimes under which oil companies pay their taxes to Government.

Taxes on goods and services accounted in total for $3.8 billion. Of this, the value added tax amounted to $2.6 billion, with the remainder contributed by seven broad categories and containing no fewer than twenty separate taxes, including the airport departure tax, beer duty and motor vehicle tax, etc. The VAT collections figure is interesting, for while large in absolute terms, it represents merely 4% of the GDP. It is imperative therefore for this system to be reviewed to determine a realistic target VAT/GDP ratio for which the Government should aim, and to implement measures to increase the level of collections in this area. This is essential as VAT collections should normally rise with expenditure increases and overall economic growth.

Taxes on international trade (at $0.9 billion) constituted the third important category of revenue. However, because of tariff reductions and trade liberalization, not much scope seems to exist for revenue enhancement except, of course, improving the efficiency of the customs division.

Incidentally, profits do constitute an important source of revenue. At $0.9 billion they are as important as trade taxes and include the contribution from National Lotteries, National Gas, Petrotrin, NP and the range of companies which fall under the 'NEL' framework. However, this is not expected to grow as Government further withdraws from the private economy.

An important category of revenue which will emerge in the near future is the area of royalties from sales of natural gas. This is estimated at close to $2 billion per annum for at least a twenty-year period, provided that the demand for Liquified National Gas (LNG) can be sustained over time. In addition, the new reports of oil finds suggest that oil revenues can grow if output exceeds the current 125,000 barrel per day, and if the price of oil is stabilized at the OPEC's targeted level of US$22.00. This new revenue inflow clearly has to be managed if the Government is to achieve fiscal flexibility. This will be explored later.

## 3. The Current Structure of Expenditure

Sixty percent of total Government spending is accounted for by two expenditure categories. These are wages and salaries ($4.5 billion, 30%) and debt servicing ($4.5 billion, 30%). Transfers to households in the form of old age pensions and payments to government retirees, transfers to state enterprises and regional institutions (such as the UWI), account for an additional $3.6 billion. The purchases of goods and services and transfers to the Tobago House of Assembly (THA) and other local government bodies account for a further $3.7 billion.

The payments of wages and salaries seem to be an unavoidable item of expense. Indeed, given the legacy of the period of adjustment 1987-1995, and the controls placed upon this category of spending by the adjustment programme, it seems that this quantum will grow over time as the government attempts to narrow the wage differentials which currently exist between employees of similar skills in the private and the public sector.

Similarly, the purchase of goods and services and transfers to local government bodies offer little by way of opportunities for expenditure cuts. Furthermore, the category of current transfers and subsidies which amount to $3.6 billion, is certain to grow over the medium term due to the sub category 'household transfers' which by itself amounts to $2 billion. The certain growth in this category results from the steady expansion in the size of the pool of government retirees on account of the increase in the life expectancy of members.

The current 'pay as you go' scheme of pension funding implies that if tax revenues are not growing at the rate of growth of the retirement pool, then naturally, a greater percentage of revenue must be allocated for this purpose. Hence, the current 6% allocated to government pensions may soon grow to 10% if benefit levels are to be maintained. This phenomenon is certain to make a significant claim on the public finances and contribute further to fiscal rigidity.

On this score, the reform of the system of social security and pension structure seems to be an item of the highest priority. The final item of expenditure is debt servicing. This category offers scope for generating flexibility in fiscal operations.

## 4. The Public Debt

The public debt now amounts to some TT$37 billion, or 67% of GDP. Its servicing appropriates an estimated 25% of revenues. An important issue to be addressed is the maximum size of this debt in relation to the GDP. The second refers to the optimal ratio of domestic to foreign debt. The third is the desired debt servicing to tax revenue ratio.

The size of the debt, naturally, has to be related to the development needs of a country. For example, as a condition for membership in the European Union (EU), countries were required to have a debt/GDP ratio no larger than 60% and a Fiscal Deficit/GDP ratio of no more than 3%. While this 60% rule seems a valuable guide for developing countries, it has to be recognized that practically all the EU countries are considered developed and possess social infrastructure which can be deemed to be optimal. This would suggest that the desired ratio may be higher for Trinidad and Tobago on account of the resources needed for development purposes. On the other hand, the debt stock and its associated servicing do have important implications for the social welfare. In particular, where there exists a need to finance an expanded social welfare programme, a higher debt stock suggests that resources which could be used for this purpose will have to be redirected to debt servicing. In this context one can speak of debt servicing crowding out income redistribution, a matter which does not arise in the EU to the same extent. It appears, therefore, that a maximum target of 60% Debt/

GDP ratio seems reasonable for the country, with a 50% ratio appearing optimal. The exact target ratio of course is one which requires further debate and analysis.

The second issue which focuses on the composition of the debt also warrants analysis. Currently, the ratio of 25% foreign to local and the level of reserves, which at 2 billion US$ is 33% higher than the foreign debt stock, suggest a position where the chances of having to reschedule because of sharp declines in the terms of trade are relatively low. Consequently, the high international credit ratings enable the country to borrow internationally at relatively attractive rates. To what extent this opportunity should be exploited depends of course on the implications of debt servicing on the discretionary revenues of government and the possibility (though currently low) that increasing the level of foreign debt can expose the country to foreign exchange earnings shocks which would require fiscal restraint, with undesirable implications for the social welfare. With 25% of revenues currently allocated to debt servicing, it is certain that this figure will have to be reduced if more is to be spent on the social safety net. The optimal target for tax revenues to debt servicing therefore has to be settled as a matter of priority.

This desired ratio, once determined, can be attained if GDP grows and tax revenues grow in tandem while debt servicing itself grows at a slower rate. Such a slowing in the growth of debt servicing will require rigid controls by the Central Government and also controls placed on the parastatals which borrow without much public scrutiny, but which have quietly added over $10 billion in contingent liabilities over the last five years.

## 5. The Burden of the Public Debt

The public debt generates burdens as well as benefits. Beneficiaries include those who gain during the period of spending. For public works these beneficiaries are the business contractors and their employees. For general expenses the beneficiaries naturally are more diffuse. Since the debt usually results in an expansion in the stock of infrastructure, then the next generation of taxpayers will naturally benefit from this enhanced capital stock. Additionally, such benefits will be extended when emphasis is placed on the maintenance of this infrastructure.

The net addition to the capital stock will increase national income if the marginal productivity of capital is positive. However, since this may not be the case in the medium term, the GDP will not necessarily grow significantly on account of the addition to the capital stock. This would imply a rising debt to GDP ratio and an associated rise in the debt/servicing-to-Government revenue ratio. Such a scenario cannot be dismissed since it was precisely because of the contraction of GDP and the persistence of debt service obligations that the domestic economy contracted for over a decade during the adjustment years, 1983-94.

The burden of the debt during a period of sluggish revenue growth will undoubtedly be felt by those in need of social assistance. The burden will also be borne by those who require assistance for tertiary education and health care as spending in these areas can be made more elastic during a period of fiscal rigidity.

The public debt finally imposes a burden on the current generation of taxpayers who must make adjustments for the resources which are divested for debt servicing. This includes the public servants, whose demands may not be adequately met, and the wider society, due to the inability of the government to purchase goods and services, to maintain the stock of infrastructure and to adequately transfer to the various agencies such as local government bodies and statutory corporations. Indeed, few will challenge the notion that the public debt will have to be controlled over the medium term if the social welfare is to be protected.

### *Strategies for Debt Management*

The control of the public debt can be achieved with the following actions:

(1) A moratorium on borrowing for a period of time.

(2) Refinancing of expensive debt by borrowing at lower interest rates to retire old debts.

(3) Realising surpluses on the Central Government's accounts and using these surpluses to retire the debt stock. Such surpluses may be secured by raising more revenue while placing a lid on certain categories of expenditure.

(4) Scrutinizing all projects so that they pass tests of economic efficiency before they are initiated. Hence the Ministry of Planning needs to play the major role in selecting and defending the choice of projects in the Public Sector Investment Program (PSIP).

(4) Making greater use of available concessionary financing from the International Financial community for the developmental needs of the country and in particular for the needs of Tobago.

(5) Ensuring that the public debt is carefully calculated and that all borrowings by parastatal agencies on behalf of the state are duly recorded and made publicly available within the fiscal year in review.

While these measures can all be implemented, it has to be recognized that the control of the public debt and the reduction of deficits are not easy to secure. It is important therefore to explore the nature of the demands placed on government to determine the internal forces which can make deficits and debt grow to undesirable levels.

The public debt rose from an estimated TT$18 billion in 1995 to TT$36 billion in 2002. This doubling can be attributed to the following:

(1) The genuine need of the government to expand the stock of infrastructure with an associated borrowing requirement.

(2) The existence of a supply of domestic credit and the availability of funds seeking an outlet.

(3) The existence of interest groups which successfully lobbied for the execution of projects. This ability of vested and organized interest groups to influence the expenditure of the State naturally suggests that economic analysis must focus attention on this important issue.

## 6. Structural Causes of Deficits and Debt

In all economies, Governments usually perform the role of allocation, stabilization, distribution and growth.

In placing the economy on a growth path, it becomes essential for Government to allocate resources to underlying infrastructure and to establishing the conditions conducive to an acceleration of human capital formation. This means that spending has to be targeted at health care, education, basic infrastructure such as drainage, nutrition, community recreation services and sanitation. In the developing economy such activities naturally have to play an essential role in order for them to acquire the co-operating inputs such as capital, know-how, infrastructure and technology, which can be combined with skilled and unskilled labour to produce goods and services. In addition, Government needs to create the environment and framework to facilitate this expansion in production. These include the legal framework for business operations, the intervention of the State in the arbitration of international trade disputes, the establishment of a system of collective bargaining and mechanisms for the settling and arbitration of labour disputes, a guarantee of the security of foreign investment, a stable domestic financial environment and a stable macro-economic environment for business to flourish.

It has to be recognized, furthermore, that Government's operations are not only influenced by public interest considerations, but also by a number of vested interest groups in the society. Since not all demands can be satisfied it is important to explore how Government, in fact, can be manipulated by special interests and how this control may result in a sub-optimal economic outcome, including debts and deficits, which subsequently can prevent the State from discharging its public interest obligations.

## 7. Public Choice Theory and Debt Dynamics

Economic theory implicitly assumes that Government relentlessly pursues the public interest and that the Government has no objectives of its own. The public choice theorists such as James Buchanan have revised this sanguine view and the government is now appropriately viewed as an amalgam of individuals who would each like to maximize his own individual welfare.

Since the Government itself is made up of elected representatives, it is fair to assume that their interest and the interest of their political party is to be re-elected. This means that the politicians who are in charge of the Government are concerned as much with maximizing votes or, more precisely, seats in the Parliament as with the public interest. This structure is certain to affect many areas of fiscal policy as the Government must not only use the resources of the State to promote the public interest but also to ensure its own survival. Here, the special interest groups assume a place of special importance. Such groups include the party financiers who have easy access to the decision-makers. Indeed, it may even be said that the elected representatives are as much representative of the people as they are agents of the party financiers and must cater to the needs of both groups when allocating the State's resources. Other groups in the spectrum include organized business, as evidenced by the claims of the Chambers of Commerce and Manufacturers Associations, organized labour and organized Non-Governmental Organizations (NGO's). The excluded groups are usually the unemployed, the retirees, the poor and the young in society. Such groups, unfortunately consist of those most in need of Government's programmes but do not have the mechanism of organization to articulate their views and force the Government to satisfy their demands.

The special interest groups naturally pursue goals which largely support their own group. These programmes which benefit a small number of people are implemented, significantly, at the expense of the rest of the society. This pursuit, through Government, of a transfer of wealth at someone else's expense is known as rent seeking behaviour and is traditionally facilitated through legislation as in the case of tax loop-holes and other fiscal concessions, tariffs protection (though this is now diminishing in importance), occupational licensing, subsidies to special groups and particularly in the case of a developing economy like Trinidad and Tobago, the award of contracts for the production of the infrastructural needs of the society.

It is in this area of the capital budget where the rules of financial control are less rigid, and greater discretion is extended to the Government to borrow and spend. Here projects which are not necessarily the most desirable but which benefit a select group will be approved by Government, as the Government itself benefits from such projects with respect to financial contributions for re-election. It is also not difficult to see how Ministers may be tempted to award contracts to certain special firms in exchange for a commission in the form of a bribe or a kickback. This, incidentally, is not peculiar to a developing economy as many would have us believe, but rather reflects the structural reality of how Governments operate across the world. Indeed, the structuralists have always argued that the existence of interest groups in the economy will influence the structure of the Government's budget. This is a matter which must now receive far more attention than it currently does in the literature.

This bargaining game between the public interest groups and the Government will continue to dominate fiscal operations in Trinidad and prolong the period of fiscal rigidity now being experienced. For example, more revenue must be raised but it would be difficult to do this via an increase in taxes and royalties from the foreign oil companies and the large enclave sector because of prior contract agreements.

The corporate sector, in like manner, will vigorously pursue its case for no increase in corporation taxes and indeed will be agitating for business loopholes or concessions which will reduce its tax obligations. Similarly, Government may be hesitant to increase taxes on income and expenditure on individuals if it wishes to be re-elected. This ability of vested groups to secure State patronage can of course be controlled. It requires, *inter alia*, reform on campaign financing, transparency on the award of contracts, the enforcement of legislation with respect to conflicts of interest and the requirement that projects be carefully scrutinized to ensure that they satisfy all criteria of economic efficiency. The implementation of such actions, however, may mean that the Government itself has to jeopardize its own survival in the process. In line with rising expenses and a sluggish revenue base, it is not surprising that deficits will remain a protracted feature of the domestic economy since corrective measures are not likely to be implemented soon.

**Conclusion**

The management of the public finances of Trinidad and Tobago must now focus attention on creating a greater level of discretion in the use of revenues over the medium term. The shift in focus from stabilization to economic growth means that the central goal of Government must now be on ensuring that the benefits of the growing economy are distributed to the largest cross-section of the population and, in particular, to those occupying the lowest 25% of the income quartile who currently live below the poverty line. Such a programme, however, is costly, for a well-designed social welfare programme will include not only direct transfers to the poor but the financing of programmes in health, education and infrastructure aimed at improving the conditions under which these persons live. In addition, poverty eradication will take time, and hence the Government must be prepared to finance the redistribution programme for an extended time period. The financing requirements, however, cannot be at a burden to the macro economy if the economic gains of the past are to be preserved. Accordingly, the Central Government will need to streamline its operations by reducing its existing commitments on debt servicing, in particular. It will also need to be cognizant of the structural characteristics of the economy which facilitate the emergence of deficits and debts which can eliminate the flexibilities which are generated. On account of this, it is now imperative that the Central Government establish clear targets for the annual deficit, the stock of debt both internal and external, the debt service to Government revenue ratio, the VAT to GDP ratio, the optimal size of the oil stabilization fund, the targeted poverty rate for the population over the medium term, and the targeted percentage of revenues which will be assigned to redistribution over time. These targets will impose the kind of discipline which is necessary for Government to generate the discretionary revenues necessary for improving the general welfare and achieving a more equitable distribution of state resources.

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# 14

# Trinidad and Tobago's Experience with the Value Added Tax (VAT)

*Ramesh Ramsaran & Corine Tang*

## Introduction

Governments the world over are continually looking for new ways to raise revenue while at the same time being conscious of the need to encourage savings, investment and growth. There are certain ideal criteria against which a 'good' tax measure could be measured, but in practice some override others, depending on the objectives and philosophy of governments as well as the prevailing circumstances affecting implementation. Some administrations, for example, may place greater emphasis on equity than others who may feel that an unequal distribution of income is necessary for higher savings, investment and growth rates. Factors such as per capita income, the distribution of income, literacy rates, the openness of the economy, the structure of the economy and the size of the formal sector may also influence the kind of fiscal measures adopted.

The Value Added Tax (VAT) in various versions is being increasingly adopted in a large number of countries as a better alternative to some of the existing taxes. The VAT became operational in Trinidad and Tobago in 1990 as part of a larger tax reform programme and has become an integral part of the tax system. From the early 1980s consideration was being given to the introduction of a general sales tax and the then PNM (People's National Movement) government sought the assistance of the IMF in determining a "form which would be most appropriate to our circumstances."[1] By 1986 a decision was taken to introduce a general sales tax,[2] but the PNM government lost the general election of that year to the National Alliance for Reconstruction (NAR) administration which eventually opted for a VAT instead. The aim of this paper is to outline the circumstances in which the tax was introduced in Trinidad and Tobago and discuss its performance since its inception. The first part of the paper discusses what is a VAT and some of the considerations that go into its design. The second section outlines the circumstances under which the VAT was introduced in Trinidad and Tobago. The third part of the paper focuses on the design of the tax and its performance since 1990.

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1 See the 1983 Budget Speech by the Honourable George Chambers, Prime Minister and Minister of Finance and Planning.

2 See the 1986 Budget Speech by Mr. Chambers.

## 1. What is a VAT and the Rationale for it?

The VAT is seen as a modern fiscal measure. While a VAT in various versions has been proposed since the 1920s, it is only in the last two or three decades that it has gained widespread popularity (see Table 1). The number of countries adopting the VAT increased from around ten (10) in 1969 to over 120 in 2001.[3] Both developed and developing countries (including the so-called transition economies) have been attracted to the measure, but not always for the same reasons.[4] Some of these include:

- The desire to avoid distortions associated with cascading indirect taxes;
- The need for a measure that can raise revenue efficiently without impacting adversely on competitiveness and exports;
- The need in transition economies to replace fiscal measures on declining activities by others more compatible with an emerging market economy;
- The need to replace trade taxes by other measures in the context of trade liberalisation both at the regional and global levels.

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3 See Liam Ebrill *et. al.*, *The Modern VAT*, IMF, Washington, D.C., 2001, pp. 5-6.

4 *Ibid.*, p. 6.

**Table 5: Composition of Total Tax Revenue (Percentages)**

| Year | (1) Taxes on Income and Profits | (2) Taxes on Property | (3) Taxes on Goods and Services | (4) *Of which* | | (5) Taxes on International Trade | (6) Other | (7) Total |
|---|---|---|---|---|---|---|---|---|
| | | | | Purchase Tax | VAT | | | |
| 1980 | 86.5 | 0.3 | 4.7 | 2.0 | - | 8.0 | 0.5 | 100.0 |
| 1981 | 86.2 | 0.3 | 5.0 | 2.0 | - | 8.0 | 0.5 | 100.0 |
| 1982 | 83.8 | 0.3 | 6.0 | 2.5 | - | 9.2 | 0.7 | 100.0 |
| 1983 | 79.7 | 0.2 | 8.9 | 3.9 | - | 10.3 | 0.9 | 100.0 |
| 1984 | 79.6 | 0.3 | 10.9 | 5.7 | - | 8.5 | 0.7 | 100.0 |
| 1985 | 75.0 | 0.5 | 11.9 | 6.0 | - | 11.6 | 1.0 | 100.0 |
| 1986 | 71.2 | 0.7 | 15.4 | 8.2 | - | 11.9 | 0.8 | 100.0 |
| 1987 | 72.5 | 0.6 | 16.8 | 9.9 | - | 9.4 | 0.7 | 100.0 |
| 1988 | 68.2 | 0.7 | 21.4 | 9.4 | - | 9.0 | 0.7 | 100.0 |
| 1989 | 65.1 | 1.0 | 23.7 | 9.4 | - | 9.4 | 0.8 | 100.0 |
| 1990 | 55.1 | 1.0 | 33.0 | 1.1 | 19.3 | 9.9 | 1.0 | 100.0 |
| 1991 | 60.7 | 0.8 | 28.1 | 0.0 | 18.5 | 9.9 | 0.5 | 100.0 |
| 1992 | 54.2 | 0.8 | 33.5 | 0.0 | 18.4 | 10.9 | 0.6 | 100.0 |
| 1993 | 49.8 | 1.4 | 36.8 | 0.0 | 20.4 | 11.3 | 0.7 | 100.0 |
| 1994 | 53.6 | 1.9 | 34.0 | 0.0 | 20.0 | 9.7 | 0.8 | 100.0 |
| 1995 | 60.0 | 1.0 | 30.8 | 0.0 | 18.7 | 7.3 | 0.9 | 100.0 |
| 1996 | 62.8 | 0.8 | 29.0 | 0.0 | 17.5 | 6.6 | 0.8 | 100.0 |
| 1997 | 54.0 | 0.8 | 35.8 | 0.0 | 21.3 | 7.9 | 1.5 | 100.0 |
| 1998 | 46.0 | 0.8 | 43.0 | 0.0 | 26.9 | 9.0 | 1.2 | 100.0 |
| 1999 | 49.1 | 0.8 | 39.5 | 0.0 | 22.8 | 9.6 | 0.1 | 100.0 |
| 2000 | 60.3 | 0.7 | 30.3 | 0.0 | 18.3 | 7.6 | 1.1 | 100.0 |
| 2001 | 63.3 | 0.5 | 28.2 | 0.0 | 18.0 | 7.0 | 1.0 | 100.0 |

**Source:** Ministry of Finance, *Review of the Economy*, Various Issues.

With the removal of purchase taxes and the introduction of VAT in 1990 revenue from taxes on goods and services increased by 67 per cent. Between 1990 and 2001 VAT revenue increased at an average rate of 8.1% per year. As indicated earlier, the VAT/GDP ratio has averaged 4.5% per year since 1990, and in only one year it crossed 5%.[17] Given the increase in the number of zero-rated and exempted items, it is difficult to make inferences about administrative efficiency, even if we had data on collection costs with respect to the various taxes. In making comparisons with other countries two ratios often used are: the efficiency ratio (the ratio of VAT revenue to GDP, divided by the standard VAT rate) and the C-efficiency ratio (the ratio of VAT revenue to consumption, divided by the standard VAT rate). These ratios are shown in Table 6. As can be seen there, the efficiency ratio is in the region of 30 per cent, which is lower than that for the Americas (around 37%) and the European Union (close to 40%), but slightly higher than that for Sub-Sahara Africa (27%).[18] Some scholars contend that in calculating the efficiency ratio the base should not be GDP but an adjusted concept of private consumption.[19] Consumption data (like GDP

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17 In Barbados, the VAT/GDP ratio averages over 9%.

18 See Liam Ebrill *et. al.*, *op.cit.* See also, "The Allure of the Value-Added Tax" by the same authors in *Finance and Development*, June 2002.

19 For a discussion on the problems involved in deriving an adjusted base see the technical appendix to Dr. Penelope Forde's paper in this volume. Dr. Forde's crude estimates "suggest that VAT-exempt expenditure items now represent 56.2 per cent of private final consumption compared with 50 percent in 1990."

**Table 6: Efficiency Ratios, 1990-2001**

| Year | (1) Vat Revenue as a % of GDP | (2) Efficiency Ratios | (3) VAT Revenue as a % of Consumption | | (4) C-Efficiency Ratios | |
|---|---|---|---|---|---|---|
| | | | Private | Total | Private | Total |
| 1990 | 4.3 | 29 | 7.9 | 6.1 | 53 | 41 |
| 1991 | 4.6 | 31 | 7.6 | 6.0 | 51 | 40 |
| 1992 | 4.2 | 28 | 7.1 | 5.5 | 47 | 37 |
| 1993 | 4.7 | 31 | 7.5 | 5.9 | 50 | 39 |
| 1994 | 4.4 | 29 | 8.3 | 6.5 | 55 | 43 |
| 1995 | 4.2 | 28 | 8.0 | 6.1 | 53 | 41 |
| 1996 | 4.1 | 27 | 7.3 | 5.8 | 49 | 39 |
| 1997 | 4.8 | 32 | 8.6 | 6.6 | 57 | 44 |
| 1998 | 5.8 | 39 | 8.6 | 6.9 | 57 | 46 |
| 1999 | 4.6 | 31 | 7.4 | 5.8 | 49 | 39 |
| 2000 | 3.9 | 26 | 6.6 | 6.1 | 44 | 41 |
| 2001 | 4.2 | 28 | 7.0 | 5.7 | 47 | 38 |

**Source:** Computed from official data.

data) are not free from errors, but as a matter of interest the ratios based on private consumption (un-adjusted) and total consumption (unadjusted) are computed. These figures are higher than those for Sub-Sahara Africa (average 38%), but lower than those for the Americas (average 57%) and the European Union (64%).[20] A VAT that taxed all consumption at a uniform rate would have a C-efficiency of 100 per cent.

A number of factors affect VAT collections. Among these are the standard rate, the number of exemptions or zero-rated items and enforcement. The fact that the scope of exemptions and zero-rated items has been increasing would indicate that the government has not been too unhappy with the way the tax has performed. Information is not available on the degree of non-compliance or corruption, and therefore, it is difficult to pronounce on the adequacy or effectiveness of the administrative machinery. There is, however, some evidence of dishonesty in the form of businesses who sell vatable goods without issuing a receipt and non-registered concerns which collect VAT from consumers but do not remit the take to the authorities. At the same time there have been complaints that the Board of Inland Revenue takes too long to make refunds.

**An Assessment**

The VAT in Trinidad and Tobago is levied at a single standard rate of 15% on commercial supplies. Commercial supplies may be in the form of goods or services imported or produced locally and may fall into one of three (3) categories:

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20 See Ebrill *et .al.* Cited in footnote 18.

1. Vatable at 15%
2. Exempt (Appendix I)
3. Zero-rated (Appendix II)

The goods and services falling in each category can change from time to time, as of course can the standard rate. Among the exempted services are medical, educational, financial and transport. Among the zero-rated items are food products, products related to agriculture, public transport services, water and sewerage services, prescription and commonly used drugs, exports, books and a range of products intended to encourage certain types of activity.

At present, only registered businesses making commercial supplies or intending to make commercial supplies of TT$200,000 or more for a period not longer than twelve consecutives months can charge VAT. The initial threshold was TT$120,000. The tax was seen as a broad-based tax intended to replace a cumbersome system of purchase and certain other indirect taxes which had become difficult to administer. The tax has proved to be feasible, and by raising the threshold and keeping it simple the government has contributed to the acceptability of this relatively new measure. With the introduction of VAT, direct taxes were reduced and purchase taxes removed. The overall system became more buoyant. To counter the charge of regressivity the system of zero rating and exempting certain goods and services has been adopted rather than adopting different rates for different categories of goods which would have been more difficult to administer. It is argued by some that with respect to regressivity, it makes more sense to look at the overall tax system than any particular tax. Government spending is also critical to the issue of equity, and expenditure policies can also be tailored to assist the disadvantaged and lower income groups if there is a buoyant tax base.

The VAT/GDP ratio should not be judged by what obtains in other countries. The natural resource base of the country and the possibilities for increased revenues would influence the approach to indirect taxation. The archaic system of direct taxation of the energy sector is in need of review. A high proportion of the population is poor, and the government may well find it necessary to make adjustments either to the standard rate or the base if its revenue situation warrants it. The structure in terms of vatable, exempted and zero-rated items needs to be reviewed on a regular basis to strike a balance between revenue needs and poverty reduction programmes. The erosion of the VAT base is as a result of deliberate government policy responding to particular objectives and circumstances. Where greater attention may be needed is in plugging leakages through staff training and organisational changes that could increase administrative efficiency.

# *Appendix 1*

## Exempt Services

1. Medical, dental, hospital, optical and paramedical services, other than veterinary services.

2. Bus and tax services other than bus services supplied by the Public Transport Service Corporation under the Public Transport Service Act.

3. (Deleted).

4. Training and education provided –

   (a) In a public school or private school within the meaning of the Education Act, where that school:

      (i) in the case of a private school, is registered under that Act; and

      (ii) in any case, is approved for the purposes of this item by the Minister to whom responsibility for education is assigned; or

   (b) through the University of the West Indies or the Hugh Wooding Law School.

5. Real estate brokerage.

6. Rental of residential property.

7. Accommodation in hotels, inns, guest houses for any period in excess of thirty days.

8. Public Postal Services.

9. Betting, gambling and lotteries.

10. Financial Services.

    Financial services are services which are closely related to financial intermediation, and risk pooling, and include:

    (a) the exchange of currency (whether effected by the exchange of bank notes or coins, by crediting or debiting accounts of otherwise);

    (b) the lending, borrowing or depositing of money;

    (c) the issue, sale, underwriting, acceptance, purchase, renewal, variation, receipt, payments or transfer of ownership of a financial instrument;

    (d) the payment or collection of any amount of interest, principal, dividend or other amount whatever in respect of a financial instrument;

    (e) the provision of credit;

    (f) the provision, taking, variation or release of a guarantee, indemnity, security or bond in respect of the performance of obligations under a financial instrument;

    (g) the provision, or transfer or ownership, of an interest in a superannuation scheme, or the management of a superannuation scheme;

    (h) agreeing to do, or arranging, any of the activities above but not advising thereon.

A "financial instrument" is a document the main effect of which is to entitle a specified person to a sum of money, and includes currency, all forms of indebtedness, shares of capital stock, policies of insurance and re-insurance, cheques and other payment instruments, letters of credit, options, future contracts, and guarantees.

11. Services supplied by a person not resident in Trinidad and Tobago to an approved enterprise under the Trinidad and Tobago Free Zones Act for the carrying on of an approved activity in a free zone.

12. Services performed by a financial institution licensed under the Financial Institutions Act in respect of which financial services tax is payable.

# *Appendix 2*

## Zero-Rated

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1. Any-

(a) unprocessed food of a kind used for human consumption;
(b) rice;
(c) flour;
(d) milk in any form, including processed and tinned milk;
(e) margarine;
(f) bread;
(g) baby formulas and baby milk substitutes
(h) cheese and curd;
(i) corned beef;
(j) curry;
(k) fresh butter;
(l) peanut butter;
(m) table salt;
(n) salted butter;
(o) tinned sardines;
(p) smoked herring;
(q) toilet paper;
(r) yeast;
(s) baking powder;

(t) pasta, whether cooked or uncooked or stuffed (with meat or other substances) or otherwise prepared, such as spaghetti, macaroni, noodles, lasagne, gnocchi, ravioli and cannelloni.

In this item "unprocessed" in relation to a food means that the food contains no additives and that it is not the result of the application of a process other than freezing, chilling or packaging, a mechanical process, or a process that solely employs the elements of the weather.

2. (1) Any live bird, fish, crustacean, mollusc or other animal of a kind generally used as, or yielding or producing, food for human consumption.

(2) Any draught animal.

3. Animal feeding stuffs suitable for any animal referred to in item 2.

4. Seeds and other means of propagation of plants and plants that are used for providing –

(a) A food referred to in item 1(1)(a), (b) or (c); or

(b) A feeding stuff referred to in item 3.

5. Preparations formulated for agricultural use including fertilisers, insecticides, herbicides and fungicides.

6. Self-propelled agricultural equipment, agricultural tractors and agricultural implements for attachment to agricultural tractors; agricultural implements

propelled by draught animals; agricultural devices designed to be carried by the operator.

7. Water and sewerage services supplied by a public authority.

7A. Bus services supplied by the Public Transport Service Corporation under the Public Transport Service Act.

8. Medicines and drugs of a kind available only by prescription.

8A. Any of the following medicines for human use:

   (a) analgesics in the form of liquids, tablets, capsules or other solid dosage forms for oral or rectal use;

   (b) cough and cold preparations in the form of liquids, tablets, capsules or other solid dosage forms for oral and nasal use;

   (c) antacids and antiflatulants in the form of liquids, tablets, capsules and other solid dosage forms for oral use;

   (d) laxatives in the form of liquids, tablets, capsules or other solid dosage forms for oral or rectal use;

   (e) anthelmintics in the form of liquids, tablets or capsules for oral use;

   (f) oral rehydration preparations in the form of salts or solutions of W.H.O./Pharmacopoeia standards.

20. Goods and water for consumption or sale on board an aeroplane or ship in the course of providing international commercial services.

21. Charter of ships or aircraft for use in international commercial services.

22. Books, namely literary works, reference books, directories collections of letters or documents permanently bound in covers, loose-leaf books, manuals or instructions whether complete with their binder or not, amendments to loose-leaf books even if issued separately, school work- books and other educational texts in question-and-answer format with spaces for insertion of answers, children's picture and painting books, exercise books; but excluding brochures, pamphlets and leaflets, newspapers, magazines, journals and periodicals, photograph and stamp albums.

23. Steelband Instruments.

24. Accommodation at a building or group of buildings occupied together for the purpose of primarily providing sleeping accommodation for reward its guests not being persons resident therein under a contract of service.

25. Repairs of yachts and pleasure craft owned by persons who are neither citizens nor residents of Trinidad and Tobago at the time when the repairs are performed.

26. (1) Any service supplied to yachts and pleasure craft owned by persons who are neither citizens nor residents of Trinidad and Tobago at the time when the service is supplied.

(2) In this item "service" includes port and harbour services, docking, berthing, mooring, conservancy or the arranging of such services.

27. Plant, equipment, machinery or components which are imported and which the Comptroller of Customs and Excise is satisfied are intended for use in –

(a) constructing, altering, reconstructing or extending an enterprise classified as a highly capital intensive enterprise under section 9 of the fiscal Incentives Act (hereinafter referred to as "the Act") and declared, by Order, to be an approved enterprise under Section 10 of the Act;

(b) equipping an enterprise referred to in paragraph

(a) for the purpose of manufacturing its approved product as defined by the Act;

during the period commencing with the date of publication of the Order referred to in paragraph (a) and terminating on the date the benefits granted by that Order cease.

28. The items contained in the First Schedule to the Customs Act under Tariff Heading No. 90.21, being orthopaedic appliances, including crutches, surgical belts and trusses; splints and other fracture appliances; artificial parts of the body; hearing aids and other appliances which are worn or carried or implanted in the body, to compensate for a defect or disability, other than items in Tariff Subheading Nos. 9021.21 and 9021.29, being artificial teeth and dental fittings.

29. The items contained in the First Schedule to the Customs Act –

    (a) Under Tariff Heading No. 84.71, being automatic data processing machines and units thereof, magnetic or optical readers, machines for transcribing data onto data media in coded form and machines for processing such data, not elsewhere specified or included;

    (b) Being parts and accessories listed in Tariff Subheading No. 8473.30 in respect of machines under paragraph (a); and

    (c) Being diskettes as contained in Tariff Subheading Nos. 8523.201 and 8524.993.

30. Diskettes.

31. Spectacles and Wheel Chairs.

33. Sporting items.

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# Development Intervention: Some Lessons for Caribbean Governments

*Nikolaos Karagiannis*


## *Abstract*

This paper discusses important economic and politico-institutional features of the 'desirable' developmental intervention in the Caribbean context. It is recognised that the public sectors of many countries have undergone changes since the 1980s, as governments try to respond to the challenges of the new millennium. Recent years have seen wider-ranging reforms than any other period of the 20th century, although both the pace and extent of these reforms are greater in some countries than in others.

Thus, states require an alternative. They need to have strong policy instruments which will enable them to plan and finance their strategic goals such as job creation, higher mass living standards, R&D, industrial competency, environmental protection, etc. This re-tooling of state

policy-making requires a re-thinking of the form of government intervention and, especially, an emphasis on its 'modern' developmental role. This is a crucial challenge today facing countries in general, and Caribbean islands in particular.

The first part of the paper discusses the 'era of change' while considering the changing role of government. The second section reviews features of government policy and decision-making in the Caribbean region. The third part examines an institutional system which appears to have been used with enormous success – the 'Developmental State': the case of the state which takes on a central developmental role in the economy without directly owning most of the productive assets. The final section pursues aspects of the 'desirable', modern developmental intervention as they relate to Caribbean government intervention.

## 1. Introduction

What governments should or should not do, as well as the essential 'opposition' between market and state, has always been at the heart of major debates in economic theory. The dividing line between those activities that fall in either the government sector or the private sector varies among different nations and at different times.

The 20th century has seen some profound changes in thinking about the economic role of government. The first quarter-century of the post-war period was largely characterised (at least among the OECD countries) by economic growth, high levels of employment along-side state activism and a widely held belief in the beneficial powers of government. State property, government intervention, discretionary fiscal and monetary policies, restrictions on trade and the like resulted in low unemployment and inflation, and economic stability and security.

The second quarter-century, in contrast, has been characterised by much lower rates of economic growth in the OECD nations (though with rapid growth in the NICs), persistent unemployment (even though unemployment declined in a number of countries, e.g. USA, UK) and a general decline of support for the role of government. Nonetheless, in many cases, the ratio of government spending to GDP continued to rise, and for much of that period governments ran substantial fiscal deficits. In country after country the state is being rolled back, and "let the market decide" has become the main policy gospel for both developed and developing countries (Arestis and Sawyer, 1998: 1).

Since the late 1970s, most OECD nations have undertaken a reassessment of the role of their government sectors. The current debate on the role of government mainly concerns its economic aspects. The same broad debate may be behind attempts to reform public sector management and to better control public spending. But it is undeniable that the intellectual and policy climate has shifted from one which saw an active role for state in economic and social matters towards a generally more skeptical view of the role of government. In all parts of the world, people are legitimately questioning what their governments ought to do. All these questions ultimately raise the most fundamental questions of political organisation. At the same time, none of these issues can be decided on political principle alone; the issues are deeply philosophical and intensely practical.

Undoubtedly, the new millennium poses new challenges for government policy; two are fundamental: it is increasingly recognised that policy must be consistent, thorough and effective, and planning must be for the long-term, as well as for the short- and medium-term; and government and private sectors together must set the development agenda of tomorrow to meet the diverse and changing needs of consumers and producers (partly as a result of global competition). In this regard, the 'appropriate' role of government in the new millennium appears to be an interesting and challenging one.

This paper discusses important features of the 'desirable' developmental intervention as they relate to Caribbean states. It is recognised that there have been some important changes and highly volatile conditions in modern economies which are often seen as changing the possibilities for government action. In particular, Caribbean countries need to make a democratic assessment of the burden and benefits of the new competitive conditions in responding to modern challenges. If Caribbean nations expect to prosper from the new international environment, they need to take stock of changes in production relations, corporate practices, investment patterns, and the growth and export potential of their economies (Boyer and Drache, 1996: 1-2).

The first part of this paper discusses the "era of change" while considering the new role of government in less-developed and developing countries. The second section reviews features of government policy and decision-making in the Caribbean. The third section examines an institutional system which appears to have been used with enormous success – the 'Developmental State' : the case of the state which takes on a central developmental role in the economy without directly owning most of the productive assets. The final sections pursue aspects of the 'Developmental State' model and deal with key elements of the 'desirable' modern state and, especially, its new developmental role in the Caribbean context.

## 2. An Era of Change in the Developing and Less-Developed Countries

Public administration in developing and less-developed countries is rooted in the colonial systems which were inherited from their colonial governments. Indeed, the government sectors of developing and less-developed countries can be characterised as following the traditional bureaucratic model of public administration (even though the model of Japan and Newly Industrialised Countries has exhibited significant differences). These systems were based on highly centralised authorities using bureaucratic means to administer their colonies, and despite the different models of economic development, followed in

Africa, Asia, Latin America, the Caribbean and in the Pacific, the familiar Weberian precepts were to be found.[1]

In the period following World War II in particular, 'development administration' for less developed and developing countries was the most powerful institutional factor. The idea was "to apply to developing [and less-developed] countries the administrative procedures derived from the former colonial countries" to modernise their economies and accelerate development in order to catch up with the leading ones (Hughes, 1998: 213).

Bureaucracies were particularly important in less-developed and developing countries (even though there is a sharp contrast between a bureaucratic state as left in the colonies and a Developmental State). These bureaucracies often operated at a remove from their own societies and constituted an elite with more in common with their counterparts in the developed nations and with foreign corporations than with their own people. Thus, in the less-developed and developing world, most bureaucracies served themselves and often looked after their own interests first. In fact, public administration itself has been susceptible to corruption since officials exercise a substantial amount of power.[2]

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1. The Weberian bureaucracy was a successful export to developed and lesser-developed countries alike. "This approach included the various features of the best administrative practice available in the developed nations and this, naturally enough, was the traditional model of public administration" (Hughes, 1998: 213).

2. Some of these problems occur in developed economies too, particularly where bureaucracies involve technical experts.

In addition to this fact, politicians often use jobs in the public sector and government enterprises to reward political friends, so payrolls swell with people whose qualifications for employment are principally political connections. Consequently, the largest share of the government current expenditure has been dedicated to wages and salaries and debt repayments, whilst the levels and share of Social Expenditure and government capital spending have been (very) low. According to Smith (1996: 221), government employment accounted for over 50 percent of non-agricultural jobs in Africa, more than 36 percent in Asia and 27 percent in Latin America in the late 1980s.

In the 1970s and 1980s, and in response to the attack on the role and size of government, many less-developed and developing countries sought to redefine the role of government and change its management. Some of this was in response to demands made by international agencies which required market reforms and public sector cuts. To meet their interest obligations, these countries mired in debt squeezed critically important programmes in education, health and infrastructure. Less-developed and developing countries found themselves undergoing various kinds of structural adjustment through international agencies, notably the World Bank and the IMF. Financial assistance to governments "comes with a panoply of conditions; it is in no way a gift" (Haynes, 1996: 84).

However, the shift to 'less state' did not work as intended. "One difficulty in the reform process has been that the advocates of reforms have assumed that 'one size fits all' and that any government could be improved by the institutionalisation of their preferred new pattern" (Peters, 1996: 17-18). The development experience since then is rather different: the state is central to economic and social development as a partner, catalyst and facilitator. Markets require or need a competent and appropriate public sector. Hence, what is more important is that government should be efficient, facilitative and appropriate to its circumstances. What really matters is not the 'extent' of government intervention but the 'quality' of such intervention.

## 3. Caribbean Budgeting and Fiscal Policy

From the historical evidence, Caribbean islands inherited a system that was basically a concoction of British fiscal arrangements. The Caribbean countries were organised in such a way that their fiscal capacity was limited and there were inadequate levels of public services in the territories. To a large extent, Britain perceived of the countries as having low fiscal capacities; thus, the public finance programmes in the Caribbean were hampered (given the internal situation of Caribbean countries and the external oversight functions of Britain). But this perception restrained the pursuit of active fiscal policies as well as the development prospects of the territories. Consequently, the impact of the state as a 'developmental state' has been limited in the Caribbean.

In assessing the fiscal capacity of Caribbean states, several issues could be identified:

- public finance in the region was practised as if there were a colonial plan for it;

- as a result of this colonial plan, the 'Mother country' had a paternalistic attitude towards the region;

- the countries' heavy reliance on indirect taxes constrained the tax effort to a low-level point of departure. In contrast, the spending levels were not low;

- in many instances, inadequate revenues have been generated over long periods;

- many loopholes were inherent in the tax system. These loopholes were exploited by big businesses and the elite in the societies;

- the distance of the Caribbean from Britain was, perhaps, a factor of neglect (Jones-Hendrickson, 1985: 52-4).

In the region, taxes are not tools which can be designated "aids of development." Taxes are collected in order to help the state to carry out its expenditure duties. From Britain, the view was fostered in the Caribbean area that governments must pay for themselves. Besides, born of the British colonial era, the welfare component of Caribbean budgets was influenced by decision-making in Great Britain. Budgets and budgeting in the region have been partially reflective of the sources and uses of revenues. In varying degrees, there are similar inherent weaknesses of budgets and the budgetary processes (or budgetary mechanisms) in the Caribbean states. According to Premchand (1975: 27), these 'identified deficiencies' are:

- absence of long-term planning of expenditure;

- inadequate link up with the development plan (if such a plan exists) and with national income accounts;

- excessive centralised control by the Ministries of Finance;

- inadequate attention to better allocation of public funds;
- lack of efforts to relate expenditure to outputs;
- absence of economic policy inputs;
- absence of identification of the future spending requirements of current programmes and projects;
- absence of expenditure objectives;
- lack of coordination with other public bodies engaged in economic management;
- preference for budgeting by 'aggregation' rather than by 'indication' or 'direction';
- multiplicity of budget categories;
- absence of yardsticks to measure performance;
- overemphasis on financial targets;
- absence of review of under-spending and over-spending;
- out-of-date procedures of recording and classification practices;
- delays in the release of funds and absence of cash management; and,
- considerable time lags.

In addition, fiscal budgets in the Caribbean via the political process often reflect the view of the political parties in power, and the class and interest group biases are usually maintained. Thus, although this deliberate policy is used, in fact the politicisation of the budgetary process in the Caribbean states highlights programmes and policies which are akin to what is called "pork-barrel policies." This process has a great deal of importance in shaping the fiscal policies of Caribbean states (Jones-Hendrickson, 1985: 83-4).

While the state has survived as a democratic institution (largely so) it is now under stress because of the increasing irrelevance of the political system inherited from the colonial office. The state lost a great deal of its effectiveness as a development tool because it was transformed into a mechanism for winning elections and meeting populist demands in a highly nationalist mode that resulted in an irrational expansion of state ownership. Because of the "winner takes all syndrome" in some societies of the Caribbean, the state became an instrument of disintegration rather than an institution around which society could cohere to deal with the development challenge. In a small society, the state is a large institution as an employer and dispenser of resources – hence the intense desire by various groups, not just special interests, to capture it.

During the 1950s, when governments began their policies of "invitation to invest," there was a noticeable shift in the public finance orientation of the region; in fact, policies of "invitation to invest" still take place today. In addition, one feature which has restricted fiscal policy is the high dependence on trade taxes (i.e. import duties) as a percentage of government revenue.[3] On the other hand, (re)current government spending levels in the Caribbean have been under continuous upward pressure resulting from: (i) high levels of 'Personal Emoluments' and debt repayments, (ii) fiscal administrative inefficiency, (iii) population growth, (iv) public expectations of social service levels and infrastructural developments based on advanced North American systems, (v) interests of elite groups and politicians, and (vi) the unionisation of the Public Service –among other reasons. However, during the last two decades or so, the continuous growth of public expenditure without the corresponding increase in tax revenues, coupled with efforts to finance fiscal deficits, has shifted the emphasis of policy towards financial control (i.e. 'tight' fiscal policy) and away from government expenditure planning.

Further, the consolidation of multinationals' power in the area (and the world) as giant states within microstates serves to undermine the relevance and effectiveness of the fiscal policies of the region. Besides, the structural problems of Caribbean economies may hamper or constrain the 'traditional' role the public sector could play *via* the budgetary process. To the extent that the weaknesses and constraints are cumulative, the system is even weaker than a listing of each weakness or constraint indicates.

3. Trade taxes account for more than one-half of government revenue in St. Lucia, Belize and The Bahamas, and over one-third of government revenue in the Dominican Republic.

## 4. Reassessing the Developmental State Model

The development experience of Japan, South Korea, Taiwan, Hong Kong, Singapore and, recently, Malaysia as they moved towards a more industrialized stage, has shown overall that there exists a new kind of state. In the transformation process, the state interacts with the rising enterprises, works with and often promotes the private sector (i.e. a plan-oriented market economy). "The intimacy of the Developmental State with the private sector and the intensity of its involvement in the market provide directional thrust to the operation of the market mechanism" (Johnson, 1981: 9-10).

Indeed, Developmental States systematically guide the market as a means of long-term economic transformation, and create the conditions for endogenous growth and industrial adaptation without directly owning most of the productive assets. Direct government ownership and control of industrial production is of secondary importance as compared with the process of building up technological infrastructure and investing in human capital formation and research. The market, on the other hand, is employed as an instrument of industrial policy by exposing particular firms to international competitive pressures.

Therefore, the 'developmental orientation' of such a 'plan rational' state was different from both the 'plan ideological' state in the Soviet-type command economies and the 'regulatory orientation' of typical liberal-democratic states. In fact, the Developmental State has possessed considerable leverage over private industries in terms of securing compliance with its strategic choices and 'national purpose' goals, while planning has been active, strategic and selective, based on wide consultation and serious efforts to reach agreement on the form of intervention.

Economic coordination and development in these states have been managed by specific institutions, whose task has been to organise the critical interactions between state and industry. These have been the core centres or 'pilot agencies' (to use Johnson's term) of strategic economic direction (Johnson, 1981: 9-10; 1982: 26 quoted in Leftwich 1995).

Selective intervention constitutes a fundamental characteristic of the Developmental State. In fact, strategic industrial policy forms a central component of the Developmental State model, and was organised around government directives. But government planning for manufacturing development in East Asian countries did not get involved with the operational detail. Well-educated, well-trained and efficient planners had a view of the future development and endogenous competency of these countries, and their incentive structures were continually revised in light of planning objectives. This planning system was described as a high degree of good and eclectic steersmanship (i.e. state capacity).

Indeed, Developmental States are distinguished by the character of their developmental elites, and the ability of the Developmental State to undertake strategic intervention was based on the formation of a 'strong' state structure and 'strong' administrative capacity. Such states "... concentrate considerable power, authority, autonomy and competence in the central political and bureaucratic institutions of the state, notably their [determined developmental elites, or] economic bureaucracies" (Leftwich, 1995: 420).

From a comparative perspective, Developmental States are characterised by relatively small scale, tightly organised bureaucratic structures with the Weberian characteristics of highly selective, meritocratic recruitment patterns and long-term career rewards, which enhance the solidarity and corporate identity of the bureaucratic elites. Highly meritocratic systems were designed so as to attract the best managerial talent available to the ranks of the bureaucratic elites and ensure a high degree of unity, capability and professionalism. The size of the bureaucratic apparatus helped to consolidate the elite position and authority of the bureaucrats in society, and achieve an equilibrium between 'accountability' and 'autonomy' (Onis, 1991: 114; 124).

Thus, the consolidated strategic power of the East Asian Developmental State has relied on both bureaucratic autonomy and close public-private cooperation. It is quite obvious that, unless the 'autonomy' and 'cooperation' requirements are satisfied, attempts to implement Developmental State policies may prove to be counterproductive. In such an environment, the inability of the state elites to discipline private businesses in exchange for subsidies may lead to a situation where selective subsidies can easily degenerate into a major instrument of rent-seeking by individual groups.

Furthermore, the strategic power of the East Asian Developmental State has depended on the formation of political coalitions with domestic industry, and government intervention has relied on organisational and institutional links between politically insulated state agencies and major private firms (i.e. the corporatist nature of the Developmental State). Indeed, the formulation and implementation of strategic industrial policy have been facilitated by specific politico-institutional arrangements. However, the Developmental State by its very nature involves an unusual concentration of state and private power, which would be hard to justify by the standards of 'Western' pluralistic democracy.

The significant element of compulsion exercised by the bureaucrats in securing public-private partnership constitutes a distinctive feature of the Developmental State model. In particular, the extraordinary degrees of control exercised by the state over the financial system and the extreme dependence of individual conglomerates on bank finance have been instrumental in eliciting compliance with the requirements of strategic industrial policy.

In terms of economic policy objectives, Developmental States have generally been serious and effective in raising the quantity and quality of industrial investment. Their attention has focused almost exclusively on increasing productivity, growth and exports (outward-oriented strategies) and they restrict their intervention to the strategic requirements of long-term economic transformation. What differentiates these high commands in NICs' Developmental States from the generality of various planning institutions in so many developing and less developed countries appears to be their real authority, technical competence and professionalism in shaping development policy (although of course this, too, varies from state to state), and their ability to use both 'sticks' and 'carrots' to influence industries' decision-making (Leftwich, 1995: 412). Compared to a 'strong' autonomous state, a 'weak' state systematically under-provides economically desirable interventions, and systematically over-provides politically motivated and economically harmful policy actions.

Furthermore, the bureaucracy is given sufficient scope to take initiatives and operate effectively. In this sense, the NICs' states have been powerful and have what political scientists often label "greater autonomy" than many other countries (Amsden, 1989; Wade, 1990; Fishlow, 1991; Onis, 1991). Autonomy of the Developmental State means that there is public-private cooperation in which the state, and the developmental elites, independently develop national goals and translate these broad national goals into effective policy action. In some countries, the state's goals are reducible to private interests (e.g. India, Mexico, Caribbean nations and the bureaucratic authoritarian regimes of some countries in South America). However,

> ...the pattern of MITI's (or its Korean and Taiwanese counterparts') involvement in the economy was consistent with both the economic logic of selective industrial policy [...] and the logic of finding an equilibrium between bureaucratic autonomy and effectiveness, on the one hand, and bureaucratic power and accountability, on the other" (i.e. correspondence between "state autonomy" and "state capacity) (Onis, 1991: 115).

The common features in both the 'authoritarian' and 'democratic' forms of the East Asian Developmental State are institutionalised public-private partnership in the process of economic policy formulation and execution, and the unusual degrees of bureaucratic autonomy (Onis, 1991: 114; 119). Indeed, the coexistence of these two key conditions facilitates the process of formulation and execution of strategic industrial policy. In the case of Japan, although there have been conflicts among various interest groups within its political system, and competition among firms within its economy, "extensive economic and political agreements have been as important to Japan's economic dynamism as competition" (Nester, 1991:57). The mainstream opposition parties often vote with the government and have a say in most policies.

Another striking element of the Developmental State is that this type of state has been sufficiently autonomous in the policy formulation and implementation process, and has not been overwhelmed by special interest groups. In fact, both state power and autonomy were consolidated before national or foreign capital and interests became influential, and private economic interests were generally politically weak (if not insignificant) relative to state power (Leftwich, 1995: 416-17).

This relative autonomy has flowed from the political power and support of the central political executives. Politicians provide the space for the bureaucrats to take important decisions by holding off special interest groups which might deflect the state from its main development priorities, and also legitimate and ratify the decisions taken by the bureaucrats. On the other hand, bureaucrats are given the freedom of action necessary for effective policy intervention. Besides, the ability of the Developmental State to deal with both civil society and particular local and foreign interests highlights the need for state capability in shaping mutually advantageous economic relationships (Onis, 1991: 115).

Thus, Developmental States are distinguished by the character of their developmental elites as well as the relative autonomy of these executive elites and the state institutions which they oversee (even though the form and extent of relative autonomy have varied). The specific nature of this 'embedded autonomy' however,

> ... must be seen as the product of a historical conjuncture of domestic and international factors. It is an autonomy embedded in the concrete set of social ties which bind state and society and provide institutional channels for the continuous negotiation and re-negotiation of goals and policies. (Steinberg, 1989: 74 quoted in Onis, 1991: 123).

Again, the successful NICs' Developmental States have played an important and active role in export-oriented development. Indeed, the generally positive strategic roles that the states of the NICs have played in endogenous competency and industrial competitiveness cannot be explained solely in terms of 'strength' or 'relative autonomy', but by their strong commitment to industrial development and high economic growth. Thus, the 'nature' of the Developmental State may be defined by the following features:

1. a relatively 'strong' state;
2. an effective and productive state-investor;
3. a state which is not (over-)influenced by interest groups; and,
4. a strategic state.[4]

If we suppose that a state which uses its military power or a military government is at one extreme (although a military government may not necessarily be a 'strong' state) and a (very) weak state influenced by interest groups is at the other (Myrdal, 1968), then the 'nature' of the Developmental State should be somewhere between these two extremes. Its relative position is, indeed, a reflection of, and/or depends on, the relative strength of the existing political forces (i.e. social classes, local governments, interest groups, trade unions, etc.).

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4. When analysing the concept of the Developmental State, three 'key-notions' are very important: (i) the role of the market and the state; (ii) emphasis on investment (especially higher levels of government investment); and, (iii) strategic planning.

An important question concerns the lesson to be drawn from the East Asian development experience which can subsequently be generalised and applied in other developing countries. In fact, the available evidence demonstrates quite conclusively that the East Asian Developmental State model is the product of specific historical circumstances with the logical corollary that there may exist major constraints on its transferability to or replicability in different or alternative national contexts.

Another fundamental question revolves around the compatibility of the Developmental State model with political liberalisation and democratic forms of governance - whether the transfer or replicability of the East Asian Developmental State forms is compatible with widespread political participation. Hence, the question whether East Asian type political economies can coexist with a liberal 'western' type political system emerges as a central problem for comparative political economy during the next decade.

It would generally be wrong to consider that the Developmental State model could, or indeed should, be transplanted to countries which have quite different histories and cultures. What is important to learn from the Far Eastern experiences is how to approach development problems – i.e. the strategic approach. Hence, the development challenge for decision and policy-makers today is to devise forms of strategic industrial policy which are consistent with the norms of democratic accountability and, perhaps, with more limited concentration of state and private power than has been the case in the East Asian context.

Like all states, Developmental States are not static. Various changes in their socio-economic structures, and their politics and international environments have brought about changes in their elite coalitions as well as in the ideas, interests and institutions which bear on them, both national and foreign (for example, structural differentiation, increased international pressures, economic and political liberalisation, globalisation). All these significant changes may induce an important modification of the Developmental State model, given the very real constraints that the global political economy imposes (Leftwich, 1995: 421).

A final lesson that emerges from this 'new experience' is that the transfer of specific Developmental State policies and strategies to new environments will be self-defeating in the absence of the political and institutional conditions required for their effective implementation. In drawing on the comparative literature, it is thus the main purpose of this paper to elaborate on elements of the desirable developmental intervention, based on developmentally-driven political purposes and institutional structures. This notion forms the subject matter of the following sections.

## 5. Key Elements of Developmental Intervention

The state can, and should, play an important role in improving the social and economic conditions of a society, and can actively and adequately contribute to development. Apart from the three traditional functions of the state and the fiscal budget (i.e. allocation, stabilisation and distribution), recent attention has been focused on its new developmental role; the 'quality' of state intervention rather than the 'extent' of such intervention. But the view that the state remains the 'main engine' of economic development, structural change and the process of policy reform inevitably raises the important issue of state capability and capacity (Ahrens, 1997: 114). As Evans (1992: 141) argues: "The consistent pursuit of any policies, whether they are aimed at 'getting prices right' or implanting local industry, requires the enduring institutionalisation of a complex set of political machinery."

In the new millennium, therefore, the role of government in adapting to and managing the needed changes will be critical, even though government action will be constrained by the pressures of globalisation and other forces. The search for the appropriate role of government needs to take seriously into consideration the importance of institutions as well as the 'environment' and incentives they create. Besides international competition, it is the organisational design of, and the incentives within, the government sector and the institutions linking the public and private sectors (i.e. the institutional environment) that are crucial to the developmental consequences of state policies (Ahrens 1997: 117).[5] In fact, effective economic policies "not only require credible commitments but crucially depend on the administrative, technical, and political capacity and capability of policy-makers" (Ahrens, 1997: 115). Furthermore,

> Different kinds of state structures create different capacities for action. Structures define the range of roles that the state is capable of playing. Outcomes depend both on whether the roles fit the context and on how well they are executed. (Evans, 1995: 11)

The outline of the above argument can be essentially recapitulated in four points:

(1) the ability to craft and adopt specifically tailored institutional structures is as important to effective governance as the formulation of policies;

5. Many (neoliberals and neoclassicals) argue against a heavy role for government social programmes in economic growth.

(2) effective governance structures and hence developmental outcomes depend on the roles that policy-makers pursue and the general character of state structure;

(3) while the initiation of economic reforms may be facilitated by discretionary authority of government, elites and political institutions that insulate policy-making from distributive claims of interest groups, their consolidation requires stabilised expectations regarding a new set of incentive structures and the confidence that these cannot be discretionarily altered; and

(4) policies need to match institutions and vice versa (Ahrens, 1997: 118-19).

What will interventionism be like in the 21st century? At the very moment when post-World War II institutions are being reassessed and partially reformed under the pressures of deregulation, liberalisation, international competition and anti-Keynesian political programmes, modern interventionist and radical analysis holds that the state remains the most powerful institution to channel and tame the power of markets. Even if the goal now is to make state action better through reinvention, the nature of government involvement has changed (and is likely to change further). Although prediction of any kind has its risks, there are several characteristics of the 'modern' developmental intervention (which Caribbean governments should pay particular attention to in the next century) compared to the 'old' one.

First, modern developmental intervention should be socially sensitive and egalitarian in the Caribbean, as governments have a key role to play in promoting social development. Indeed, the state has the main responsibility to provide adequate social services and promote the well-being of citizens. Thus, well-planned and conscious social programmes should be an important component in any development strategy because they meet real, basic needs of a wide spectrum of the population (MacEwan, 1999: 176).

More than this, however, the implementation of social programmes has broad potential implications in terms of the whole set of goals of national development. There is wide agreement, for example, that well-planned social programmes are important components of successful economic growth. In fact, while social programmes can be important causal components of economic growth, economic growth can also be a foundation for the expansion of social programmes (MacEwan, 1999: 177).

Whether or not the expansion of social programmes enhances economic growth and has an impact on productivity depends on the way social programmes are constructed and on the particular social programmes that are emphasised. On the other hand, it is useful to recognise – and practice would suggest that it is not as obvious as it seems – that the expansion of social programmes may not necessarily lead to economic growth or other desirable ends.[6] Even the best shaped social programmes (in terms of their impact on productivity) are likely to have limited impact on economic growth or competitiveness unless the overall development strategy also contains explicit consideration of growth-generating policies and com-

6. The Japanese Governments tried to create 'winners'; through this there was centralisation and consolidation of state power.

petency-inducing plans. The macroeconomic framework is one set of such policies, and the means to shape the private sector activity are another (MacEwan, 1999: 195).

Second, there should be increased focus on improving relations between the government and private sectors in the Caribbean. Governments might seek to ensure the evolution of institutional frameworks characterised by integrated and dynamic public and private sector partnerships with the capacity to capitalise on strategic and tactical alliances. In fact, the public and private sectors can cooperate in a range of different arrangements, each contributing what it does best and both participating in the financial returns, within the context of socially defined agendas. The complementarity between them can enhance the operation of markets, and can create opportunities which would not otherwise exist. In Sawyer's words,

> The complementarity arises from the government setting the [comprehensive and developmental] framework within which firms operate, and seeking to aid firms to fulfil the developmental[-ist] strategy. The potential complementarity between them implies that the state adopts an entrepreneurial role and is thereby able to create opportunities which would not otherwise exist. If successful, the operation of the state enhances the operation of markets. Moreover, a variety of relationships between firms themselves and between firms and the government can be involved, with substantial differences emerging as between different economies. (Sawyer, 1992: 64)

Third, Caribbean government intervention should be strategic. Traditional government bureaucracies required little conception of strategy and serious forward planning was either not carried out or carried out in rather limited ways. Indeed, strategy of any kind would have been considered 'political', if thought of at all (Hughes, 1998: 149).

However, it is the government that can look ahead of the market when drawing up long-term parameters of a developmental intervention, which actually does not deny the importance of the market system operating within this overall strategy. In its developmental part, the state takes a leading and proactive role and the market works within the long-term parameters set by government at various levels, e.g. local, regional and national (Cowling, 1990: 32).

Markets are complex structures that have to be shaped, moulded and regulated. Just as there are systemic arguments for relying on the creative dynamics of the market forces to play a centrally important role in modern economies, there are parallel arguments for imposing on these market forces coherent strategies, within which they are allowed to operate (Cowling, 1990: 11-12). Hence, strategic planning may be seen as essential for promoting "national purpose goals" in Caribbean economies.

The essence of strategy is to achieve results. The role of strategy is to try to specify what the results should be and to set out how achievements aggregate into the overall purpose ('national purpose' in the case of Japan and NICs). Strategic planning gives direction and purpose to public organisations; without strategy, policy-making is without direction. In fact, it is the planning process not the plan itself which is more important; that is, the use of long-term parameters allows the public institutions from top management down to develop a shared vision for the future.

Moreover, the nature of planning is all important, but planning should not get involved with the operational detail (comprehensive centralised planning may be both unfeasible and undesirable in the Caribbean). In fact, planning should be strategic and (pro)active rather than passive; selective rather than comprehensive; but wherever possible based on some notion of consensus (Cowling, 1990: 16-17).

Fourth, the system of accountability forms the key link between the administration of government and the political system. A system of accountability would be required by Caribbean governments, as the two forms of accountability, political and managerial, are tightly related (even though this link has quite often been problematic). Indeed, "the system of accountability is what ties the administrative part of government with the political part and ultimately to the public itself" (Hughes, 1998: 225).

In the traditional bureaucratic administration there is some form of accountability. This form of accountability relies upon the formal links provided through the hierarchical structure. It is accountability for avoiding errors rather than achieving outcomes (Hughes, 1998: 233). Thus, improving accountability should be a specific aim of the move towards developmental intervention. Effective institutions of political authority in Caribbean countries would then be responsible for the effective execution of strategic plans and monitoring the progress of these plans, as well as for their own performance. In fact,

> ... institutions can formalise the commitment to such [strategies], and their structure, procedures and personnel can act to ensure that such commitments cannot easily be reversed, but they are simply ratifying plans already established. The history of planning [in Caribbean nations] shows how fragile was the commitment, despite the creation of many

> new institutions, [and the lack of teeth of these institutions was obvious]. With clear goals, and a determination to pursue them, institutions with teeth should be forthcoming [in the Caribbean]. (Cowling, 1990: 23)

However, state effectiveness depends on the coherence of state policies, which is difficult to maintain when important parts of the state are beholden to "pork-barrel" policies and specific interests. Effectiveness in the Caribbean, therefore, will be highly dependent on the degree of "relative insulation" (or "relative autonomy") from the surrounding social and political structures and pressure (Wade, 1990: 375).

Fifth, quite often, public sector reforms and capacity-building programmes have been introduced in many countries without the benefit of systematic and disciplined diagnoses of institutional capacities. This has resulted in wasted investments, inadequate levels of skill and competence, ineffectiveness and performance shortcomings. In contrast, the economic success of Japan and NICs could not have been achieved without the decisive role of their competent 'technostructures' and their determined developmental elites in economic and social planning. Indeed, an important feature of these technocracies has been their technical competence, and many of the top officials of Japan and East Asian countries have received advanced training abroad.

Obviously, capacity building and competence must be important strategic goals that will determine the extent and pace of fundamental changes within the public sectors and within institutions in the Caribbean. There are several kinds of institution-building measures, which comprise intellectual, managerial and fiscal resources. Strategic human resource management and planning coupled with investments in human resource development (i.e. high quality and timely education, training and the continuous development of scientific manpower) should be strongly linked to conscious modernisation efforts by Caribbean governments and institutions towards better and more effective state action.

Furthermore, competitive wages for well-educated, well-trained technocrats can attract more talented individuals and increase capacity, integrity and professionalism. Indeed,

> ... the executive technostructures must be in a position to recruit from among the best and the brightest people of outstanding talent based on meritocratic criteria. Once the central bureaucracy acquires a reputation for attracting the most competent and talented, the system can develop a momentum of its own. It continues to attract such people (even at lower salaries than the private sector) because selection is based on meritocracy. Its personnel can be motivated by the belief that what they are doing promotes the national development and welfare. This sense of "national mission" can motivate the executive technostructure to use its powers in line with "national purpose" goals. The more the government intends to intervene and to play a leading role, the more important are the staffing, motivation, authority, professionalism and responsibilities of the central core. (Wade, 1990: 371)

Moving more towards a meritocracy means that Caribbean governments would have to reduce political patronage and clientelism, effectively heralding new forms of governance and administration.

Sixth, developmental intervention requires increased attention on better use of resources. This involves directing resources to emphasise those programmes which most assist the attainment of strategic objectives. It also involves more state spending on infrastructure and the modern factors of growth and competitiveness, and less spending on unnecessary and non-essential kinds of government expenditure (i.e. an appropriate redistribution of available/existing funds from government consumption to government investment).

Furthermore, with the advent of modern information technology, the need for a highly centralised public administration with paper as the focal point of communicating became obsolete. With the computer, fax machines, electronic mail, satellite transmission and the Internet, new types of communication tools are widely used. This is expected to lead to reductions in clerical staffing levels and/or dislocations in the work force of Caribbean public organisations and institutions. Nevertheless, while these reductions and dislocations may be inevitable, they should be based on 'rational', efficient and effective human resource management and planning. For instance, fewer employees (but well-educated and well-trained) may replace those civil servants who retire or resign. Such a decision/policy action is expected to bring about twofold benefits: (i) it will improve skills, efficiency, effectiveness, competence and operations quality, especially when combined with better utilisation of new technology; and, (ii) it will release resources for higher levels of public investment (which will improve the environment for productive activities to take place within Caribbean economies).

The current economic difficulties, and fiscal pressures in particular, are making many governments more prepared to tackle difficult institutional issues than would have been the case in more normal times. At the same time, the current conditions in the world economy may increase the potential advantages of pursuing governed market policies, thereby bringing seriously the "nation state back to business."

However, Caribbean governments have to find ways to ensure that the best business practices and success of leading (mainly foreign) firms benefit their respective national economies. They have to take proactive measures which require that firms invest in new production facilities, skills training and upgrading, and critical kinds of science and technology initiatives. Besides, research suggests that nations which do best in the global arena are those which manage change and use their institutional arrangements to protect their national economies from international vagaries and disorder (Tyson, 1992; Chang, 1994; Singh, 1995 and 1998; Boyer and Drache, 1996 – among others).

These important suggestions and policy considerations have attracted the support of many (if not most) governments of developed, developing and less-developed countries, and are probably irreversible. However, the wider effects of modern intervention on "not only the public sector [and institutions] but the entire political system still have some distance to travel" in the Caribbean region (Hughes, 1998: 261).

## 6. Creating Modern Politico-Institutional Structures

It has been often argued that Developmental State policies in the Caribbean should be concerned with the long-term aim of altering both the direction and pace of development of local economies. However, Caribbean governments have been captured by powerful interests, and can hardly implement politico-institutional structures which decisively promote structural changes and economic reforms. Besides, changes in the structure of class relations during the last few decades induced an erosion of political institutions in the region. Thus, there are major constraints on local developmental policies as Caribbean public institutions are limited in their abilities to perform certain tasks. For these reasons, and perhaps for others, the pursuit of Developmental State strategies and policies by Caribbean governments requires specific politico-institutional structures, whose task would be to organise the critical interactions between state and industry.

First of all, a central core – a Bureau of Industry and Trade (BIT) composed of a small, entrepreneurial team of well-educated, well-trained and efficient technocratic planners motivated by a sense of national mission- will have to be instituted in any Caribbean country seeking a successful, proactive developmental role for the state (Cowling, 1990: 19).[7, 8] This central Bureau should be organised around the requirements of a dedicated and determined Strategic Planning Agency (SPA), with a long-term commitment, the independent capability and the powers to implement the interventionist strategy in line with national goals. Indeed, the more the government intends to play a leading role in the economy, the more

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7. The Japanese planning, its various instruments, institutions and mechanisms are "a product of its own history and culture." Nevertheless, different countries are characterised by "quite different historical and cultural circumstances," (quite) different socio-political elements (Cowling, 1990: 18).

8. This approach allows "considerable autonomy in determining the mode of operation, and adjusting it as experience accumulates." The main objective is "a dynamic economy rather than sticking to a set of rigid rules imposed by a central bureaucracy." We must avoid squandering people and resources over a whole range of bureaucratic activities (Cowling, 1990: 25).

important are the staffing, motivation, authorities and responsibilities of the executive agency.

On the other hand, building strong technostructures and embedding them into a network of close cooperative and consultative relations with targeted industries and other social segments (banks, universities, trade unions, etc.) can be both feasible and operational in Caribbean nations. Indeed, the involvement of dynamic businesses and social segments in government policy-making through institutionalised channels represents an adequate means to establish a state-business-society interface by which the mutual exchange of information can be encouraged, risk sharing facilitated, bureaucratic autonomy and flexibility enhanced, and a consensual process of policy formulation realised (Cowling, 1990: 24-5). This combination of bureaucratic autonomy and social connectedness (what Evans (1995) calls 'embedded autonomy') may represent the institutional basis for effective and accountable government involvement in Caribbean economies, while being independent of societal pressures (Ahrens, 1997: 125).[9]

Sectoral Agencies (SA) should also be part of the BIT, close to the firms and industries with whose future they will be intimately concerned and responsible for the strategic direction in their specific sectors; hence, the sectoral agency will perform a key role in the industrial regeneration of the island. "The process could be started off by the SA within the BIT" identifying sectors in which

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9. As Cowling argues: "Economic policy will be built around the twin pillars of Treasury and Industry; the former with a relatively short-term demand perspective, the latter with a longer-term supply perspective" (Cowling, 1990: 24).

strategic intervention is warranted and advantageous. Yet, the act of putting the strategic decision-making machinery within the regions would allow officials to disaggregate and tailor development plans to local needs (Cowling, 1990: 25).

In order to make state action more effective, both effective procedures and increased participation are of vital importance. Loose and transparent links between the core planning agency and Government Ministries and Departments involved in the industrial strategy (such as Treasury, Education, Training, etc.), and sectoral agencies and local authorities/boards would decentralise much of the work of the central bureau. "To be successful [...] planning must be democratic, and [this new] institutional structure must allow for participation at all levels." Indeed, participation by the 'social partners' can improve the organisation of production and help restrain the power of small groups which have access to government decision-making (Cowling, 1990: 28).

Thus, in the course of a fundamental redirection of the development strategies, as in the case of Caribbean economies, simply matching Developmental State policies to existing political institutions will be counterproductive. Effective Developmental State action is a dynamic process that requires continuing fine-tuning and adjusting institutions and policy solutions to changing technological, social, economic and political environments (Ahrens, 1997: 119). To the extent that a chosen path falls short in this respect, changes and adjustments in certain policy areas will be needed. However, it is difficult to retain a disposition against change in a world where basic conditions are subject to constant mutation.

Obviously, such a network of institutions, as advocated before, must be derived from a prior commitment to fundamental changes in policy-making. Indeed, institutions with a strategic planning role are a necessary part of any attempt to introduce a long-term perspective to development policy in the Caribbean, and short-term perspectives must be replaced by long-term ones which are much more favourable to productive investments and production-oriented, sustained economic growth. Furthermore, the institutional structures must provide continuity, consistency and commitment to the direction and pace of local development. This may require a high degree of incentive-compatibility of state policies and development and economic performance, as well as the creation of institutional arrangements that constitute a stable economic and political environment – in which consensus-building concerning developmental strategies works (Ahrens, 1997: 119; 126). Without such commitments, accountability, 'embedded autonomy', effectiveness, competence, capacity and professionalism, Developmental State policy-making will founder on short-term expedients; the power of the transnationals and foreign interests; the conservatism, ineffectiveness and inefficiency of the civil service; or the resistance of the people (Cowling, 1990: 23).

## 7. Concluding Remarks

In most capitalist economies, the state undertakes a number of functions. Its role can be defined either in terms of institutions or in terms of its functions. But in both cases, the government has a certain role to play with substantial effects on the economy and society. There are also many cases where the range of state activities extends beyond the passage of laws and the levying of taxation; activities which range from facilitating and/or promoting industrial growth to its direct involvement in the productive process.

As the pressures grow for increased liberalisation, the policy problem of operationalising an appropriate role for the state in Caribbean economies intensifies. But in the absence of rational and realistic foundations, those who seek to use neoclassical theoretical premises are led to adopt a dismal view of the state's active involvement, beyond some minimalist level, and suggest state action should be neutral, rather than active or sensitive to any 'special cases'.

In the Caribbean, however, it seems inevitable that the leading and supportive 'visible hand' of the entrepreneurial type of state must extend its strategy and scope beyond the World Bank's prescriptive box, as proactive state policy and its associated multiplier effects can be used to 'crowd in' private spending and promote endogenous development, competency and competitiveness. In addition, a sophisticated understanding of the need for government action is a requisite for the appropriate selection of thorough and well-planned strategies and policies for Caribbean economies.

Hence, contrary to the current orthodoxy, developmentally-driven institutional structures and political purposes may better be achieved by an active state (as a capable corporate agent) which approximates the Developmental State model (ideally, but not necessarily, the 'western democratic' type). This might be the best viable development policy option left for Caribbean nations.

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# 16

# The OECD's Harmful Tax Competition Initiative and Offshore Financial Centres in the Caribbean Basin

*Richard Woodward*[1]

The problems confronting small states in their quest for sustainable economic development are widely recognised (see, for example, Commonwealth Secretariat, 1985, 1997; Kakazu, 1994; Briguglio, 1995; Commonwealth Secretariat/World Bank Joint Task Force, 2000; Peretz, Faruqi and Kisanga, 2001; Nicholls, 2002). The choice of feasible development strategies open to small states is restricted not only by tiny domestic markets, remote export markets, a paucity of natural and human resources, proneness to natural

1 Department of Politics and International Studies, University of Hull, HULL, United Kingdom.

catastrophes and environmental change, but also by limits on their capacity to govern economic activity. With these constraints in mind, many small states have seized upon the provision of offshore financial services as a means to develop and diversify their fragile economies. Though there is no precise definition of what constitutes a small state, most commentators now subscribe to the threshold used by the Commonwealth Secretariat (1997) which designates small states as those with a population of less than 1.5 million. According to figures from the World Bank (2002), there are currently 62 states or territories which meet this criterion and of these, 35 have Offshore Financial Centres (OFCs) (Errico and Musalem, 1999).

Nowhere has the trend towards small states hosting OFCs been more pronounced than in the Caribbean. Today no fewer than 17 Caribbean small states have a presence in the offshore financial sector (see Table 1) which many commentators, despite some reservations, see as yielding significant benefits to the territories concerned (Hampton, 1994, 1996; Hampton and Levi, 1999; Biswas, 2001). Though tax havens had existed for decades, it was not until the 1970s that the growth of offshore finance in the Caribbean began in earnest. In this period the international community tacitly encouraged small states in the Caribbean to establish OFCs. The British and to a lesser extent the Dutch governments felt that OFCs had a vital role to play in the development of their former colonies and dependent territories (see Hampton, 1996: 95-100). The United States eyed the proliferation of OFCs more warily. It has nevertheless tolerated their emergence, not least in recognition of the fact that OFCs provide a cheaper source of funding with which to tackle their endemic fiscal and trade deficits (Palan and Abbott, 1996; Strange, 1998). Moreover, the provision of offshore financial services have imparted economic benefits that serve to douse tensions in the United States' backyard and deter countries from diversifying into more damaging industries, particularly the production of narcotics. The problem now confronting the small states of the Caribbean is that the benevolent attitude of the international community, which initially enabled offshore finance to flourish, has been progressively displaced by an attitude of 'antagonism and hostility' (Woodward, 2002). Increasingly, OFCs in small states have been portrayed as the pariahs of the global financial system whose inadequate regulatory and supervisory arrangements have amplified threats to global financial stability and assisted criminal activity, including money laundering and tax evasion. Indeed, all of the Caribbean small states with OFCs have appeared on at least one of the lists published by the Financial Action Task Force (FATF), the Financial Stability Forum (FSF), or the Organisation for Economic Cooperation and Development (OECD) to indicate that they have substandard fiscal or regulatory arrangements (see Table 1). In the last decade these bodies, along with the International Monetary Fund (IMF), have spearheaded attempts to develop a more sophisticated and elaborate governance regime for OFCs designed to bring their regulatory systems in line with international best practice (see FSF, 2000b; IMF, 2002) and leading regulators have promised a 'bleak future' (Financial Services Authority (UK) 2001) for those offshore centres which seek a competitive advantage by contravening international standards. These more exacting standards demanded by the international financial institutions are thought to be undermining the viability of offshore finance, leading some commentators to caution small states against the use of OFCs as the mainstay of their development strategy (Christensen and Hampton, 1999a, 1999b; Hampton and Christensen, 1999, 2002).

The remainder of this chapter will focus on one aspect of this nascent international regime for the governance of offshore finance, the OECD's Harmful Tax Competition

Initiative, and its potential impact on small states in the Caribbean. Before going on to look in detail at the OECD's project, the chapter first presents an overview of the merits and dangers of OFC-led development strategies in small states. The chapter then goes on to outline and analyse the OECD's work on tax competition. The project will be split into two main phases. Phase one covers the period from 1996 to 2000 which marked a period of aggressive action by the OECD to rid the global economy of the scourge of harmful tax practices. This section will ask what prompted the OECD's interest in tax competition, run through the OECD's proposals, and discuss their implications for the small states of the Caribbean. The second phase covers the period from 2001 to the present, which has seen the OECD's initiative grind to a halt as a result of wavering political support from leading states, particularly the US. Finally, the chapter examines whether the impasse now facing the OECD represents just a temporary reprieve for Caribbean OFCs or whether the inherent dynamism of financial markets will enable OFCs to survive in the future.

**Table 1: Caribbean Small States Offering Offshore Financial Services and their Classification by Leading Multilateral Initiatives**

| | Geographical Information | | Assessment by International Institutions (Date of Latest Listings) | | | | |
|---|---|---|---|---|---|---|---|
| | | | Organisation for Economic Cooperation and Development (April 18, 2002) | | | Financial Action Task Force (Feb. 14, 2003) | Financial Stability Forum (May 26, 2000) |
| | Population | GDP Per Capita (US$ PPP) | Listed as Tax Haven in OECD Report[1] | Listed as Uncooperative Jursidiction | Date of Commitment | Non-Cooperative Jurisdiction[4] | Quality of Financial Regulation[8] |
| Anguilla | 12,446 | 8,600 | Yes | No | March 2002 | - | Group III |
| Antigua and Barbuda | 67,448 | 10,000 | Yes | No | February 2002 | No | Group III |
| Aruba | 70,441 | 28,000 | Yes | No | July 2001 | - | Group III |
| The Bahamas | 300,529 | 15,000 | Yes | No | March 2002 | No | Group III |
| Barbados | 276,607 | 14,500 | Yes | No | -[2] | - | Group II |
| Belize | 262,999 | 3,250 | Yes | No | March 2002 | - | Group III |
| British Virgin Islands | 21,272 | 16,000 | Yes | No | April 2002 | No | Group III |
| Cayman Islands | 36,273 | 30,000 | No[3] | No | May 2000 | No | Group III |
| Dominica | 70,158 | 3,700 | Yes | No | March 2002 | No[5] | - |
| Grenada | 89,211 | 4,750 | Yes | No | February 2002 | No[6] | - |
| Montserrat | 8,437 | 2,400 | Yes | No | March 2002 | - | - |
| Netherlands Antilles | 241,258 | 11,400 | Yes | No | November 2000 | - | Group III |
| St Kitts and Nevis | 38,736 | 8,700 | Yes | No | March 2002 | No[7] | Group III |
| St Lucia | 160,145 | 4,400 | Yes | No | February 2002 | No | Group III |
| St Vincent and the Grenadines | 116,394 | 2,900 | Yes | No | February 2002 | Yes | Group III |
| Turks and Caicos | 18,738 | 7,300 | Yes | No | March 2002 | No | Group III |
| US Virgin Islands | 123,498 | 15,000 | Yes | No | March 2002 | - | Group III |

**Sources:** Data compiled from OECD (2000; 2002a), World Bank (2002), US Central Intelligence Agency (2002), FSF (2000a) and the FATF (2003)

**Notes to Table 1:**

1. All the jurisdictions listed in this section continue to meet the OECD's tax havens criteria and will continue to be classified as such. However, those jurisdictions which have committed to eliminate harmful tax practices by 2005 will not be considered for inclusion on any future list of *uncooperative* jurisdictions unless they abrogate their agreement by introducing tax practices that the OECD considers harmful or by failing to keep to their proposed timetable of reform. Those jurisdictions that failed to make a commitment to the OECD initiative appeared on the first OECD blacklist published in April 2002. They were Andorra, Liberia, Liechtenstein, Marshall Islands, Monaco, Nauru and Vanuatu.

2. Barbados is yet to commit to the OECD initiative but has negotiated a separate deal with the OECD (announced in January 2002) which means it does not appear on the list of uncooperative jurisdictions.

3. The Cayman Islands were recognised by the OECD as meeting the tax haven criteria but were not listed in the 2000 Report because they had already made a commitment to eliminate harmful tax practices.

4. All of the jurisdictions assessed by the FATF were identified as having some deficiencies in their money laundering regimes. However, only those jurisdictions whose shortcomings were serious enough to prohibit or seriously impair international co-operation are deemed non-co-operative. A dash indicates that the FATF has not rated the jurisdiction.

5. This jurisdiction was removed from the FATF list of Non-Cooperative Countries and Territories in October 2002.

6. This jurisdiction was removed from the FATF list of Non-Cooperative Countries and Territories in February 2003.

7. This jurisdiction was removed from the FATF list of Non-Cooperative Countries and Territories in June 2002.

8. The quality of financial regulation is ranked by inclusion within one of three groups. The three groups are (i) Group I "jurisdictions generally viewed as co-operative jurisdictions with a high quality of supervision, which largely adhere to international standards; (ii) Group II "jurisdictions generally seen as having procedures for supervision and co-operation in place, but where actual performance falls below international standards, and there is substantial room for improvement"; and (iii) Group III "jurisdictions generally seen as having a low quality of supervision, and/ or being non-co-operative with onshore supervisors, and with little or no attempt being made to adhere to international standards" (Financial Stability Forum, 2000a: 46).

**Offshore Financial Centres in Small States - Merits and Dangers**

Assessing the contribution of OFCs to the economic wellbeing of small states is fraught with difficulties. Each OFC is unique and the costs and benefits associated with hosting an OFC vary according to the type of business being undertaken. At a very general level Hampton (1996), following McCarthy (1979) and Johns (1983) distinguishe between 'functional' and 'notional' OFCs. Functional OFCs are deemed to be fully-fledged financial centres wherein financial intermediaries maintain a physical presence and a wide range of real financial activities occur. These activities are buttressed by a sophisticated financial services infrastructure, comprising the availability of legal and accounting expertise by accredited professionals and the regulatory paraphernalia that is emblematic of contemporary financial centres. Finally, functional OFCs employ a sizeable proportion of the local labour force and make a substantial contribution to national GDP. Notional OFCs, on the other hand, act primarily as booking centres for financial transactions. Financial institutions are merely shell or 'brass-plate operations' which record their financial transactions in the jurisdiction but do not establish a physical presence to back it up. Though the centre may generate valuable revenue for the government from licensing and registration fees, its overall importance to the economy in terms of income and employment is significantly less than that of a functional centre.

Despite these problems, academics and policy makers have made a number of generalisations about the positive and negative effects of OFC-led development in small states. The first advantage is that providing the basic conditions for offshore finance is inexpensive and relatively straightforward. The kinds of constraints on small states outlined in the introduction means that 'in some ways their best resource for development is their jurisdiction' (Hudson, 1998: 543). The most obvious manifestation of this is the tourism industry which thrives upon the tropical climate and outstanding beauty of the small Caribbean states. In addition to the physical landscape, the sovereignty or autonomy of small Caribbean states is a 'natural' resource that has been harnessed to construct a fiscal and regulatory landscape that is conducive to investors.

Secondly, OFCs are said to confer economic benefits upon their hosts. Hampton and Abbott (1999b: 1) suggest that 'the provision of such offshore financial facilities has lifted a host of small jurisdictions from the poverty of the developing world to levels of affluence few would have believed within their grasp'. The buoyancy and dynamism of the financial services sector in the past two decades contrasts sharply with the primary commodities sector upon which many Caribbean economies traditionally depended. The rapid expansion of the financial services sector and the accompanying rise in the price of international financial services has contributed to economic growth and better terms of trade for small states with OFCs. Conversely, those small states which continue to rely on traditional industries have experienced a marked deterioration in their terms of trade as the price of primary commodities has stagnated or collapsed (Commonwealth Secretariat, 2000: 3).

Thirdly, the development of an OFC can bequeath a significant legacy to the human and physical infrastructure of small states. OFCs make a quantitative and qualitative contribution to employment in small states. Not only do OFCs generate extra local employment, but they create jobs that are well-paid and offer training opportunities for indigenous labour. In this way financial services have developed human capital in a manner that alternative forms of development have failed to do. Moreover, attractive local employment opportunities have assisted in arresting the brain drain that afflicts many small states (Biswas, 2001). These relatively high rates of remuneration in the financial sector also have multiplier effects in the rest of the economy. The Commonwealth Secretariat (2000: 4) estimates that every job created by the OFC results in two or three more in other sectors as personal and corporate income is spent or reinvested in the locality. In terms of the physical infrastructure-telecommunications facilities, airports, and hotels are among the amenities which tend to accompany the development of an OFC. These services have helped to complement existing, or launch new industries, especially tourism.

The tangible benefits accruing to the pioneers of the offshore development strategy have created powerful incentives for others to emulate them, particularly given the meagre dividends brought by alternative paths to development. Nonetheless, not all commentators are convinced of the efficacy of using offshore financial services as the lynchpin for development. Opponents of OFC-led development suggest that the benefits of hosting an OFC are overstated. Furthermore, they question whether these negligible benefits are adequate recompense for the new costs and attendant dangers connected with financial services (Maingot, 1994; Palan and Abbott, 1996; Hampton and Christensen 2002).

The economic benefits of an OFC can vary enormously. Critics suggest that small states such as Guernsey, Jersey and the Cayman Islands, where offshore financial services account for over 15% of total employment and around 30% of GDP, are the exception rather than the rule. In most small states OFCs employ a minute fraction of the local labour force and are of secondary importance to national GDP (Hampton, 1996; Financial Times, 2000a).

Furthermore, though there are benefits associated with hosting an OFC, the question of who harvests these benefits is frequently glossed over. As Hampton and Levi (1999: 654) have argued, 'there is no doubt that the move into Offshore Financial Centres has been lucrative for SIE (small island economy) hosts'; however, the rewards bestowed 'on the local (as opposed to the expatriate) community remain untested and variable'. For instance, the GDP per capita of the Cayman Islands stands at US$30,000, the ninth highest in the world (World Bank, 2002). Yet, many native Caymanians earn barely enough to pay for the necessities of life such as food, rent and utility bills (Financial Times, 2001b). Not only does this imply that the returns from OFCs accumulate primarily to expatriates but it also casts doubts on the supposed multiplier effect of the OFC on the wider economy.

A second set of concerns relates to the political, economic, and social upheavals which accompany the growth and development of OFCs in small states. OFCs in small states have been likened to a 'cuckoo in the nest' (Christensen and Hampton, 1999a; Hampton and Christensen, 2002) crowding out existing industries and capturing the state apparatus. OFCs are voracious consumers of the already strained resources of small states, swallowing up factors of production used by pre-existing industries. Two obvious symptoms of these problems are the diminution of agricultural land to make way for commercial and residential building projects and chronic labour shortages as workers are lured away to better paid employment in the financial sector. In other words, OFCs have tended to supplant rather than supplement existing industries so that, far from lessening the dependency of small states by diversifying the industrial base, they have compounded dependency by displacing other sectors. The experience of Jersey and

Guernsey provides salutary examples of this process in action. At the end of the 1960s both islands had reasonably diverse economies with their export earnings coming from a mixture of agriculture, light manufacturing and tourism. However, the subsequent growth of the financial services industry has gradually squeezed out these other sectors. By the end of the 1990s the export of manufactured goods from Jersey 'had virtually ceased' and in excess of 90% of the island's tax revenues came from the financial sector and related activities (Hampton and Christensen, 2002: 1666). Similarly, in Guernsey the financial sector now generates over half the island's profits and three fifths of its exports (*Financial Times,* 2002). This heavy reliance on one sector combined with the notoriously fickle nature of international finance means the development of small states relying on OFCs is extremely precarious. Furthermore, once the OFC has entrenched its position as the dominant industry in a small state, it is then in a position to extract concessions from the government. Powerful financial interests come to dominate the local political apparatus enabling them to 'exert considerable political influence in sponsoring favourable tax and regulatory legislation' (Christensen and Hampton, 1999b: 16). In Bermuda two large financial services firms Ace and XL Capital 'have more political influence than whole sections of the electorate' (*Financial Times,* 2000b) and in Jersey the passage of the Limited Liability Partnership legislation, which had been drafted by financial services firms, in 1996 led to the State of Jersey parliament being dubbed 'a legislature for hire' (Christensen and Hampton, 1999a; Mitchell *et.al.,* 2002: Chapter 6). This leads to the danger that the broader public interest of small states is sacrificed in order to ensure the continued vitality of the OFC. To take one example, the continued expansion of the Caymanian economy has compelled the government to allow mass immigration to slake the demands of the labour market. As a result, the population of the Cayman Islands has doubled to 40,000 in just ten years with the size of the expatriate community now rivalling that of the native Caymanians. These new arrivals have not only placed further pressure on the existing infrastructure but have also disturbed the delicate social balance of the islands with the government now struggling to contain the simmering disharmony between the different communities (*Financial Times,* 2001a). The paradox of the OFC-led development strategy is that they sponsor a development trajectory characterised by rapid change. However, in so doing, they run the risk of tearing the delicate social and economic fabric of small states, which in turn undermines the political, economic and social stability upon which a successful financial centre relies.

Finally, the OFC imposes new direct costs upon a small state (see Hampton, 1994). The financial services industry is heavily dependent on the very latest advances in technology and telecommunications. However, the infrastructure of many small states is somewhat rudimentary and upgrading these facilities to meet the expectations of financial services firms may necessitate significant expenditure. The OFC also requires a competent and well-resourced regulatory apparatus if it is to draw in legitimate business activity. This issue has become particularly salient in recent years with the costs of regulation escalating rapidly as small states have striven to act in accordance with the increasingly stringent standards set down by the international financial institutions.

## The OECD's Harmful Tax Competition Initiative: Phase 1 1996 - 2000

In 1996 the annual meeting of the OECD Council at Ministerial Level called upon the OECD to 'develop measures to counter the distorting effects of harmful tax competition' (OECD, 1998: 7). The OECD's Committee on Fiscal Affairs assumed responsibility for pursuing this work and its report *Harmful Tax Competition: An Emerging Global Issue* (hereafter the 1998 Report) was approved by the OECD Council (with the exception of Switzerland and Luxembourg) in April 1998. The report acknowledged the importance of tax competition in disciplining profligate governments and promoting a favourable climate for investment. Nonetheless, it argued that certain tax practices were diminishing global welfare because they were distorting patterns of trade and investment, and eroding tax bases by encouraging non-compliance with tax laws (OECD, 1998:8). With the liberalisation of financial markets making it easier to transfer capital across national boundaries, tax havens, with their combination of low taxation and impenetrable secrecy laws that obscure the identity of the assets' owners, are a tempting proposition for corporations and High Net Worth Individuals (HNWIs) seeking to minimise their tax bills. Each year tax evasion and tax avoidance is estimated to cost the US Treasury somewhere in the region of $70 billion (Wechsler, 2001: 45) while Mitchell *et.al.*, (2002: 2) report that the coffers of the British Treasury would be swelled by £85 billion a year if it were better able to tax income being held offshore. Developed nations, too, are victims of tax shirkers with $50 billion lost annually as a result of tax avoidance, a sum equivalent to the global aid budget (Oxfam, 2000). These fiscal leakages, together with an unwillingness to increase tax rates for fear of stimulating capital outflows, make it increasingly difficult for states to raise sufficient revenue to provide the public goods called for by their citizens. The preferred way of overcoming these fiscal constraints has been to shift the tax burden from mobile to fixed factors of production and from income to consumption. The drawback is that these moves are highly regressive and interfere with the broader objectives of social justice that many governments hold sacrosanct. In short, harmful tax competition 'undermines the fairness, neutrality and broad social acceptance of tax systems' (OECD, 1998: 8).

Broadly speaking, the 1998 Report argued that harmful tax competition occurs when a jurisdiction combines low or no rates of taxation on foreign owned assets with legal or administrative restrictions that prevent overseas tax authorities from identifying the owners of those assets and hence, levying tax upon them. The report distinguishes two types of jurisdictions which pursue harmful tax practices: tax havens and preferential tax regimes. A tax haven is defined as a jurisdiction that 'imposes no or only nominal taxes and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence' (OECD, 1998: 22). These low levels of taxation are judged to be harmful only when they are applied in conjunction with one or more of the following. Firstly, a 'lack of effective exchange of information' (OECD, 1998: 24). All tax havens have strict secrecy laws making it a criminal offence for a financial intermediary to publicly disclose a client's information without prior consent. For example, it would be illegal for a bank to respond to a request from overseas tax authorities for information about suspected tax dodgers. The second feature is the absence of transparency. Tax havens specialise in the provision of investment vehicles such as International Business Companies (IBCs) where assets are notionally controlled by nominee directors and shareholders on behalf of the real owners of the assets. These vehicles are used to conceal the identity of the assets' owners, making it impossible for tax authorities to audit the foreign activities of their residents and to tax them accordingly. The final factor relates to the absence of substantial business activities which the OECD says indicates that the jurisdiction is trying to lure investment motivated solely by tax considerations. The criteria for identifying harmful preferential tax regimes are similar to those for tax havens. Again the OECD proceeds from the premise that low or no taxation is a necessary but not sufficient condition for identifying harmful tax practices and that low or no taxation only becomes harmful when the regime lacks transparency and does not have mechanisms in place to facilitate the effective exchange of information with overseas tax authorities (OECD, 1998: 26-30). The vital difference between a tax haven and a preferential tax regime is that in a tax haven low tax rates and secrecy provisions affect the entire jurisdiction and are uniformly applicable to both domestic and foreign assets. In contrast, preferential tax regimes exist in countries which raise substantial revenue from taxing domestic assets but grant exemptions to assets held by non-residents. Furthermore, the less burdensome tax and regulatory preferences offered to non-resident investors are not available to resident investors. This phenomenon, which the OECD (1998: 27) terms 'ring fencing', is thought to be harmful because while the country sponsoring the regime is able to insulate its own tax base by offering immunity exclusively to non-resident investors, it simultaneously embezzles the tax bases of other states by attracting mobile capital seeking to avoid taxation in its resident jurisdiction.

Having outlined the principal features of harmful tax competition, the 1998 Report goes on to make 19 Recommendations aimed at eliminating these practices. Fourteen of the Recommendations were unilateral or bilateral courses of action that built upon or refined existing rules on international taxation (OECD, 1998: 40-52). The novelty of the OECD's approach lay in its proposals for intensified multilateral action to counter harmful tax practices. Initially, the OECD advocated the creation of a Global Forum on Harmful Tax Practices which would coordinate international work and monitor the implementation of the OECD's Recommendations. Secondly, OECD member states, by acceding to the 1998 Report, committed to eliminate harmful aspects of their own tax regimes within five years of the report being approved by the OECD Council (i.e. by April 2003). The process of identifying potentially harmful preferential tax regimes began immediately. OECD members were asked to examine their own tax regimes and to report to the Forum any practice that might be considered harmful under the rubric of the 1998 Report. These submissions were subject to peer review by three working groups convened by the Forum on Harmful Tax Practices. The Forum concluded that there were 61 potentially harmful preferential tax regimes in OECD countries and these were listed in the OECD's 2000 Progress Report *Towards Global Tax Cooperation* (hereafter the 2000 Report) (OECD, 2000: 12-4). The final substantive recommendation was for the Forum to produce a list of tax havens. However, unlike preferential tax regimes, potential tax havens were not trusted to review their own arrangements. Instead, the Forum conducted external assessments of jurisdictions suspected of meeting the tax haven criteria. The Forum identified 41 jurisdictions which met the tax haven criteria. In mid-2000 six of the accused jurisdictions, Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino, made commitments to eliminate harmful elements of their tax systems. The remaining 35 jurisdictions were placed on a list of tax havens and given until the end of July 2001 to make a commitment to eradicate harmful tax practices by 2005. Failure by a listed tax haven to make a commitment would render it liable to sanctions[2] from OECD countries ranging from the imposition of withholding taxes, levies on transactions and the termination of tax conventions (OECD, 2000: 25).

The OECD's proposals for dealing with harmful tax practices provoked consternation amongst the many small states with OFCs. They argued that the OECD's campaign would undermine, or even force the closure of OFCs in small states, doing irreparable damage to their economies. The outlook for the Caribbean was especially forbidding. All 17 Caribbean small states with OFCs were identified by the OECD's Global Forum on Tax Practices as meeting the tax haven criteria. A serious shrinking of offshore financial activity as a result of the OECD's initiative would have devastating consequences for the regional economy.

The future for tax havens did not seem promising. On the one hand tax haven jurisdictions could decide to make a commitment to the OECD's plans. This would negate the threat of sanctions from OECD countries but the jurisdiction concerned would be compelled to exchange information with foreign tax authorities and would need to introduce measures to make the financial system more

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2 The OECD employs a number of interchangeable euphemisms to describe the punishments for jurisdictions who fail to make a commitment. The 1998 Report refers at various times to 'countermeasures' (OECD, 1998: 40), 'enforcement measures' (OECD, 1998: 58), 'counteracting measures' (OECD, 1998: 10, 38), and 'defensive measures' (OECD, 1998: 38, 40, 52) which would be deployed against recalcitrant territories. This paper uses the term sanctions not in its legalistic sense but as a portmanteau expression to encompass the different OECD terminology.

transparent. These changes would lift the shroud of secrecy that constitutes one of the principal attractions of locating funds offshore, resulting in a loss of business. Alternatively, tax haven jurisdictions could elect to defy the OECD and not make a commitment. Under those circumstances the jurisdiction concerned would appear on an OECD list of uncooperative jurisdictions and would face countermeasures from OECD members. These countermeasures would prohibit or significantly increase the cost of undertaking business in these jurisdictions, prompting investors to flee to more propitious climes. A press statement from the Pacific Islands Forum (2001), many of whose members were being targeted by the OECD, neatly summed up the unenviable choice confronting tax haven countries of 'either committing to the initiative (so suffering possible and immediate to long-term loss of economic activity through the loss of offshore sector clients) or not providing a commitment (and suffering loss of economic activity through the imposition of defensive measures by OECD members).' In either eventuality 'the elements which make offshore financial tools attractive will be removed and so cause the shrinkage or closure of this sector in listed nations' (quoted in Woodward, 2002: 19).

Anxieties about the exodus of business from tax havens were amplified by the absence of a level playing field between OECD and non-OECD members. According to small states, the whole process, from the selection of the OECD to develop rules to govern tax competition through to the assessment of tax practices and the application of punitive measures, was riddled with inconsistencies and systematic biases towards developed countries. Space precludes a detailed discussion of all the different aspects of this uneven playing surface but the main reservations are sketched in Table 2. By far the biggest worry centred on the deployment of sanctions against noncompliant territories. Many in the Caribbean expressed disquiet that two OECD members, Switzerland and Luxembourg, who compete energetically with Caribbean small states for offshore funds, had abstained from the 1998 and 2000 Reports, citing their reluctance to dismantle their secrecy laws and their unhappiness over the criteria used to identify harmful tax practices (OECD, 1998: 73-8). The OECD convention states that when an OECD member abstains from a decision or recommendation the relevant decision or recommendation is not applicable to the abstaining party.[3] By not endorsing the 1998 or 2000 Reports, Luxembourg and Switzerland are not bound by their recommendations and are free to perpetuate harmful tax practices. Small states had little doubt that the OECD would ask its members to use sanctions against noncompliant tax havens in the Caribbean and elsewhere. What was less clear was whether the OECD was ready to countenance punishment of equal severity against its own members if they persisted with harmful tax practices. If the OECD meted out sanctions against tax havens but allowed its own members to maintain their preferential tax regimes the impact on Caribbean OFCs would be calamitous as funds would be drained away to those OECD countries that were not quaking in the shadow of OECD sanctions. Close reading of the 2000 Report suggests that tax haven jurisdictions were right to be suspicious. The report envisages a framework of possible defensive measures with 'regard to Uncooperative *Tax Havens*' (OECD, 2000:25, my

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3 Article 6(2) of the OECD Convention states that 'If a Member abstains from voting on a decision or recommendation, such abstention shall not invalidate the decision or recommendation, which shall be applicable to the other Members but not to the abstaining Member'.

**Table 2: No Level Playing Field: Key Differences in the OECD's Approach to OECD Member Preferential Tax Regimes and Non-OECD Member Tax Havens**

| Issue | Tax Haven | Preferential Tax Regime |
|---|---|---|
| Sanctions | Uncooperative tax havens liable to sanctions by OECD members | Unclear whether OECD sanctions will apply against OECD members who persist with preferential tax arrangements |
| Timetable | Sanctions could apply as early as July 2001 | Sanctions would not apply until 2003 at the earliest |
| Consultation/Membership of Globa lForum on Tax Practices | Dependent on Commitment | Automatic |
| Assessment | Tax practices assessed externally by OECD's Global Forum on Harmful Tax Practices | Self-assessment |
| Advance Commitment | Required to submit separate advance Commitment harmful tax competition | OECD members automatically committed to eliminating elements of |
| Use of Language | Tax practices designated as 'harmful' | Tax practices designated as *'potentially'* harmful |
| Listing | Non-committed tax havens to appear on List of Uncooperative Tax Havens | No plans for non-committed OECD members with preferential tax regimes to appear on List of Uncooperative Tax Havens |

emphasis). There is no mention of similar provisions being made for uncooperative *preferential tax regimes*. The International Tax and Investment Organisation (ITIO)[4] (2002) reported that uncertainty over whether sanctions would be applied to OECD countries was already causing a discernable trend of business being transferred to Switzerland in order to protect it from potential sanctions in the Caribbean and elsewhere. The OECD's pronouncements have done little to allay these uncertainties. Indeed OECD officials have resorted to sophistry to disguise these double standards. When asked directly whether 'the defensive measures will apply to uncooperative OECD countries' Jeffrey Owens, the Head of the OECD's Centre for Tax Policy and Administration, trotted out the OECD's party line that 'there is only going to be one distinction: cooperative versus unco-operative' (Owens, 2002). Despite Owens' reassurances, in practice this distinction has not been applied. The OECD has *never* referred to Switzerland or Luxembourg as uncooperative jurisdictions and Switzerland and Luxembourg were conspicuous by their absence from the OECD's first List of Uncooperative

4 The ITIO was established in March 2001 as a forum for small and developing economies. It 'aims to help members contribute more effectively to the ongoing debate on international tax and investment measures and ensure that development implications are taken into account' (ITIO website). The ITIO has 14 members: Anguilla, Antigua and Barbuda, the Bahamas, Belize, the British Virgin Islands, the Cayman Islands, Cook Islands, Malaysia, St. Kitts and Nevis, St. Lucia, the Turks and Caicos and Vanuatu. The Commonwealth Secretariat, Pacific Islands Forum Secretariat, CARICOM Secretariat and the Caribbean Development Bank and Eastern Caribbean Development Bank hold observer status.

Jurisdictions issued in 2002 despite their continued refusal to commit to the project.

Two further observations are worth making with regard to the absence of a level playing field in the application of sanctions. Firstly, even if the OECD were true to its word and directed sanctions against all uncooperative jurisdictions irrespective of whether they were members or non-members, the fact remained that sanctions could be applied to non-members two years before OECD members. The 2000 Report stated that defensive measures could be applied to non-committed tax havens immediately after the expiry of the deadline for commitments at the end of July 2001. However, the 1998 Report gave OECD members *five* years to remove harmful elements of their preferential tax regimes, meaning that corrective action could not come into force against OECD members until 2003. This two-year hiatus would be disastrous for the Caribbean as money would be funnelled away to OECD jurisdictions still offering tax shelters that Caribbean OFCs had been forced to dismantle. Caribbean financial centres have also pointed out that there is a lack of a level playing field *among non-OECD* members. Places such as Hong Kong, Dubai, and Singapore have significant offshore financial markets and dabble in the kinds of practices dubbed harmful by the OECD, yet none of these jurisdictions have been censured (Langer, 2000: Hay, 2002). Again this poses a threat to offshore centres in the Caribbean as capital will emigrate to jurisdictions which are not cowering beneath the force of OECD sanctions.

The OECD's consultation process has also been criticised for being heavily tilted in favour of OECD members. Many observers questioned the suitability of the OECD as a forum for the development of global standards (Persaud, 2001). Though the OECD has recently launched a number of initiatives to expand and consolidate links with non-members the fact remains that the OECD is a body of 30 advanced industrialised nations where non-members lack a formal voice. The OECD has been accused of adopting an 'exclusionary and confrontational approach' (Hay, 2001) to the issue of harmful tax competition. The OECD has decreed that the only place where the initiative will be officially discussed is in the inaptly named Global Forum on Taxation. The Forum's remit is 'to encourage an ongoing dialogue between fiscal officials in OECD countries and non-OECD economies, allowing for the development of models, standards and guidelines in respect of international tax issues' (OECD, 2002b). On the surface, the development of an institution to foster cooperation with non-OECD members appears to point towards a level playing field. The reality is somewhat different. Recall, for instance, the different way in which the Forum went about assessing tax havens and preferential tax regimes. While OECD countries with preferential tax regimes conducted a self-assessment and peer review, tax havens were the focus of external assessment by the Forum. Secondly, tax haven jurisdictions can only gain admission to the Global Forum after they have committed to eliminate harmful tax practices. This puts tax havens in a difficult position. To influence the direction of the initiative tax haven economies must be members of the Global Forum because this is the only gathering where the project will be debated. However, by assenting to the initiative the tax havens are tacitly accepting that their regimes are harmful and that the methodology proposed by the OECD is the best way of tackling the problem, fatally undermining their bargaining position from the beginning (Sanders, 2002). Finally, OECD countries are automatically eligible for Membership of the Forum even if they have not committed to the initiative. Switzerland and Luxembourg, despite their decision not to commit to the initiative, 'are not excluded from any

Global Forum events to which OECD members are invited'.[5] So while non-committed tax havens are barred from proceedings, Switzerland and Luxembourg are freely able to participate in the Global Forum, giving them an opportunity to consolidate their own position at the expense of their competitors from the Caribbean. This feeling of distrust among small Caribbean states is compounded by the fact that the OECD has permitted over 80 other non-member countries to participate in the Global Forum without having to make prior commitments.

Overall the proposals contained in the 1998 and 2000 Reports put the economies of the many small Caribbean states with offshore financial sectors in grave danger. If tax havens were to sign up to the deal they would lose the business of entities thriving on their opaque financial structures; if they did not sign up the OECD would invoke sanctions which would make them outcasts in the global financial order.

## The OECD's Harmful Tax Competition Initiative: Phase 2 2001 to the Present - the OECD at an Impasse

The belligerence and arrogance of the OECD engendered a spirit of defiance amongst targeted tax havens, especially those in the Caribbean basin. The most vitriolic condemnation of the OECD's proposals emanated from the Caribbean with officials, politicians and business leaders from the region issuing passionate vignettes accusing the OECD of neo-colonialism and a new

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5 E-mail correspondence with Greg Wood of the OECD Centre for Tax Policy Administration (11th February 2003).

imperialism (see, for example, Sanders, 2001). Despite the imminent threat of sanctions Caribbean tax haven jurisdictions did not rush to commit to the OECD's initiative, with only the Cayman Islands (May 2000), the Netherlands Antilles (November 2000) and Aruba (July 2001) committing in advance of the original July 2001 deadline. Meanwhile, Caribbean tax havens used other international fora to draw attention to the iniquities of the OECD's crusade. They used the meeting of the Commonwealth Finance Ministers in Malta in September 2000 to launch a strident attack on the OECD proposals, prompting the Commonwealth to lobby the OECD seeking a more inclusive dialogue on the matter of harmful tax practices. In January 2001 a Joint OECD-Commonwealth meeting was held in Barbados under the chairmanship of the Barbadian Prime Minister Owen Arthur. The meeting agreed to the creation of a Joint Working Group on Global Co-operation on Harmful Tax Practices. This group, comprising 6 developed and 7 developing country representatives and under the joint chairmanship of Owen Arthur and Australia's ambassador to the OECD Tony Hinton, looked to foster a process for the elimination of harmful tax practices that was acceptable to all members. The Working Group met twice in London and Paris in early 2001. However, the talks were acrimonious with neither side prepared to yield ground, and following the Paris conference the OECD signalled that it did not want any further meetings.

With the deadline for commitments looming, the collapse of the Joint Working Group seemed to have removed the Caribbean tax havens' last opportunity to broker a compromise with the OECD. However, in May 2001 the United States added its voice to the chorus of disapproval over the harmful tax competition initiative. The newly elected Bush administration had been the focus of a frenetic lobbying campaign orchestrated by a coalition of free-market, libertarian think-tanks marching under the banner of the Coalition for Tax Competition. These groups regurgitated the case for lower taxes and limited government and reminded policymakers that tax competition of the type the OECD was trying to prevent was one of the foundations of the US economic strategy. Low taxes along with strict secrecy laws for non-resident investors have helped attract over $9 trillion of capital to the US (Mitchell, 2002), dwarfing the losses to the Treasury consequent upon tax avoidance and making it 'the world's biggest beneficiary of tax competition' (Mitchell, 2001). Powerful commercial interests, who had invested heavily in the hope of securing the return of a Republican President, were also unhappy at the prospect of tighter rules governing tax competition. As well as earning a third of their profits in low tax jurisdictions (Mitchell, 2001) US transnationals thought that the auxiliary bureaucracy and higher effective tax rates that would be the concomitant of the OECD's plan would undermine the competitiveness of the US economy. In other words, the abolition of tax competition was presented to the incoming administration as both economically unsound and emphatically not in the United States' national interest.

The Republican government, with its inveterate sympathy towards unfettered markets, was receptive to these views and set about undermining central planks of OECD's initiative. In a press statement in May 2001 US Treasury Secretary Paul O'Neill remarked that the US had 'serious concerns....about the direction of the OECD initiative' (US Treasury Department, 2001). O'Neill reiterated US support for what he called the 'core elements' of the OECD proposals, namely greater transparency and better mechanisms to facilitate the exchange of specific information. However, he expressed concern over the unequal treatment of some non-OECD countries and the presupposition that low or no rates of taxation were inherently harmful. This announcement was a public acknowledgement of months of behind the scenes negotiations between Treasury officials and their counterparts from other OECD countries aimed at securing substantial modifications to the original plans. The other OECD members realising that the governance of tax competition required a collective approach and could not succeed without the backing of the world's largest economy had little option but to acquiesce.

The alterations to the OECD's work on tax havens were unveiled at the G7 Finance Ministers' meeting in Rome in July 2001. Firstly, the project was narrowed with the OECD dropping its call for investment to be linked to substantial business activities. Commitments from tax havens would now only be sought in connection with ensuring transparency and the exchange of information. Secondly, the OECD guaranteed that co-ordinated defensive measures would not be applied to non-OECD tax havens any earlier that they would be applied to an OECD member hosting a preferential tax regime. Finally, tax havens were to be given extra time to make a commitment with the deadline being put back to the end of November 2001 (Group of Seven Finance Ministers 2001). Later that year the OECD's 2001 progress report on the harmful tax practices initiative confirmed these changes and further extended the deadline for commitments to the end of February 2002 (OECD, 2001a: 9-10). Two further OECD members, Belgium and Portugal, joined Switzerland and Luxembourg in abstaining from the report.

Though it may seem trivial, it was the second of these changes which brought the OECD juggernaut grinding to a halt. As the closing date for commitments approached, all Caribbean tax havens, with the exception of Barbados, pledged to abide by the OECD's rules. However, they inserted a clause into their commitments which stated that 'The commitment is offered on the basis that..........those jurisdictions, including OECD Member countries and other countries and jurisdictions yet to be identified, that fail to make equivalent commitments or to satisfy the standards of the 1998 Tax Competition Report, will be the subject of a framework of co-ordinated defensive measures....'.[6] This means the commitments offered by tax havens will not be binding unless the OECD can secure the elimination of harmful tax practices among its own members or unless it signals its willingness to recommend coercive action against its own members harbouring preferential tax regimes. The continued intransigence of Switzerland and Luxembourg, the new-found opposition of Belgium and Portugal, plus the rapidly evaporating enthusiasm for rules to govern tax competition in Washington suggest that full compliance of OECD countries with the stipulations of transparency and information exchange is unlikely to be forthcoming in the near future. Furthermore, the idea that OECD countries would take corrective action against the US if it failed to comply simply lacks credibility. Nevertheless until these conditions are fulfilled, the promises made by tax havens are "virtually meaningless" (Mitchell, quoted by the Centre for Freedom and Prosperity 2002).

Thus, the OECD harmful tax competition initiative reached an impasse. By March 2002 all but eight of the original 41 jurisdictions considered by the OECD to be tax havens had made a commitment, but none of these

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6 Copies of the letters of commitment from tax havens are available from the OECD's website at http://www.oecd.org/EN/document/0,,EN-document-103-nodirectorate-no-4-4393-22,00.html.

undertakings would become 'live' without reform amongst OECD nations. Undaunted by these setbacks, in April 2002 the OECD went ahead with its threat to publish a list of noncompliant jurisdictions. Of the eight jurisdictions that had not made a commitment, one, Barbados, reached a deal with the OECD in January 2002. Following intense discussions, the OECD accepted that Barbados' arrangements for informational exchange and transparency were adequate and agreed that the territory would not appear on the forthcoming list of uncooperative jurisdictions. The other seven jurisdictions (Andorra, Liberia, Liechtenstein, the Marshall Islands, Monaco, Nauru and Vanuatu) were listed as uncooperative tax havens and, notionally at least, were liable to sanctions from the OECD.

## Conclusion - The Future for Caribbean OFCs

In the short-term the OECD's harmful tax competition initiative has had a happy ending as far as Caribbean OFCs are concerned. The OECD's inaugural list of uncooperative tax havens contained no jurisdictions from the Caribbean, meaning that for the time-being the region's OFCs have averted the threat of sanctions. Moreover, by publicly committing to the plans, small states in the Caribbean have demonstrated that they are responsible members of the international community, prepared to abide by internationally agreed rules aimed at ensuring the smooth running of the global financial system. At the same time the potential fallout from the OECD project has raised concerns about the long-term viability of OFCs.

The OECD project emphasised how vulnerable OFCs are to exogenous policy shocks. On this occasion Caribbean OFCs were saved from what were likely to have been the extremely negative effects of an international initiative by the fracturing of the political coalition driving the harmful tax competition agenda. Next time, Caribbean tax havens may not be so fortunate. Though the OECD initiative looks moribund the battlefield for greater financial transparency has not been abandoned completely. In early 2003 the European Union (EU) finally secured agreement amongst its own members to exchange banking information or to apply withholding taxes so that the savings of their citizens being held in other EU member states could be taxed. Initially, it was thought that any such agreement within the EU might benefit the Caribbean as funds were relocated outside the EU in order to circumvent these rules. To combat this the EU has asked its members to ensure that their dependent territories adopt matching procedures with regard to the exchange of information or to agree to impose a withholding tax. In other words, the EU is asking Caribbean OFCs to implement an almost identical set of policies to those previously being demanded by the OECD. However, in a similar way to the OECD initiative, the agreements with Caribbean centres will only come into force when the European Council is satisfied that 'equivalent measures' are being applied in the US, Switzerland, Liechtenstein, Monaco, Andorra and San Marino. Continued lobbying and intense Congressional antagonism to the EU's policy make it unlikely that the US would adopt these measures. Nevertheless, it is a further indication of the continued threat posed by international initiatives.

A series of unfortunate international events has also given the agenda for financial and fiscal transparency new momentum. Following the terrorist attacks of September 11th and the corporate scandals afflicting Enron and Worldcom the US suddenly rediscovered its interest in financial transparency. Since then, the US has 'used its "persuasive powers" to bully tax information exchange agreements' from a number of Caribbean tax havens including the Cayman Islands, the British Virgin Islands and Antigua (*Observer*, 2002). The desire to crackdown on money laundering has also allowed the OECD to open up a second front in the war on secrecy. In November 2001 it issued a report entitled *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* which called upon governments to eliminate measures that conceal the beneficial owners of corporate vehicles (OECD, 2001b). The report has been criticised for precisely the same reasons as the OECD's work on taxation: there was no consultation with, and it focuses solely on corporate entities in, non-OECD member countries (International Tax and Investment Organisation and The Society of Trust and Estate Practitioners, 2002). This again shows that attacks on secrecy and the dangers that the elimination of such practices would bring to Caribbean OFCs will not go away.

On a more positive note, one might question whether it matters that financial services are vulnerable to the whims of international policymakers. As the introduction made clear, the peculiarities of small states mean that almost any development strategy cannot be insulated from a capricious global economy. The dispute over the EU's banana regime has shown that even the more traditional industries cannot be inoculated against the vagaries of international policymaking. Finally, one must not underestimate the ingenuity of financial practitioners in outflanking regulatory constraints. Despite being burdened under an avalanche of new international codes and standards in recent years OFCs have continued to grow faster than ever. This suggests that while international regulation has certainly challenged the fertile minds of financial practitioners, the capacity of financial markets to innovate and provide a ceaseless stream of new products will probably ensure the survival of OFCs in the Caribbean in the years ahead.

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# Measuring Vulnerability: Prospects for Evaluating Public Expenditure

*Godfrey St. Bernard*

## Introduction

Public expenditure is based principally upon revenues that accrue from direct and indirect taxes, loans from a variety of lending agencies, grants from donor agencies and, to a lesser extent, the sale of public goods and services. Needless to say, such expenditure is limited in supply and public spending has to be undertaken in a manner that will maximize public gain at minimal cost. Taxpayers, whether they be members of households or corporate entities, have been accumulating wealth and could derive great utility from that portion that assumes the form of direct and indirect taxation. Loans bestow debt burdens that transcend successive generations to the extent that current governments have obligations to manage them prudently, in addition to fostering the public good. Given the competition for scarce resources such as grants, governments are faced with the onerous task of demonstrating diligence and rationality in the disbursement of public funds and therefore have to be accountable.

In the Anglophone Caribbean, governments have traditionally disbursed public funds in areas such as education, health, national security, infrastructural development, public utilities and social services. Notwithstanding the necessity to make such provisions and the enormous outlays that have characterized such disbursements, countries in the Caribbean Sub-Region continue to exhibit unacceptable levels of achievement in educational spheres, critical challenges in the delivery of health care, the persistence of threats to national security as evidenced by the burgeoning levels of serious crime and public misdemeanours, and gross inequalities in the quality of housing and access to basic human needs. Social service delivery has usually targeted disadvantaged groups such as the poor and those classified as vulnerable. These are concerns that transcend economic decision-making and have implications for public policy formulation, implementation, monitoring and evaluation.

This chapter is presenting a framework that will permit countries to evaluate their vulnerability status. Its focus is upon vulnerability at national levels to the extent that it becomes a critical criterion in shaping decisions about public expenditure and national budgetary allocations. At national levels, thrusts toward enhancing vulnerability status strive to ensure that key social attributes attain desirable levels that would enable sub-institutional domains within nations to resist, recover, and rebound from threats that have their origins in external sources. St. Bernard (2003) has articulated a position on social vulnerability as an experience that is variable cross-nationally and becomes manifest in accordance with variations in vulnerability status as it relates to five key sub-institutional domains - education, health, security, social order and governance, resources allocation and communications architecture. While acknowledging that these domains are instrumental in the establishment of sub-indexes of social vulnerability, all of which combine linearly to construct a national index, the chapter also recognizes that the sub-domains represent some of the principal arenas where public funds ought to be disbursed to facilitate public well-being and satisfy key requirements of public policy.

The construction of a social vulnerability index embracing the proposed framework has substantial utility for individual countries. The chapter posits that social vulnerability transcends poverty and human development insofar as it goes beyond the intrinsic character of a nation's citizenry to secure their basic human needs and capitalize upon exposure to opportunities for development based upon their educational, health and wealth creation attributes. While taking some of these attributes into account, it also considers a number of additional attributes that collectively provide a basis for evaluating social vulnerability status. With respect to the potential for resilience in terms of nations' ability to recover and rebound, the proposed framework is based upon indicators that constitute indirect measures of intrinsic character and resilience, the two being important insofar as the former is considered to be an indicator of resistance to external threats while the latter might be considered to be an indicator of resilience.

Within the sub-institutional domains, the proposed framework posits that indicators constitute indirect measures of intrinsic character and resilience. Such indicators could be used to gauge vulnerability status in the respective domains to the extent that variations in vulnerability could be assessed in relation to variations in public expenditure within the respective domains. This rests on the premise that public expenditure should strive to enhance the intrinsic character of nations within each of the five domains. In addition, such expenditure should focus upon promoting greater levels of resilience by strengthening the capacity of the domains to resist the onslaught of external threats and where necessary, facilitate cost-effective efforts towards recovery and sustenance. This means that the proposed framework has the potential for determining the domains that are likely to be the most critical in increasing the vulnerability of nations to external threats. More important, the proposed framework is likely to provide an empirical basis for monitoring and evaluating the impact and effectiveness of efforts to reduce the vulnerability status of nations.

**Table 1: Gross National Income (GNI) Per Capita (PPP US$)[1] of Developing Regions and Selected Caribbean Countries, 2000**

| Regions/Countries | GNI per Capita 2000 (PPP US$) |
|---|---|
| Northern Africa | $3,500 |
| Western Africa | $1,030 |
| Eastern Africa | $880 |
| Middle Africa | $1,000 |
| Southern Africa | $8,160 |
| Central America | $7,490 |
| South America | $7,070 |
| Western Asia | $5,920 |
| South Central Asia | $2,370 |
| South East Asia | $3,450 |
| East Asia | $6,280 |
| Bahamas | $17, 012 |
| Barbados | $15,494 |
| St. Kitts/Nevis | $12,510 |
| Antigua and Barbuda | $10,541 |
| Trinidad and Tobago | $ 8,964 |

1. Purchasing Power Parity US$.

**Source:** Population Reference Bureau (2002).

**The Caribbean: Counter-Balancing Social and Economic Conditions**

This chapter recognizes that the majority of countries in the Caribbean Sub-Region need to improve their performance in social arenas despite exhibiting favourable economic indicators. In 2000, in countries such as the Bahamas, Barbados, St. Kitts and Nevis, Antigua and Barbuda, and Trinidad and Tobago, GDP per capita in PPP US$ was estimated to be $17,012, $15,494, $12,510, $10,541 and $8,964 respectively (Population Reference Bureau, 2002). On examining Table 1, the five countries have exhibited economic performance at levels substantially higher than those for the set of countries that comprise the different regions of the developing world. With reference to the proportion of the population 15-49 years with HIV/AIDS at the beginning of 2001, the percentage in the Caribbean Sub-Region (2.4%) was higher than those of all of the other regions where the percentage was less than 1 %. In contrast, it was lower than those observed in Western, Eastern, Middle and Southern Africa (5%, 9.7%, 6.3% and 21.6%).

With respect to HIV/AIDS in the Caribbean, the highest rates of prevalence were evident in Haiti (6.1%), the Bahamas (3.1%), the Dominican Republic (2.7%), Guyana (2.7%) and Trinidad and Tobago (2.5%). Insofar as these estimates are likely to be biased downwards, the Bahamas and Trinidad and Tobago find themselves in a worrisome situation despite the current performance of their respective economies. Judging by the standards of the Caribbean Sub-Region at the dawn of the new millennium, Trinidad and Tobago has also been observed to have one of the lowest levels of life expectancy at birth, irrespective of gender. Only the Dominican Republic and Haiti were observed to have had markedly lower levels. On examining gross enrolment at primary, secondary and tertiary levels, proportions of less than 70% were generally observed for Caribbean countries, the exceptions being the Bahamas (74%), Barbados (77%), St. Kitts and Nevis (70%), Cuba (76%), St. Lucia (70%) and Belize (73%). Of the 53 countries classified as having high levels of human development, 44 were observed as having gross enrolment of at least 70%. This has implications for a country such as Trinidad and Tobago where the corresponding gross enrolment rate is 65 % and ought to be at least 70% to be consistent with levels observed for the majority of countries that are classified as having high levels of human development.

In 2002, a number of Caribbean countries have witnessed the persistence of high levels of violent crime assuming the form of homicides. There were in excess of 1000 murders in Jamaica, in excess of 200 in Guyana and 172 in Trinidad and Tobago. These figures are indicative of levels of social vulnerability pervading national social systems in the respective countries. Specifically, they are indicative of the incapacity of the respective legislative and law enforcement structures and symbols to overcome threats from external sources whether extra-national or intra-national as in cases where threats may emerge in other sub-national institutional settings.

## Reviewing Conceptions of Vulnerability

From a layperson's perspective vulnerability is synonymous with susceptibility and defencelessness. In development studies, vulnerability is evaluated in the context of socio-economic units that embrace cultural dimensions in the form of material and non-material culture. These units are tantamount to institutional settings characterized by several sources of disempowerment that are the genesis of their inherent vulnerability. In order to counteract such vulnerability, one ought to ascertain the presence of factors that contribute towards and foster the persistence of forces of disempowerment. Thus, overcoming vulnerability implies the realization of empowerment processes that, from a social perspective require social systems to strengthen their material and non-material bases. Collectively, such achievements should promote and sustain levels of resilience within social systems rendering them less vulnerable to a host of external threats. In essence, they contribute towards the sustainability of social systems.

In defining social sustainability, Chambers and Conway (1991) made reference to a "livelihood" as "a means of living and the capabilities, assets and activities required for it". They have defined social sustainability as "the ability of a human unit (individual, household or family) to cope with and recover from stresses and shocks, to adapt to and exploit changes in its physical, social and economic environment, and to maintain and enhance capabilities for future generations." Barbier (1987) treats with the symbolic aspects of social systems and social institutions in his conception of social sustainability. Specifically, he defines social sustainability as "the ability to maintain desired social values, traditions, institutions, cultures, or other social characteristics." St. Bernard (2003) argues that social vulnerability can be defined as the converse of social sustainability. Such a conception of social vulnerability lends itself to interpretation in accordance with the definitions of social sustainability offered by Chambers and Conway (1991) and Barbier (1987).

Embracing a United Nations notion of a sustainable process, one can identify a number of principal domains of action - economic, political, environmental, social and cultural. Accordingly, a development process is sustainable insofar as it is economically viable, politically feasible, environmentally responsible and social and culturally acceptable. By being economically viable and politically feasible, a sustainable development process can be evaluated in terms of rationality and efficiency. By being environmentally responsible, such a process could be evaluated in terms of conservation while the criterion of social and cultural acceptability could be gauged according to levels of participation, representation, transparency and justice. In essence, such a conception implies that rationality, efficiency, conservation, participation, representation, transparency and justice ought to be critical dimensions in evaluating social vulnerability.

Economic conceptions of vulnerability have traditionally pervaded the literature. Several contributors including Briguglio (1995; 1997 and 1998), Crowards and Coulter (1999) and Guillaumont (1999) have grappled with the concept of economic vulnerability. In a seminal paper on the subject, Briguglio (1995) defined economic vulnerability[1] as "fragility and lack of resilience in the face of outside forces." His primary focus was to establish a framework for measuring economic fragility or the inability of an economic system to resist or be resilient in the face of external threats in the form of shocks and

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1 According to Briguglio (1995), economic vulnerability is measured by a composite index that is computed as a result of averaging five sub-indices that are as follows: trade openness (exports, imports as a ratio of GDP), export concentration, peripherality (transport and freight costs in relation to foreign trade), energy dependence (imported energy as a ratio of energy consumed) and financial dependence (aid or international debt as a ratio of GDP).

stresses.[2] This is consistent with the notion of social vulnerability defined as the converse of social sustainability. It hinges upon the idea that vulnerability, in any of its forms, is a function not only of a system's susceptibility to decay or degradation but also its ability to protect itself or recover, having been exposed to stresses and shocks from outside forces.

The literature also refers more specifically to a geo-economic conception that UWICED (2002) interpreted as "the risks faced by economies from exogenous shocks to the systems of production, distribution (including and especially markets), and consumption." From another standpoint, the geo-economic conception is concerned with the implications of "smallness" in terms of country-size, insularity and remoteness. These geographic criteria have implications that become manifest in the limitations facing economic outcomes such as natural resource endowments, import substitution possibilities, domestic market size, ability to influence domestic prices due to export dependence, ability to exploit economies of scale, the capacity to promote domestic competition and the optimal allocation of human resources (Streeten 1993). "Smallness" is associated with high import content and a greater dependence on export markets while insularity and remoteness are associated with high per unit transportation costs, uncertainty of supplies and the accumulation of large stock (Briguglio, 1995).

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2 Chambers and Conway (1991) define shocks as "impacts which are typically sudden, unpredictable, and traumatic, such as fires, floods, storms, epidemics, thefts, civil disorder and wars". Stresses, on the other hand, are "pressures which are typically cumulative, predictable and variously continuous or cyclical, such as seasonal shortages, rising populations, declining soil fertility, and air pollution."

The South Pacific Applied Geoscience Commission (SOPAC) based in Fiji has been the agency at the forefront in the establishment of a methodological framework to gauge variation in environmental vulnerability. With reference to environmental systems, Kaly *et. al.* (1999) define vulnerability as "the potential for attributes of a system to be damaged by exogenous impacts." Their primary focus has been on damage[3] and degradation due to the activities of humans and the force of nature. This is captured by a methodological framework consisting of forty-nine indicators reflecting variations in human activities and natural systems. UWICED (2002), in addressing environmental vulnerability, notes that it is concerned with "the risk of damage to a country's natural ecosystems (e.g. coral reefs, wetlands, fresh water, coastal areas and marine resources, forests, and soils)."

So far, this discussion reinforces the view that vulnerability is a complex, multifaceted construct that transcends poverty and capabilities to produce economic goods and services. Moser (1996) defines vulnerability as "the well being of individuals, households or communities in the face of a changing environment." In so doing, she notes that environmental change is due to threats that can be described as ecological, economic, social and political, and may either be long term or seasonal. This line of thinking is consistent with a negative association between levels of well being and vulnerability. Moser also recognizes that vulnerability is a function, not only of the threats to resisting, but also the threats to recovering in response to the negative effects associated with the different categories of environmental changes. She

3 With reference to the environmental vulnerability index, Kaly and Pratt (2001) note that damage represents 'the loss of diversity, extent, quality and function of ecosystems."

associates vulnerability with asset ownership so that a greater proliferation of favourable assets is associated with a lower risk of exposure to vulnerability. For Moser, the primary units of analysis have been the individual, the household and the community. In conclusion, vulnerability, in its broadest sense, can be assessed according to the capacity of individuals, households, communities and nations to sustain, regain and enhance well-being in the face of persistent threats from external forces.

With respect to social vulnerability, UWICED (2002) focuses its attention upon societies or socio-economic groups of people and the degree to which such entities are negatively affected by stresses and hazards emanating from within or due to external forces. The UWICED also notes that "social vulnerability is characterized by increased growth in criminal activities, growing rates of HIV/AIDS infection, growing rates of children dropping out of school, declining age of prison population, declining public health, rotting public infrastructure and migration of skilled professionals." Though not relevant in this context, other conceptions of social vulnerability focus upon the "resilience" and "fragility" dimensions of units such as individuals, families and communities. In such cases, the main focus is upon the quantity and quality of resources and assets characterizing individuals, families and communities rendering them capable or incapable of adjusting to sudden shocks in social systems. In the context of individuals and families, reductions in vulnerability are manifest when their inherent resources and assets empower individuals raising their living standards or at a minimum, maintaining it in response to situations that threaten it. From the standpoint of social entities such as individuals and households, CEPAL (2000) notes that resources and assets assume the form of labour force characteristics, human capital, productive resources, social capital and family relationships. These attributes are deemed to be critical to the defence mechanism of individuals, households and communities and likely to become manifest at national levels in their quest to combat and overcome threats posed by sudden shocks.

## Towards Evaluating Vulnerability in the Caribbean Sub-Region

In the context of development studies, vulnerability as a concept was popularized during the 1980s and had its roots in a Conference on Small States held in Malta during 1985. In April-May 1994, vulnerability as an issue was placed centre-stage when the United Nations Conference on Small Island Developing States (SIDS) was convened in Barbados. Since that time, there have been laudable efforts to understand the implications of vulnerability in development spheres and particularly in applied research. To date, the main thrusts have been in the direction of evaluating vulnerability from the standpoint of the economic and environmental circumstances of SIDS. The SIDS have generally been located in tropical and subtropical latitudes in major seas and oceans including the Mediterranean and Caribbean Seas, the Atlantic Ocean, the Indian Ocean and in the South Pacific.

Interestingly, core researchers from different regional SIDS have embraced substantively different foci in their efforts to understand vulnerability in the context of development. In the Mediterranean, for example, the thrust has been overwhelmingly towards the development of methodologies to determine variation in vulnerability status with a bias towards its economic dimension. In the South Pacific, on the other hand, a great deal of attention has been channelled in the direction of measuring environmental vulnerability. In the Caribbean Sub-Region, social problems abound and the Social Affairs Division, Economic Commission of Latin America and the Caribbean

United Nations Economic Commission for Latin America and the Caribbean (ECLAC) is cognizant of such developments and has implemented processes to effect change. The UWICED (2002) has expressed some thoughts on the question of social vulnerability.

Given its commitment to linking development with social equity, the ECLAC through its Sub-Regional Headquarters for the Caribbean has embraced opportunities to foster initiatives that strengthen the delivery of social statistics to support evidence-based social policy. Towards such an end, the ECLAC sought to embark upon a regional database project through its Social Affairs Division. By virtue of its mandate, the ECLAC is seeking to enhance social conditions and promote social equity in myriad institutional settings across the twenty-three countries and associated states that fall within its jurisdiction. In particular, the ECLAC has recognized the importance of evidence-based social policy analysis within the Caribbean Sub-Region and has been leading a paradigmatic shift resulting in the full-scale adoption of evidence-based approaches to social policy decision-making. Apart from improving social indicators to inform social policy, a principal initiative of the ECLAC is to develop a statistical database that should provide the means to monitor and evaluate vulnerability status at sub-national and national levels within member countries and associated states.

The measurement and appraisal of social and economic systems are mandatory requirements in order to evaluate countries on the basis of their prospective levels of dependence on financial assistance and aid from funding and donor agencies. Judging from the development literature, efforts to appraise these systems transcend assessments of poverty status, level of economic activity and capacity to spawn human development. Despite having high vulnerability status, some countries continue to exhibit low levels of poverty, high levels of economic growth and high prospects for human development. Chambers (1989) emphasized the importance of being able to make a distinction between poverty and vulnerability, a distinction that could be easily overlooked despite the fact that individuals, households, communities and nations may exhibit high levels of vulnerability despite not being afflicted by a high prevalence of poverty. This chapter draws attention towards the prospect of evaluating variations in vulnerability status based upon proposed measures of vulnerability. During the 1990s, there have been tremendous scholarly efforts toward the establish-ment of indexes to measure vulnerability whether in an economic context (Briguglio, 1995 and 1997; Chander, 1996; Pantin, 1997; Wells, 1997; Atkins *et al.*, 1998; Crowards and Coulter, 1999 and Guillaumont 1999), environmental dimension (Ribot 1996; Kaly *et al.*, 1999 and Kaly and Pratt, 2001), natural disasters (Pelling and Uitto 2001 and Crowards 2000) or social spheres (CEPAL, 2000; UWICED, 2002 and St. Bernard, 2003).

In order to demonstrate the impact of vulnerability on development status as adjudged in accordance with the gross domestic product, Briguglio (1995) examined indicators of vulnerability and per capita domestic production for selected Caribbean countries. While countries such as Antigua and Barbuda, Barbados and the Bahamas had been observed to have favourable international rankings on GDP per capita (78, 88 and 91 respectively in relation to 114, the highest rank, the three countries had also been observed to be among the most vulnerable internationally. Antigua and Barbuda was observed to be the most vulnerable, ranking 1, while the Bahamas and Barbados were ranked 11 and 20 respectively. Briguglio also ranked the development status of countries based upon adjusting the per capita GDP indexes in accordance with variations in vulnerability indexes. The end result was labelled a vulnerability adjusted development index that was indicative of the impact that vulnerability could, in fact, be having in lowering the development status of the three countries. This decline was most pronounced in Antigua and Barbuda and more modest in the Bahamas and Barbados.[4] In this regard, Briguglio's focus had primarily been on the economic dimension of vulnerability and its impact upon a purely economic evaluation of development status.

With respect to measuring vulnerability status inter-spatially and intra-spatially, this chapter acknowledges that the vast majority of methodological work has been directed towards the economic and environmental dimensions of vulnerability. It also recognizes that little or no attention has been placed upon measuring the social dimension of vulnerability. In order to address the latter, the chapter advances some thoughts on a systematic framework toward evaluating variations in vulnerability status in Caribbean countries. It considers this to be an essential initiative because social vulnerability is deemed as sharing a symbiotic relationship with economic and environmental states. Any evaluation of such a relationship is a difficult and challenging prospect that could only be tackled on the basis of attempts to operationalize the underlying conceptual properties that engage the attention

4 Based upon per capita GDP, the development status of Antigua and Barbuda, the Bahamas and Barbados was ranked as follows: 78, 91 and 88 respectively where 114 was the highest rank. When development status is adjusted for variations in vulnerability status, the respective rankings were as follows: 21, 72 and 68 where 114 was the highest rank.

of stakeholders who have a vested interest in the relevance of vulnerability in human and national development initiatives.

## Disciplinary Influences and Vulnerability Status

Insofar as attempts to measure vulnerability are multifaceted, it is not surprising that such attempts have focused upon approaches that traverse disciplinary boundaries. In the main, disciplinary influences have embraced three substantive arenas – the geo-economic, the ecological/environmental and the social. In the quest to measure vulnerability status, most contributions have either followed the geo-economic or the environmental approaches. In such cases, the primary unit of analysis has been the nation and the sources of data have mainly been official statistics either from administrative records or survey data resulting from the administration of questionnaires to suitably qualified observation units. As stated earlier, thrusts toward the evaluation of social vulnerability have not been as commonplace as those toward the evaluation of geo-economic and environmental vulnerabilities. This could be a function of the nascent stage of social measurement in developing countries and SIDS in particular.

## Reviewing Established Vulnerability Indexes

**Economic Vulnerability:** In the context of attempts to measure economic vulnerability in SIDS, Briguglio (1995) provides one of the major contributions. For example, he identified three principal domains, these being (i) exposure to foreign economic conditions, (ii) remoteness and insularity and (iii) proneness to natural disasters. Given this framework, exposure to foreign economic conditions may become manifest in terms of (i) the degree to which an economy depends upon foreign trade (imports and exports), (ii) the degree to which an economy depends upon a narrow range of exports, (iii) the degree to which an economy depends upon imported technologies and imported expertise and (iv) the degree to which an economy is a price taker. Briguglio noted that an indicator such as the ratio of exports and imports to GDP constitutes a reasonable indicator of exposure in accordance with item (i). Given the high correlation between item (i) and each of items (ii) to (iv) and the fact that requisite data for items (ii) to (iv) were unavailable for the majority of countries, Briguglio surmised that the ratio of exports and imports to GDP would constitute a reasonably good indicator of exposure to foreign conditions. With respect to remoteness and insularity, the proposed indicators were (i) the ratio of FOB/CIF factors and (ii) the ratio of transportation and freight costs to export proceeds. For the purposes of measuring economic vulnerability, Briguglio argued that it was more meaningful to use item (ii). The third principal domain, disaster proneness[5] is measured in terms of money damage relative to the GDP of a given country. Altogether, three indicators have been combined to compute economic vulnerability.

5 Based upon a total index that is estimated to reflect damages over a 20-year period, the United Nations Disaster Relief Organization (UNDRO) has computed an average index that is indicative of damage per disaster. It is predicated on the fact that damage causes funds to be channeled away from productive initiatives.

According to Crowards and Coulter, economic vulnerability (V) is represented as follows:

$$V = Average\ (F, E, C^1, C^3, O, D^1, D^3, A, I)^6$$

where dimension 1 - peripherality and energy is associated with $F$ and $E$, dimension 2 – export concentration associated with $C^1$, $C^3$ and $O$, dimension 3 – export destination associated with $D^1$ and $D^3$, and dimension 4 – external finance associated with $A$ and $I$. Essentially, each of the dimensions that are linearly combined to obtain measures of economic vulnerability is, on its own accord, a linear combination of at least two of the nine indicators.

In both cases, the principal unit of analysis is the national economy of countries. The input data have generally been obtained from official statistical sources and are usually included on the basis of hypothesized or

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6 According to Crowards and Coulter (1999), the notation in the vulnerability function represents the following: freight and insurance costs as a percentage of imports CIF (F), net energy imports as a percentage of total energy consumption (E), the proportion of total exports represented by the top one export category ($C^1$), the proportion of total exports represented by the top three export categories ($C^3$), total export receipts as a percentage of GDP (O), the proportion of total exports converging on the top one export destination ($D^1$), the proportion of total exports converging on the top three export destinations ($D^3$), the ratio of overseas development assistance disbursement to gross fixed capital formation (A) and the ratio of the flow of foreign direct investment to gross fixed capital formation (I).

theoretical linkages. It should also be borne in mind that an *index* constitutes an indirect attempt to measure a construct and at best, a primary option is the specification of a combination of measurable indicators that may be regarded as reasonable proxies for the construct of interest. To this end, every effort to establish a methodological framework to measure vulnerability is expected to result in a different measurement model that can only be validated on the basis of empirical assessments.

**Environmental Vulnerability:** Kaly and Pratt (2001) saw vulnerability in terms of the risks that affect human and natural systems. They consider environmental vulnerability to be "the extent to which the natural environment is prone to damage and degradation." In this context, damage is defined in terms of "the loss of diversity, extent, quality and function of ecosystems." The establishment of a methodology for measuring variability in environmental vulnerability has its roots in the South Pacific Applied Geoscience Commission (SOPAC). Insofar as vulnerability has been defined in terms of "risk" and "resilience", the notion of an environmental vulnerability index hinges upon three sub-indexes, one focusing upon risk and two upon resilience. Altogether, the environmental vulnerability index (EVI) is expressed as a linear combination of three sub-indexes – a risk of exposure sub-index (REI), an intrinsic resilience sub-index (IRI) and an extrinsic resilience or environmental degradation sub-index (EDI).

For the purposes of computing the EVI,[7] the data collection targeted forty-nine indicators that had been reduced to the three sub-indexes.[8] Each of the forty-nine indicators was classified as either meteorological, geological, biological, anthropogenic, geomorphological or biogeographical. Generally speaking, the risk of exposure sub-index is a function of meteorological, geological and biological indicators as opposed to the extrinsic resilience sub-index that is based upon anthropogenic indicators.

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7 The data collection exercise undertaken by SOPAC in the South Pacific targeted 13 countries. The natural systems of these countries constituted the unit of analysis and the requisite input data assumed the form of a country profile consisting of the 49 indicators. Pratt *et. al.*, (2001) provide some useful insights into efforts to obtain environmental profiles of the countries in the South Pacific. While 100% coverage was targeted, the minimal requirement for completeness was set at 80%. Having developed the data collection instrument, the EVI team visited countries participating in the exercise and discovered a number of problems including the prospect of identifying sources of data, accessibility, completeness, data quality and capacity. Only 6 countries satisfied the minimal requirement of at least 80% completion of the data collection instrument.

8 According to Kaly *et al.*, (1999), the REI is indicative of the frequency and intensity of natural and human stresses and shocks that are likely to affect ecosystems. The IDI is indicative of the infrastructural features that render an ecosystem more or less capable of resisting the threats from human or natural sources. The EDI is indicative of the level of degradation that is characteristic of an ecosystem and its cumulative effect on the vulnerability of the ecosystem. Of the 49 indicators, 26 were associated with REI, 16 with EDI and 7 with IDI. Moreover, 6 indicators defined as meteorological, 3 as geological, 8 as biological, 25 as anthropogenic and the remaining 7 as either geomorphological or biogeographical.

The intrinsic resilience is a function of geomorphological or biogeographic indicators. Each indicator is measured on a Likert Scale with response categories ranging between 1 and 7 with "one" being indicative of a low risk of vulnerability and "seven" being indicative of a high risk of vulnerability. For every country, the EVI profile is a composite function of the scores ranging from 1 to 7.

## Measuring Social Vulnerability: The Proposed Framework

Whether reference is to individuals, households, communities and nations, resilience is recognized as a critical factor in enabling units to withstand internal and external shocks. According to the ECLAC, resilience is tantamount to an ability that is based on entitlement, enfranchisement, empowerment and capabilities. In attempting to measure social vulnerability, the ECLAC embraces a position that is consistent with conventional interpretations and at each of the four levels, views variation in such vulnerability as the net effect of the competition between social risks and social resilience. This chapter is primarily directed toward permitting measurement at the national level. Nonetheless, it showcases a framework that has been articulated by the ECLAC to measure vulnerability at the different levels including the nation. Table 2 summarizes such a framework according to the social, economic and physical environment, the movement of skilled personnel and organized crime.

It is also worth noting that St. Bernard (2003) has operationalized social vulnerability using the logic of SWOT analysis. He contends:

> ... Every social institutional setting has its strengths and weaknesses, both of which combine to have either a positive or negative effect on social well being.

**Table 2. Schematic Representation of Social Vulnerability: Proposed ECLAC Model**

| Social Risk | Units of Analysis | Social Resilience |
|---|---|---|
| **SOCIAL, ECONOMIC AND PHYSICAL ENVIRONMENT** | | |
| The prevalence of pandemics such as HIV/AIDS and other communicable infections | *Individual, household, community and nation* | The promotion of health well-being |
| Exposure to human-made and natural disasters | *Individual, household, community and nation* | The strength of social capital |
| Exposure to secular forces including increasing rates of dissolution of family units | *Individual, household, community and nation* | The acquisition of adequate levels of education |
| The prevalence of poverty | | The promotion of economic well- being |
| **MOVEMENT OF SKILLED PERSONNEL** | | |
| Attraction of skilled persons to the metropole | *Individual, household, community and nation* | Stable family units |
| Poor working conditions | *Individual, household, community and nation* | Adequate and well-managed labour market with competitive wages |
| Non-competitive wages in sending countries | *Individual, household, community and nation* | Flexible labour supply |
| Weak prospects for personal and professional growth | *Individual, household, community and nation* | The existence of opportunities for personal growth and advancement |

Table 2. **Schematic Representation of Social Vulnerability: Proposed ECLAC Model - Concluded**

| Social Risk | Units of Analysis | Social Resilience |
|---|---|---|
| **ORGANIZED CRIME** | | |
| Violent influences on the domestic and international front | *Individual, household, community and nation* | Adequate health facilities |
| Weak security systems and prospects of increases in self gratification among security officers | *Individual, household, community and nation* | Closely knit communities and strong family ties |
| Increased availability and access to dangerous weapons such as firearms | *Individual, household, community and nation* | Adequate security services |
| The prospect of high levels of corruption among the ruling elite | *Individual, household, community and nation* | Strong democratic framework |
| Increased family disruption and violence | *Individual, household, community and nation* | Adequate ICT |
| Growing demand for illicit drugs e.g. cocaine from the South to the North | *Individual, household, community and nation* | Strong labour market alternatives |

> Such well being might be further enhanced if opportunity structures are in place to the extent that the net effects of strengths and weaknesses complemented by exposure to opportunities permit nations to overcome threats. In the Caribbean Sub-Region, it is highly likely that several countries face a set of threats but their strengths, weaknesses and opportunity structures are likely to vary, resulting in differential outcomes. These outcomes are captured in the form of selected indicators that could be standardized and combined linearly to yield social vulnerability indexes. (St. Bernard, 2003).

St. Bernard has also made reference to the five critical institutional domains - education, health, security, social order and governance, resources allocation and communications architecture and claimed that each can be individually assessed to determine its vulnerability status. In addition, he noted that composite scores for the five domains can be linearly combined in order to derive a national measure of social vulnerability. Interestingly, the risk factors identified in ECLAC's model are operational in the context of the five institutional domains. These domains and their respective indicators are shown in Box 1.

According to St. Bernard (2003), the proposed social vulnerability index is hypothesized as being based upon thirteen (13) indicators. According to Box 2, each input indicator $(X_i)$ assumes a value $x_i$ that is transformed and captured as a new value $a_i$. The value $a_i$ facilitates the computation of a deprivation index $Z_i$ such that:

$$Z_i = (a_i - Min\,A_i)/(Max\,A_i - Min\,A_i)$$

where $Max\,A_i$ represents the maximum value of the transformation of variable $X_i$ while $Min\,A_i$ represents the

**Box 1**
**Proposed Indicators of Social Vulnerability According to Institutional Domains**

**Education:-**

- The proportion of the population 20 years and over with exposure to tertiary level education - E1.
- The proportion of the population 20 years and over that has successfully completed secondary education (i.e. highest level of educational attainment being a minimum of 5 GCE 'O' Level or CXC Basic Subjects or equivalent secondary school leaving qualifications) - E2.
- Adult literacy rate - population aged 15 years and over - E3.

**Health:**

- Life expectancy at birth - H1.

**Security, social order and governance:**

- Indictable crimes per 100,000 population - S1.
- Index of rule of law - S2.
- Measure of minority groups' participation in the economy - S3.
- Measure of new governments' respect for previous governments' commitments - S4.

**Resources allocation:**

- Proportion of all children (under 15 years) belonging to the two poorest quintiles - R1.
- Proportion of working age population (15-64) belonging to the two poorest quintiles with no more than primary school education - R2.
- Proportion of the population (15 years and over) belonging to the two poorest quintiles with no medical insurance coverage - R3.
- Proportion of the population belonging to the two poorest quintiles and living in households where the head was not employed - R4.

**Communications Architecture:**

- Computer literacy rate – population aged 15 years and over - C1.

**Source:** St. Bernard (2003).

**Box 2**
**Transformation of Proposed Indicators of Social Vulnerability According to Institutional Domains**

- **Education #1:** Proportion of the population 20 years and over with exposure to tertiary level education ($x_1$). Then $Z_1$ is based on $a_1 = x_1$, Min $A_1$ = Min $X_1$ and Max $A_1$ = Max $X_1$.

- **Education #2:** Proportion of the population 20 years and over that has successfully completed secondary education ($x_2$). Then $Z_2$ is based on $a_2 = x_2$, Min $A_2$ = Min $X_2$ and Max $A_2$ = Max $X_2$.

- **Education #3:** Adult literacy rate – population 15 years and over ($x_3$). Then $Z_3$ is based on $a_3 = x_3$, Min $A_3$ = Min $X_3$ and Max $A_3$ = Max $X_3$.

- **Health #1:** Life expectancy at birth ($x_4$). Then $Z_4$ is based on $a_4 = x_4$, Min $A_4$ = Min $X_4$ and Max $A_4$ = Max $X_4$.

- **Security, Social Order and Governance #1:** Indictable Crimes per 100,000 population ($x_5$). Then $Z_5$ is based on $a_5 = 1 - x_5$, Min $A_5$ = 1 - Min $X_5$ and Max $A_5$ = 1 - Max $X_5$.

- **Security, Social Order and Governance #2:** Index of Rule of Law[1]: Scale from -2.153 to 1.996 ($x_6$). Then $Z_6$ is based on $a_6 = x_6$, Min $A_6$ = Min $X_6$ and Max $A_6$ = Max $X_6$.

- **Security, Social Order and Governance #3:** Measure of Minority Groups' Participation in the Economy[2] ($x_7$). Then $Z_7$ is based on $a_7 = x_7$, Min $A_7$ = Min $X_7$ and Max $A_7$ = Max $X_7$.

- **Security, Social Order and Governance #4:** Measure of New Governments' Respect for Previous Governments' Commitments[3] ($x_8$). Then $Z_8$ is based on $a_8 = x_8$, Min $A_8$ = Min $X_8$ and Max $A_8$ = Max $X_8$.

- **Resources Allocation #1:** Proportion of all children (under 15 years) belonging to the two poorest quintiles ($x_9$). Then $Z_9$ is based on $a_9 = 1 - x_9$, Min $A_9$ = 1 - Min $X_9$ and Max $A_9$ = 1 - Max $X_9$.

- **Resources Allocation #2:** Proportion of working age population (15-64) belonging to the two poorest quintiles with no more than primary school education ($x_{10}$). Then $Z_{10}$ is based on $a_{10} = 1 - x_{10}$, Min $A_{10}$ = 1 - Min $X_{10}$ and Max $A_{10}$ = 1 - Max $X_{10}$.

- **Resources Allocation #3:** Proportion of the population (15 years and over) belonging to the two poorest quintiles with no medical insurance coverage ($x_{11}$). Then $Z_{11}$ is based on $a_{11} = 1 - x_{11}$, Min $A_{11}$ = 1 - Min $X_{11}$ and Max $A_{11}$ = 1 - Max $X_{11}$.

- **Resources Allocation #4:** Proportion of population belonging to the two poorest quintiles and living in households where the head was not employed ($x_{12}$). Then $Z_{12}$ is based on $a_{12} = 1 - x_{12}$, Min $A_{12}$ = 1 - Min $X_{12}$ and Max $A_{12}$ = 1 - Max $X_{12}$.

- **Communications Architecture #1:** Computer literacy rate - population 15 years and over ($x_{13}$). Then $Z_{13}$ is based on $a_{13} = x_{13}$, Min $A_{13}$ = Min $X_{13}$ and Max $A_{13}$ = Max $X_{13}$.

**Source:** St. Bernard (2003).

**Notes:**

1 Kaufmann, Kraay and Zoido-Lobaton (1999a and 1999b) identify **rule of law** as one of a number of governance clusters. The cluster includes a number of indicators that measure the extent to which individuals and institutions have confidence in and abide by the rules of society. They include "perceptions of the incidence of violent and non-violent crime, the effectiveness and predictability of the judiciary and the enforceability of contracts". Altogether, these indicators should combine to measure "the success of a society in developing an environment in which fair and predictable rules form the basis for economic and social interactions". In general, the **Index of Rule of Law** is captured on a scale from -2.153 to 1.996.

2 **Minority groups' participation in the economy** is measured on the following scale: (from **1**= limited and usually takes place in less important jobs to **7** = equal to that of other jobs). This will be based largely upon the results of expert polls that will have to be conducted to elicit responses on the situation of different countries.

3 **New government's respect for previous government's commitments** is measured on the following scale: (from **1** = does not honour the contractual commitments and obligations of previous regimes to **7** = honour the contractual obligations and commitments of previous regimes). This will largely be based upon the results of expert polls that will have to be conducted to elicit responses on the situation in different countries. This should also take into account measures of the credibility of government's commitment to policies. The latter was identified as an indicator of government effectiveness as specified by Kaufmann, Kraay and Zoido-Lobaton (1999a and 1999b).

minimum value of the transformation of variable $X_i$. For the $i^{th}$ input indicator, the deprivation index $Z_i$ assumes the form of a standard score varying between a minimum of zero *(0)* and a maximum of one *(1)*. In conclusion, the vulnerability index can be computed as $1 - V_i$ where $V_i$ is as follows:

$$V_i = (\Sigma Z_i)/13$$

## Social Vulnerability: Prospective Links to Public Expenditure

In the context of social vulnerability, sources of vulnerability can be detected by examining the magnitude $Z_i$, the standardized score on the $i^{th}$ input indicator and in particular, the social institutional domain that it is linked to in the proposed framework. In general, there is an inverse relationship between the magnitude of $Z_i$ and the prospect of the $i^{th}$ input indicator being a source of vulnerability. Given that the $Z_i$ scores are standardized, they constitute a basis for ranking and comparing the contribution of each of the $i$ indicators to variation in vulnerability status of the 13 indicators. Such a ranking has the potential for flagging specific levers that have to be manipulated to strengthen vulnerability status within specific institutional domains. This provides a basis for evaluating the social impact of sectoral public expenditure within specific domains whether inter-spatially or intra-spatially.

As indicated earlier, public expenditure targets social sectors such as education, health, social services delivery and national security. It ought to strengthen infra-structural bases and build capacity to resist, recover and sustain equilibrium in the face of uncertainty spawned by the persistence of threats whether sudden, emergent, national or international. Apart from being a mechanism for evaluating the social impact of sectoral expenditure, the social vulnerability index and its 13 components have the potential for reinforcing the merit of evidence-based research to justify the disbursement of public funds in the quest to maximize returns on social investment.

## Concluding Remarks

In the majority of Caribbean societies, there is a paucity of data that are needed to yield the indicators that feed into the construction of the proposed index. Such paucity poses a problem for empirically evaluating the proposed framework. Nonetheless, several countries have been embarking upon sample surveys targeting national concerns such as living conditions, adult and computer literacy, labour force and household expenditure. Together with the collection of routine official statistics, the survey data will be instrumental in ensuring that the requisite data become available to the extent that the proposed framework can be tested, evaluated, refined and incorporated as a standard for assessing social vulnerability status among nations within the Caribbean Sub-Region.

The main thrust of this chapter has been to highlight the framework that has been proposed to measure changes in social vulnerability status whether nationally or cross-nationally. This is undertaken in the context of informing decisions to disburse and evaluate the disbursement of public funds. Insofar as the chapter thrives on the premise that enhancing social vulnerability ought to be a primary objective of national development policies, the development and prospective endorsement of such a framework will have utility. In particular, such processes will have the potential for providing an objective basis for evaluating national vulnerability status in relation to public expenditure. In addition, they would pave the way for the evaluation of public spending in areas such as health, education, social order and social services insofar as the different sub-domains facilitate the generation of sub-indexes to gauge sources of vulnerability within the respective sub-domains.

Insofar as the proposed model is subject to empirical evaluation, there are likely to be changes in the number and content of the relevant input indicators. Generally speaking, the proposed framework was advanced with a view towards stimulating discussion and arriving at consensus about evaluating variations in social vulnerability status in developing countries. Whether the model is re-specified or not, the link between the disbursement of public expenditure and vulnerability measures in sub-institutional domains and at national levels remains paramount and ought to be a critical consideration in efforts generated toward re-specification. While this chapter's focus has been upon formulating approaches to measure social vulnerability, it has acknowledged similar but earlier efforts to measure vulnerability from economic and environmental standpoints. In concluding, therefore, the chapter suggests that similar linkages are likely to be envisaged between public expenditure and the capacity of nations to withstand, rebound and persevere in the face of shocks that might be linked to their geo-economic and environmental circumstances.

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# 18

# Trade and Public Finance in Caricom Countries

*Roger Hosein*[1]

## 1. Introduction

A major constraint to the development of small poor nations is their inability to finance the development process. An important aspect of this process is the expansion of infrastructural, human and physical capital, which is critical to the growth of output and the creation of employment. In the absence of adequate domestic financial resources, countries tend to look abroad, but given the increasing competition for foreign capital Caricom countries need to pay greater attention not only to resource mobilization but to resource use.

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Standard Keynesian economics states that the level of savings determines the level of investment in any country. Aggregate savings is comprised of three main components: government savings, private savings and corporate savings. Government savings in most Less Developed Countries (LDCs) are customarily low, particularly as the revenue base of the government is usually narrow and the growth of the main taxable items is either low or negative. In contrast, the pressure on governments to spend is great, given the need to not only provide current goods and services to their populations, but to increase the capital stock.[2] With respect to personal savings, low levels of income mean that the marginal propensity to consume is high so that the amount of savings that would be available from the private sector, at least from individual, may be quite low.[3] Low savings in turn tend to hamper the capital formation process and so create a vicious cycle by inhibiting income growth.

Foreign savings can be used to help finance the developmental process in LDCs. Foreign direct investment, loans and gifts can increase foreign exchange availability to developing countries and can play a critical role in

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2 In most Caricom member states, the population has increased since their attainment of independence. This, in turn, has placed increased pressure on government revenues since elected governments tend to yield easily to the demands of the electorate in order to be reelected. It is also worth noting that some forms of government expenditure (e.g. building roads and primary schools) do not yield immediate or direct returns.

3 In developing countries, corporate savings usually account for a small proportion of total savings because of the small size of the corporate sector.

financing consumption and investment. In the absence of adequate foreign exchange earnings from exports, countries tend to become increasingly dependent on foreign borrowing to the extent they can do so. Borrowing itself, however, can become a problem when servicing capacity is adversely affected for one reason or another, including the poor use of resources. When a high proportion of foreign exchange earnings and public revenues are diverted to debt servicing, not only can serious social problems emerge creating an unstable environment, but the development effort itself can be compromised in terms of expanding and diversifying output and trade capacity. As far as Caricom countries are concerned, trade has a deep influence on their welfare and development prospects.[4]

This paper focuses on the relationship between trade and public finance in the Caricom region and is organized as follows. Section 2 assesses the macro-economic performance of Caricom countries in the 1990s. In Section 3, the paper focuses on the debt dilemma of Caricom states and includes a discussion of the fiscal burden of interest payments on these states. In Section 4 some important characteristics of Caricom trade are considered, including their external competitiveness, their terms of trade and the relationship between the composition of trade and public revenues growth. In Section 5 the implications of free trade for future public revenue flows in the region are considered. The paper concludes in Section 6.

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4 When a country borrows (sovereign debt), if the funds are not invested in dynamic areas, but are instead used to fuel current consumption or to save sunset industries, then the servicing of the debt could easily become a problem in the future.

## 2. Economic Overview of Caricom Countries

### 2.1 GDP: Growth and Structure

The level and growth of economic activity have a major effect on the magnitude of the public revenues of any country as they condition the size of individual and corporate incomes. (Of course, there are other factors which determine the relationship between the two aggregates). A decline in total production often has a negative impact on the government purse, and any reduction in revenue can have a ripple effect on the society, impacting on the basic social and economic conditions which in turn can have a negative feedback on productive capacity. As open economies, trade plays a major role in the economic performance of Caribbean states. Prices and production levels are affected by a wide array of internal and external factors, making volatility a major feature of these societies. In the year 2000, real GDP of all CARICOM member states, excluding Suriname, were higher than in 1990, but there were wide differences in rates of growth during the period (see Table 1). The fastest growing economies were Belize, Guyana and St. Kitts and Nevis (over 5% per annum), followed by Grenada (4.2%). Four other countries had rates exceeding 3% per year while Jamaica, which has the largest population in Caricom (excluding Haiti), experienced an average rate of less than 1% per year.

The structure of a nation's economic activity is always an important matter as it has implications for the nature of its employment patterns and the extent of foreign technological diffusion, etc. In particular, it is widely understood that a country with a large manufacturing sector can benefit from favourable price and income elasticities of demand, technological spillovers and greater learning by doing. Some authors, such as Hirschman (1957), have also identified the greater backward and

**Table 1: Real GDP Growth Rates (%) in Caricom Member States, 1991-2000**

| Country | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | Average Growth Per Annum 1991-2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Antigua and Barbuda | 2.7 | 1.03 | 4.86 | 6.34 | -4.82 | 6.02 | 5.6 | 3.9 | 5 | 3.5 | 3.65 |
| Bahamas | -4.0 | -2.0 | 1.7 | 0.9 | 0.3 | 4.2 | 3.3 | 3 | 6 | 5 | 2.35 |
| Barbados | -4.1 | -5.49 | 0.95 | 3.48 | 2.65 | 4.03 | 2.9 | 4.4 | 2.5 | 3.7 | 1.96 |
| Belize | 3.1 | 8.98 | 4.23 | 1.71 | 3.57 | 1.42 | 3.2 | 1.5 | 6.5 | 10.5 | 5.11 |
| Dominica | 2.2 | 2.48 | 1.93 | 1.90 | 1.40 | 2.75 | 2 | 3.4 | 0.4 | -1 | 1.66 |
| Grenada | 3.6 | 0.91 | -0.90 | 3.20 | 3.10 | 3.43 | 4.2 | 7.3 | 7.5 | 6.4 | 4.22 |
| Guyana | 6.0 | 9.34 | 11.85 | 9.61 | 3.15 | 8.50 | 6.2 | -1.7 | 2.9 | -0.6 | 6.38 |
| Jamaica | 0.7 | 2.54 | 1.83 | 1.90 | 1.79 | -0.25 | -2 | -0.5 | -0.4 | 0.8 | 0.58 |
| St. Kitts and Nevis | 2.3 | 3.66 | 5.29 | 5.03 | 3.19 | 6.19 | 7.3 | 1 | 3.7 | 7.5 | 5.29 |
| St. Lucia | 0.1 | 7.41 | 1.72 | 1.69 | 1.94 | 0.82 | 0.6 | 2.9 | 3 | 2 | 2.42 |
| St .Vincent & the Grenadines | 1.4 | 6.67 | 2.40 | -2.82 | 7.73 | 1.79 | 3.2 | 5.7 | 4 | 3.5 | 3.72 |
| Suriname | 3.2 | -1.72 | -11.71 | -0.79 | 3.59 | 7.71 | 7.2 | 4.1 | -5 | -5.5 | -0.39 |
| Trinidad and Tobago | 2.7 | -1.03 | -1.18 | 4.14 | 4.19 | 4.41 | 3.1 | 4.8 | 6.8 | 3.8 | 3.36 |

**Source:** *UNECLAC (2001).*

forward linkages which manufacturing has with the rest of the economy.[5]

In 1998, Belize, Dominica and Guyana were the only member states of Caricom in which the agricultural sector accounted for more than one fifth of their national GDP at current prices.[6] As concerns Guyana itself, the rice and

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5 Manufacturing also helps to increase the level of total factor productivity which a country realizes. Even further, the share of manufacturing exports to total exports influences the impact that export expansion has on total productivity (Evans, 1984).

6 The trends in and the general performance of the banana sector reflect some of the overall problems affecting the agricultural sector in the Caricom sphere. During the 1990s the Windward Islands (Dominica, Grenada, St. Lucia and St. Vincent and the Grenadines) experienced a sharp decline in the amount of bananas they produced. In particular, at the start of the 1990s, banana production accounted for 12% of the GDP of the Windward Islands, but by 1999 this decreased by five percentage points to reach 7%. Even more, between 1993 and 1999 the amount of bananas exported by the Windward Islands decreased by more than 50% from 238,878 tons in 1993 to 130,419 tons in 1999. Over the same interval of time, the number of banana producers declined from 24,111 to 11,665, a decrease of 51.6%. In more recent times Latin American producers have increasingly attacked the margins of preference offered to Caricom producers in the Lome Convention, under which bananas are traded. In particular, in 1997 Guatemala, Honduras, Mexico and the United States of America challenged the European Union on the New Banana Regime (NBR) it established in 1993. The NBR restricted the import of bananas from the Latin American and other non-African Caribbean Pacific (ACP) industrial producers to a quota of 2mn tons, UNECLAC (2002).

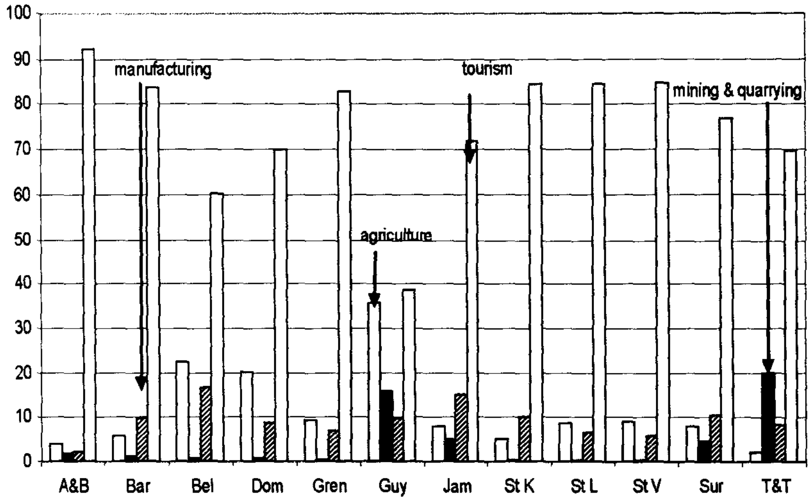
sugar industries have benefited from measures aimed at increasing production through reorganization and the adoption of more up-to-date and relevant technologies. The success of these measures is partially reflected in an increase in sugar cane GDP from 9% to 17% of total GDP between 1990 and 2000 in the Guyanese economy.

It may be argued that for Caricom as a whole, the relative decline in the output share of the agricultural sector is as a result of its weakening competitiveness. This is the consequence of higher production costs, external shocks and, in particular, dependence on margins of preference, which have helped to stimulate X-inefficiency in intra-regional production functions (in this context X-inefficiency refers to the managerial slack that safe extra-regional markets such as the European Union offers). With high costs of production, profit margins are seriously affected and this, in turn, retards the reinvestment capability of firms and hence, their dynamic competitiveness.

Mining and quarrying activities (shown here as a percentage of GDP in 1998) are important mainly to the mineral rich member states of Guyana (16%), Jamaica (4.9%), Suriname (4.6%) and Trinidad and Tobago (19.7%). The manufacturing sector of Caricom member states, however, remains small ranging from 2.3% of GDP in Antigua and Barbuda to 16.7% of GDP in Belize. The regional average is 9.2%. Leaving aside traditional refining activities, the manufacturing sector of Caricom caters mainly to the protected intra-regional market and the Canadian (under Caribcan) and United States (through Caribbean Basin Initiative (CBI)) markets. In many regards though, this manufacturing sector has not adequately blossomed to achieve the level of efficiency necessary to break into extra-regional markets, which do not offer Caricom states margins of preference.

In Figure 1, it is clearly illustrated that the member states of Caricom are service-oriented economies with an average contribution of the service sector to GDP of 74.9% and with a range stretching from 69.8% in T&T to 92% in Antigua and Barbuda.

**Figure 1: Structure of GDP in Caricom Member States, 1998**




**Source**: UNELAC (2000).

## 2.2 The Balance of Payments and Foreign Direct Investment (FDI) Flows

Caricom exports are concentrated in a narrow range of export commodities and are targeted at a narrow range of preferential export markets. In some cases, especially in the OECS sub-regional bloc, a single merchandise export accounts for as much as one half of the country's total merchandise exports (bananas in St. Lucia and Dominica and sugar in St. Kitts and Nevis). In aggregate, Caricom merchandise exports increased from US$4.7bn to US$8.1bn between 1990 and 2000. Aggregate Caricom merchandise imports for 1990 were US$6.8bn with the import bill for 2001 being US$11.15bn (excludes data for Antigua and Barbuda, Dominica, Grenada, St. Kitts, St. Lucia and Suriname).[7] Amongst the individual member states only Suriname's import bill fell between 1990 and 2000, whilst the import bill of Trinidad and Tobago increased by 243% between 1990 and 2001. Grenada was the only other Caricom member state whose import bill increased more than 100% in the time interval 1990-2000. As a consequence of the trends in exports and imports, the trade balance of Caricom countries as a group worsened from a deficit of US$2.2bn in 1990 to a deficit of US$3.7bn in 2000, a decline of 72%.

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7 In 2000, when data for all Caricom countries are taken into account, the total merchandise import bill was US$11.8bn.

Commercial service exports of Caricom countries increased from US$4.15bn in 1990 to US$6.46bn in 2000, an increase of 55.6% at current prices.[8] For all individual member states, the trend has been for the exports of commercial services to increase between 1990 and 2000. The range of commercial service exports for 1990 was from US$0.03bn in Dominica and Suriname to US$1.47bn in the Bahamas. In 2000 the range of commercial service exports was from US$0.012bn in Suriname to US$2bn in the Bahamas.[9]

Tourism export revenues have become an important part of the export earnings of some Caricom economies. In terms of tourist arrivals, the number of tourists visiting each Caricom member state expanded between 1990 and 1999 and correspondingly, the amount of tourist receipts earned by each member state also increased. The Bahamas remains the largest recipient of tourists amongst all the member states. It is also the Caricom member state that receives the largest amount of tourism export earnings (US$1.50bn in 1999). Note though that between 1990 and 1999 the relative share of total export earnings accounted

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8 The main commercial service export of Caricom is tourism.

9 Tourism export revenues have always featured importantly in the development experience of Caricom countries. For some Caricom states, e.g. Bahamas, St. Lucia and Barbados, tourism has been always ranked as the main foreign exchange earner, especially after the sugar industry collapsed.

**Table 2: Commercial Service Exports of Caricom Member States, US$bn, 1990-2000**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1995 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Antigua and Barbuda | 0.31 | 0.31 | 0.33 | 0.37 | 0.39 | 0.35 | 0.36 | 0.40 | 0.42 | 0.43 | 0.41 |
| Bahamas, The | 1.47 | 1.31 | 1.36 | 1.43 | 1.49 | 1.52 | 1.56 | 1.57 | 1.52 | 1.79 | 2.00 |
| Barbados | 0.63 | 0.59 | 0.59 | 0.66 | 0.79 | 0.84 | 0.90 | 0.93 | 0.99 | 1.00 | 1.06 |
| Belize | 0.08 | 0.09 | 0.11 | 0.12 | 0.11 | 0.12 | 0.12 | 0.12 | 0.12 | 0.14 | 0.15 |
| Dominica | 0.03 | 0.04 | 0.04 | 0.05 | 0.05 | 0.06 | 0.07 | 0.08 | 0.08 | 0.10 | 0.09 |
| Grenada | 0.06 | 0.07 | 0.08 | 0.09 | 0.10 | 0.10 | 0.11 | 0.10 | 0.12 | 0.14 | 0.15 |
| Guyana | n.a. | n.a. | 0.10 | 0.11 | 0.12 | 0.13 | n.a. | n.a. | n.a. | n.a. | n.a. |
| Jamaica | 0.98 | 0.95 | 1.06 | 1.21 | 1.45 | 1.57 | 1.57 | 1.67 | 1.74 | 1.95 | 1.99 |
| St. Kitts and Nevis | 0.05 | 0.07 | 0.08 | 0.08 | 0.09 | 0.08 | 0.09 | 0.09 | 0.10 | 0.10 | 0.09 |
| St. Lucia | 0.15 | 0.17 | 0.19 | 0.20 | 0.24 | 0.26 | 0.27 | 0.29 | 0.31 | 0.32 | 0.31 |
| St. Vincent and the Grenadines | 0.04 | 0.04 | 0.06 | 0.06 | 0.06 | 0.07 | 0.10 | 0.10 | 0.11 | 0.12 | 0.12 |
| Suriname | 0.03 | 0.03 | 0.04 | 0.04 | 0.07 | 0.10 | 0.10 | 0.08 | 0.07 | 0.07 | 0.09 |
| Trinidad and Tobago | 0.32 | 0.40 | 0.44 | 0.34 | 0.32 | 0.33 | 0.45 | 0.54 | 0.57 | n.a. | n.a. |

**Source:** *http://publications.worldbank.org/WDI/.*

for by the tourism sector declined in Grenada, St. Kitts and Nevis, Bahamas, Barbados, Guyana and Jamaica.[10]

With respect to current account balances as a percentage of GDP, the following trends are detected in the period 1990-2000. In 1990, the average current account balance as a percentage of GDP for Caricom as a whole was –8.02%, worsening slightly to –8.17% in 2000. On average, for the period 1990-2000, the only Caricom member state with current account deficits as a percent of GDP which exceeded 15% were Dominica, Grenada, Guyana and St. Kitts. T&T stands out as the member state with the largest number of current account surpluses during the time period (see Panel 4a of Table 4).

Panel 4b above provides data on the position of Caricom member states with respect to net Foreign Direct Investment (FDI) inflows.[11] Amongst the countries for

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10 Some Caricom member states have attempted to develop other service sector activities, particularly offshore banking. In recent years, however, offshore banking has run into a substantial amount of controversy and problems particularly as regards money laundering and other illegal practices. The (International) Financial Action Task Force (FATF) has noted that the scale of money laundering in some Caricom territories is substantial. At present, there are four countries in the Caricom region; Dominica, St. Kitts and Nevis, St. Vincent and the Grenadines and Grenada, which are characterized by the FATF as centres where money laundering takes place. Other Caricom states, e.g. The Bahamas, were removed from the list of countries that were considered as centres for money laundering. Despite some of its members being blacklisted, the Caribbean Financial Action Task Force continues to upgrade and improve banking supervision in the Caribbean area (UNECLAC, 2002).

11 Data are recorded on a net basis in accordance with IMF specifications.

**Table 3: Tourist Arrivals and Tourism Receipts in Selected Caribbean Countries, 1990 and 1999**

| | Number of tourist arrivals | | Tourism receipts (US$ mn) | | Tourism earnings as % of total export earnings | |
|---|---|---|---|---|---|---|
| | 1990 | 1999 | 1990 | 1999 | 1990 | 1999 |
| | OECS Countries | | | | | |
| Antigua & Barbuda | 197 | 232 | 298 | 291 | 86.4 | n.a. |
| Dominica | 45 | 74 | 20 | 49 | 19.4 | 27.5 |
| Grenada | 76 | 125 | 38 | 63 | 36 | 35.8 |
| Montserrat | 13 | 19 | | 3 | n.a. | n.a. |
| St Kitts & Nevis | 73 | 84 | 63 | 70 | 61.2 | 52.3 |
| St Lucia | 141 | 261 | 154 | 311 | 51.1 | 75.4 |
| St Vincent & the Grenadines | 54 | 68 | 56 | 77 | 37.7 | 45.1 |
| Bahamas, The | 1562 | 1577 | 1324 | 1503 | 87.9 | 74.3 |
| Barbados | 432 | 515 | 494 | 677 | 59.1 | 50 |
| Belize | 88 | 300[a] | 51 | 99 | 19 | 28.1 |
| Guyana | 6 | 76 | 27 | 60 | 10.7 | 8.6 |
| Jamaica | 841 | 1248 | 740 | 1333 | 30.1 | 28.5 |
| Suriname | 28 | 55 | 1 | 45 | 0.2 | 0 |
| Trinidad & Tobago | 195 | 336 | 95 | 210 | 4.1 | 6.6 |

a: *Refers to 1998 data.*

**Source:** *UNECLAC (2002).*

Table 4: Trends in the Current Account Balance as a Percentage of GDP and FDI in Caricom Countries, 1990-2000

| Country | Panel 4a: Current Account Balances as a Percentage of GDP in Caricom Countries, 1990-2000 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
| Antigua and Barbuda | -7.95 | -8.14 | -4.91 | -0.12 | -3.59 | -0.11 | -11.04 | -8.14 | -10.18 | -11.92 | -11.47 |
| Bahamas, The | -3.06 | -3.50 | -1.68 | -2.22 | -6.64 | -4.22 | -7.04 | -11.98 | -23.76 | -14.83 | -8.33 |
| Barbados | -0.96 | -1.49 | 9.04 | 3.92 | 7.55 | 2.28 | 3.52 | -2.28 | -2.67 | -5.98 | -5.60 |
| Belize | 3.85 | -6.00 | -5.96 | -9.33 | -7.29 | -2.92 | -1.05 | -4.91 | -8.93 | -10.62 | 17.01 |
| Dominica | -25.61 | -18.67 | -13.54 | -14.08 | -16.24 | -18.51 | -13.86 | -10.92 | -4.69 | -15.25 | -25.53 |
| Grenada | -20.92 | -19.33 | -13.20 | -17.42 | -12.64 | -14.80 | -18.91 | -27.98 | -30.93 | -17.92 | -29.30 |
| Guyana | n.a. | n.a. | -37.43 | -31.16 | -23.13 | -21.74 | -7.58 | -14.01 | -13.68 | -11.03 | -15.92 |
| Jamaica | -8.22 | -11.70 | 0.87 | -6.22 | 1.03 | -1.75 | -2.25 | -4.56 | -4.50 | -2.95 | -3.71 |
| St. Kitts/Nevis | -29.36 | -20.53 | -8.76 | -15.04 | -12.02 | -19.77 | -26.38 | -19.28 | -14.31 | -27.65 | -20.11 |
| St. Lucia | -11.37 | -16.76 | -11.42 | -8.42 | -12.49 | -5.91 | -9.54 | -13.52 | -10.47 | -11.82 | -11.61 |
| St. Vincent & the Grenadines | -13.45 | -20.97 | -11.24 | -19.77 | -25.53 | -5.80 | -4.73 | -10.74 | -10.91 | -8.12 | -2.95 |
| Suriname | 11.69 | -20.75 | 4.18 | 13.75 | 20.93 | 17.94 | -9.62 | -8.57 | -14.61 | -3.31 | 3.80 |
| Trinidad and Tobago | 9.05 | -0.09 | 2.61 | 2.47 | 4.40 | 5.51 | 1.82 | -10.52 | -10.51 | 0.46 | 7.45 |

Table 4: Trends in the Current Account Balance as a Percentage of GDP and FDI in Caricom Countries, 1990-2000 - Cont'd

| Country | Panel 4b: Net Foreign Direct Investment Inflows, $USmn, in Caricom Member States, 1990-2000 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
| Antigua and Barbuda | 61 | 55 | 20 | 15 | 25 | 31 | 19 | 23 | 27 | 37 | 33 |
| Bahamas, The | -17 | 0 | 0 | 27 | 24 | 107 | 88 | 210 | 146 | 144 | 250 |
| Barbados | 10 | 6 | 14 | 7 | 12 | 8 | 10 | 14 | 15 | 16 | 18 |
| Belize | 17 | 14 | 16 | 9 | 15 | 21 | 11 | 8 | 13 | 47 | 17.7 |
| Dominica | 13 | 15 | 20 | 13 | 23 | 54 | 18 | 21 | 7 | 18 | 11 |
| Grenada | 13 | 15 | 23 | 20 | 19 | 20 | 17 | 34 | 49 | 42 | 37 |
| Guyana | 8 | 13 | 146 | 70 | 107 | 74 | 92 | 52 | 47 | 48 | |
| Jamaica | 138 | 133 | 142 | 78 | 77 | 81 | 90 | 147 | 287 | 429 | 382 |
| St. Kitts and Nevis | 49 | 21 | 13 | 14 | 15 | 20 | 35 | 20 | 32 | 58 | 96 |
| St. Lucia | 45 | 58 | 41 | 34 | 33 | 33 | 18 | 50 | 83 | 83 | 49 |
| St. Vincent & the Grenadines | 8 | 9 | 15 | 31 | 47 | 31 | 18 | 42 | 28 | 25 | |
| Suriname | -77 | 19 | -54 | -47 | -30 | -21 | 19 | -9 | 9 | -61.5 | -148.0 |
| Trinidad and Tobago | 109 | 169 | 178 | 379 | 516 | 295.7 | 356 | 999.6 | 731.9 | 643.3 | 679.5 |

**Table 4: Trends in the Current Account Balance as a Percentage of GDP and FDI in Caricom Countries, 1990-2000 - Concluded**

| Country | Panel 4c: Net inflows of Foreign Direct Investment, (as a % of gross capital formation), 1990-2000 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
| Antigua and Barbuda | 48.03 | 35.71 | 13.61 | 10.34 | 15.43 | 17.03 | 9.95 | 12.11 | 13.43 | 17.29 | 16.02 |
| Bahamas, The | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Barbados | 3.48 | 2.56 | 9.60 | 4.50 | 5.60 | 4.18 | 4.70 | 4.05 | 3.60 | 3.61 | 4.12 |
| Belize | 14.85 | 10.93 | 11.07 | 5.66 | 11.15 | 17.74 | 13.68 | 7.47 | 10.27 | 24.89 | 6.83 |
| Dominica | 19.16 | 26.30 | 37.06 | 24.23 | 38.98 | 74.62 | 27.42 | 28.43 | 9.41 | 23.84 | 13.39 |
| Grenada | 15.43 | 16.39 | 31.13 | 25.65 | 20.53 | 22.57 | 16.37 | 29.50 | 38.47 | 31.14 | 23.36 |
| Guyana | 0.00 | 0.00 | 94.04 | 36.84 | 72.46 | 37.73 | 43.95 | 23.31 | 22.74 | 28.87 | 42.20 |
| Jamaica | 11.68 | 13.33 | 13.55 | 5.62 | 9.79 | 10.24 | 13.03 | 9.34 | 18.65 | 28.51 | 22.98 |
| St. Kitts and Nevis | 55.56 | 29.72 | 18.32 | 15.57 | 17.77 | 18.72 | 31.07 | 16.53 | 25.94 | 51.62 | 67.92 |
| St. Lucia | 43.93 | 53.06 | 35.55 | 28.03 | 26.27 | 31.47 | 14.85 | 34.97 | 55.76 | 48.22 | 28.28 |
| St. Vincent and the Grenadines | 13.58 | 14.39 | 26.51 | 50.63 | 68.45 | 38.35 | 54.56 | 105.6 | 88.43 | 52.30 | 30.04 |
| Suriname | n.a. | 23.46 | -69.23 | -64.38 | -69.77 | -44.68 | 21.84 | -7.83 | 4.71 | 3.68 | n.a. |
| Trinidad and Tobago | 17.07 | 19.52 | 23.72 | 57.69 | 51.63 | 27.00 | 25.39 | 47.26 | 42.66 | 43.97 | 46.55 |

**Source**: *IMF International Financial Statistics Yearbook (various years);*
*IMF Balance of Payments Statistics Yearbook (1999);*
*http://publications.worldbank.org/WDI/.*

which data are available, the Caricom region received a total of US$377mn in net FDI inflows in 1990 as compared to US$1,555.7mn in 2000, an increase of 321% at current prices.[12] In 1990, the biggest recipient of foreign direct investment was Jamaica which received US$138mn, with Suriname experiencing a net outflow of FDI amounting US$77mn. By 2000, however, the largest recipient of net FDI in the Caricom region was Trinidad and Tobago which received US$679.5mn as compared to the paltry US$11mn received by Dominica and a net outflow of US$148mn from Suriname. The growth in T&T's receipt of net FDI flows between 1990 and 2000 was 523%, attributable mainly to a significant amount of resource (petrochemical) based industrialization activities. Significantly, the net FDI flows to some Caricom countries, including Antigua and Barbuda and Dominica, decreased between 1990 and 2000.[13] Cumulative net FDI inflows for the 11-year period to the Caricom bloc of countries amounted to US$10,794mn, of

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12 Even so, much of the FDI flows to the countries of Latin America and the Caribbean region went principally to the larger economies in Latin America.

13 Some of the lesser developed Caricom countries e.g. Suriname and the smaller OECS countries, e.g. Antigua and Barbuda and Dominica have not been able to attract significant flows of FDI because they are either politically unstable (Suriname) or have weak factor endowment bundles (the OECS countries). A decline in official development flows and the inability to attract foreign direct investment inflows have adversely affected the ability of Caricom countries to finance important development projects. In this regard, UNECLAC (2002) has suggested that the benefits of financial globalization would have accrued to the resource rich or relatively more advanced Caricom member states.

which one member state, Trinidad and Tobago, received US$5,057mn, or approximately 50%.

One of the more important contributions made by FDI to the overall process of economic development in the Caricom region has been its role in financing domestic investment. In general, Caricom economies have tended to depend on FDI flows to reduce their two main financing gaps, the foreign exchange and the savings/investment gaps. FDI as a percentage of gross capital formation in the various member countries for which data are available is also shown in Table 4 (Panel 4c) above. In 1990, only St. Kitts and Nevis had a net FDI inflow which, as a percentage of gross capital formation, exceeded 50%. By 2000, the percentage representation of net FDI in gross capital formation increased for all of the listed Caricom countries except Belize, Dominica and St. Lucia.

For Caricom as a whole, the average share of FDI in gross capital formation increased by 9.1 percentage points between 1990 and 2000 (i.e. from 19.4% in 1990 to 28.5% in 2000) with one member state alone, T&T, realizing a 29.4 percentage point increase. On average for Caricom as a whole, the ratio of FDI to gross capital formation was almost 3 times the international average for all developing countries (Caricom Secretariat, 2000). Part of the reason for this involves the fact that foreign investment projects in Caricom tend to be expensive and capital intensive. In contrast, most projects in which domestic capital is involved are labour intensive.

However, the less developed countries of the OECS region did not have the same type of access to foreign capital as enjoyed by, say T&T, and as a consequence have had to place a greater degree of reliance on official and multilateral financial flows. Other forms of private capital flows, however, have not been important as FDI inflows have been for Caricom countries. Importantly though, some member states, especially T&T, Jamaica and Barbados, have utilized bonds on the international marketplace to raise financial resources. In part, as UNECLAC (2002) notes, this was made possible because these particular countries were given improved credit ratings by the international investment agencies such as Standard and Poor's and Moody's Investor services. In the Caricom sphere, portfolio flows were zero except in 1996 and 1997 when some portfolio capital flowed into Barbados, although as Brunton (2001) notes there is some indication that these portfolio flows were recorded because of accounting practices for investment in that country.[14]

In summary, we see that although Caricom countries have managed to achieve a moderate (unweighted) real growth rate for the 1990s of 3.1%, the manufacturing sector remains relatively underdeveloped. Also, import growth continues to outstrip export growth so that the current account balances in the region have continued to be in deficit. The overall macroeconomic position of a region is important to its trade sector, as it influences its ability to borrow from abroad. Macroeconomic strength at home also influences the growth of the domestic price level and so impacts on the country's external competitiveness. These factors would affect the country's export capability which, in turn would influence the magnitude of public revenues, and hence, the fiscal balance of the country.

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14 In the smaller Caricom member states underdeveloped or absent capital and equity markets have significantly reduced the likelihood that they would be able to turn to bonds and/or equity flows to obtain financial capital. Notably though, some member states are attempting to improve upon this position and have taken a number of steps to deepen their financial markets.

## 3. The Debt Dilemma

In the absence of sufficient savings, governments tend to borrow both locally and abroad. Borrowed resources are sometimes wasted, but even when they are used to expand the country's infrastructure, the returns are not immediately forthcoming. Complementary investments by private investors are also sometimes necessary to make full use of infrastructural developments. In the absence of proper debt management, debt servicing can become a major problem, worsening fiscal deficits. Current fiscal deficits are a notable feature of most Caricom economies. In 1990 the deficit as a percentage of GDP ranged from minus 25% for Guyana to a surplus of 4.8% in Jamaica. By 2000, the country with the largest fiscal deficit as a percentage of GDP was St. Kitts (-14.2%) with T&T having the largest surplus of 1.6% (see Table 5). On average per annum for the period 1990-2000, Guyana had the largest fiscal deficit as a proportion of GDP whilst Trinidad & Tobago had the smallest. In 2000, the average fiscal deficit as a percentage of GDP across all Caricom countries had worsened to –5.15%. For Guyana, economic reforms in the 1990s have helped to improve the fiscal balance to a deficit of 8.3% in 2000. The fiscal balance in Jamaica continues to be a cause for concern.[15]

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15 Part of the reason for the high fiscal deficits Jamaica encountered in the mid-1990s was due to a large fiscal outlay expended to correct some problems in its financial sector.

**Table 5: Fiscal Balance as a Percent of GDP in Caricom Member States, 1990-2001**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 200 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Antigua | 1.2 | -1.9 | -0.5 | -1.4 | -2.8 | -2.9 | -3.1 | -4.3 | -4.4 | -2.5 | -2.2 | n.a. |
| Bahamas, The | n.a. | n.a. | n.a. | n.a. | n.a. | -1.2 | -0.9 | -3.2 | -1.1 | -0.3 | 0.4 | -0.8 |
| Barbados | -8.4 | -1.8 | -1.9 | -2.5 | -1.2 | -0.9 | -3.8 | -1.4 | -1.0 | -2.3 | -1.5 | -3.5 |
| Belize | 0.3 | -5 | -7.5 | -9.1 | -7.6 | -4.3 | -0.4 | -2.2 | -2.3 | -2.1 | -9 | -11.0 |
| Dominica | -10 | -3.3 | -5.7 | -0.3 | -4.8 | -5.7 | -1.9 | -2.3 | -1.2 | -9.9 | -5.5 | n.a. |
| Grenada | -15 | -4.8 | -0.6 | -0.9 | -1.9 | 0.3 | -2.7 | -2.2 | -3.2 | -2.8 | -3.4 | n.a. |
| Guyana | -25 | -27 | -20 | -8.1 | -1.8 | 0.1 | -1.6 | -7.0 | -7.4 | -5.7 | -6.6 | -8.3 |
| Jamaica | 4.8 | -5.6 | -6.6 | -2.7 | -11 | -5.4 | -24.6 | -8.3 | -8.1 | -6.1 | -0.3 | -6.9 |
| St. Kitts/Nevis | -0.3 | -2.3 | -1.2 | -1.4 | -3 | -6.6 | -3.8 | -3.1 | -6.2 | -11 | -14.2 | n.a. |
| St. Lucia | 1 | 0.7 | -1.8 | -0.7 | -0.8 | -1.2 | -2.2 | n.a. | n.a. | n.a. | n.a. | n.a. |
| St. Vincent & the Grenadines | -0.8 | -0.2 | -4.3 | -4.8 | -0.3 | -2.4 | 0.6 | -4 | -3 | -1.5 | -5.8 | n.a. |
| Suriname | n.a. | n.a. | -8.7 | -9.4 | 5.1 | 4.3 | 0.8 | n.a. | n.a. | n.a. | n.a. | n.a. |
| Trinidad | -1.2 | -0.2 | -2.7 | -0.2 | 0 | 0.2 | 0.5 | 0.1 | -2 | -3.2 | 1.6 | -0.4 |

**Note:** N.A is not available.

**Source:** *UNELAC (2002).*

### 3.1 Fiscal Burden of Interest Payments

For small states, interest payments on debt can have a serious impact on the growth potential of their economy. As a proportion of current expenditures, interest payments for Caricom as a whole averaged 18.03% in 1990 with a range of 54.9% in Guyana to 4.26% in St. Lucia. In 2000, the average value of this ratio increased marginally to 18.14% with a range of 45.2% in Jamaica to 7.2% in St. Lucia.[16] Note that the interest payments as a percent of current expenditures had increased to as much as 56.5% in Guyana in 1996. For the entire data period, the lowest mean value of this ratio was realized in St. Lucia with two countries, Guyana and Jamaica, having an average value in excess of 40%. Significantly, in every Caricom member state except Antigua and Barbuda and Guyana, interest payments as a percent of current expenditures fell. As concerns Guyana in particular, this country started the 1990s with a high element of external debt, but this has since been substantially reduced on account of that country's increased access to debt relief and grants associated with the Heavily Indebted Poor Countries Initiative.

In terms of interest payments as a percent of current revenues, the average value of this ratio for the entire Caricom body was 19.9% with a range of 3.27% in St. Lucia to 78.24% in Guyana in 1990. By 2000, the average value of this variable across all Caricom member states would have increased to 16.7% with a range from 5.52% in St. Lucia to 45.9% in Jamaica. Between 1990 and 2000,

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16 For some member states, rising interest payments have contributed to increasing government expenditure.

**Table 6: Interest Payments in Caricom Countries, 1990-2001**

| Country | (a) Interest Payments as a Percent of Current Expenditures in Caricom Member States, 1990-2001 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
| Antigua | 19.14 | 18.40 | 16.65 | 9.09 | 9.91 | 8.98 | 12.24 | 11.93 | 11.07 | 8.18 | 10.19 | n.a |
| Bahamas, The | n.a | n.a | n.a | 13.47 | 13.88 | 13.91 | 13.78 | 13.11 | n.a | n.a | n.a | n.a |
| Barbados | 12.60 | 14.34 | 15.15 | 12.66 | 13.44 | 15.27 | 15.32 | 13.38 | 16.42 | 15.88 | 14.77 | 16.47 |
| Dominica | 6.6 | 6.7 | 8.3 | 10.1 | 9.7 | 10.8 | 10.6 | 9.0 | 9.7 | 9.5 | 18.6 | n.a |
| Grenada | 9.11 | 12.12 | 10.42 | 10.78 | 10.19 | 9.61 | 7.49 | 9.68 | 6.70 | 10.86 | 10.49 | n.a |
| Guyana | 54.98 | 49.34 | 49.40 | 47.52 | 51.81 | 36.3 | 56.49 | 55.28 | 30.62 | 29.35 | 27.41 | n.a |
| Jamaica | 39.17 | 38.92 | 42.11 | 38.93 | 43.58 | 40.44 | 42.48 | 34.06 | 40.82 | 44.85 | 45.28 | 43.27 |
| St. Kitts/ Nevis | 12.88 | 13.93 | 10.83 | 11.36 | 10.02 | 9.08 | 12.39 | 10.84 | 10.57 | 12.25 | 14.50 | n.a |
| St. Lucia | 4.26 | 3.72 | 4.15 | 4.31 | 3.89 | 3.94 | 4.48 | 5.57 | 6.06 | 7.46 | 7.41 | n.a |
| St. Vincent & the Grenadines | 4.91 | 3.94 | 4.42 | 4.94 | 5.14 | 6.91 | 6.36 | 6.32 | 6.42 | 9.01 | 10.41 | n.a |
| Suriname | n.a | n.a | 10.77 | 10.13 | 7.90 | 2.45 | 2.40 | n.a | n.a | n.a | n.a | n.a |
| Trinidad | 16.74 | 15.86 | 18.31 | 21.33 | 24.64 | 20.12 | 17.47 | 19.27 | 18.63 | 19.85 | 22.35 | 17.43 |

**Table 6: Interest Payments in Caricom Countries, 1990-2001 - Concluded**

| Country | (b) Interest Payments as a Percentage of Current Revenues in Caricom Member States, 1990-2001 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **1990** | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** |
| Antigua | 19.90 | 19.86 | 17.47 | 8.82 | 9.72 | 8.91 | 11.92 | 11.81 | 11.77 | 9.16 | 11.97 | n.a |
| Bahamas, The | n.a | n.a | n.a | 12.80 | 12.26 | 12.81 | 13.58 | 12.80 | n.a | n.a | n.a | n.a |
| Barbados | 13.92 | 16.51 | 16.38 | 14.29 | 15.42 | 16.28 | 16.28 | 13.84 | 14.17 | 13.95 | 13.04 | 14.92 |
| Dominica | 5.61 | 6.23 | 7.77 | 9.97 | 9.81 | 10.76 | 10.18 | 8.77 | 9.23 | 9.78 | 19.56 | n.a |
| Grenada | 9.53 | 12.27 | 10.89 | 10.22 | 9.65 | 8.75 | 6.69 | 9.40 | 6.43 | 9.16 | 8.14 | n.a |
| Guyana | 78.24 | 73.39 | 64.14 | 45.12 | 51.56 | 29.3 | 24.61 | 30.35 | 27.92 | 27.94 | 26.2 | n.a |
| Jamaica | 35.16 | 33.76 | 33.92 | 32.39 | 37.54 | 33.37 | 46.63 | 39.41 | 49.37 | 51.44 | 45.99 | 49.05 |
| St. Kitts/ Nevis | 12.55 | 14.59 | 10.33 | 10.53 | 9.84 | 9.29 | 12.83 | 11.05 | 10.43 | 12.68 | 16.75 | n.a |
| St. Lucia | 3.27 | 2.76 | 3.06 | 3.06 | 2.92 | 3.36 | 4.32 | 5.40 | 4.69 | 5.59 | 5.52 | n.a |
| St. Vincent & the Grenadines | 4.07 | 3.31 | 3.93 | 4.21 | 4.43 | 6.10 | 5.49 | 5.44 | 5.38 | 7.87 | 9.01 | n.a |
| Suriname | n.a | n.a | 12.97 | 11.91 | 6.12 | 1.92 | 2.09 | n.a | n.a | n.a | n.a | n.a |
| Trinidad | 17.53 | 15.97 | 20.24 | 21.52 | 20.98 | 18.65 | 15.73 | 18.52 | 18.13 | 19.87 | 20.77 | 16.67 |

**Note: N.A. is not available.**
**Source:** *Economist Intelligence Unit; Country Reports* (various years).

interest payments as a percent of current revenues increased in all the member states for which consistent data are available except for Antigua and Barbuda, Barbados, Grenada and Guyana. Both Dominica and Jamaica realized an increase in the share of interest payments as a proportion of current revenues by more than ten percentage points.

Recent advances in endogenous growth theory have emphasized the importance of human capital formation in the economic growth of nations. By expending almost one fifth of their current revenues on interest payments, Caricom member states are deprived of resources to finance education (creating human capital) and health (preserving human capital). Resources targeted at interest payments could also have helped to encourage the growth of non-traditional dynamic comparative advantage in export commodities on the upswing of the international product cycle or in the creation of an even better infrastructural base to attract foreign direct investment inflow in export oriented sectors.

## 4. Some Important Characteristics of Caricom Trade Relations

### 4.1 External Competitiveness of Caricom Countries

Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines (Montserrat and Anguilla are still territories of the UK) formed the Eastern Caribbean Central Bank in 1983 after a period of extensive monetary cooperation. These countries have a common currency, the Eastern Caribbean dollar, currently pegged at the rate $EC2.7 = US$1. The Bahamian, Belizean and Barbadian currencies are also pegged at the rates $Bahamian 1 = $US1, $Barbadian 2 =

**Table 7: Nominal Units of National Currency for US Dollar (Annual Average) in Caricom Member States, 1990-2000**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Antigua & Barbuda | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| Bahamas, The | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Barbados | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| Belize | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| Dominica | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| Grenada | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| Guyana | 39.5 | 112 | 125 | 126.7 | 138.3 | 142 | 140.4 | 142.4 | 150.5 | 178 | 182.4 |
| Jamaica | 8.04 | 21.49 | 22.19 | 32.47 | 33.2 | 39.6 | 34.86 | 34.98 | 36.0 | 38.9 | 43.1 |
| St. Kitts / Nevis | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| St. Lucia | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| St. Vincent & the Grenadines | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| Suriname | 1.78 | 1.78 | 1.78 | 1.78 | 134.12 | 442.23 | 401.26 | 401 | 401 | 987.5 | 2178.5 |
| Trinidad and Tobago | 4.25 | 4.25 | 4.25 | 5.81 | 5.93 | 5.94 | 6.00 | 6.25 | 6.29 | 6.29 | 6.29 |

**Source:** *International Financial Statistics Yearbook (2001).*

$US1 and $Belizean 2 = US$1 respectively. Three member states, Guyana, Trinidad and Tobago and Jamaica have floating exchange rates, with their respective Central Banks intervening in the foreign exchange market if necessary. Suriname has a dual exchange rate system with a wide margin between the dual and parallel exchange rates.[17] In practice, most Caricom countries peg their exchange rates, as is reflected in the generally low degree of variability in their nominal exchange rates.

Controversy exists as to the effectiveness of exchange rate policy to correct trade imbalances in small countries with a fledgling manufacturing base and which operate very much in the Dudley Seerian sense of "exporting what they don't need and importing what they need" (the consequence of which are high import bills). With a devaluation, if the Marshall-Lerner[18] criteria do not hold, then what we may find happening is that a devaluation, by increasing the price of imports, can lead (in the tradition of the "J curve") to a worsening current account balance, at least in the short-run. Even more, the rise in imported goods can lead to imported inflation which in turn can spark an increase in demand for higher wages and salaries that can offset any competitive gain the devaluation (or

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17 The government of Suriname undertook some stabilization measures in 2001 (this is partly reflected in the devaluation of the currency from SF987.5 per US dollar to SF2178.5 per US dollar. This devaluation reduced the exchange rate differential in Suriname between the market and the official rate from 113% to 24% (World Bank, 2002).

18 The Marshall-Lerner condition postulates that foreign exchange flows would be stable if the absolute sum of the price elasticity of demand for imports and exports is greater than unity.

**Table 8a: Nominal Exchange Rates (National Currency Per US Dollar) in Guyana, Jamaica, Suriname and Trinidad and Tobago, 1990-2000**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | Percentage change between 1990 & 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Guyana | 39.5 | 112 | 125 | 126.7 | 138.3 | 142 | 140.4 | 142.4 | 150.5 | 178 | 182.4 | 361.77 |
| Jamaica | 8.04 | 21.49 | 22.19 | 32.47 | 33.2 | 39.6 | 34.86 | 34.98 | 36 | 38.9 | 43.1 | 436.07 |
| Suriname | 1.78 | 1.78 | 1.78 | 1.78 | 134.12 | 442.23 | 401.26 | 401 | 401 | 987.5 | 2178.5 | 122287.6 |
| Trinidad & Tobago | 4.25 | 4.25 | 4.25 | 5.81 | 5.93 | 5.94 | 6 | 6.25 | 6.29 | 6.29 | 6.29 | 48 |

**Table 8b: Current Account Balances of Guyana, Jamaica, Suriname and T&T, $USmn, 1990-2000**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Guyana | n.a. | n.a. | -138.5 | -140.2 | -124.9 | -134.8 | -53.8 | -105.1 | -98.5 | -75 | -113 |
| Jamaica | -312.1 | -240.1 | 28.5 | -184 | 48.4 | -98.7 | -142.6 | -332.2 | -327.8 | -211.4 | -274.6 |
| Suriname | 37.4 | -74.7 | 14.2 | 44 | 58.6 | 62.8 | -63.5 | -67.7 | -154.9 | -29.1 | 32.3 |
| Trinidad and Tobago | 459 | -4.7 | 138.9 | 113.1 | 217.8 | 293.8 | 105.1 | -613.6 | -643.5 | 30.6 | 544.3 |

**Source**: *E.I.U. Country Reports*, (various years).

depreciation) of the nominal exchange rate provided in the first instance.

Devaluations or depreciations of their respective currencies did not apparently lead to any significant improvements in the current account balances of Guyana, Jamaica and Suriname as shown in the Table 8a above.[19] Thus, the source of the current account imbalances in the Caribbean is perhaps not to be found in currency misalignment or overvaluation but is reflective of deeper underlying structural problems relating to the nature of exports, outdated technology and absence of relevant skills. Continuous depreciation of the currencies of the region (especially in Guyana and Jamaica) may also have eroded the confidence economic agents had in their domestic currencies as a store of wealth. In many instances, this may have prompted capital flight as economic agents seek out more stable foreign currencies (e.g. the US or Canadian dollar). Note though, even if foreign currency accounts are held in banking accounts located in the domestic economy, these resources can represent a potential leakage from the system if they are not put to use in the interest of the domestic economy.

One aspect of the external competitiveness of Caricom countries is presented in Table 9 which provides data on real effective exchange rates. The real effective exchange rate is a non-oil trade weighted index (it also considers relative inflation rates) which takes into account the bilateral exchange rates between the home country and its trading partners. A rise in this index reflects a decrease in external competitiveness. In general, what the data are

19 All other member states of Caricom had fixed nominal exchange rates.

**Table 9: Real Effective Exchange Rate Index (1995 = 100) in Caricom Member States, 1990-2000**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Antigua and Barbuda | 106.07 | 107.95 | 106.46 | 112.73 | 103.71 | 100 | 101.61 | 102.81 | 105.05 | 105.5 | 107.65 |
| Bahamas, The | 99.42 | 102.72 | 105.39 | 107.75 | 103.51 | 100 | 100.53 | 102.68 | 104.6 | 107.47 | 110.29 |
| Barbados | 109 | 107.4 | 104.26 | 104.89 | 101.01 | 100 | 99.4 | 104.56 | 103.52 | 93.6 | n.a |
| Belize | 104.75 | 103.3 | 100.66 | 106.55 | 102.32 | 100 | 105.27 | 108.54 | 108.23 | 105.61 | 107.14 |
| Dominica | 104.25 | 106.06 | 106.99 | 110.04 | 106.16 | 100 | 101.4 | 106.92 | 112.08 | 111.16 | 113.35 |
| Grenada | 99.8 | 98.97 | 98.12 | 103.54 | 103.52 | 100 | 101.19 | 103.82 | 104.94 | 105.68 | 109.57 |
| Guyana | 96.63 | 82.46 | 90.61 | 98.92 | 98.21 | 100 | 107.97 | 113.81 | 114.48 | 103.76 | 109.44 |
| Jamaica | 73.9 | 82.18 | 94.61 | 87.137 | 98.81 | 100 | 129.2 | 140.44 | 143.24 | 132.3 | n.a |
| St. Kitts and Nevis | 102.11 | 101.84 | 100.49 | 103.32 | 102.25 | 100 | 100.8 | 109.57 | 112.51 | 115 | 117.63 |
| St. Lucia | 95.52 | 97.72 | 98.43 | 102.29 | 101.3 | 100 | 101.25 | 103.65 | 106.9 | 110.33 | 116.36 |
| St. Vincent and the Grenadines | 100.28 | 102.51 | 100.99 | 107.97 | 105.04 | 100 | 104.24 | 107.8 | 111.68 | 111.24 | 114.22 |
| Suriname | 75.46 | 63.9 | 68.37 | 65.43 | 69.68 | 100 | 100.4 | 123.09 | 148.20 | .. | .. |
| Trinidad and Tobago | 118.71 | 119.13 | 121.69 | 109.94 | 102.43 | 100 | 101.88 | 102.29 | 107.34 | 110.23 | 115.37 |

**Source:** *http://publications.worldbank.org/WDI/.*

suggesting is that Caricom countries are becoming less competitive externally.[20] This is very disturbing as the world economy is becoming increasingly globalized and the economies of the Caricom region are being asked to enter into trading arrangements with greater 'reciprocation', the consequence of which may be an eventual loss of market share for Caricom member states which do not improve their external competitiveness. With respect to public finance concerns, one would expect that government current revenues would expand as their external competitiveness is improved. Improving external competitiveness by stimulating exports can have both a direct impact on government revenues and an indirect effect working through the multiplier effect on other activities.

### 4.2 Terms of Trade

The amount of export revenues that a country collects is not only conditioned by the volume of its exports but also by their unit prices. If the export prices of a country are increasing less slowly than its import prices, then this country would have to export a greater volume of its produce and deploy more of its scarce productive resources in order to procure the same amount of imported goods as it did previously. The terms of trade index shows the relationship of the export price index to the import price index. A rise in this index above 100 implies an improvement in the purchasing capabilities of the home country.

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20 It is well known that a real effective exchange index value of 100 indicates trade neutrality, one below 100 is indicative of an ultra export-led growth strategy whilst an index value above 100 is indicative of a trading regime that is inclined towards import substituting industrialization.

**Table 10: Terms of Trade (1995=100) of Some Caricom Member States, 1991-1998**

| Country | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|---|---|
| Antigua and Barbuda | 105.17 | 123.58 | 85.89 | 72.83 | 100.00 | 33.60 | 37.87 | 35.63 |
| Bahamas, The | 99.23 | 97.74 | 105.26 | 105.26 | 100.00 | 100.10 | 106.21 | 105.68 |
| Barbados | 89.98 | 93.40 | 96.02 | 87.95 | 100.00 | 102.80 | 103.93 | 105.39 |
| Belize | 89.89 | 91.60 | 102.13 | 104.28 | 100.00 | 102.00 | 102.41 | 103.12 |
| Dominica | 109.26 | 106.20 | 101.32 | 101.42 | 100.00 | 100.10 | 102.60 | 105.27 |
| Guyana | 126.37 | 109.19 | 111.37 | 97.56 | 100.00 | 93.20 | 84.16 | 83.49 |
| Jamaica | 99.75 | 92.77 | 90.64 | 96.62 | 100.00 | 92.40 | 95.54 | 93.25 |
| St. Kitts | 98.56 | 102.80 | 99.40 | 99.90 | 100.00 | 98.90 | 98.80 | 99.89 |
| St. Lucia | 122.18 | 116.93 | 113.31 | 105.37 | 100.00 | 94.50 | 101.68 | 104.63 |
| St. Vincent & the Grenadines | 124.27 | 113.21 | 105.29 | 108.34 | 100.00 | 103.10 | 102.79 | 100.73 |
| Suriname | 112.01 | 106.85 | 107.39 | 103.20 | 100.00 | 103.50 | 102.67 | 102.06 |
| Trinidad and Tobago | 97.36 | 90.64 | 85.11 | 93.20 | 100.00 | 101.90 | 108.32 | 93.70 |

**Source:** *Itam (2000).*

The data in the table above suggest that the terms of trade of Antigua and Barbuda, Guyana, Jamaica, St. Kitts and Trinidad and Tobago worsened during the period 1991-1998. Further, based on the information in the table, the terms of trade of Dominica, St. Lucia, St. Vincent and the Grenadines and Suriname, although still above 100, have definitely deteriorated. Part of the reason for the deteriorating terms of trade is shown in Table 11. For Dominica, St. Lucia and St. Vincent, banana accounts for a significant part of their export earnings, and although the price offered by the European Union (the main export market for bananas from these countries) remains above the price level in the more competitive USA market, it appears in a state of decline.

For at least one of the member states of Caricom, Trinidad and Tobago, the time has probably come or is close to arriving when researchers would need to look at the income terms of trade as compared to the commodity terms of trade. The income terms of trade cater for feedback of changes in the output levels of the exporting country on the export prices of its main export commodities. As it stands, T&T is the world's number one exporter of ammonia, methanol and urea and when Train 3 of Atlantic LNG comes on stream, at the end of March 2003, T&T would have matured into being the 6$^{th}$ largest exporter of LNG in the world. For T&T, its income terms of trade moved from 100 (base year 1988) in 1988 to 163.1 in 1998 (Coker, 1999). Very clearly then, when the feedback effect of changing prices on output is considered, T&T's (income) terms of trade have improved.

Fluctuating export prices have both direct and indirect effects on Caricom economies. A change in the export prices for any country affects the capacity of the country to import foreign goods, the country's international reserves, the government's fiscal accounts and also the level of income

**Table 11: Prices of Bananas and Sugar in the EU and USA Markets 1999-2001**

| Commodity | Unit | Jan-Dec. 1999 | July-Sept. 2000 | October-Dec. 2000 | January-March 2001 | April-June 2001 | July-Sept. 2001 | November 2001 |
|---|---|---|---|---|---|---|---|---|
| Bananas (EU) | $m/t | 850.4 | 611 | 628.2 | 910.2 | 834.9 | 686 | 650.8 |
| Bananas (USA) | $m/t | 373.8 | 354.1 | 399.4 | 587.4 | 599.2 | 650.9 | 496 |
| Sugar (EU) | cents/kg | 59.17 | 54.2 | 52.89 | 53 | 53.12 | 52.6 | 52.6 |
| Sugar (USA) | cents/kg | 46.6 | 42.1 | 47.56 | 47.44 | 46.9 | 46.8 | 47 |

**Source:** *UNECLAC (2001).*

in the industries concerned. (Adverse movements in the price of key export commodities could be offset by increases in production. But there are limits on the extent to which this can be done, assuming the demand is there). The reduction in the capacity of a country to import goods can affect its economic development. The indirect effect of price fluctuations occurs through the exchange rate. In floating exchange rate regimes, falling export prices can trigger current account deficits and prompt a worsening of a country's BOP, thus encouraging a depreciation of a country's currency. In this context, if the appropriate import and export elasticities are not present, then the country's net exports can decrease and this could lead to a fall in overall tax revenues collected.

### 4.3 Imports and Exports and the Fiscal Position of Caricom Countries

Caricom countries are very dependent on import taxes for their current revenues. In a study in 1999, Bourne *et. al.* found that import taxes as a proportion of tax revenues were in excess of 47% for Antigua and Barbuda (66.6%), The Bahamas (50.5%), Dominica (54.2%), Grenada (64.6%), Montserrat (47.2%), St. Kitts and Nevis (53.3%), St. Lucia (57.9%), and St. Vincent and the Grenadines (50.8%). The present trend in trade liberalization would place increasing pressures on these countries to reduce their dependence on import taxes. This relationship between revenues and import taxes is discussed more extensively in my other paper included in this volume entitled: "The CARICOM's Common External Tariff (CET): Development and Fiscal Implications."

Export earnings and other capital inflows determine the ability of a country to service its external debt. Debt-service payments can consume a large portion of a debtor nation's foreign exchange earnings, and so divert foreign exchange from the purchase of essential imports. Debt-service payments would also reduce a government's ability to invest in the social and economic infrastructure necessary to take advantage of trade and other opportunities. In general, the debt burden of the commodity-exporting countries of the world is high in relation to their export earnings, and this puts continuous pressure on them to expand exports, leading to further reductions in the export prices of commodities.[21]

In terms of the relationship between exports and government current revenues, the table below indicates a close relationship between exports and public revenues in certain Caribbean countries. In particular, the correlation scores in the table below indicate that current revenues increase when exports increase, and fall when exports fall.

**Table 12: Correlations Between Export Earnings and Government Current Revenues, 1990-2000**

| Barbados | Guyana | Jamaica | Trinidad & Tobago |
|---|---|---|---|
| 0.69 | 0.88 | 0.50 | 0.72 |

**Source**: Computed.

21 This generalization is not fully applicable to Caricom producers who are price takers on international commodity markets.

Another important correlation statistic for Caricom countries is the relationship between real GDP growth and real merchandise exports. On average for all Caricom countries for the time period 1991-2000, there is a positive correlation between these two variables of 0.38.[22] The correlation coefficients are strongest for Grenada and Guyana, whilst for St. Vincent and the Grenadines and St. Kitts and Nevis the relationship is only weakly positive.

### 4.4 Composition of Trade

The composition of the export baskets of Caricom countries also influences their export earnings. According to the Prebisch–Singer Hypothesis (PSH), the prices of agricultural commodities are constantly decreasing relative to the prices of manufactures, so that in a global economy characterised by low price and income elasticity of demand for agricultural goods, expanding the output of primary commodities may not be the best developmental option.

To compound matters, Myrdal (1975) argues that the income elasticity of demand for the exports of the metropolitan countries (imports of the hinterlands) exhibited a 'ratchet' effect as a result of the so called 'demonstration effect' creating even greater problems. As Lewis (1980) has pointed out:

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22 Real exports were obtained by deflating nominal exports by the retail price index of the respective member countries.

**Table 13: Correlation Between Real GDP Growth and Real Exports, 1991-2000**

| Barbados | Belize | Dominica | Grenada | Guyana | Jamaica |
|---|---|---|---|---|---|
| 0.35 | 0.44 | 0.55 | 0.74 | 0.58 | 0.37 |

| St. Kitts and Nevis | St. Lucia | St. Vincent and the Grenadines | Trinidad and Tobago | Average |
|---|---|---|---|---|
| 0.15 | 0.20 | 0.01 | 0.32 | 0.37 |

**Source:** Own Derivations.

> The preference of consumers in rich countries for services rather than manufactured commodities will result in a relative decline of the industrial population. Among the effects of this may be a decline in the rate of growth of imports of primary production (Lewis, 1980: 559).

The implications of a low price elasticity of demand for primary agricultural goods for a country exporting such commodities may be expanded as follows. A rise in price would lead to a less than proportional increase in output because of factor input and other constraints. Even more, if enough producers of a commodity which is inelastic in demand expand output, then its price would fall more than proportional to any increase in its quantity demanded, with the consequence that export revenues would fall (this is the familiar 'fallacy of composition' argument). Fluctuations in the prices of export commodities for the price-taking small firms in Caricom also result in greater export earnings instability which also adversely affects economic growth.[23]

For Caricom countries, the majority of their export earnings come from the primary sector, represented here by the sum of sitc 0 through sitc 4.[24] If we exclude sitc 3 which mainly represents the mineral exports of Caricom countries, then the non-mineral primary commodity exports of Caricom countries in 1990 were 40% of total merchandise exports. If mineral exports are included, the primary exports of Caricom countries tallied to 76.1% in 1990. By 2000, primary commodity exports (non-sitc 3) of Caricom countries amounted to 26.1%, or 72% when sitc 3 is included.

In general, countries that depend on the manufacturing sector experience more stable economic growth than those which depend on primary products. Manufacturing export revenues also help to facilitate stable

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23 For countries with a high degree of export concentration on a single or just a few primary agricultural commodities, variations in price can lead to rapid and acute fluctuations in export earnings. Thus, the need to adjust to changes in export prices that occur sporadically will be greatest in those countries with the highest levels of export concentration.

24 According to the World Bank (2002) if tourism revenues were added to the export revenues of the four main merchandise exports of each Caricom member state, then the extent of their export concentration would appear very high, exceeding 80% in Suriname and St. Lucia, 60% in St. Kitts and Nevis and Antigua and Barbuda and reaching 50% for Barbados, Belize, Dominica, and Guyana.

Table 14: Caricom Exports, 1990-2000

Panel 14a: Value of Caricom Total Domestic Exports by Single Digit Sectors, EC$000, 1990-2000

| Year | Total Export | Sitc 0 | Sitc 1 | Sitc 2 | Sitc 3 | Sitc 4 | Sitc 5 | Sitc 6 | Sitc 7 | Sitc 8 | Sitc 9 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1990 | 11024.6 | 1912.9 | 243.1 | 2225.3 | 3990.4 | 21.8 | 982.8 | 719.5 | 352.8 | 566.2 | 19.5 |
| 1991 | 9707.5 | 1396.4 | 203.3 | 1801.6 | 3687.9 | 15.5 | 1062.5 | 644.1 | 408.6 | 477.9 | 8.6 |
| 1992 | 9433.2 | 1689.3 | 228.7 | 1560.3 | 3362.1 | 10.1 | 945.1 | 666.8 | 256.5 | 707.1 | 8.3 |
| 1993 | 8730.5 | 1618.3 | 254.2 | 1458.0 | 2635.9 | 19.3 | 910.0 | 682.4 | 302.9 | 843.5 | 7.4 |
| 1994 | 10741.6 | 1623.2 | 283.3 | 1703.7 | 3081.2 | 16.2 | 1800.7 | 895.5 | 343.7 | 984.9 | 9.1 |
| 1995 | 13592.3 | 2171.8 | 337.7 | 2793.1 | 3367.4 | 19.2 | 2015.6 | 1301.0 | 463.7 | 1127.1 | 11.5 |
| 1996 | 12429.6 | 2086.0 | 362.5 | 1913.4 | 3612.9 | 17.5 | 1851.4 | 1038.5 | 504.6 | 993.7 | 41.0 |
| 1997 | 13859.3 | 2750.2 | 434.0 | 2296.9 | 3356.7 | 24.7 | 1971.4 | 1208.5 | 465.3 | 968.3 | 383.3 |
| 1998 | 12666.4 | 2497.5 | 515.7 | 2146.2 | 2862.1 | 26.2 | 1675.9 | 1208.0 | 474.8 | 897.7 | 349.7 |
| 1999 | 13792.0 | 2523.5 | 434.2 | 2117.2 | 4155.7 | 15.9 | 1729.5 | 1107.6 | 608.1 | 805.2 | 303.6 |
| 2000 | 17007.4 | 1922.2 | 464.7 | 2044.6 | 7795.7 | 12.7 | 2351.8 | 1147.4 | 494.8 | 756.6 | 13.8 |

Table 14: Caricom Exports, 1990-2000 - Concluded

Panel 14b: Percentage Distribution of Caricom's Total Domestic Exports by Single Digit Sectors, 1990-2000

| Year | Total Export | Sitc 0 | Sitc 1 | Sitc 2 | Sitc 3 | Sitc 4 | Sitc 5 | Sitc 6 | Sitc 7 | Sitc 8 | Sitc 9 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1990 | 100.0 | 17.4 | 2.2 | 20.2 | 36.2 | 0.2 | 8.9 | 6.5 | 3.2 | 5.1 | 0.2 |
| 1991 | 100.0 | 14.4 | 2.1 | 18.6 | 38.0 | 0.2 | 10.9 | 6.6 | 4.2 | 4.9 | 0.1 |
| 1992 | 100.0 | 17.9 | 2.4 | 16.5 | 35.6 | 0.1 | 10.0 | 7.1 | 2.7 | 7.5 | 0.1 |
| 1993 | 100.0 | 18.5 | 2.9 | 16.7 | 30.2 | 0.2 | 10.4 | 7.8 | 3.5 | 9.7 | 0.1 |
| 1994 | 100.0 | 15.1 | 2.6 | 15.9 | 28.7 | 0.2 | 16.8 | 8.3 | 3.2 | 9.2 | 0.1 |
| 1995 | 100.0 | 16.0 | 2.5 | 20.5 | 24.8 | 0.1 | 14.8 | 9.6 | 3.4 | 8.3 | 0.1 |
| 1996 | 100.0 | 16.8 | 2.9 | 15.4 | 29.1 | 0.1 | 14.9 | 8.4 | 4.1 | 8.0 | 0.3 |
| 1997 | 100.0 | 19.8 | 3.1 | 16.6 | 24.2 | 0.2 | 14.2 | 8.7 | 3.4 | 7.0 | 2.8 |
| 1998 | 100.0 | 19.7 | 4.1 | 16.9 | 22.6 | 0.2 | 13.2 | 9.5 | 3.7 | 7.1 | 2.8 |
| 1999 | 100.0 | 18.3 | 3.1 | 15.4 | 30.1 | 0.1 | 12.5 | 8.0 | 4.4 | 5.8 | 2.2 |
| 2000 | 100.0 | 11.3 | 2.7 | 12.0 | 45.8 | 0.1 | 13.8 | 6.7 | 2.9 | 4.4 | 0.1 |

**Source:** *Caricom Secretariat (2002).*sitc0: food and live animals, sitc1: beverages and tobacco, sitc2: crude materials and inedible oils except fuels, sitc3: minerals, fuels, lubricants and related materials, sitc4: animals and vegetable oils and fats, sitc5: chemicals, sitc6: manufactured goods classified by materials, sitc7: machinery and transport equipment, sitc8: miscellaneous manufactured articles, sitc9: miscellaneous transactions and commodities.

economic growth in a more pronounced manner than primary commodity exports.[25] Other benefits of manufacturing include learning by doing, the realization of positive scale economies and the stimulation of positive externalities attached to the export of manufactured goods.[26]

Manufacturing also helps to increase the level of total factor productivity (TFP) in a country. TFP increases as a result of technological and organizational development. Technological improvement may arise as a result of foreign direct investment as it enables a country to move closer to international best practices in terms of technology and ideas. Increases in TFP imply more efficient production, which facilitates an increase in the country's output and hence, ushers in economic growth (Evans, 1989), which in turn would favourably impact upon a country's public revenues.

The benefit of investments in manufacturing exports is given greater clarification by recent theoretical work presented in endogenous growth models.[27] Unlike the neo-

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25 Generally speaking, the income elasticity of demand and price elasticity of demand are higher for manufactures than for primary export products (Das, 1998).

26 Some econometric information does exist which shows that manufactured exports may be the result of, rather than the cause of, rapid economic growth (Bradford 1994, Fosu 1990, Helleiner, 1995).

27 The notion of dynamic economies of scale in the sense that success leads to success has always been an important aspect of the argument that manufacturing is an engine for economic growth (Cornwall, 1977).

classical growth model, endogenous growth theory demonstrates that economic growth can be influenced by variations in fiscal, human capital and foreign trade policies. This provides a direct challenge to the neo-classical presumption that policy can affect the level of economic activity but not the rate of economic growth. Endogenous growth models stress the importance of technological innovation and the accumulation of human capital in economic growth and the development process. The initial endogenous growth models by Romer (1986, 1995) and Lucas (1988) treated physical capital as the long-run engine of growth. Endogenous growth theorists noted that although at the level of the firm, a new idea might be subjected to the law of diminishing returns, it would induce a positive externality associated with production, technology and knowledge for other firms so that at the level of the economy a new idea can lead to increasing returns to scale.[28] The manufacturing sector is important in this regard as it is one of the main sectors where the process of obtaining knowledge endogenously and increasing returns in the production of goods take place (Romer, 1995).

The following table shows that as a proportion of total exports, manufacturing exports from Caricom member states increased from 23.7% in 1990 to 27.9% in 2000. In the same interval of time, the collection of revenue by governments in the Caricom sphere increased from US$3,926.8mn to US$7,548mn. The correlation between

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28 In general, poor countries experience slow growth rates because they fail to generate or use new technological ideas to explore greater economic opportunity (Barbier and Homer-Dixon, 1996).

**Table 15: Correlation Between the Share of Manufacturing Exports in Total Merchandise Exports and Total Government Current Revenues (US$Mn), 1990-2000 [a]**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Share of manufacturing exports in total exports | 23.78 | 26.71 | 27.30 | 31.37 | 37.47 | 36.10 | 35.30 | 33.29 | 33.60 | 30.82 | 27.93 |
| Total government revenues (US$mn) | 3926.85 | 3780.12 | 4069.31 | 3973.58 | 4445.42 | 4868.72 | 5484.61 | 5678.97 | 6036.14 | 6280.09 | 7546.02 |
| **Correlation** | | | | | 0.49 | | | | | | |

**Source:** *Computed.*

a: Manufacturing exports is treated as the sum of sitc 5, 6, 7 and 8.

these two variables, i.e. the share of manufacturing exports in total exports and government revenue collections was 0.49, clearly indicating that an increase in manufacturing export shares is associated with an increase in government revenues.

## 5. Free Trade and Future Public Revenues Flows

The *Global Economic Prospects* (2002) has indicated that the events of September 11$^{th}$ 2001 would have a sharp negative impact on the global economy, which by the summer of 2001 was already precariously positioned between a recession and a recovery.[29] The growth of global trade fell from 13.3% in 2000 to 1% in 2001. The source of this global slowdown has its roots in a sudden decline in US financial markets in 2000, which in turn prompted an end to the worldwide bubble in equity values and also led to the development of excess capacity in high-tech areas of global production. With the slowdown in the US economy, the level of investor confidence and consumer demand fell and this also had a demonstration effect on the countries in the European Union. For the first time since the period 1974-75, the largest economies in the world are decelerating together. With Japan in a recession, Europe in a decline and the USA still coping with the aftermath of the events of September 11$^{th}$ 2001, the

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29 The report goes on to note that since the events of September 11$^{th}$, the likelihood of a more serious slowdown in the global economy has heightened. However, because it remains extremely difficult to ascertain the way in which economic agents would respond to these events, these forecasts can be subjected to a wide margin of error.

prospects of a downturn, argues the *Global Economic Prospects* (2002), may become global. The invasion of Iraq by the US and its allies in March 2003 has added to the uncertainty.

Even more than this, the prices of several key exports from the Caribbean have fallen in the recent past so that the fall-off in prices and the slow growth in external demand could lead to a fall in growth and export earnings of Caricom countries. At the same time, the trends in the merchandise imports of Caricom countries are likely to stay high, leading to a worsening trade balance.

The events of September 11th would have increased the perceived risk by American travellers to foreign destinations, including the Caribbean, especially as it remains uncertain whether Osama bin Laden, the alleged mastermind behind the events of September 11th, is still alive. In this regard, it may be argued that American citizens may be more hesitant to travel abroad. Another factor is that many airlines have cut the number of flights that come into the Caricom block and so the volume of visitor arrival traffic from this source may also be adversely affected. Even further, increases in insurance costs associated with the events of September 11th would have amplified the per-unit cost of travelling and thus, have a dampening effect on consumer demand for travel. Additionally, hotel occupancy rates in many countries have fallen considerably from a 60% occupancy rate in September-October 2001 to about 15% at present (UNELAC 2002). In summary, then, a worsening trade balance and a prospective decline in the service balance are expected to lead to a deteriorating current account balance.

One fundamental area of concern for Caricom countries remains the extent of their export concentration revenues extremely volatile. Because export revenues contribute both directly and indirectly to public revenues there is urgent need for diversification of exports and markets. Even further, with the various challenges being made to the preferential export market base of Caricom countries, new trade options will have to be explored. In this regard, greater effort has to be made by Caricom member states to embrace productive activities on the upswing of the international product cycle which acutely match their factor endowment base. In this context there may still be substantial scope for the use of industrial policy to help create dynamic comparative advantage based on new levels of technology and research and development. Dynamic comparative advantage in the Caricom area has to be built on greater productivity and improved efficiency levels as compared to cheap labor arrangements.[30]

Importantly, the public sector deficits in some Caricom member countries have shown clear signs of increasing and governments in these member states would need to become more proactive in increasing public savings and investments. This problem has to be addressed on both the revenue and expenditure fronts. On the revenue side, Caricom governments would have to introduce more productive tax systems. For most states an improvement in their fiscal position would reduce the need to borrow. Strengthening national savings becomes even more urgent when one considers that Caricom's common external tariff is coming under increasing pressure to be dismantled in the context of the pending Free Trade Areas of the Americas and the deepening of Caricom *via* the Caricom Single

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30 China has made a mockery of any claims to cheap labour

Market and Economy. On the expenditure side, Caricom governments would need to cut cost and reduce wastage. In some member states, greater attention may have to be paid to the implementation of user charges in the provision of public services.

Caribbean countries have had some success in terms of structurally reforming their economies into the 1990s, including the privatization of bankrupt state-owned enterprises. Further, some member states have started to engage in greater elements of trade liberalization and a general removal of price controls as necessitated by the structural adjustment programmes embraced by some of these countries. However, Caricom countries need to do even more to better position themselves in a rapidly globalizing world.

## 6. Conclusion

The external debt position of Caricom countries continues to be a serious one. In the context of the anticipated slowdown in the world economy, the debt servicing capacity of Caricom countries is likely to weaken necessitating urgent and immediate steps in order to deal with the question of resource mobilization and use. Already, the real growth rate of Caricom member states in 2001 (0.2%) is lower than in 1991 (1.5%) and unemployment continues to be in double digits, although inflation has generally been at low levels in most states (except Suriname). Imports continue to grow whilst the growth of exports has not been impressive, leading to persistent trade deficits in most cases.

Fiscal discipline in Caricom has not always been as sharp as it should be, and despite the economic reforms adopted by several Caricom states in the 1990s, fiscal imbalances persist in many cases. Although most of the countries have achieved a debt service ratio in 2000 of less than the 15% benchmark proposed by the Caricom Secretariat, several member states, notably Belize, Guyana and Jamaica, continue to have debt-servicing ratios which exceed this target (the debt service ratio of St. Kitts and Nevis has also climbed rapidly in 1999 and 2000). Interest payments on debt continue to absorb a significant chunk of the current expenditure and revenues of several countries, thus placing constraints on social expenditures which can be used to develop the human capital stock of these countries.

Strengthening export revenues in a rapidly globalizing economy must remain high on the agenda for Caricom countries if they are to limit their dependence on external savings. Trade drives these economies. With the possibility that some markets will be lost, regional entrepreneurs and governments need to pay closer attention to their factor endowment bundles and areas of comparative and dynamic advantage to maintain and even improve their global export market shares. Export sector reform is imperative for Caricom countries if they are to function in this new century and increase their level of social and economic development.

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# 19

# Tax Reform and the Changing Direct/Indirect Tax Revenue Mix in the Caribbean: Implications for Efficiency and Equity

*Dave Seerattan & Leslie Charles*

## 1.0 Introduction

Tax policy is fundamentally concerned with the development of a tax system that is capable of financing public expenditure in the most efficient and equitable way possible. In developing countries, underdeveloped economic structures, weak tax administration and inadequate information systems present serious obstacles to the development of effective and efficient tax systems. As a result, tax policy in developing countries can most appropriately be characterised as the "art of the possible rather than the pursuit of the optimal" (Tanzi and Zee 2000, p.4). This reality manifests itself in the existence of numerous small taxes, a heavy reliance on external trade taxes and the under-utilization of personal income taxes.

The apparent political reluctance to pursue fundamental tax reform, at least until the late 1980s and the 1990s, meant that changes to the tax structure have often been piecemeal and marginal rather than structural and comprehensive. The increasing burden on governments in the last two decades in terms of the level of services they are expected to provide, chronic economic imbalances and tax systems in which tax revenue buoyancy was low, meant that the fiscal authorities in the Caribbean were forced to confront the need for fundamental tax reform in the last decade. Tax reform is therefore now very high on the policy agenda of most Caribbean countries. Indeed, a number of countries in the region have already instituted significant reforms to their tax systems (Due and Greaney 1992).

In all cases the main focus of the reforms has been lowering direct marginal tax rates applied to a broader base and the simplification of the indirect tax system, especially in terms of the replacement of the numerous small indirect taxes with a broad-based sales or value added tax. In this context, a major challenge for the reforms has been finding the appropriate mix between direct and indirect taxes. The choice between direct and indirect taxes is one of the oldest issues in the literature on taxation policy (Atkinson 1977). This topic has remained relevant over the years because the theoretical issues it deals with are of direct relevance to policymakers.

This is no different in the Caribbean where resource constraints add greater urgency to these issues. In particular, the gradual move to a greater reliance on indirect taxes driven by efficiency and revenue yield considerations has raised concerns about increasing inequity,[1] especially given the already unequal distribution of income in these jurisdictions and relatively high levels of poverty. Equity considerations in the recent past have, however, been overshadowed by the economic reality of the need to raise revenue more efficiently to fund governments' increased provision of services (Gandhi 1992). Most of the work done on tax reform in the region has therefore focused on efficiency and revenue yield considerations. A complete analysis of the welfare implications of tax reform initiatives, however, requires that both the efficiency and equity considerations be explicitly evaluated in the review.

In this context, this paper attempts to evaluate the efficiency and equity impact of tax reforms that targeted the tax revenue mix in selected Caribbean countries in the 1980s and 1990s. The paper is structured as follows. Section 2 reviews the tax reform efforts of selected Caribbean countries in the 1980s and 1990s. Section 3 looks at the theoretical issues related to the mix between direct and indirect taxes. Section 4 outlines how the mix between direct and indirect taxes has evolved over time and attempts to measure the efficiency and equity consequences of these changes. Section 5 concludes by attempting to distil policy implications from the analysis.

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1 The basic hypothesis is that changing the mix in favour of more indirect taxes will improve efficiency in revenue collection but will result in adverse distributive consequences.

## 2.0 The Tax Reform Experiences in Selected Caribbean Countries (Barbados, Jamaica and Trinidad and Tobago)

Tax reform initiatives in the Caribbean have focused on simplifying the tax system and increasing its efficiency by lowering rates, increasing the tax base and by increasing the reliance on indirect taxes. The impetus for tax reforms such as narrowing or narrow tax bases, concerns about horizontal equity and administrative efficiency are similar across developed and developing countries but the need for reform is generally more pressing in developing countries. An issue which tax reforms inevitably have to deal with is the definition of the tax base, that is, what proportion of tax revenues should come from income, consumption or wealth. Another important issue is that of the rate structure for various taxes. This deals with problems such as whether to have uniform rates across tax units to foster horizontal equity and administrative simplicity or whether to have differentiated rates to promote vertical equity and the most appropriate response from individual tax units. Last but by no means least is the need to improve the revenue elasticity of the tax system.

In the Caribbean, the most pressing issues are the need to improve the revenue bouyancy of tax systems and to improve administrative efficiency. This has forced the authorities in these jurisdictions to focus more on efficiency rather than an equity considerations in their tax reform efforts. All the main facets of the tax reform programmes therefore flow from this orientation. In particular, the move to increase reliance on indirect taxes as opposed to direct taxes has been driven by this objective. The following review of tax reform efforts in selected Caribbean countries bear this out.

***Barbados***

The principal factors driving tax reforms over the years have been sequentially the strategy to build a service economy by reducing the burden of personal income tax and the need to simplify the tax system and make it more efficient. The most significant adjustment to the tax system prior to 1985 involved the introduction of a tax credit system, which sought to reduce the tax burden of the individuals in the lower income scales. In effect, these tax credits reduced the marginal income tax rates for low-income individuals in the pursuit of vertical equity. Other changes to the income tax structure included a small adjustment to the top income tax rate from 70% to 60% and the widening of income bands to accommodate wage increases.

These changes to the income tax structure invariably had a negative impact on government revenue and the shortfall was usually covered by increases in indirect taxes. In fact, from 1980 the reduction in direct tax revenue occasioned by the reforms to the direct tax structure was made up by increases in stamp duties, consumption taxes, levies and other indirect taxes. These increases in indirect taxes occurred in the context of efforts to stabilise the economy (Howard, 1992). The rate of growth of indirect tax revenues therefore outstripped that of direct tax revenues over the period 1980 to 2000.

In 1986, the system of tax credits was abolished and persons earning $15,000 and below were exempt from income tax. A basic tax allowance of $15,000 was introduced and the top rate of income tax was also reduced from 60% to 50%. These reforms simplified the tax system but some have argued that they reduced the progressivity of the system especially since the $15,000 allowance was available to individuals in all income categories (Howard

1992). The reforms further reduced income tax revenues by reducing the effective marginal income tax rate for all individuals. The corporate income tax was also reduced from 45% to 35% in 1986 to encourage corporate investment. The revenue loss from these reforms was managed by reductions in current as well capital expenditure. These expenditure cuts were a short-term measure and could not be sustained. The reduction in the direct tax burden was therefore, in most cases, accompanied by increases in indirect taxes. As a result of this, indirect tax revenue to total tax revenue rose from 55.8% in 1980 to 73.0% in 1986 while the ratio of direct tax revenue to total tax revenue fell from 44.2% in 1980 to 27.0% in 1986. After the direct tax reform in 1986 reduced the effective marginal income tax rate, the government had to resort to huge increases of indirect taxes in 1987 to bolster tax revenues and to curb consumption expenditure. The increased reliance on indirect taxes, especially consumption taxes, was also thought to be regressive and inflationary.

The other major phase of tax reform was introduced in 1992 and was designed to simplify the tax system and make it more efficient. The direct tax system in Barbados in 1992 was based on a personal income tax, a corporate income tax, a stabilisation tax and a host of levies on employment, health, training and transport. The personal income tax also had a range of marginal rates for different classes designed to promote vertical equity but this objective was frustrated by a host of exemptions and deductions available to mostly middle and higher income individuals. The reforms to the direct tax system included the lowering of the top rate of the personal income tax to 40% and the equalisation of this rate to the corporate income tax rate (which meant an increase from 35% to 40%). It also included the reduction of personal income tax brackets from six to two and the elimination of most exemptions and deductions. Most levies were also removed as part of the reforms. This general simplification of the direct tax system was not followed rigidly as allowances were introduced for dependent children and spouses, as well as a personal allowance for mortgage interest and home repairs. Allowances to stimulate business and deductions to encourage savings were also introduced. These exceptions to the rule were designed to achieve particular policy objectives within the overall framework designed to simplify and make more efficient the process for collecting direct tax revenues.

In terms of reforms to the indirect tax system, the central objectives were the replacement of the various small indirect taxes with a value added tax and the reduction of import tariffs. The indirect tax system in Barbados before 1992 was made up of import duties, consumption taxes, a hotel and restaurant sales tax, stamp duties and numerous minor taxes. The great number and variety of indirect taxes made administration of this system very unwieldy, and this was compounded by numerous exemptions and cascading effects.

The Value Added Tax (VAT) was eventually introduced at the start of 1997 at a rate of 15% (except hotel accommodation which was taxed at a rate of 7.5%), replacing 11 different taxes. The VAT on products such as motor vehicles, alcoholic beverages and tobacco products which were taxed heavily before 1997, was supplemented by excise duties so as to maintain the high level of tax revenues from taxes on these products (to ensure revenue neutrality).

In an attempt to maintain a level of equity in the tax system and improve its targeting, the VAT system included a number of products and services that were either zero-rated or exempt from the VAT. Zero-rated items included goods for exports, supplies to foreign sales corporations and basic food items. Items exempt from VAT included the supply of financial services, real estate transactions and the supply of essential services such as water, health and educational services. Measures were also adopted to ease the impact of the VAT on disadvantaged sections of the population. These measures were estimated to provide relief to approximately 32,430 individuals. These measures included a 9% increase in the contributory pension scheme, a 12% increase in the non-contributory pension scheme and a BDS$53 annual grant to pensioners in the contributory and no-contributory pension schemes to defray the cost of the increase in electricity bills due to VAT. Additionally, persons in receipt of minimum wages would receive a BDS$350 annual grant to ease the burden of the VAT.

These two major tax reform efforts were designed to achieve a system that is much simpler to administer and one in which indirect taxes play a much more prominent role. There are, however, features of both the direct and indirect tax systems that seek to promote equity and distribution objectives. There are also features that seek to facilitate economic efficiency by providing incentives for growth and to promote competitiveness. The need to promote balanced growth and development seems therefore not to have been subordinated to administrative simplicity and revenue buoyancy. We explore this issue later in Section 3.

***Jamaica***

Comprehensive and systematic tax reform efforts began in Jamaica in 1983 with the commissioning of the Jamaica Tax Structure Examination Project in that year. This Project would eventually lead to the reform of the personal income tax system in 1986, the corporate income tax system in 1987 and the indirect tax system in 1991.

The reforms to the personal income tax system became effective from the beginning of 1986. The tax base of the personal income tax system was constrained by widespread evasion and avoidance, numerous tax credits and generous allowances. Other problems included the fact that the progressivity of the system was compromised by the system of tax credits and allowances and the existence of significant horizontal inequalities. The objectives of the reforms in this area of the system were therefore to broaden the tax base, reduce the top marginal rate and to provide relief to low-income families.

The main components of the reform programme for the personal tax system therefore included the following (Bahl 1997):

1. The progressive rate structure was replaced by a flat tax of 33.33% on personal income above J$8580.

2. The tax credit system was replaced by a standard deduction of J$8580.

3. There was a withholding tax of 33.33% on interest income from financial institutions registered under the Protection of Depositors Act.

4. Allowances were now generally included in taxable income.

5. Overtime income was no longer taxed at a lower rate.

The new system was easier to administer; it increased the effective progressivity of the system (which suffered because of the number of tax credits and allowances)[2] but it would initially have a negative impact on revenue. The objectives of the reforms therefore essentially mirrored the reform objectives in Barbados.

As part of the reform process, the corporate income tax system was also amended in 1987 through Act number 3 of 1987. The main problems affecting the corporate tax regime before the reforms included the fact that the rate structure was uneven, non-neutral and there were many avenues for tax avoidance. This resulted in high compliance costs for firms, made tax administration complicated and costly and constrained buoyancy. The main objectives of the reforms were, therefore, to make the system more horizontally equitable, administratively simpler and to broaden the base. The main features of the reform programme included:

1. The replacement of the 35% profit tax and the additional profit tax of 10% with a flat rate of 33.33%;

2. Losses could now be carried forward indefinitely until fully utilised against income;

3. Dividend distribution was now taxed at a rate of 33.33% under a withholding system.

The reforms essentially shifted the onus of payment from companies to individuals.

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2 The introduction of a tax on interest income also targeted higher income individuals, which helped improve the progressivity of the system.

The tax reform programme also targeted the indirect tax system and in October 1991 the proposed reforms to the indirect tax system were implemented. The structure of the indirect tax system in Jamaica prior to 1991 was one of piecemeal developments to boost revenues. The pre-1991 system comprised 5 taxes, the consumption duties levied on imports and domestically produced goods, excise taxes, a retail sales tax, customs duties and stamp duties. The majority of the indirect tax revenue (about 40%) was generated by the consumption duty. The major problems confronting the indirect tax system before the reforms included the fragmented nature of the coverage, the variety of rates, the non-neutral nature of the system and its low revenue elasticity. These factors made the administration of this system extremely difficult and generated a number of distortions, which contributed to inefficiency. The distributional impact of the system was also largely unknown because of the ad hoc way in which the system developed.

The reforms to the indirect tax system were designed to promote neutrality and horizontal equity, to increase its revenue elasticity and to improve its administrative efficiency. The implementation of the changes was delayed because the administrative structure was not yet in place. The reforms were implemented in October 1991 in the form of the introduction of the General Consumption Tax (GCT). The GCT was introduced at a rate of 10%, a rate that was lower than the one estimated to be revenue neutral. A system of zero rating was also used to promote equity, with products such as agricultural inputs, foodstuff, export goods and related services and health supplies being zero rated. This tax had a VAT feature that allowed credits for taxes paid on inputs.

The overall impact of the tax reform was felt in many areas. The reforms have helped to broaden the tax base and flatten the rate structure. The reforms led to a slight improvement in equity (Sjoquist and Green 1992) in the immediate post-reform period driven by the inclusion of interest income in the tax base, the increase in the standard deduction and the slight progessivity of the GCT. The broadening of the tax base is still incomplete in certain areas. For example, the coverage of self-employed persons has not improved, capital gains remain untaxed and certain allowances remain outside of the tax net. Moreover, although the GCT has helped to broaden the tax base, it still allows for a significant number of exemptions and zero-rated items. The level of equity in the system seems to have suffered subsequently as the top tax rate on the personal income tax was reduced and the rate of the GCT was increased. The maintenance of the system of tax incentives provided on a case by case basis has also compromised horizontal equity. The reforms have led to improvements but significant work still needs to be done to simplify the system and make it more efficient.

### *Trinidad and Tobago*

There have been a number of efforts to reform the tax system in Trinidad and Tobago over the years. The tax structure of Trinidad and Tobago is relatively different when compared to other Caribbean countries, essentially because of the dominance of petroleum taxes in government revenues. This means that in Trinidad and Tobago direct taxes have played a much more significant role in tax revenues relative to other countries in the Caribbean.

After independence, the government started to play a more active role in the economy, which inevitably led to faster growth in government expenditure. This, combined with the slowdown in the petroleum sector and the resultant weak revenue growth, led to a need to bolster the revenue capacity of the government. The revenue elasticity was low because of widespread evasion and avoidance in the personal income tax system. In terms of the corporate income tax system, the number of fiscal incentives granted to businesses effectively lowered the tax rate and the revenue elasticity of this tax. This situation distorted economic decisions and produced large fluctuations in government revenues as economic conditions changed. The reforms used to address this situation involved the broadening of the tax base to include companies and self-employed persons, the strengthening of tax administration and greater emphasis on indirect taxes.

To address these problems, a comprehensive tax reform programme was initiated in 1989 to improve the equity of the system, to minimise distortions and to simplify the computation of tax liability. The first phase of the reform programme, reforms to the income tax system, was implemented in 1989. This involved the following:

1. A reduction in the number of tax brackets, as well as a reduction in the marginal rates for all brackets, inclusive of the top bracket;

2. A reduction in the rate of corporation tax and the consolidation of several business levies into a single levy;

3. Elimination of special interest tax preferences;

4. An increase in the tax-free income level to provide relief to low-income taxpayers.

The second phase of the reforms involved a further reduction in income tax rates and an increased reliance on indirect taxation to fill the revenue gap left by reforms to the direct tax system. To diversify the tax revenue structure and simplify the complicated indirect tax system, the major reform included replacing the numerous indirect taxes with a broad-based Value Added Tax (VAT) in 1990. The VAT, applied at a single rate to a wide range of goods and services, would be a more efficient tax in terms of revenue than the numerous small indirect taxes levied on small bases and subject to a range of exemptions. The VAT structure also made allowance for equity by including exemptions and zero rated items. The second phase of the programme also equalised the top rate of personal income tax with the corporate income tax rate at 35%. Further changes were made subsequently to exempt a greater portion of income from personal income tax to ease the burden on lower income earners.

The reforms in all three countries have common elements that define the evolution of the tax system. These common elements include the following:

1. The simplification of both the direct and indirect components of the tax system, through the elimination of multiple rates, the reduction in the number of different taxes and the elimination of special interest allowances and exemptions; and

2. The greater reliance on indirect taxes to boost revenue buoyancy.

This common strategy is designed to increase the revenue elasticity of the tax system to meet greater expenditures and to deal with tax systems which had become structurally incapable of revenue buoyancy. This strategy was also designed to capitalized on the supposed advantage of indirect taxes, notably the VAT, in terms of efficiency (both in terms of revenue and administrative simplicity). This of course had to be weighed against the supposed regressive nature of such taxes. These issues are explored in more detail in the following section.

## 3.0 The Direct/Indirect Tax Mix: Theoretical Issues

Much of the earlier debate on the issue of the appropriate mix between direct and indirect taxation was clouded by some ambiguity in the definition of direct and indirect taxes. The definition that found favour initially was one based on incidence where the ability to shift a tax classified it as an indirect tax (Due and Friendlander 1973, Buchanan 1970). A more appropriate basis for classification, however, seems to be the method adopted by Atkinson (1977). He argued that the main basis for distinction between direct and indirect taxes was that the former could be adjusted to the individual characteristics of the taxpayer, whereas the latter could only be levied on transactions, irrespective of the type of buyer or seller. Income taxation is therefore direct and can be made progressive, whereas commodity taxation is indirect since it is based on anonymous transactions that can only be proportional.

It is not possible in this paper to adequately summarize all the views that have been expressed over the years on the subject of the mix between direct and indirect taxes but we attempt to present some of the central issues covered by this literature over the years. The choice between direct and indirect taxes in government finances is one of the oldest issues in taxation policy. The basic decision in this policy area is the choice of the tax base. Efficiency and equity considerations are central to the evaluation of the optimal mix of these two taxes in government revenue. The issue of equity in particular is important in developing countries where GINI coefficients tend to be high. The theoretical literature on the other hand has concentrated on efficiency considerations, possibly because information on income distribution is inadequate or missing in many developing countries.

The conventional belief that taxing income (direct taxation) imposes a higher efficiency (welfare) cost is based on the observation that an income tax has both labour and capital tax components. Since the labour tax is essentially a tax on consumption (indirect tax) in an inter-temporal framework, income taxation has an additional cost in terms of a tax on savings, which the consumption (indirect) tax is not encumbered by. In this context, the consumption tax (indirect tax) is superior to the income tax (direct tax).[3] On the other hand, equity considerations tilt the balance in favour of direct taxes since it is believed that consumption taxes are inherently more regressive than income taxes. This is based on the difficulties involved in implementing a broad based graduated consumption tax, which would promote equity.[4] One can therefore discern a type of policy assignment rule with particular policy objectives being assigned to particular taxes. In particular, many people assign the equity objective to direct

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3 The optimal mix of direct (income) and indirect (consumption) taxes is also dependent on the length of the planning horizon. If based on life cycle considerations the mix would be dependent on the tax elasticity with respect to labour and savings. If based on an infinite horizon the optimal tax structure would involve no tax on capital, which would exclude income taxation from the optimal tax mix (see Chamley 1986).

4 This view has been challenged on the grounds that a graduated consumption tax can be implemented if the problem is viewed from a life cycle rather than a static perspective (see Metcalf, 1994).

taxation in much the same way that people assign the goal of raising revenue efficiently to indirect taxes. The rationale for the equity assignment is that an indirect tax, even if differentiated by luxuries and necessities, is a poor re-distributive tool. The second assignment is based on the belief that indirect taxation would create fewer distortions because it impacts more on consumption than on savings and is therefore more efficient.

The optimal tax literature provides much of the basis for discussions on this debate about the appropriate mix between direct and indirect taxation. The essential spirit of the optimal taxation framework is that it recognizes the efficiency costs generated by taxation and looks at ways of reducing these costs. In the most basic models, the only taxes available are commodity taxes and the only objective is to minimize efficiency costs for a given level of tax revenue. These models also make the simplified assumption that all taxpayers are identical in endowment and taste, so there is no need to deal with the complication of equity considerations. These models also assume that taxes could be raised without administrative or compliance costs. The basic problem faced in this framework is how to minimize the excess burden for a given level of tax revenue. Ramsey (1927) demonstrated that differentiated commodity taxation based on a rule where taxes were levied in an inverse proportion to their compensated elasticity of demand would serve to minimize distortions. This was exactly the opposite view to the conventional wisdom that uniform taxation was more appropriate. When one includes features such as different taxpayers (equity considerations) and the possibility of an extra instrument, an income tax, the optimal tax structure changes drastically.

The role of indirect taxes as instruments of optimal tax policy has been weakened by the work of Atkinson and Stiglitz (1976). They demonstrated that when an income tax is available to the fiscal authorities and preferences are weakly separable in labour supply and produced goods, commodity (indirect) taxation would not be part of the optimum tax structure as non-linear income taxation satisfies both efficiency and equity considerations. This is so because the optimal commodity tax structure under these conditions is a uniform one, which would be equivalent to a proportional income tax. The validity of the Atkinson and Stiglitz result rests on the separability assumption. The main weakness of this analysis, however, is that it assumes that individuals only differ in their wage levels, ignoring other areas of heterogeneity such as taste and wealth. In fact, Cremer, Pestieau and Rochet (2001) argue that the Atkinson and Stiglitz result does not hold when these areas of heterogeneity are included in the analysis. In fact, they show that commodity (indirect) taxation is needed *except* in the implausible case when all individuals have identical endowments, which drives the Atkinson and Stiglitz result.

Cremer, Pestieau and Rochet (2001) analysed the optimal direct/indirect tax mix in a framework similar to Atkinson and Stiglitz but where individuals differ in many unobservable characteristics. They found that differentiated commodity taxation does have a role to play in an optimal mix but they offered no guidelines with respect to the appropriate mix. In general, the theoretical models offer little help in empirically defining the appropriate direct/indirect tax mix. This is so since all the factors which impact on the tax mix are related through a web of complex interactions, which makes the determination of the relative welfare cost/benefit of the two taxes uncertain (Tanzi and Zee 2000). The modern theory of optimal commodity and income taxation also sends ambiguous signals. In some cases it suggests that optimal income taxation would suffice. In other special cases (based on different assumptions) a mix of taxes is desirable but the exact mix is indeterminable since any tax structure can be constructed by an arbitrary combination of various levels of direct and indirect taxation.

Optimal tax theory is also incomplete as a guide to actual policy initiatives in this area because it is based on models, which are based on highly stylized versions of the environment, that exclude important determinants of the tax mix. Factors such as imperfect competition, increasing returns to scale, limited information, underdeveloped tax administration and tax compliance costs would all have a major impact on the decision about the appropriate mix. These are, however, not explicitly included in optimal tax models.

Nevertheless, the various models do throw up important factors to consider in determining the appropriate mix. These include the objectives of the fiscal authorities, the ease of administering the tax, the level of distortions it generates, the level of evasion and avoidance and the structure of the economy. Most of these factors really speak to the ease with which the system can be managed - in other words, the best mix would be determined by the easiest way to collect the needed revenue with the minimum costs in terms of economic distortion and equity. In this regard, direct taxes can be more easily tailored to achieve equity objectives whereas indirect taxation can be applied to the widest possible base for revenue purposes and it is also very difficult to evade or avoid. Theoretically, however, both types of taxes can be used to further equity and efficiency. Both types of taxes can also be used to alter economic incentives. The net effect of tax reforms therefore has to be settled by empirics. The optimal mix for any jurisdiction will therefore vary according to the conditions on the ground and the objective function of the tax authorities. The authorities therefore need to determine their priorities, whether it is raising revenue, equity or specific sector objectives. In this context, we review the evolution of the distribution of the mix between direct and indirect taxes in selected Caribbean countries to highlight the factors driving the changes in the tax mix.

## 4.0 Impact Analysis

### *The Tax Revenue Mix*

The evolution of the tax revenue mix in the Caribbean has generally been driven by ad hoc changes to boost revenues (before the major tax reform programmes) and structured tax reform initiatives. These changes have not always generated the desired outcome. In this section we look at the evolution of the revenue mix as the tax structure changed, driven by reforms and the general economic environment.

The major reforms to the direct tax system in Caribbean countries included the removal of deductions and allowances, as well as the lowering of the top rate on the highest income group and the reduction in the number of income classes. One of the major reforms that was implemented in these three countries was the introduction of a broad-based indirect tax in the form of a value added tax in Barbados and Trinidad and Tobago in 1997 and 1990 respectively, as well as a general consumption tax in Jamaica in 1991. The introduction of these general indirect taxes was usually done in conjunction with the removal of a wide range of small indirect taxes to simplify the administration of the tax system. The tax reform measures introduced in these territories were expected to alter the tax revenue mix in favour of the indirect taxes through:

1. The lowering of the income tax rate for the different income brackets;

2. The introduction of a general system of indirect taxes at a higher rate and applied to a broader base which was expected to increase indirect taxes.

The impact of the tax reform initiatives on the tax mix is evaluated by looking at the average tax mix before and after the major tax reforms were implemented. The major tax reforms in all jurisdictions culminated in the introduction of a general indirect tax so the introduction of this tax represents the end of the major reforms. This is an appropriate timeline since the reforms were implemented in stages so that the full set of reforms in the direct tax system for all intents and purpose would in most cases only have been implemented fully just about the time[5] that the major changes to the indirect tax system were being implemented. The pre-reform period is therefore considered the period up to the introduction of either VAT in Barbados and Trinidad and Tobago or the General Consumption Tax in Jamaica. The post reform period is of course the period after the introduction of these general indirect taxes.

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5 In the case of Barbados, significant changes to the direct tax system such as the elimination of tax credits, the reduction of the tax rates and the reduction in the number of income bands had started well before the introduction of a 15 percent VAT in 1997. In Jamaica and Trinidad and Tobago, similar changes to the direct tax system had taken place five and two years respectively prior to the reform of the indirect tax system.

During the period under review total nominal tax revenue increased in all three countries, total revenues in Barbados expanding from B$333.6 million in 1980 B$1,615 million in 2000; in Jamaica it expanded from J$1,292.9 million in 1980 to J$87,074.2 million in 2000; and in Trinidad and Tobago it expanded from TT$5,939.8 million in 1983 to TT$12,128.5 million in 2000 (see Table1).

The impact of tax reform initiatives on the tax mix depended, however, on the growth of direct tax revenues relative to the growth in indirect tax revenues. A faster growth in indirect (direct) tax generally means a greater share of that tax in the revenue base. Over the period under review, the growth rate of indirect tax revenues for Barbados, Jamaica and Trinidad and Tobago increased by 8.2%, 28.2% and 8.7%, all higher than direct tax revenues which grew by 7.9%, 22.8% and 4.7% respectively. In terms of the pre- and post-reform periods, the average annual growth rate in indirect tax revenues increased from 7.8% to 9.5% while in Jamaica and Trinidad and Tobago the growth rate of indirect tax revenues increased from 27.0% to 29.3% and from 0.6% to 13.1% respectively in the pre- and post-reform periods. In terms of direct tax revenues, the annual average growth rate for Barbados, Jamaica and Trinidad and Tobago increased from 7.2% to 10.8%, from 17.4% to 27.3% and from -5.5% to 10.2% between the pre- and post-reform periods respectively. This pattern is of course also reflected in total tax revenues, which increased significantly in the post-reform period (see Table 2).

The experiences of these countries are generally in sync with what was expected from the tax reform programmes, that is, the growth rates for direct and indirect tax revenues should increase but indirect tax revenues should grow faster than direct tax revenues, driven by a much wider base and a less cumbersome administrative

**Table 1**
**Tax Revenue by Source in Millions of National Currency**

| | | Years | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Country** | **Tax Revenue** | **1980** | **1981** | **1982** | **1983** | **1984** | **1985** | **1986** |
| Barbados | Direct Taxes | 161.5 | 166.4 | 193.6 | 194.7 | 188.5 | 204.1 | 160.5 |
| | Indirect Taxes | 172.1 | 182.3 | 226.2 | 265 | 304.3 | 350.3 | 417.4 |
| | Total | 333.6 | 348.7 | 419.8 | 459.7 | 492.8 | 554.4 | 577.9 |
| Jamaica | Direct Taxes | 847.7 | 1073.7 | 1310.5 | 731.2 | 928.6 | 1443.9 | 1578.2 |
| | Indirect Taxes | 445.2 | 580.3 | 691.5 | 771.8 | 1096.0 | 1689.6 | 2184.1 |
| | Total | 1292.9 | 1654.0 | 2002.0 | 1503 | 2024.6 | 3133.5 | 3762.3 |
| Trinidad and Tobago | Direct Taxes | 5,243.7 | 5,737.6 | 5,565.7 | 4,864.0 | 5,053.6 | 4,615.0 | 3,492.9 |
| | Indirect Taxes | 686.3 | 777.3 | 911.3 | 1075.8 | 1076.3 | 1259.3 | 1116.1 |
| | Total | 5,920.6 | 6,514.9 | 6,477.6 | 5939.8 | 6129.9 | 5874.3 | 4609 |

**Source:** The Central Bank of Barbados, The Central Bank of Trinidad and Tobago and the Bank of Jamaica.

**Table 1**
**Tax Revenue by Source in Millions of National Currency - Cont'd**

| Country | Years | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Tax Revenue | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 |
| Barbados | Direct Taxes | 135.7 | 227.4 | 246.8 | 249.7 | 293.3 | 283.1 | 294 |
| | Indirect Taxes | 496.1 | 525.6 | 601.4 | 578.5 | 566.6 | 562.1 | 566.7 |
| | Total | 631.8 | 753 | 848.2 | 828.2 | 859.9 | 845.2 | 860.7 |
| Jamaica | Direct Taxes | 1819.2 | 2154.6 | 2733.7 | 3854.2 | 4749 | 7885.2 | 10895.9 |
| | Indirect Taxes | 2487.7 | 2747.0 | 3630.4 | 4019.0 | 6,195.1 | 10548.8 | 17788.7 |
| | Total | 4306.9 | 4901.6 | 6364.1 | 7873.2 | 10944.1 | 18434 | 28684.6 |
| Trinidad and Tobago | Direct Taxes | 3,611.8 | 3,294.7 | 3,346.1 | 3,471.3 | 4,237.6 | 3,670.7 | 3,962.4 |
| | Indirect Taxes | 1053.5 | 1034.4 | 1090.1 | 1825.6 | 1979 | 2006.2 | 2257.6 |
| | Total | 4665.3 | 4329.1 | 4436.2 | 5296.9 | 6216.6 | 5676.9 | 6220 |

**Source:** The Central Bank of Barbados, The Central Bank of Trinidad and Tobago and the Bank of Jamaica.

**Table 1**
**Tax Revenue by Source in Millions of National Currency - Concluded**

| | | Years | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Country** | **Tax Revenue** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** |
| Barbados | Direct Taxes | 333.2 | 367.5 | 397.6 | 429.9 | 470.6 | 527.8 | 698.9 |
| | Indirect Taxes | 568 | 613.1 | 638.1 | 877.5 | 915.5 | 896.3 | 917 |
| | Total | 901.2 | 980.6 | 1035.7 | 1307.4 | 1386.1 | 1424.1 | 1615.9 |
| Jamaica | Direct Taxes | 15376.6 | 18889.2 | 21645.8 | 23296.6 | 25843.3 | 29389.9 | 35456.6 |
| | Indirect Taxes | 22248.4 | 30896.7 | 34475 | 37381 | 41127 | 46575 | 51617.6 |
| | Total | 37625 | 49785.9 | 56120.8 | 60677.6 | 66970.3 | 75964.9 | 87074.2 |
| Trinidad and Tobago | Direct Taxes | 4,292.1 | 5,282.9 | 6,155.1 | 5,260.8 | 5,155.5 | 5,509.9 | 8,457.0 |
| | Indirect Taxes | 2398.3 | 2468.8 | 2597.8 | 2992.5 | 3767.3 | 3242.2 | 3671.5 |
| | Total | 6690.4 | 7751.7 | 8752.9 | 8253.3 | 8922.8 | 8752.1 | 12128.5 |

**Source:** The Central Bank of Barbados, The Central Bank of Trinidad and Tobago and the Bank of Jamaica.

system. The experience of Barbados is, however, slightly different from Jamaica and Trinidad and Tobago. In Barbados, the growth rate of indirect tax revenues was only marginally higher than that of direct tax revenues in the 1980-2000 period. Moreover, the growth rate of direct tax revenues was faster than that of indirect taxes for the post reform period. These results could be explained either by the fact that the direct tax revenues were growing from a smaller base when compared to indirect taxes, which predisposes the direct tax revenue to register relatively higher rates, or it could be driven by the number of zero-rated and exempt items, which reduces the growth in revenues from these taxes. At the same time, in the direct tax system, exemptions and deductions were being eliminated. This, combined with the simplification of the income bands from 6 to 2 in 1992, helped to increase the effective income tax rate and cut evasion and avoidance, which helped to boost revenues from direct taxes.

The differential growth rates in direct and indirect tax revenues have direct implications for the tax revenue mix. The relatively faster average annual growth rate of indirect taxes in Jamaica and Trinidad and Tobago over the period 1980-2000 resulted in these countries becoming more reliant on indirect taxes for revenue in the 1990s (Table 3). This process accelerated in the post-reform period. The converse is of course true for direct taxes in these countries, that is, they are becoming less reliant on these taxes. In the case of Barbados, however, the growth of indirect tax revenue has only been marginally higher than that of direct tax revenue over the period 1980 to 2000 (8.2% compared to 7.9%). Moreover, the growth rate of direct tax revenue in Barbados is higher than that of indirect tax revenues in the post-reform period (10.8% to 9.5%). This is reflected in the fact that the share of indirect tax revenue to total tax revenue in Barbados, though a dominant share of total tax revenue, is falling relative to

**Table 2: Growth Rates of Direct and Indirect Tax Revenues Before and After the Major Tax Reforms**

| Country | Annual Average % Change in Total Tax | | | Annual Average % Change in Direct Tax | | | Annual Average % Change in Indirect Tax | | |
|---|---|---|---|---|---|---|---|---|---|
| | Period (1981-2000) | Period Before Re-forms | Period After Re-forms | Period (1981-2000) | Period Before Re-forms | Period After Re-forms | Period (1981-2000) | Period Before Re-forms | Period After Re-forms |
| Barbados | 8.4 | 7.0 | 9.8 | 7.9 | 7.2 | 10.8 | 8.2 | 7.8 | 9.5 |
| Jamaica | 25.1 | 21.3 | 28.1 | 22.8 | 17.4 | 27.3 | 28.2 | 27.0 | 29.3 |
| Trinidad and Tobago | 5.1 | -4.3 | 10.3 | 4.7 | -5.5 | 10.2 | 8.7 | 0.6 | 13.1 |

**Source:** Various Central Banks.

**Note:** The major reforms were completed in Barbados, Jamaica and Trinidad and Tobago in 1997, 1991 and 1990 respectively, with the implementation of broad based indirect taxes (VAT and GCT).

the share of direct tax revenue in total tax revenue (Table 3).

Additionally, while the growth rate of both types of tax revenues in all countries has increased in the post-reform period compared to the pre-reform era, the improvement has been more pronounced in the case of direct tax revenues, with direct tax revenues increasing in Barbados, Jamaica and Trinidad and Tobago by 3.6, 9.9 and 15.7 percentage points respectively compared increases of 1.7, 2.3 and 12.5 percentage points in indirect tax revenues. This demonstrates that significant increase in total tax revenues could still be generated through the direct tax system and the conventional view that indirect taxes have the biggest potential for improving tax revenues in the Caribbean may therefore need to be revisited.

The different trends in the tax revenue mix observed in Jamaica and Trinidad and Tobago as opposed to Barbados seem to be driven by the fact that Jamaica and Trinidad and Tobago started at a different end of the direct/ indirect tax mix continuum from Barbados and all three are moving towards some middle ground, which hopefully is the appropriate mix for the respective countries. In Barbados, therefore, the direct tax base is growing from a relatively small point whereas in Jamaica and Trinidad and Tobago the indirect taxes are growing from a relatively small base. Jamaica and Trinidad and Tobago are therefore becoming more reliant on indirect taxes whereas Barbados is becoming less reliant on indirect taxes. These countries adopted relatively similar reforms but the reform initiatives seemed to be moving the countries in different directions with respect to the tax mix. What remains to be seen, however, is whether these different trends generated different results for equity and efficiency in Barbados as opposed to Jamaica and Trinidad and Tobago. It also remains to be seen whether these changes led to an

**Table 3: Summary of the Share of Tax revenue by Source Before and After the Introduction of Major Tax Reforms**

| Country | Annual Average % Share of Direct Taxes in Total Tax Revenue | | | Annual Average % Share of Indirect Taxes in Total Tax Revenue | | |
|---|---|---|---|---|---|---|
| | Period (1980-2000) | Period Before Reforms | Period After Reforms | Period (1980-2000) | Period Before Reforms | Period After Reforms |
| **Barbados** | 34.6 | 34.2 | 35.8 | 65.4 | 65.8 | 64.2 |
| **Jamaica** | 45.5 | 50.6 | 39.8 | 54.6 | 49.4 | 60.2 |
| **Trinidad and Tobago** | 70.4 | 76.6 | 65.0 | 29.6 | 23.4 | 35.0 |

**Source:** Various Central Banks.

**Note:** The major reforms were completed in Barbados, Jamaica and Trinidad and Tobago in 1997, 1991 and 1990 respectively, with the implementation of broad based indirect taxes (VAT and GCT).

improvement in both equity and efficiency, which would suggest that the reforms improved welfare.

### *Efficiency*

When evaluating the efficiency of a particular tax, or indeed the entire tax system, it is customary to use the tax buoyancy ratio as a measure of the ability of the system to raise revenues efficiently. This ratio measures the responsiveness of the tax system to changes in income (GDP). A tax system with a robust buoyancy ratio (greater than or equal to one) is a desirable characteristic since it signals that the tax system is relatively efficient at raising tax revenues from the economy to fund public expenditure. Tax buoyancy is distinct from tax elasticity, with the latter measuring changes in tax revenue from a given base, which does not include discretionary changes in the tax system. This is almost impossible to measure and is, for all intents and purposes, a hypothetical construct. Tax buoyancy, which measures the changes in tax revenues from a given base and includes all factors impacting on the change in revenues, including discretionary changes to the tax system, is the measure normally used to measure the revenue efficiency of the tax system.

The data seem to indicate that the efficiency in revenue collection, as judged by buoyancy ratios for total tax revenue, improved in Jamaica and Trinidad and Tobago but fell in Barbados following implementation of the major reforms (Table 4).

The tax buoyancy for the direct tax system improved for all countries between the pre- and post-reform periods but the converse was true in the indirect tax system as buoyancy ratios fell; this, in spite of the fact that the buoyancy ratios for indirect tax revenue were generally higher than the ratios for direct tax revenue. This seems

**Table 4: Summary of Buoyancy Ratios[1]**
**Before and After the Introduction of Major Reforms**

| Country | Annual Average Tax Buoyancy: Total Tax | | | Annual Average Tax Buoyancy: Direct Tax | | | Annual Average Tax Buoyancy: Indirect Tax | | |
|---|---|---|---|---|---|---|---|---|---|
| | Period (1980-2000) | Period Before Re-forms | Period After Re-forms | Period (1980-2000) | Period Before Re-forms | Period After Re-forms | Period (1980 2000) | Period Before Re-forms | Period After Re-forms |
| Barbados[3] | 1.40 | 1.39 | 0.94 | 1.22 | 0.94 | 2.14 | 1.54 | 1.69 | 0.26 |
| Jamaica[3] | 0.99 | 0.95 | 1.12 | 0.90 | 0.73 | 1.06 | 1.09 | 1.22 | 1.16 |
| Trinidad and Tobago[3] | 0.63 | 0.08[2] | 0.82 | 0.38 | -0.21[2] | 0.81 | 1.39 | 1.75 | 0.82 |

**Source:** Authors' calculations.

**Notes:** (1) Buoyancy ratios were estimated using the equation Ln(revenue)=f{c, Ln(GDP)}, where the coefficient of GDP is the buoyancy ratio as in Haughton (1998).

(2) Not significantly different from zero. Most of the other buoyancy ratios were significant at the 5% level and one at the 10% level of significance.

(3) The major reforms were completed in Barbados, Jamaica and Trinidad and Tobago in 1997, 1991 and 1990 respectively, with the implementation of broad based indirect taxes (VAT and GCT).

to corroborate the evidence from the growth rates for direct and indirect tax revenues before and after the tax reforms, where the average growth rate of indirect tax revenue was higher than direct tax revenue but the improvement in the growth rate of direct tax revenue was more pronounced than that of indirect tax revenues between the pre- and post- reform periods. It appears therefore that the complex of reforms to the overall tax system in these countries led to the efficiency of the direct tax system improving while that of the indirect tax system fell off. Reforms such as the removal of the various tax credits and exemptions, as well as the reduction in the range of income tax bands and other efforts to simplify the direct tax system, reduced many of the opportunities and incentives for tax avoidance and evasion and, as a result, tightened the relationship between direct tax revenue and GDP.

The converse seems to have occurred in the indirect tax system. In this part of the tax system buoyancy ratios fell in all three countries, with Barbados experiencing the worst deterioration.[6] This performance could be due to the number of exemptions and zero-rated items in the VAT and GCT systems that were introduced as the main reform to the indirect tax system in these jurisdictions. It could also be due to weaknesses in the administrative system for these taxes, which allow substantial leakages from the system. The buoyancy ratios in the indirect tax system of these countries is unlikely to have been due to low economic growth in these jurisdictions (except probably Jamaica), since real economic growth for Barbados,

6 The fact that VAT on hotel accommodation, a major sphere of economic activity in Barbados, is 7.5% rather than the 15% highlights the fact that exemptions, zero rating and other special provisions could significantly reduce the revenue efficiency of the VAT.

Jamaica and Trinidad and Tobago in the post-reform period averaged 3.2%, 0.3% and 2.7% respectively.

For Barbados, direct tax buoyancy improved from 0.94 in the pre-reform period to 2.14 after the reforms. In the case of Jamaica, the direct tax buoyancy improved from 0.73 to 1.06 while in Trinidad and Tobago it improved from approximately zero to 0.81. On the other hand, the efficiency in indirect tax revenue fell between the pre- and post- reform periods. In Barbados, Jamaica and Trinidad and Tobago it fell from 1.69, 1.22 and 1.75 to 0.26, 1.16 ınd 0.82 respectively between these two periods. The ıcrease in the overall tax revenue buoyancy in Jamaica nd Trinidad and Tobago could therefore have been better and Barbados could have performed much better in this area if this deterioration in the indirect tax revenue buoyancy did not occur. This apparent fall in revenue buoyancy of the indirect tax system implies that the number of exemptions and zero rated items in the genera indirect taxes (VAT and GCT) may have to be re-evaluate Moreover, the elimination of and/or reductions in the ot' indirect taxes may not have been fully covered by introduction of the general indirect taxes, that is reforms may not have been revenue neutral as most to be. Problems in the administration of these indirect taxes may also have contributed to this f efficiency.

The tax reforms may have achieved t' objectives in Jamaica and Trinidad and increasing revenue efficiency overall but no was envisaged, that is, with the direct tax than the indirect tax system seemin improvements. The increasing reliance observed in both Jamaica and Trinidad in the future actually reduce their overa'

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if the potential sources of inefficiency in the indirect tax system are not addressed.

### *Equity*

The equity effect of tax reform measures flows through both the direct and indirect tax systems, although the direct tax system is the main channel through which this issue is operationalised because of its differentiated nature. The equity effect generally flows through the direct tax system via income taxes and the differential impact these taxes have on individuals in different income classes, ir particular the differential impact on high and low incom individuals. If the reform measures increase the effectiv tax rate on low-income individuals relative to high-incon individuals it is seen as regressive, which impacts negatively on equity.

The equity impact of indirect taxes generally comes through the undifferentiated impact of these taxes on the cost of living of all individuals. That is, if the cost of living ncreases equally across all income groups it is seen as educing equity since low-income individuals are relatively orse off since they face the same costs with much less ome. Efforts are generally made to deal with the adverse act indirect taxes can have on equity by granting nptions or zero-rating some products and services ght to be consumed more by disadvantaged iduals, but this is still very clumsy because of the ure of indirect taxes. Due to the absence of data on st of living impact of indirect taxes on all individuals me levels, it is difficult to evaluate how the reforms ndirect tax system have impacted on equity. The npact of the tax reforms is therefore evaluated by nly at the direct tax system, in particular the x system.

The equity effect will be analysed by looking at changes to the effective income tax rates of representative individuals from the low-, middle- and high-income classes in Barbados, Jamaica and Trinidad and Tobago (Mascol 1991). The effective income tax rates were calculated for these countries by first deriving the income level for high-, low- and middle-income groups from the latest available household budgetary surveys, using interpolation to derive the average income for these groups over the period under review and then using the nominal income tax rates and the various exemptions and allowances for the relevant years to arrive at the effective rates. If the effective income tax rate for the low-income group increased relative to that of high-income individuals after the reforms, then the reforms would be viewed as having reduced equity. The converse is of course true.

The estimate of the effective tax for the various income groups for Barbados was based on the 1988/89 Household Budgetary Survey, for Jamaica it was based on the 2000 Household Budgetary Survey and for Trinidad and Tobago it was based on the 1997/98 Household Budgetary Survey. Table 5 presents the calculations of the representative income for the different countries for the year of their latest household budgetary survey.

The lower and upper quartile were used to represent individuals in the lower and upper income classes while the median was used to represent individuals in the middle income bracket. The estimates for the three income quartiles for the years preceding and following the years of the latest surveys were calculated by deflating the income for survey years by the change in the consumer price index for years prior to the year of estimate and inflating the income for years subsequent to the given year of income, following the approach used by Mascol (1991). The income quartiles so generated were then used to calculate average effective income tax rates for low-, medium- and high-income individuals in all three countries before and after the tax reforms.

**Table 5: Annual Income of Representative Individuals in Barbados, Jamaica and Trinidad And Tobago in National Currencies**

| Country | Lower Quartile | Median | Upper Quartile |
|---|---|---|---|
| Barbados (1988/89) | $7,377 | $17,644 | $30,084 |
| Jamaica (2000) | $32,660 | $50,282 | $80,051 |
| Trinidad and Tobago (1997/98) | $17,227 | $34,160 | $46,633 |

To make calculations of their effective tax rates, some assumptions about their allowances were made. All income groups were assumed to be four-person households comprised of two children, one head and one spouse, with one sibling attending university for the high-income household. All individuals were allowed to claim for National Insurance.

The average effective tax rate was calculated for the period before and after the tax reform for respective countries. The average for Barbados in the pre-reform years was based on three representative years: 1990, 1992 and 1993 while the post-reform average effective rate was based on data for the years 1997-2000. For Trinidad and Tobago, the average effective tax rate was calculated using each year over the 1980-2000 period. The effective rates for Jamaica were not calculated because the method used for interpolation generated values that were unusable because of the excessive volatility experienced in that country.

Table 6 shows the resultant annual average effective tax rates for the periods under review. In the case of Barbados, the figures show the adjustments placed a heavier burden on middle and high income earners in the post tax reform period when compared with the pre-tax reform period. The effective tax rates for the representative middle and high-income earners increased from 6.0 and 13.3 percent of income to 9.6 and 17.0 percent of income respectively, between the pre- and post-reform periods. With respect to the low-income group there were no changes.

In the case of Trinidad and Tobago, the tax reform placed a greater burden on the representative high-income

**Table 6: Summary of the Average Annual Effective Tax Rate for Lower, Middle and Upper Income Groups Before and After the Introduction of Reforms**

| Country | Period (1980-2000) | Period Before Reforms | Period After Reforms |
|---|---|---|---|
| **Barbados** | | | |
| Lower Income | 0.0 | 0.0 | 0.0 |
| Middle Income | 8.4 | 6.7 | 9.8 |
| Upper Income | 15.8 | 13.9 | 17.4 |
| **Trinidad and Tobago** | | | |
| Lower Income | 1.4 | 1.4 | 1.3 |
| Middle Income | 9.5 | 7.3 | 10.3 |
| Upper Income | 10.8 | 7.7 | 12.1 |

**Source:** Authors' Calculations.

and middle-income earners and reduced the burden on low-income earners. The system therefore appeared to have become more progressive.

Although the effective tax rates for Jamaica were not calculated because of methodological problems, anecdotal information suggests that considerable relief was provided for low-income earners. The tax classes were abolished in 1986 and replaced with a single rate applicable to income earned above a certain amount. In the 1986-92 period this rate was 33 1/3 percent. Thereafter this rate was reduced to 25 percent where it has remained to date. The threshold level of income below which no tax was applied was adjusted almost annually. It was increased from J$8580 in the 1986-1988 period to J$10,400 in the 1989-91 period. It went from J$14,352 in 1992 to J$100,464 in 2000. Given the relatively high threshold it means that lower income earners would escape most income taxation.

It therefore seems that the direct tax system became more progressive after the reforms, which would have helped improve equity. Since the information was not available to calculate effective tax rates on the indirect tax side we are not in a position to make definitive statements about the overall impact of tax reform on equity.[7] We can

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7 Value added taxes are generally thought to decrease equity because individuals from all income groups pay the same rate so lower income individuals are subject to a relatively higher marginal rate than their higher income counterparts. On the other hand, the reforms also include exemptions and the zero rating of some goods and services thought to make up a greater proportion of the consumption basket of lower income households. The notion that indirect taxes unambiguously reduce equity may therefore not be as accurate as previously thought.

say, however, that equity seemed to have improved in the direct tax system due to the reforms.

In general, the reforms therefore seemed to have increased the revenue efficiency of the entire tax system in Jamaica and Trinidad and Tobago, as well as improved equity in the direct tax system, seemingly for all countries (even though effective tax rates for Jamaica are not available). The fact that the reforms seemed to have improved the tax system in two important areas in Jamaica and Trinidad and Tobago seems to support the contention that the reforms, which reinforced certain trends in the direct/indirect tax mix, did help to increase welfare overall in these countries. Based on the available evidence, the reforms in Barbados only seemed to improve equity and therefore one cannot say unequivocally[8] that welfare improved in that country.

## 5.0 Conclusions

In summary, the tax mix in the three select countries seems to be changing, with Jamaica and Trinidad and Tobago becoming increasingly dependent on indirect taxes for tax revenues while the share of indirect taxes in total tax revenue in Barbados seems to be falling. These trends have been reinforced by the major tax reforms that were undertaken in these countries. In Barbados, the growth rate in direct tax revenues has been faster than that of indirect tax revenues since the reforms were implemented. On the other hand, in Jamaica and Trinidad and Tobago

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8 This analysis abstracts from the impact that government expenditure programmes can have on equity and welfare and is therefore incomplete.

the growth rate for indirect tax revenues has been higher than that of direct tax revenues both before and after the reforms. This has resulted in the share of indirect tax revenue in total tax revenue increasing in Jamaica and Trinidad but falling in Barbados. These trends have had an impact on revenue efficiency and equity.

Revenue efficiency as measured by the tax buoyancy ratio improved in Jamaica and Trinidad and Tobago but fell in Barbados after the reforms. Surprisingly, however, this improvement seems to have been driven by direct taxes rather then indirect taxes as tax buoyancy increased in the direct tax system but fell in the indirect tax system, although the buoyancy ratios for the indirect tax system were generally larger than those of the direct tax system in an absolute sense. When we look at the other issue that determines the overall welfare impact of the tax reforms – that of equity – we see that the reforms to the direct tax system have actually led to an improvement in equity as they have made the direct tax system more progressive. Overall, therefore, we can say that both efficiency and equity (and by extension welfare) seem to have been positively affected by the major reforms, which reinforced the trends observed in the direct/indirect tax revenue mixes in Jamaica and Trinidad and Tobago. This improvement was, however, driven mainly by the direct tax system rather than the indirect tax system as was believed to be the case.

The traditional wisdom in the Caribbean that indirect taxes tend to be the catalyst for improvements in the revenue efficiency of the tax systems in the regions, while the direct tax system, though not as efficient at raising revenue is nonetheless better at shoring up equity, may have to be revisited. Indeed, in the three countries under review, although there were differences in the trend in the direct/indirect tax mix, the evidence seems to suggest that the direct tax system is not only better at shoring up equity but is also good at improving revenue efficiency, once the system is simplified by the removal of unnecessary exemptions, allowances and a reduction in the number of rates applicable to various income classes.

Moreover, the fact that the revenue efficiency of the indirect tax system seems to have fallen after the reforms to this part of the tax system (which largely focused on the replacement of a variety of small indirect taxes with a general consumption tax or a value added tax) seems to suggest that the new general indirect taxes which were introduced are not as efficient as thought to be. This may be due in large part to the numerous goods and services that are either exempted or zero rated, ostensibly to improve the equity of this tax. It could also be due to the fact that the reforms did not ensure revenue neutrality when other indirect taxes were abolished or their rates reduced, so that the rates for the VAT and GCT, as well as other indirect taxes, may have to be re-evaluated to deal with this problem.

The policy implications which flow from this are, first of all, that to get the maximum benefit from the introduction of a VAT or a general consumption tax, the fiscal authorities must resist the temptation to try to include supposedly equity enhancing features in a tax which is inherently unsuited to the achievement of greater equity. This only complicates the administration of the tax and reduces its revenue buoyancy, thus detracting from the main rationale for introducing this type of tax in the first place. Rather, it should be used to maximize revenue (a function which this sort of tax is designed for as is reflected in the fact that the tax buoyancy of these taxes was generally higher than the direct taxes), which can then be used to drive expenditure patterns in a way that shores purpose. They can be relied on to improve the revenue efficiency of the tax system, once appropriate reforms are implemented, as well as to serve their more traditional role of improving equity in the tax system. The ideal system therefore appears to be a system in which there is a mix of direct and indirect taxes, with the exact proportion of these taxes in the tax revenue mix being determined by the conditions on the ground and the objectives of the tax authorities. That is, if the need to shore up revenues is greater than the need to improve the equity in the system, then greater use must be made of indirect taxes relative to direct taxes, and if the objective conditions on the ground are reversed then greater use should be made of direct rather than indirect taxes.

The tax reforms in these three jurisdictions therefore seem to have improved welfare generally, except in terms of revenue efficiency in Barbados, but the improvement could have been more significant if the authorities had avoided the mistake of trying to use indirect taxes to achieve both revenue and equity objectives.

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