



# **Fiscal Unruliness: Checking the Usual Suspects for Jamaica's Debt Buildup**

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## Abstract<sup>1</sup>

Jamaica's fiscal and debt position has long been recognized as a major issue for the country, and the country has made several attempts to resolve this challenge by increasing revenue or reducing expenditures. Despite these adjustments, Jamaica has systematically failed to achieve its budget targets. This analysis shows that the major weakness in the budget planning execution is revenue projection, which influences planned expenditures. In contrast, the limitation in reducing rigid recurrent expenditures—mostly interest and wage salary payments—has led to the introduction of measures aimed at meeting appropriate revenue targets. In addition, capital expenditure has systematically underperformed relative to the budget, possibly to compensate for these weaknesses. However, fiscal targets have still underperformed relative to budget projections. These repeated, lower-than-expected revenues combined with rigid expenditures led to continuous debt buildup, reaching a level that needs deep institutional reforms.

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## Introduction

Jamaica's high debt-to-GDP ratio has been recognized as a serious issue for a long time. Several Budget Speeches outline the measures proposed to drastically reduce debt. However, despite recognizing this objective, Jamaica today continues to face a challenging fiscal path; the country has failed to significantly reduce its high debt-to-GDP ratio, which is estimated at around 140 percent as at the end of November 2013.

On the surface, the debt-reduction mechanics is simple in that the debt evolution depends only on a few major factors. The debt-to-GDP ratio at any given time is the result of the previous year's debt stock; the fiscal balance; and possible effects of exchange rate movements on debt denominated in external currency, changes in GDP, and inflation. GDP growth decreases the debt ratio as it increases the denominator; similarly, inflation decreases the debt ratio as it increases nominal GDP. Given that interest payments depend on the debt stock, the fiscal balance is often represented as the primary surplus minus interest payments.<sup>2</sup>

Figures 1a and 1b present the evolution of the debt drivers over the past 8 years (for a similar analysis including earlier years, see King and Kiddoe 2010). Direct central government debt stood at 110 percent of GDP in 2005, almost double the level in the mid-1990s. According to King and Kiddoe (2010), the increase in that period was strongly driven because of assumptions by the government of liabilities contracted outside the central government. From 2005 to 2007, debt-to-GDP decreased as the primary surplus, GDP growth, and inflation were more than sufficient to compensate for the effects of the exchange rate and the interest payments. However, since 2008, debt-to-GDP has been increasing as exchange rate movements, contraction in GDP, and interest payments have not compensated by sufficient increases in the primary balance and inflation. Expenditures in Jamaica increased until 2009/10 both as a share of GDP and in real terms (Figures 2a and 2b). The fiscal consolidation is evident afterwards as expenditures decrease. Rigid expenditures, wages, and interest payments, decrease stronger than other expenditures, mostly because the debt exchange and subsequent International Monetary

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<sup>2</sup> Formally, this can be represented by the following:

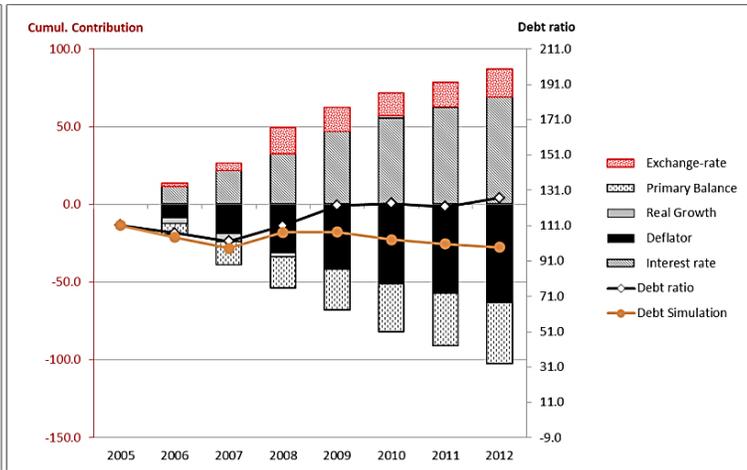
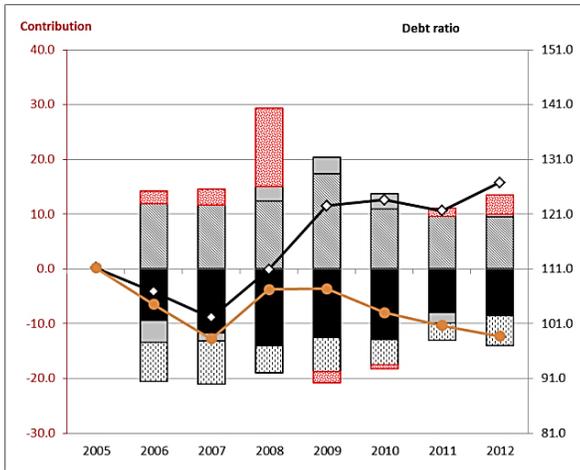
$$d_t = \left[ (1 - \alpha) \frac{(1 + \Delta e)}{1 + g_t} \right] d_{t-1} - fb_t = \left[ \frac{1 + r_t^d}{1 + g_t} + (1 - \alpha) \frac{(1 + r_t^f)(1 + \Delta e)}{1 + g_t} \right] d_{t-1} - ps_t,$$

where  $d_t$  is the debt-to-GDP ratio at time  $t$ ,  $\alpha$  is the proportion of total public debt denominated in domestic currency, and  $(1 - \alpha)$  is the proportion of debt denominated in foreign currency.  $\Delta e$  is the annual change in the exchange rate;  $r^d$ ,  $r^f$ , and  $g_t$  are, respectively, the nominal interest rate of the domestic currency debt, nominal interest rate on foreign currency debt, and the GDP growth rate. Last,  $fb_t$  is the fiscal balance, and  $ps_t$  is the primary fiscal surplus.

Fund program led to a fall in interest rates and a real appreciation of the exchange rate, both of which reduced interest payments. At the same time, revenues were relatively flat before the recession but decreased afterwards even as a share of GDP.

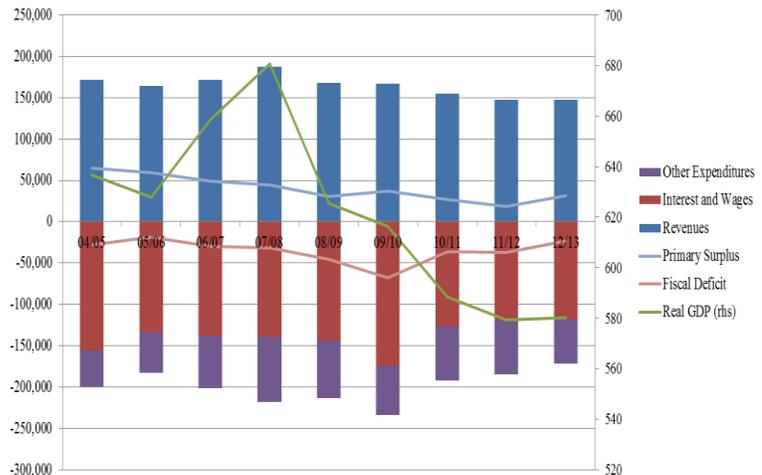
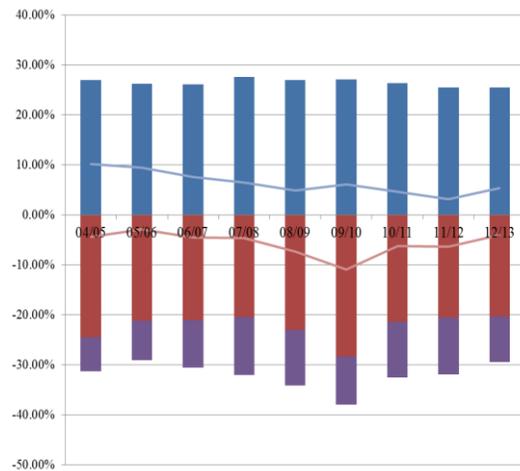
**Figure 1a. Drivers of Debt in Jamaica, 2005–2012**

**Figure 1b. Drivers of Debt in Jamaica, Cumulative for 2005–2012**



**Figure 2a. Revenues and Expenditures as a Share of GDP, 2004/05 to 2012/13**

**Figure 2b. Revenues and Expenditures at constant prices, 2004/05 to 2012/13**



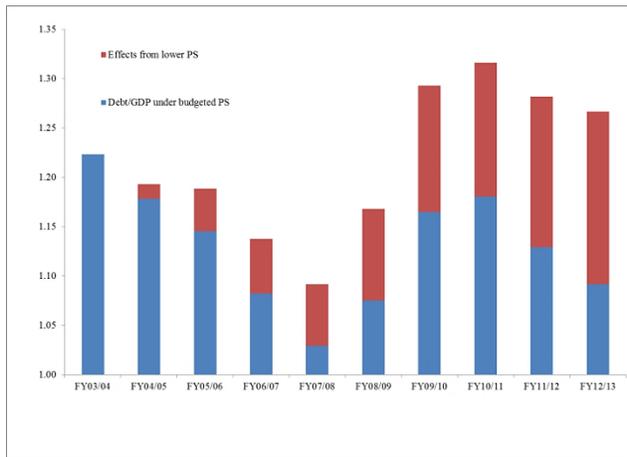
Source: Ministry of Finance and Planning and author's own calculations.

Notes: Expenditures are displayed as negative values.

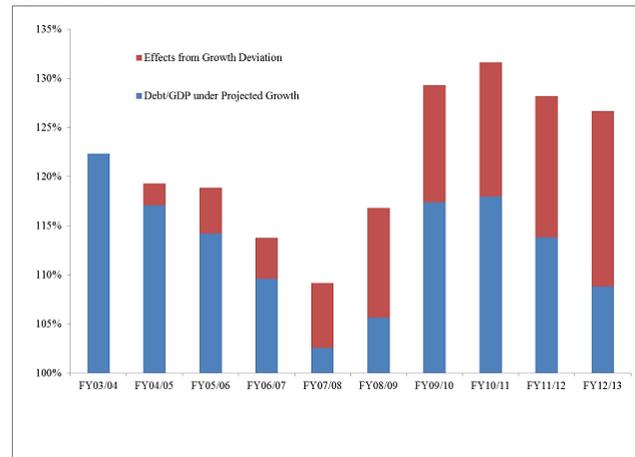
## Debt and the Budget Process

Two variables get most of the attention in the discussion about fiscal sustainability: the primary surplus, which is the only one that is under direct government control; and economic growth, which becomes a major determinant when debt-to-GDP and the fiscal effort are already high, as in Jamaica. Overestimating the ability to create a certain primary surplus or growth rate has important consequences for fiscal sustainability. The current debt-to-GDP ratio would be almost 20 percent lower today if either the projected primary surplus or economic growth had materialized over the past 8 years (Figures 3a and 3b).

**Figure 3a. Simulated Debt-to-GDP Ratio With Budgeted Primary Surplus**



**Figure 3b. Simulated Debt-to-GDP Ratio With Projected Economic Growth**



*Source:* Ministry of Finance and Planning and author's own calculations.

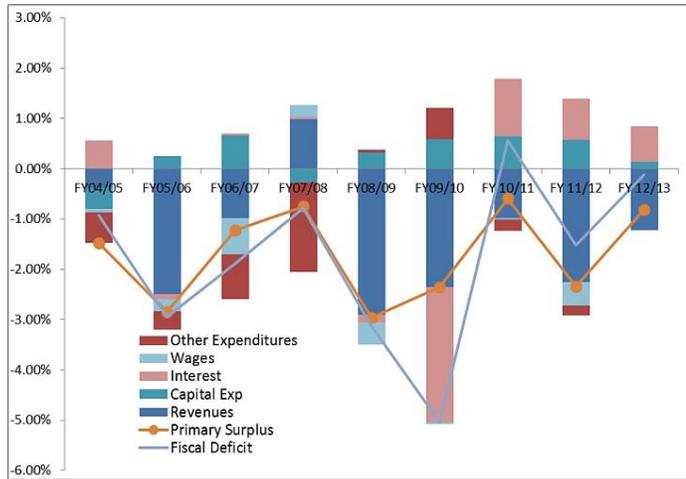
In addition to the difficult political decision of whether to raise revenues, cut expenditures, or do both to reduce the debt, a major issue is that in the budget process, revenues and expenditures are determined simultaneously on the basis of targets and projections of macroeconomic influences, including GDP growth. Consistently missing projections—in the budget and in economic activity—contributes to worse-than-expected fiscal outcomes.

In Jamaica, wrong projections contributed to debt buildup. Over the past 8 years, the primary balance has been, on average, 1.8 percentage points of GDP lower than projected in the budget, and the fiscal balance was 2 percentage points of GDP below budget projections,

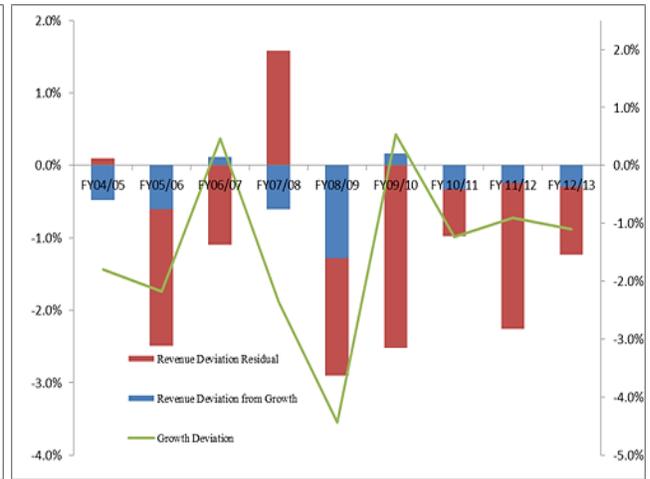
implying that, measured against the budget expectations, the debt-to-GDP ratio could have been (at least) 16 percent of GDP lower than it is now.

A decomposition of the deviation of the primary and fiscal balance into deviations of revenues and deviations of different types of expenditures indicates that the budget systematically overestimates revenues and underestimates expenditures. However, lower-than-expected revenue majorly contributes to budget underperformance (Figure 4a). Regarding expenditure, current expenditures—particularly wages—are more systematically underestimated. Interest expenditures have been important in the past few years, both improving and worsening the budget balance, even though the government cannot directly control their evolution. Offsetting this are capital expenditures, which are often lower than projected in the budget.

**Figure 4a. Deviation of Fiscal and Primary Balance From Budget: Decomposition, by Revenues and Expenditure Type**



**Figure 4b. Deviation of Revenues and Growth Deviations**



Source: Ministry of Finance and Planning and author's own calculations.

## Fiscal Effects

The systematic shortfall has important effects over the debt-to-GDP ratio because starting from a required fiscal target, in the Jamaican case one that reduces the debt-to-GDP ratio, the budget defines revenue collection efforts and expenditures simultaneously (for a detailed analysis of Jamaica's budget process, see Whyte-Givans 2014). As a result, the debt trajectory has been much less sustainable than predicted, particularly during the recent economic contraction. In addition, the shortfall requires Jamaica to seek higher-than-budgeted deficit financing, which could lead to higher-than-projected interest rates on new debt issues, feeding into a higher deficit. If Jamaica had stayed on budget over the analyzed period, the debt-to-GDP as of March 2012 would have reached only 114 percent—instead of 129 percent—of GDP. The deviations were especially important between FY2007/08 and FY2009/10 when the weaker-than-expected budget outturns added around 4 percentage points of debt-to-GDP in each year (Figure 3a). Infrastructure can also suffer from the weak budget process. Lower-than-projected revenues or higher-than-projected recurrent expenditure lead to adjustments in the budget. Given the rigidity of expenditure in Jamaica with its high share of interest and wage payments, adjustment often leads to lower capital expenditure. The consistent underexecution of capital expenditure can lead to a deterioration of public goods and infrastructure with adverse consequences for future growth.

Overestimating GDP growth also has important effects. As mentioned earlier, debt-to-GDP would be substantially lower if the Jamaican economy had grown in line with forecasts (see Figure 3b). However, overestimating GDP growth also adversely affects the primary surplus because revenues are strongly related to GDP. As such, lower GDP growth will also decrease revenue outcomes. Decomposition of the revenue deviation into the part caused by lower-than-expected GDP and other factors confirms that the deviation of revenues was partly due to an overestimation of GDP growth. The line in Figure 4b shows the deviation from the projected growth rate by the International Monetary Fund with the realized growth rate.<sup>3</sup> The series of shocks that hit Jamaica over the past few years led to substantial deviations of economic growth

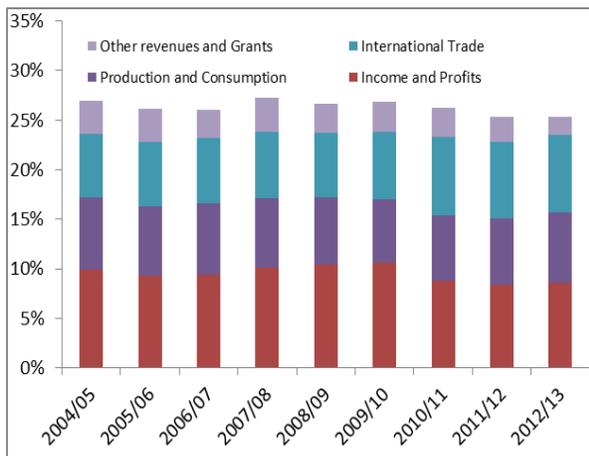
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<sup>3</sup> The use of the International Monetary Fund's projections avoids the possibility that politically influenced growth rates are used, which could distort the results. For example, the government might project high growth rates before elections to improve its chances to be reelected.

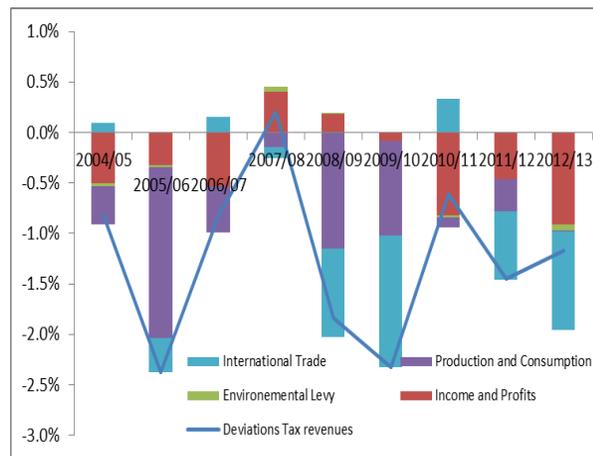
from its projected values. However, revenues still underperformed when adjusting for the lower growth rate (Figure 4b), indicating that problems related to revenue collection constitute the major issue in Jamaica.

Also, despite several tax measures, which combined were expected to yield 3.5 percent of GDP, revenues and grants as a share of GDP have been declining steadily since FY2009/10 (Figure 5a).

**Figure 5a. Revenue Composition as a Share of GDP**



**Figure 5b. Revenue Shortfall: Tax Revenue Decomposition**



Source: Ministry of Finance and Planning and author's own calculations.

Looking more closely at the revenue shortfall, taxes on production and consumption as well as international trade taxes were the main underperformers (Figure 5b). Together, they accounted for around 55 percent of revenues (equivalent to around 14 percent of GDP), so fluctuations in these have important effects on the budget.

## Conclusion and Policy Recommendations

The analysis points to the importance of using realistic budget projections, especially for revenues. Trying to reach a fiscal target on the basis of unrealistic budget assumptions, which will suffer from deviations for both revenues and expenditures, will result in an unpredictable debt-to-GDP trajectory.

However, the consistent underperformance also suggests that the limitation of collecting sufficient revenues may be largely associated with unsustainably high expenditures that need to

be funded. It is clear that reforms on the revenue side of the budget could yield substantial gains, given that revenues as a share of GDP have been decreasing over the past few years. Also, expenditure cuts are difficult because of Jamaica's rigid expenditures: Interest rate payments and wages and salaries alone constitute around 70 percent of expenditures; this figure can be reduced only through deep reforms that take time to yield results. This analysis confirms that achieving a sustainable debt trajectory requires bold reforms, whether in budget expenditure or revenue. It is inadequate to implement incremental tax measures to fund systematic financing gaps because this plan is likely to lead to continued debt accumulation.

In this light, the results underscore the importance of the current reform agenda under the Extended Fund Facility with the International Monetary Fund and other multilaterals, especially on tax reform, public financial management, and introduction of a legally binding fiscal rule. Jamaica currently collects relatively high taxes from a narrow tax base. However, the narrow tax base implies a share of the tax burden on a few taxpayers, which results in challenges for compliance and revenue consistency. In addition, high taxes for compliant taxpayers encumber their profit, and several rounds of tax measures to increase revenues have introduced distortions in the Jamaican economy.

In addition, the predicted public financial management reforms and the fiscal rule will strengthen the budget process and limit the discretion in the budget process—two major factors behind the systematic overestimation of revenues and underestimation of costs. An often-neglected effect is better allocation of fiscal space, including allocation to growth-supporting capital expenditure, which has recently suffered from tight fiscal space and under execution as a result of necessary adjustments in expenditures in the budget year.

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