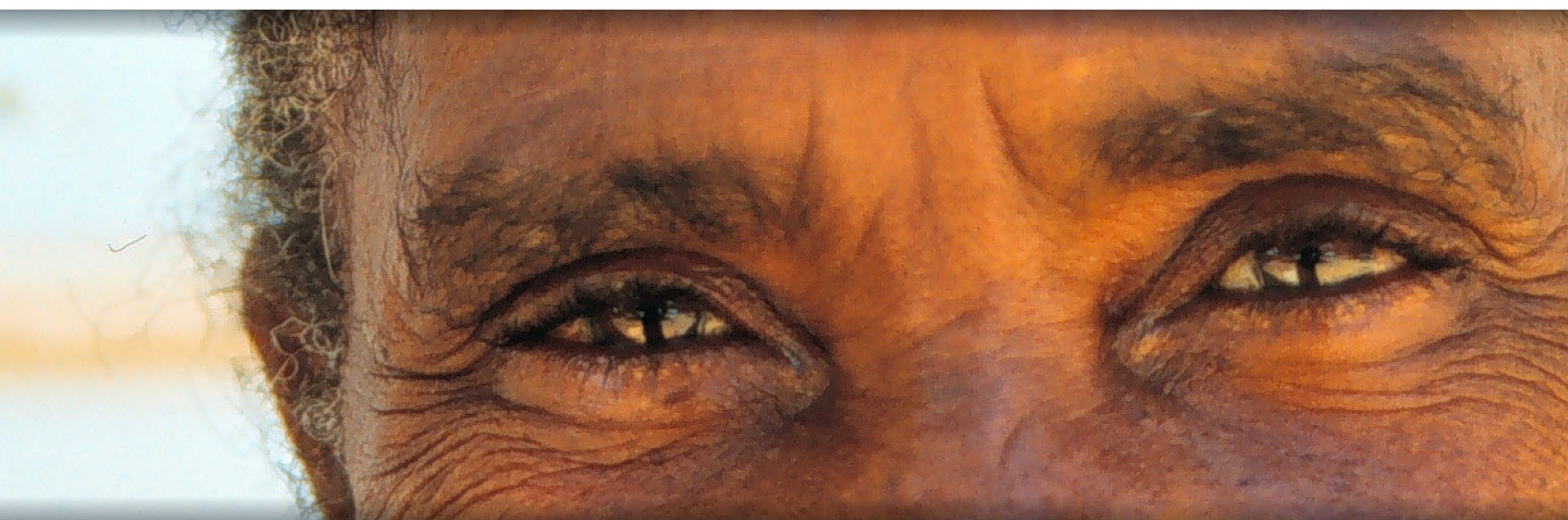
Caribbean Region Quarterly Bulletin



Revisiting Fiscal Challenges

Volume 6, Issue 3 | September 2017

Revisiting Fiscal Challenges

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CARIBBEAN REGION

FISCAL CHALLENGES REMAIN

Dear Reader,

Welcome to the new *Caribbean Region Quarterly Bulletin.* In order to keep the bulletin fresh and interesting, we are changing the format and content going forward. Instead of presenting a detailed summary of recent economic developments plus a special analytical report in each edition, we will have separate editions for economic updates and for analytical themes. This will allow us to provide deeper analysis and keep the bulletin shorter and more to the point. With this new format, the new schedule for the Quarterly Bulletin will be as follows: the June and December bulletins will provide in-depth analysis of recent economic developments, while the March and September bulletins will explore a special theme in detail.

With this in mind, we welcome you to the *September 2017 Quarterly Bulletin*, dedicated to probably the most imporant issue facing the Caribbean: the fiscal challenge. Each country in our region faces some sort of fiscal challenge, be it high debt, volatile revenues, or unsustainable expenditures. However, the specific challenges differ between countries, as do the actions taken so far to address them and policy recommendations going forward.

Special Regional Report: Fiscal Challenges in the Caribbean

All countries in the Caribbean face fiscal challenges. On the one hand, the countries that depend on tourism – Jamaica, Barbados, and The Bahamas – are at different stages of dealing with the tailwinds from the 2009 global financial crisis. All are making adjustments, with Jamaica ahead because it started aggressive fiscal consolidation in 2013. On the other hand, the commodity-exporting countries of Suriname and Trinidad and Tobago, which were relatively unscathed by the global financial crisis, have been strongly affected by the fall in international commodity prices in the last three years, especially oil. Guyana is an outlier, with strong growth supported by elevated gold prices.

The introductory section summarizes fiscal challenges facing the region. As in the country sections that follow, we explore issues related to debt, revenue, and expenditure, then conclude with policy recommendations.

The Bahamas

Evidence suggests that local economic activity was slightly positive through the end of June 2017, led by buoyancy in the construction sector from private investment projects and public sector rebuilding efforts. Weak tourism performance from a loss of significant room inventory (Grand Bahama) remains a medium-term growth concern.

Growth in foreign exchange transactions through payments for imports of goods and services shows stronger levels of private sector demand. Higher capital outlay expenditure from the public sector expanded fiscal deficit levels for the first 10 months of FY2016/17, despite improvements in revenue collection. Bank liquidity levels expanded as deposit gains outpaced growth in credit, while external reserves remained stable as real sector activity firmed up. Unemployment levels declined by roughly 1.7 percent and reached 9.9 percent as of the end of May 2017.

Efforts to strengthen public financial management are now receiving renewed focus. The enhancing of property taxes, customs, the value-added tax (VAT), and business license enforcement, along with improved procurement and a review of public expenditure to align it with public sector priorities, are all part of current efforts to bring greater efficiency to the operations of government.

The Bahamas' Baa3 credit rating was maintained by the rating agency Moody's following the conclusion of its review. The government's current efforts at fiscal consolidation were credit-positive, but weaker growth and natural disaster shocks from hurricanes or storms would negatively impact the outlook. Standards and Poor (S&P) is expected to complete its assessment by the fall of 2017.

Barbados

The economy grew by 2.2 percent during the first half of 2017 compared to growth of 1.8 percent over the same period in 2016. The tourism and construction sectors led the way, with tourism value-added increasing by 8.6 percent while activity in the construction sector grew by 4.5 percent. While total long-stay arrivals were up 7.5 percent, arrivals from the United Kingdom were the same as in 2016. However, the average length of stay of long-stay visitors was down by 1.6 percent. In the construction sector, the improved performance was mainly related to the expansion of the Sandals Royal Hotel. The inflation rate rose to 3.2 percent at the end of April compared to deflation of one percent 12 months earlier. Rising international oil prices and the implementation of the National Social Responsibility Levy in September 2016 are partly responsible for the increasing prices.

The government's fiscal position improved slightly but remains troublesome. The fiscal deficit was reduced by 9 percent to US$76.9 million after the first three months of FY2017/18 (April–June). This improvement was mainly a result of an increase in tax revenues by US$12.7 million (4.3 percent), led primarily by implementation of the National Social Responsibility Levy on goods and services before application of the value-added tax (VAT), which also saw increased collection levels. Additionally, corporate tax revenues more than doubled during the first quarter of the fiscal year. On the other hand, current expenditures were largely maintained in line with 2016 levels, but growth-enhancing capital expenditure was down by 15.1 percent. Gross central government debt rose slightly to 143.6 percent of GDP from 142.3 percent at the end of June 2016.

International reserves continue to fall. At the end of June 2017, international reserves totalled US$317.8 million or 9.7 weeks of imports, compared to US$442.9 million or 13.9 weeks of imports a year earlier. Higher international oil prices, which caused an increase in imports, and the servicing of foreign debt obligations were the main causes of the fall in international reserves.

Economic growth is expected to range between 1.3 and 1.8 percent in 2017. The government is counting on strong performances in tourism and construction to offset the dampening effects on weaker domestic demand expected from the imposition of additional revenue-raising measures.

Guyana

Sectoral growth has been uneven. Through the mid-point of 2017, the Guyanese economy was estimated to have grown in real terms at 2.2 percent, slightly better than the 2 percent recorded for the corresponding period in 2016, and higher than many Caribbean neighbors. However the rate of growth varies widely across sectors. Sectors showing positive growth on a half-year to half-year basis were rice, horticulture, fisheries, manufacturing, and services (except for finance and insurance). Sectors that contracted during the first half of 2017 were mining and quarrying and, within agriculture, forestry (18.2 percent), livestock (10.9 percent), and sugar (12.4 percent). Authorities project a year-end growth rate of 3.1 percent, revised downward from a 3.8 percent projection at the start of the year, and slightly lower than 2016.

The fiscal stance continues to be procyclical. In the last decade and a half, Guyana has run an expansionary fiscal policy, incurring deficits before grants both in years when export commodity prices were high and when they faltered. The largest categories of current expenditures have tended to be transfers and purchases of goods and services. Successive administrations have pursued ambitious capital expenditure programs, but variances between planned and actual expenditures have been high, indicating some aborption issues.

International reserves remain at prudential levels. At the end of June 2017, gross international reserves stood at US$578 million, equivalent to 3.4 months imports of goods and services.

The downward trajectory of Guyana's debt is ending. From 2006 to 2015, the ratio of public debt to GDP declined. In 2016, the ratio ticked up slightly and is expected to rise to 60 percent of GDP by 2019 and then decline as oil production starts.

Deteriorating asset quality is triggering a slowing of credit expansion in financial markets. At the peak of the commodity boom in 2011, the ratio of non-performing loans (NPLs) to overall loans was 5.4 percent, close to the international benchmark of less than 5 percent. But by March 2017, NPLs were 12.71 percent. In response, commercial banks have decelerated the expansion of private credit, increased lending to the public sector, and continued to invest heavily in Treasury bills. In 2016, credit was 2 percent and in 2017 it is forecast to be less than 1 percent. The banking sector, while well capitalized with a capital adequacy ratio of 28.6 percent, seems vulnerable to loan concentration and exposure to top borrowers. Better provisioning for NPLs and better screening of the financial system is needed.

Jamaica

Economic stabilization is continuing in Jamaica. An International Monetary Fund (IMF) mission visited Kingston in early September 2017 for the second review of the new Stand-by Agreement (SBA). Program implementation has been strong, including for the predecessor program, the four-year 2013 Extended Fund Facility (EFF). The IMF approved the first review in April 2017. As was the case in the 2010 SBA and the 2013 EFF, reducing the public sector wage bill under the public sector transformation program remains an important and difficult reform.

Economic recovery is under way, with growth expected at around 1.6 percent in FY2017/18. The Jamaican economy grew by 1.7 percent in FY2016/17, continuing its recovery over the last three years. Developments in agriculture, tourism, and the business process outsourcing sectors have supported the acceleration. At the same time, inflation remained subdued at 4.1 percent for FY2016/17, slightly higher than the 3 percent a year earlier but within the inflation target of 4.5 to 6.5 percent. As the effect from the decline in oil prices has faded, inflation has moved back into the target range.

International reserves remain above prudential levels. At the end of July 2017, net international reserves amounted to US$2.7 billion, while gross international reserves stood at US$3.3 billion, equivalent to 21 weeks of imports of goods and services.

The downward trajectory of Jamaica's debt continues. Under the SBA definition, the debt-to-GDP ratio as of March 2017 stood at 115.2 percent (122.5 percent using the definition under the EFF, with the main difference being the IMF loans held by the central bank). However, debt remains high by international comparison. Simulations suggest that to reduce debt to 60 percent of GDP by 2026, as mandated by the Fiscal Rule, Jamaica would require primary surpluses of around 6 percent from 2019 to 2026. Jamaica's debt would stabilize at current levels with a primary surplus of just below 4 percent.

Jamaica has again accessed international bond markets. The authorities re-opened two bonds in August 2017, attaining the lowest yields ever for 10- and 30-year securities (5 percent and 6.45 percent, respectively). The transaction raised US$869 million. The proceeds will be used for budgetary purposes as well as to retire more expensive short-term securities that would have to be repaid between 2019 and 2025. The bond placement reduces external repayments in 2019–2025, and the lower interest rate instrument will reduce the debt service burden. In addition, the demand for Jamaican debt at this interest rate underscores the confidence of investors in Jamaica's successful stabilization.

Suriname

Economic recovery is under way. The adjustment plan launched by the authorities in late 2015, which included cuts to government expenditure and floating the exchange rate, have produced some results. Fiscal and external imbalances have narrowed, economic growth is expected to return in 2018, and inflation decelerated in the first half of 2017. The International Monetary Fund (IMF) projects another year of negative growth for Suriname in 2017 (-1.2 percent), but growth of 0.8 percent in 2018. For the 2019–2022 period, economic growth is expected to improve, averaging about 1.7 percent annually.

Inflation is on a downward path. The inflation rate decelerated to 19.7 percent in June 2017 (year-over-year) after spiking to 79.2 percent in October 2016. Renewed exchange rate stability has helped produce this period of sustained disinflation.

Suriname recorded a primary fiscal deficit in the first half of 2017. The fiscal deficit for January-June 2017 was estimated at SRD$ 548 million (equivalent to 2.56 percent of 2016 GDP) and slightly lower than the estimate for the same period in the previous fiscal year. The overall deficit, however, worsened from 3.3 percent of GDP in 2016 to 4.6 percent of GDP in 2017, as interest payments on debt (as a percentage of 2016 GDP) increased from 0.7 to 2 percent. Revenues were boosted by direct taxes and non-tax revenues which increased by 1.6 and 0.9 percent of GDP, respectively.

International reserves improved slightly and the current account balance recorded a surplus. Foreign reserves increased to US$401.4 million (equivalent to 2.3 months of import cover) in June 2017 from US$381 million in December 2016. Also, a current account surplus of US$92.8 million (equivalent to 2.6 percent of 2016 GDP) was realized in the first quarter of 2017, compared to a deficit of US$73.3 million for the same period in the previous year. The current account surplus was due mainly to a positive goods trade balance, as exports increased by 54 percent and imports decreased by 7 percent.

The IMF estimates that Suriname's debt has increased significantly over the past three years. The debt-to-GDP ratio increased from 29 percent in 2014 to 64.6 percent in 2016. A significant factor contributing to this change was the issuance of a 10-year external bond at 9.25 percent in October 2016 in the amount of US$550 million (equivalent to 13 percent of GDP).

Trinidad and Tobago

Trinidad and Tobago continues in a recession due to the sharp decline in energy prices and lower domestic production of oil and natural gas. The economy has been in recession since 2015, and estimates indicate that output dropped by 2.3 percent in 2016 and that there will be zero growth in 2017. Adverse price and production conditions prevailed in the energy sector, and the non-energy sectors stagnated. Domestic natural gas production will recover in 2017–2018 on the back of new fields. Most projections indicate global oil and gas prices may stabilize in the coming months, but any such forecasts are subject to considerable uncertainty.

Foreign exchange shortages persist amid central bank reserve losses and a mild currency depreciation. Reduced hard-currency flows supplied by energy companies, coupled with increased demand for speculative and precautionary motives, are feeding shortages in the foreign exchange market. Central bank interventions are preserving the de facto currency peg and partly covering these shortages. Net official reserves declined by US$2.6 billion between end-2014 and mid-2017 and currently amount to US$8.7 billion. The local currency has been allowed to depreciate by some 7 percent since late 2015. The government has expressed its intention to give manufacturing companies priviledged access to hard currency . A recovery in natural gas prices and exports, as well as in oil prices, is likely to ease tensions in the foreign exchange market and reduce shortages.

The loss of energy export receipts largely reduced the saving margins that had allowed the country to accumulate external assets. External accounts reported by the central bank in its July 2017 Monetary Policy Report reveal that Trinidad and Tobago suffered an energy export receipt loss of US$6.1 billion between 2014 and 2016. As a consequence, the country has faced a trade-off between financing the emerging imbalance in foreign trade flows (e.g., by borrowing from abroad or tapping external assets saved in the past) and adjusting such an imbalance (e.g., by compressing imports, expanding non-energy exports, or reducing net investment income paid to foreigners). By and large, the external imbalance has been financed rather than adjusted. In particular, the capital and financial account (inclusive of errors and omissions) provided additional net foreign financing of US$4.6 billion in 2016 vis-à-vis 2014. Higher net foreign financing resulted mainly from reduced private capital flight (as suggested by the errors and omissions, which amounted to US$2.5 billion in 2014 but were nearly zero in 2016) and higher gross foreign borrowing (e.g., the US$1 billion sovereign global bond issued in 2016). In addition, net international reserves fell by US$500 million in 2016 as opposed to an

accumulation of US$1.3 billion in 2014. Hence, the country is no longer accumulating foreign assets, and has taken on external debt on a limited scale.

The lack of adjustment to the loss of energy export receipts is also apparent in a deteriorated current account balance. The current account deteriorated by US$6.3 billion between 2014 and 2016, moving from a surplus of 15.1 percent of GDP to a deficit of 10.9 percent of GDP. The decline reveals the absence of import compression and export diversification that would have helped the country adjust to the loss of energy export receipts. In particular, Trinidad and Tobago has exhibited higher merchandise imports (which led to an additional expense of US$900 million in 2016 relative to 2014), higher net imports of services (leading to a US$500 million additional expense), and lower non-energy export receipts (which reduced incomes by US$700 million). Jointly, these developments more than offset lower net investment income paid to foreigners (which implied a savings of US$1.7 billion in 2016 vis-à-vis 2014). Arguably, both the lack of import compression despite the domestic recession, and the difficulties of diversifying exports in the short run, are associated with a large currency overvaluation in real terms.

Organisation of Eastern Caribbean States (OECS) countries

Hurricanes devasted parts of the OECS countries. The impact of hurricane Irma was particularly devastating in Antigua's sister island Barbuda, where it is estimated that 90 percent of buildings were destroyed and 50 percent of the population was left homeless.[1] Moreover, potable water service, telecommunications infrastructure, and electric power were affected. Government buildings were destroyed and the airport in Barbuda was damaged. To a lesser extent, St. Kitts and Nevis also saw damage to infrastructure and property, flooding of the airport, and the interruption of electrical power. Only a few days later, hurricane Maria devastated the tiny island of Dominica, leaving at least 30 dead and damaging an estimated 80 percent of buildings. The Caribbean Catastrophe Risk Insurance Facility SPC (CCRIF) is estimated to be making payments of US$19 million, US$6.8 million and US$2.3 million to Dominica, Antigua and Barbuda and St. Kitts and Nevis, respectively, on their tropical cyclone insurance policies.

Tourism performance was mixed at the end of the first three months of 2017. Total visitor arrivals to the OECS increased by 3 percent, with a 6.3 percent increase in cruise passengers offset by a 2.2 percent fall in stay-over arrivals. Total visitor expenditure grew by 3.8 percent at the end of March 2017. There were declines in stay-over arrivals for most member countries, except for Dominica (7.8 percent) and St. Lucia (3.2 percent). St. Lucia recorded the largest increase in cruise ship passengers, followed by St. Vincent and the Grenadines and then Antigua and Barbuda, when compared with the similar period in 2016.

Across the OECS, credit to the private sector declined by 2.2 percent as of June 2017. This decline was driven by St. Lucia, where credit fell by 6.7 percent, and by Dominica, where it fell by 3.8 percent, with less lending to households and businesses. Lending to the private sector expanded in St. Vincent and the Grenadines (1.9 percent) and remained flat in St. Kitts and Nevis (0.3 percent) compared with the same period a year earlier. The lack of access to finance in the OECS is reported by firms as a major constraint for business operations.

Consumer prices increased at the end of March 2017. There were increases in the inflation rate ranging from 0.2 percent in Dominica and 0.3 percent in Grenada to 2.4 percent in Antigua and Barbuda. This was driven by higher costs for food and transport linked to higher international commodity prices. On the other hand, the inflation rate remained unchanged in St. Kitts and Nevis.

[1] According to the Caribbean Catastrophe Risk Insurance Facility, September 2017.

CARIBBEAN REGION

SELECTED INDICATORS

	The Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
	2016/17	2017(p)	2016	2016/17	2016/17	2016
(Annual percentage changes, unless otherwise indicated)						
Real Sector						
Real GDP	0.0	1.7	3.3	1.7	-1.24	-2.3
Nominal GDP	1.9	2.1	4.5	4.0	28.5	-2.9
Inflation (end of period)	1.1	2.0	1.5	4.1	29.9	3.1
Exchange rate (end of period)	1.0	2.0	206.5	128.7	7.4	6.8
External Sector						
Exports of goods and services (yoy, %)	2.2	0.1	23.1	5.0	69	-26.1
Tourism receipts (yoy, %)	…	5.5	n.a.	6.8	…	n.a.
Imports of goods and services (yoy, %)	-8.1	1.5	0.0	-7.3	36	9.5
Current account (percentage of GDP)	-11.4	-3.3	0.4	-3.6	-4.4	10.9
Treasury bill rate (percent, end of period)	2.0	3.3	1.5	6.2	…	n.a.
(In percentage of GDP, unless otherwise indicated, on a calendar year basis)						
Central Government						
Revenue and grants	21.4	30.7	26.9	27.9	15.2	30.8
Budgetary expenditure	24.9	35.1	30.9	28.8	20.9	36.3
Primary balance	-0.4	2.9	-2.0	7.0	-4.4	-2.9
Budget balance	-3.5	-4.4	-2.9	-0.9	-5.7	-5.5
Public sector balance	-3.5	…	-2.9	-0.9	-5.7	n.a.
Debt Indicators						
Public sector debt	66.6	143.6	49.6	115.2	64.6	60.5
Public sector debt over revenues	311.2	467.8	184.5	412.9	425.9	196.4
Foreign currency public debt (end of period)	23.4	29.5	33.8	75.0	47.6	14.6
External interest payments as percentage of exports of goods and services	…	…	…	…	…	1.6
International Reserves						
Net international reserves (USD Mill)	865	317.8	615	2769	404	9.5
Gross international reserves (weeks of good and services imports)	12.5	9.7	14.4	23.3	9.0	10

Sources: Country authorities; International Monetary Fund; and IDB calculations.

FISCAL CHALLENGES IN THE CARIBBEAN: OVERVIEW

Overview

All countries in the Caribbean face fiscal challenges. On the one hand, the countries that depend on tourism – Jamaica, Barbados, and The Bahamas – are at different stages of dealing with the tailwinds from the 2009 global financial crisis. All three are making adjustments, with Jamaica ahead because it started an aggressive fiscal consolidation in 2013. On the other hand, the commodity-exporting countries of Suriname and Trinidad and Tobago, relatively unscathed by that crisis, have been strongly affected by the fall in international commodity prices in the last three years, especially oil. Guyana is an outlier, with strong growth supported by elevated gold prices.

This regional section summarizes the fiscal challenges in the region. As in the country sections, we explore issues related to debt, revenue, and expenditure, and then conclude with policy recommendations.

Debt

Excessive debt brings several problems. High debt levels represent a drag to the economy. When the debt level is too high, economic growth is severely affected. Combined with a low credit rating, this implies high interest rates that squeeze out private and public investment and social expenditure.

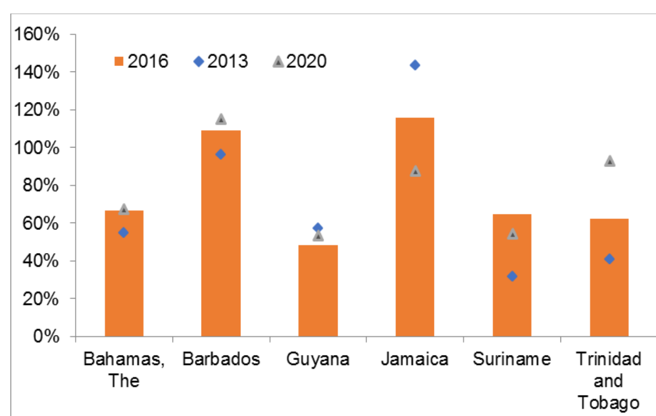
Debt-to-GDP ratios in the Caribbean in 2016 were higher than they were in 2013 in all but two countries (Figure 1). Suriname recorded the largest increase, more than doubling its debt-to-GDP ratio between 2013 and 2016. However, the increase was also substantial in Trinidad and Tobago. Both countries experienced a combination of large GDP contractions and increases in nominal debt (in the case of Suriname, nominal debt increased by 168 percent between 2013 and 2016). Increases in debt-to-GDP in The Bahamas and Barbados occurred because nominal debt increased faster than nominal GDP. The debt-to-GDP ratios in Jamaica and Guyana fell, as nominal debt decreased while GDP increased.

Debt could continue to rise. The International Monetary Fund's April 2017 *World Economic Outlook* projects that debt-to-GDP ratios in 2020 will linger at levels similar to the current ones for most countries (including a small rise in The Bahamas and Barbados and a small reduction in Suriname and Guyana) (Figure 1). The forecast for Jamaica assumes continued fiscal consolidation with debt reduction. For the other countries, other than Trinidad and Tobago, increased fiscal efforts should slow or reverse the debt build-up. However, the forecasts for Trinidad and Tobago currently do not include the fiscal consolidation that the government has started.

Drivers of debt vary among countries (Figure 2). The Bahamas and Barbados have a fixed exchange rate, while Guyana and Trinidad and Tobago have a managed float. As such, exchange rate movements did not influence the level of debt in these countries. Both Jamaica and Suriname experienced increases in debt from a depreciation of the exchange rate.

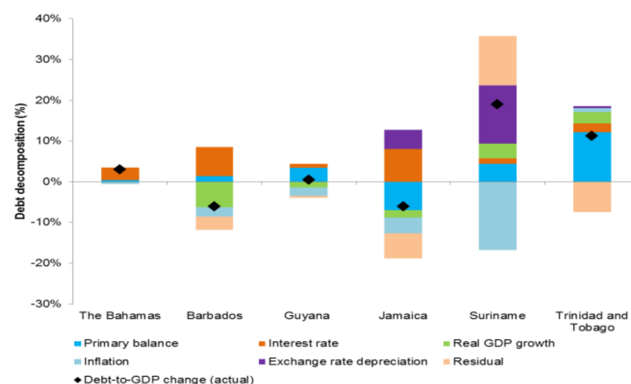
Interest payments also are an important driver of debt. A rise in public debt can place a country into a vicious cycle of increasing debt and rising interest payments. An insufficient fiscal effort, measured by the primary balance, contributed to an increase in debt in all countries except Jamaica. The residual – such as debt relief, an assumption of contingent liabilities, or measurement errors – also played a role in the evolution of debt in all countries other than The Bahamas.

Figure 1. Debt-to-GDP Ratios (percent)



Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

Figure 2. Drivers of Debt, 2016 (percent of GDP)



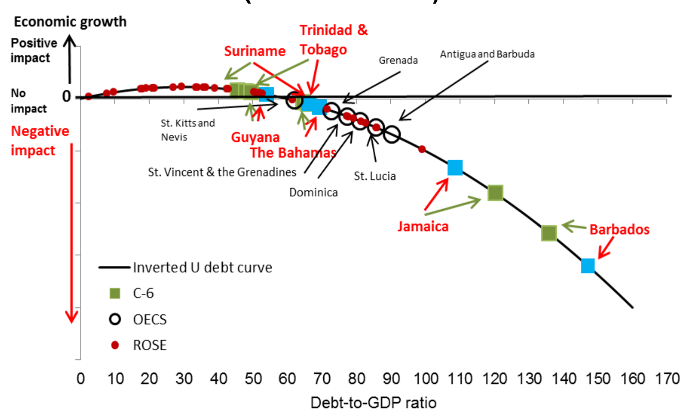
Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

Determining whether fiscal policy is adequate requires having a benchmark to ascertain whether debt is, or is forecast to become, too high. One possible debt benchmark is derived from the estimated relation between debt and economic growth, as shown in

Figure 3. The inverted U shape relation shows that for a debt-to-GDP ratio lower than 30 percent, any increase has a positive marginal and average effect on economic growth. However, above that level (the turning point on the inverted U curve), any further increase has a negative marginal effect, and above 60 percent the impact (marginal and average) becomes negative.[1]

Using the inverted U-curve as a benchmark paints a worrying picture for the Caribbean. The tourism-dependent countries, the countries of the Organisation of Eastern Caribbean States (OECS), and Suriname and Trinidad and Tobago are already in the negative region of the debt-growth relation. Guyana would cross the threshold soon but the projected jump in GDP from the commencement of oil extraction in 2020 should stop the increase in the debt-to-GDP ratio. Jamaica and Barbados are forecast to reduce their debt ratios, but both remain in the negative region of the relation.

Figure 3. Debt-to-GDP Ratio and Economic Growth (2015 and 2017)

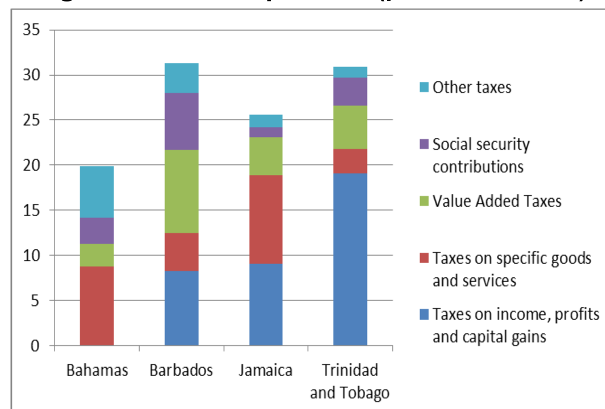


Sources: IDB calculations; and International Monetary Fund, World Economic Outlook (April 2017).

Revenue

Tax revenue in the CCB countries is in line with the region. Tax revenues vary from 19 percent of GDP in The Bahamas to over 30 percent of GDP in Barbados and Trinidad and Tobago, compared to an average of 22.8 percent for all of Latin America and the Caribbean.[2] Differences exist in terms of tax types (Figure 4): While The Bahamas does not tax income and profits, Trinidad and Tobago gets almost two thirds of revenues from income and profits. In addition, while both Jamaica and Barbados tax income and profits, two thirds or more of revenues come from taxing consumption and services, including through the Value Added Tax[3].

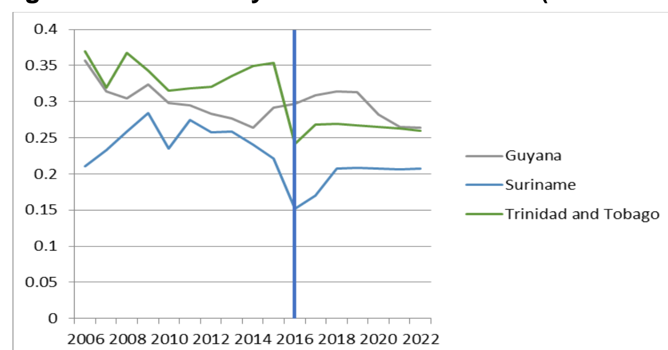
Figure 4. Tax Composition (percent of GDP)



Sources: IDB calculations; and see OECS Database: Revenue Statistics for Latin America and the Caribbean.

Revenue in commodity countries plummeted as a result of the sharp fall in commodity prices (Figure 5). Commodity-related revenue averaged 16 percent, 36 percent, and 50 percent of total revenue for Guyana, Suriname, and Trinidad and Tobago, respectively, during the period 2011–2014. In these countries, this revenue had helped to boost expenditure on infrastructure, education, and other social programs. However, commodity-related revenue is expected to remain depressed over the short term (Figure 6).

Figure 5. Commodity Producers: Revenue (share GDP)



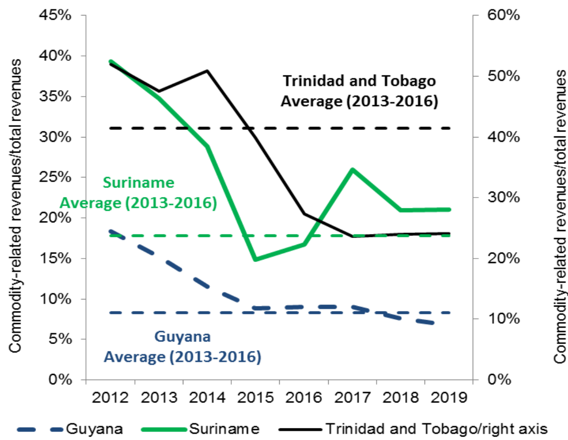
Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

[1] Kevin Greenidge et al., 2012, "Threshold Effects of Sovereign Debt: Evidence from the Caribbean." IMF Working Paper 12/157, International Monetary Fund, Washington, DC. Available at: https://www.imf.org/external/pubs/ft/wp/2012/wp12157.pdf.

[2] Value is for 2015, see OECS Database: Revenue Statistics for Latin America and the Caribbean.

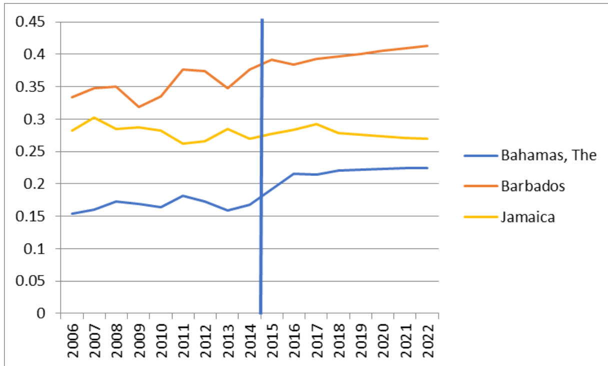
[3] The low collection of the VAT in Jamaica has been noted before (see for instance OECD Revenue Statistics in Latin America and the Caribbean 2017). Besides exceptions for a large number of zero rated goods, some goods are subject to a special consumption tax rather than the VAT.

Figure 6. General Government Commodity-related Revenue (percent of total revenue)



Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

Figure 7. Tourism Countries: Revenue (share GDP)



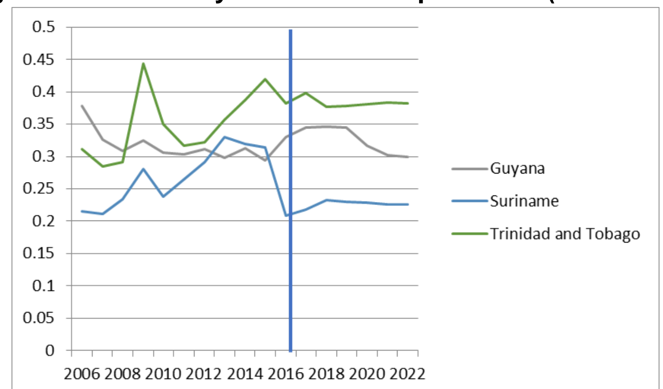
Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

Revenue in tourism countries reflects the fiscal adjustment (Figure 7). In Jamaica, revenue has stabilized and is expected to remain around 25 percent of GDP. Jamaica's adjustment going forward focuses on expenditure reduction, shifting the focus to avoiding distortions while keeping the level of revenue at current levels. Conversely, Barbados and The Bahamas are trying to increase revenue as a reaction to expenditure pressures.

Expenditure

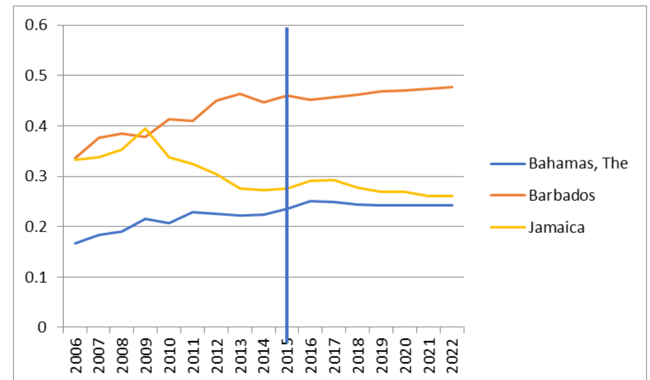
Commodity producers adjusted expenditure as a result of the fall in revenue. The high revenue during the commodity boom had helped boost expenditure (Figure 6). The rise in debt reflects that there will be insufficient fiscal retrenchment to offset the revenue loss discussed above. Further actions, either on revenue or expenditure, will be needed to balance budgets again. Guyana is again an exception, as the country foresees an increase in expenditure in the short term to stimulate the economy.

Figure 8. Commodity Producers: Expenditure (share GDP)



Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

Figure 9. Tourism Countries: Expenditure (share GDP)



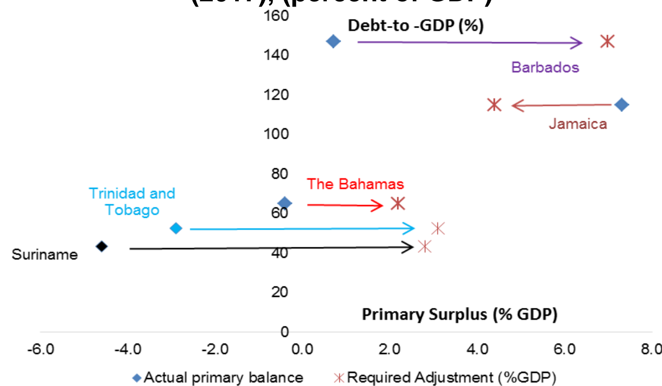
Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

Expenditure adjustment is necessary in the tourism-dependent countries. The rise in expenditure in both Barbados and The Bahamas has been rapid over the last 10 years and poses challenges to fiscal sustainability (Figure 9). Part of the increase in expenditure results from increased interest payments because of higher debt, fuelling a vicious cycle of higher debt that leads to higher interest payments that can lead to higher debt. Jamaica is an exception, as interest expenditure has been decreasing after peaking during the global financial crisis.

Significant fiscal effort is required to stabilize the debt. Comparing the actual primary balance with the required primary balance to stabilize the debt-to-GDP ratio gives an indication of the direction and size of the fiscal adjustments needed. Figure 11 shows the estimated fiscal adjustment, drawn in terms of percentage points of GDP. With the exception of Jamaica, the required fiscal adjustment to stabilize the debt-to-GDP ratio averages 5 percentage points of GDP for Caribbean

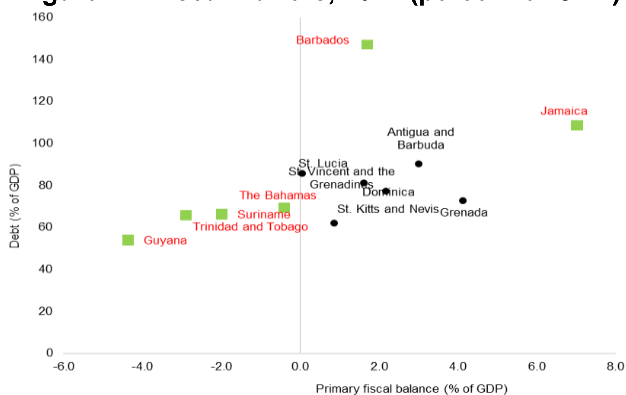
countries.[4] Suriname's adjustment is the largest at around 7 percent of GDP, followed by Barbados and Trinidad and Tobago at around 6 percent, and The Bahamas (2.6 percentage points). Jamaica's actual primary balance, a surplus of 7 percent of GDP, derives from the country's fiscal rule to reduce debt-to-GDP ratio to 100 percent of GDP by 2020 and 60 percent by 2026.[5]

Figure 10. Actual (2016) and Required Fiscal Balance (2017), (percent of GDP)



Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

Figure 11. Fiscal Buffers, 2017 (percent of GDP)



Sources: IDB calculations; and International Monetary Fund, *World Economic Outlook* (April 2017).

Fiscal buffers are low (Figure 11). The higher the primary balance and the lower the current debt, the better the ability of a country to absorb a shock. In this respect, fiscal buffers in the Caribbean are weak. The two countries with positive primary balances have high debt. In the other countries, the primary balances are already negative, implying that they are already contributing to building up debt. Also, as mentioned above, projections are for most countries to remain at current levels or increase their debt-to-GDP ratio. As a result, the ratios could accelerate if the countries face a shock.

Conclusion and Policy Recommendations

There is no shortage of fiscal challenges in the Caribbean. The country sections discuss the individual challenges in more detail, but broadly there are two groups. Commodity producers that had become accustomed to high growth and high revenue were caught by the slump in commodity prices. While revenue fell immediately, expenditure only reacted slowly, leading to increases in deficits and debt while economic output contracted. An exception is Guyana, which relies on gold for both growth and revenue. As the fall in commodity prices coincided with global uncertainties, gold prices have remained buoyant, supporting strong economic performance in Guyana. In addition, recent oil discoveries in the country should change the economic outlook in 2020 when extraction is expected. The situation is different in the tourism-dependent countries. A lacklustre economic performance, especially since the global financial crisis, combined with high and rigid expenditure, has led to a steady build-up of debt and interest payments that is increasing macroeconomic vulnerability and endangering fiscal and debt sustainability.

All countries in the Caribbean are either already undertaking fiscal consolidation or are expected to embark on it soon. While the short-term focus is often on revenue measures and cuts to capital investment, deeper and more long-lasting measures will be required to achieve sustainable fiscal accounts while providing essential services and infrastructure.

Institutional strengthening would better guide fiscal and economic policies. Institutions that anchor fiscal policy, such as fiscal rules, offer several advantages, especially in a region that is so vulnerable and prone to external shocks. Such rules also remove discretion from fiscal policy, lower uncertainty, prevent procyclical fiscal policy, and help avoid the build-up of unsustainable situations. Jamaica has taken the lead in this regard, introducing a legally binding fiscal rule that determines fiscal targets in line with an overarching debt target. In a similar vein, Trinidad and Tobago has a sovereign wealth fund that serves a similar function by accumulating foreign assets when energy revenues are high and softening the adjustment during slumps.

[4] This figure excludes Guyana, which is a participant in the Heavily Indebted Poor Country Initiative, for which a different criterion is used. See the section on Guyana.

[5] The country-level analysis suggests a large difference between budgeted and actual fiscal outcomes. This implies that the countries' budgetary processes may need to be strengthened.

THE BAHAMAS Fiscal Challenges

Contributor: Allan Wright.

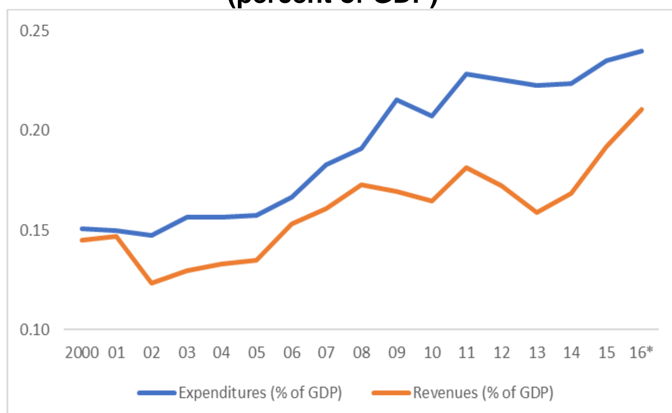
> ***Highlights***
>
> - *Revenues have increased in recent years because of implementation of the value-added tax.*
> - *Tax administration has been weak historically, though major structural reforms are under way.*
> - *Expenditures are continuing an upward trend despite implementation of the Medium-Term Fiscal Plan.*
> - *State-owned enterprises represent a significant portion of expenditures.*

Overview

The Bahamas has had a budget deficit since 1999. The debt-to-GDP ratio before the global financial crisis was 32 percent, and after the crisis it increased by roughly 4 percent a year. General government debt in 2016 was estimated at 67 percent of GDP. The current debt trajectory is expected to stabilize between 2017 and 2021 following government fiscal reforms and improvements in tax collection. Growth for the past decade has been weak at less than 0.5 percent. Contractions in 2014 (-0.5 percent) and 2015 (-1.7 percent), along with the estimated flat performance in 2016, juxtaposed against current levels of expenditure (25 percent of GDP) and revenues (21 percent of GDP), suggest that without corrective actions the debt level will continue to increase for the foreseeable future.

Efforts to control and limit government expenditures and to improve tax collection will help stabilize and eventually reduce the current debt level and its trajectory. Implementation of the value-added tax (VAT) in 2015 contributed to an improvement in government revenues by some 3 percent of GDP (from 16 to 19 percent from FY 2014/2015 to FY 2015/2016) (Figure 1). However, further reforms might be required. The current VAT structure appears to have reached peak efficiency, and garnering additional revenue relative to GDP might be difficult. This will probably require either increasing rates (politically unfeasible) or improving efforts to collect current taxes through more efficient measures.

Figure 1: Government Revenues and Expenditures (percent of GDP)



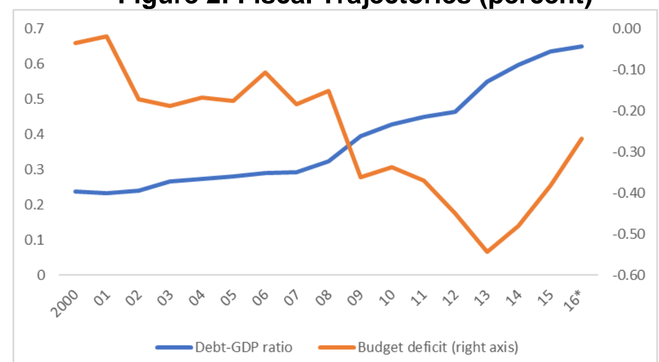
Source: International Monetary Fund, *World Economic Outlook* (April 2017).
*Data for 2016 are estimates.

In terms, of expenditure, the only plan at present is the Medium-Term Fiscal Plan, which recommends (but does not mandate) maintaining expenditures at 23 percent of GDP. The government of The Bahamas must continue current expenditure reforms to reduce the burden on debt levels. Long-term reforms are needed for state-owned enterprises, which account for up to 33 percent of the budget and more than 7 percent of GDP annually. It is estimated that pension liabilities, under their current structure, will rise to more than 200 percent of GDP over the next few decades and be fiscally unsustainable, according to the IMF Article IV 2016 Report.

Fiscal Challenges

The fiscal history of The Bahamas prior to the global financial crisis saw a small budget deficit, with average tax revenues at 14.4 percent of GDP and expenditures at 16 percent of GDP (Figure 2). This was below regional levels of 24 percent and 25 percent of GDP, respectively. The tax regime relied primarily on trade – imports and tourism kept levels historically fluctuating and sometimes low. Since 2007, expenditures have risen steadily, as increases in the cost of oil affected import levels and costs, and by extension, impacted government social assistance programs. Since the global financial crisis, expenditures have increased by almost 10 percent of GDP over the past decade and the upward trend appears to be continuing.

Figure 2: Fiscal Trajectories (percent)

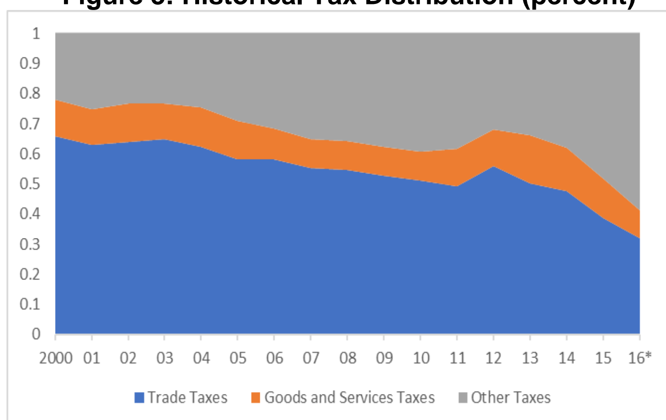


Source: International Monetary Fund, *World Economic Outlook* (April 2017). *Data for 2016 are estimates.

Tax Policy

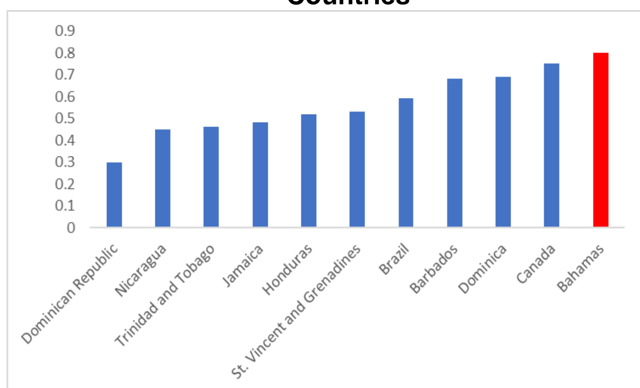
Tax reform, including the VAT reform in 2015, ended a revenue stream that was subject to fluctuations in the international trade market and was without a broad domestic base to provide stability. Before the VAT, taxes from international trade and tourism accounted for almost half of total revenue (Figure 3), with revenues frequently varying by up to 3 percent of GDP during periods of instability with trade taxes. Revenue forecasting, budgeting, and macroeconomic planning have continued to be difficult during this period. The VAT reform provides stability to the revenue base, and that tax is now one of the most efficient and least distortionary VATs in the world (Figure 4). Tax revenues increased from 16 percent of GDP in 2013 to 21 percent of GDP in 2016, due in large part to the VAT reform (Figures 5 and 6).

Figure 3: Historical Tax Distribution (percent)



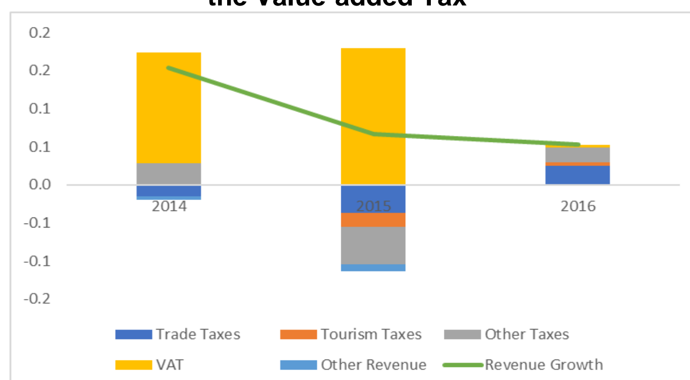
Sources: International Monetary Fund, *World Economic Outlook* (April 2017); and IDB staff calculations.
*Data for 2016 are estimates.

Figure 4: Value-added Tax Efficiency Ratios, Selected Countries



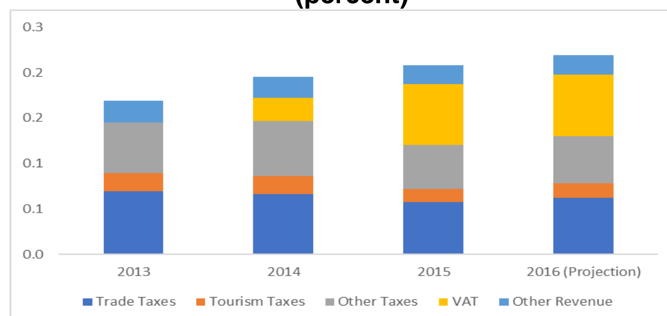
Source: International Monetary Fund, 2016 Article IV Report.

Figure 5: Revenue Changes following Reform of the Value-added Tax



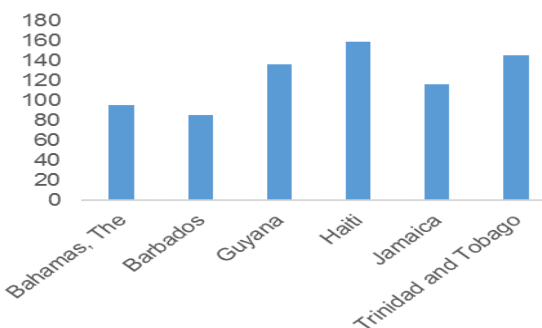
Sources: International Monetary Fund, *World Economic Outlook* (April 2017); and IDB staff calculations.

Figure 6: Revenue Impact of the Value-added Tax (percent)



Source: International Monetary Fund, Article IV 2016 Report.

Figure 7: Ease of Paying Taxes Ranking of in Selected Caribbean Countries



Source: World Bank, Doing Business Indicators, 2017.

Tax Administration

Ongoing reforms to the tax administration system include centralizing the country's 30+ revenue authorities into a single Central Revenue Authority. The process started in 2015 and will be completed in four years. Currently, there is a lack of online services

and e-filing/e-payment options and few public-facing offices, all of which contributes to long wait times. This has been exacerbated by the complexity of the VAT, despite an online payment system. One result has been that the ranking of The Bahamas on the "ease of paying taxes" indicator in the World's Bank's Doing Business Index has plummeted from 24th to 95th (Figure 7), and the approximate time to pay has increased from 58 to 233 hours.

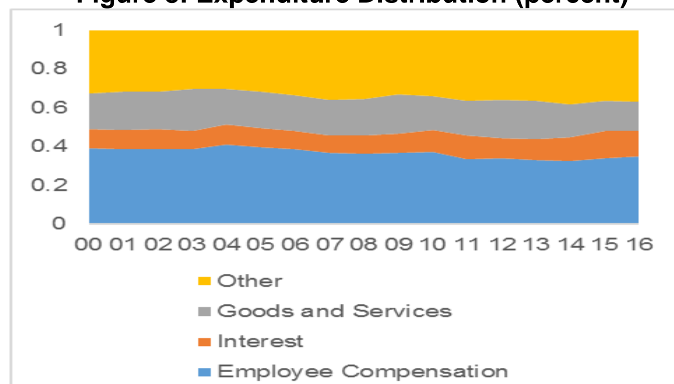
Public Sector Expenditure

Mitigating fiscal challenges requires controlling public sector expenditures. The path of expenditures in The Bahamas is on an upward trajectory and is currently outpacing revenue gains from implementation of the VAT reforms. If this trend continues, declining fiscal space and rising debt levels will limit the government's ability to direct scarce resources to other pro-growth areas such as vital infrastructure development. Successful reforms of expenditures must include plans to restructure the administration of ministries and state-owned enterprises to provide more efficient service with fewer resources, and to channel any savings to partially fund infrastructure maintenance and growth-driven infrastructure development.

Government expenditures have been steadily increasing, averaging 23 percent of GDP over the last five years (Figure 1), but account for roughly 6 percent of gross value added in the economy. Of total expenditures, 90 percent are recurrent expenditures (21 percent of GDP over last five years) and 10 percent are capital expenditures. Wages and salaries, and subsidies and transfers (primarily to state-owned enterprises), account for about a third of the expenditures, or over 7 percent of GDP each. The remainder of expenditures is for goods and services (3.6 percent of GDP) and interest payments (3 percent of GDP) (Figure 8).

As wages and salaries and subsidies to state-owned enterprises constitute most of the Bahamian budget, they are the best places to consider improving the efficiency of government expenditures. The government of The Bahamas is currently working towards achieving targets on fiscal prudence by enhancing public financial management techniques. New procurement regulations and a comprehensive public expenditure review are expected shortly, with the aim of achieving savings and ensuring consistency with the government's fiscal policy priorities.

Figure 8: Expenditure Distribution (percent)



Sources: International Monetary Fund, *World Economic Outlook* (April 2017); and IDB staff calculations

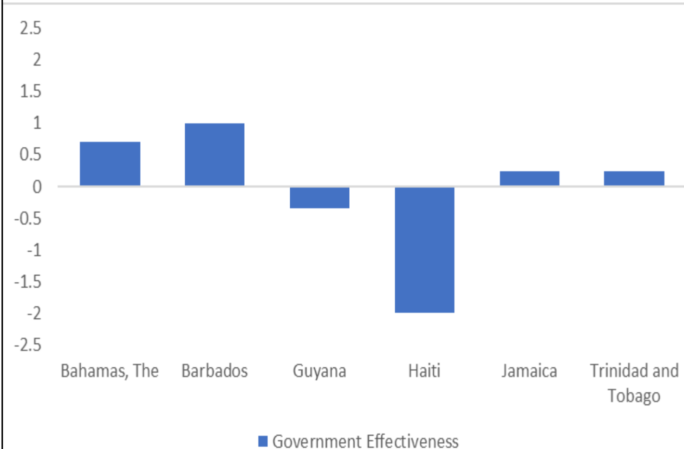
Conclusion and Policy Discussion

The Bahamas faces many challenges in terms of its fiscal framework. VAT reforms in 2015 have increased tax revenues in recent years and reduced the budget deficit in the short term, but the VAT provides limited long-term capacity to continue increasing revenues to meet rising expenditures. Tax administration has been weak historically, although major structural reforms are under way. Expenditures are continuing on an upward trend despite guidelines in the Medium-Term Fiscal Plan to restrain them below 23 percent of GDP. State-owned enterprises represent a significant portion of these expenditures. Given their high number of staff and high technical losses due to poor infrastructure, these enterprises require subsidies and transfers equivalent to 7 percent of GDP to maintain their operational capacity. Despite these challenges, the VAT reform shows that fiscal reform can produce benefits. The ongoing tax administration reforms will provide a solid base for further institutional strengthening.

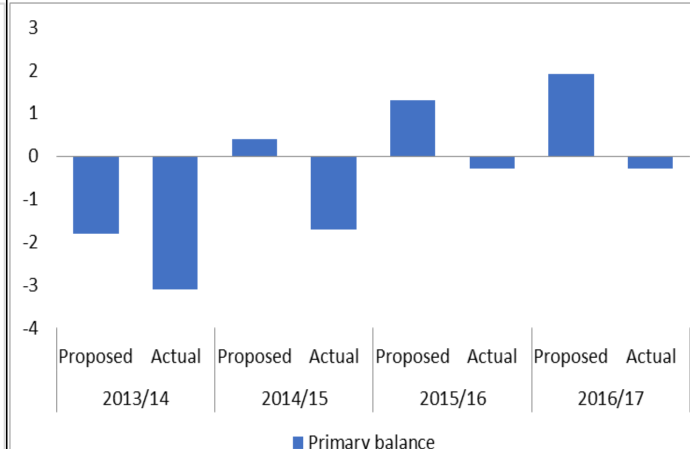
Quarterly Bulletin September 2017

THE BAHAMAS FISCAL SNAPSHOT

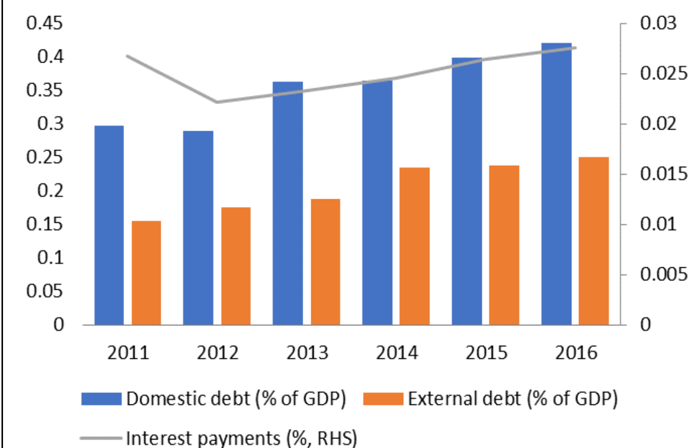
Government Effectiveness



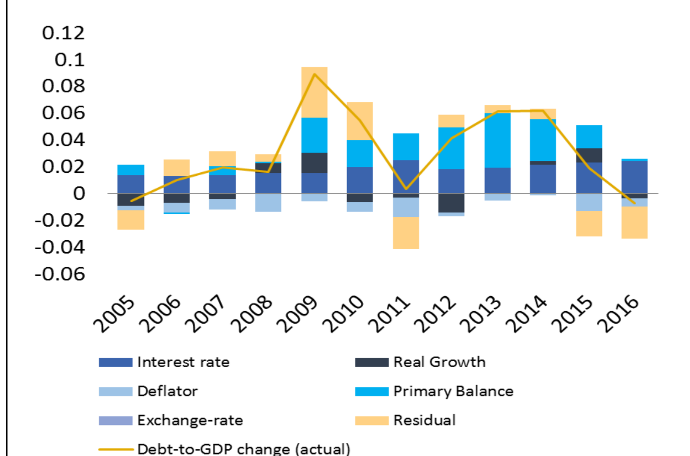
Medium-Term Fiscal Plan



Debt



Debt Decomposition



Sources: International Monetary Fund, 2016 Article IV Report ; and IDB staff estimates based on the International Monetarty Fund's *World Economic Outlook* (April 2017).

BARBADOS

RISING FISCAL DEFICITS

Contributors: Juan Pedro Schmid and Kimberly Waithe.

Introduction

Over the last decade, Barbados's macro stability has been challenged by high fiscal deficits and increasing public debt. Since the 2008 global financial crisis, the country has seen rising fiscal deficits that peaked at 10.4 percent of GDP in FY2013/14. At the same time, there has been a rise in the debt-to-GDP ratio, which reached almost 144 percent by the end of the first half of 2017.

The size of the deficit and its financing, along with the high levels of public debt, are a constraint to growth. Barbados had low and negative real economic growth that averaged 0.6 percent annually during 2010–2016. In comparison, pre-crisis real GDP growth averaged 2.6 percent from 2003–2008. In addition, a series of downgrades of the country's sovereign credit rating, with the most recent ones by Moody's in March 2017 and S&P Global ratings in September 2017, indicate fewer financing options. This could challenge the government's ability to service its debt. The government has been pursuing fiscal adjustment since 2013 that has reduced the financing need but has not yet stabilized an increasing debt trend. Tighter fiscal adjustment could change the trajectory of debt and growth over the medium term. The next section examines Barbados's public finances, decomposes the debt portfolio, and provides policy suggestions.

Debt

Barbados's public debt structure is primarily domestic. As of end-June 2017, about 80 percent of public debt was domestic (US$5.3 billion) and the remainder external (US$1.4 billion). About 26 percent of central government debt is held by the National Insurance Scheme (NIS), followed by commercial banks and the central bank, each with around 16 percent. With the increase in the debt, there has been a change in the debt structure, with a rise in the share of short-term debt (Treasury bills) from 5.9 percent of GDP in 2006 to 41 percent of GDP in June 2017. Saving bonds accounted for 2 percent while the share of debentures gradually increased to 66 percent. The portfolio has relatively limited exposure to exchange rate risk, with about 20 percent of liabilities denominated in foreign currency. External debt is primarily held in bond placements (9.9 percent). International financial institutions held about 6.9 percent of central government debt as of June 2017 (Figure 1).

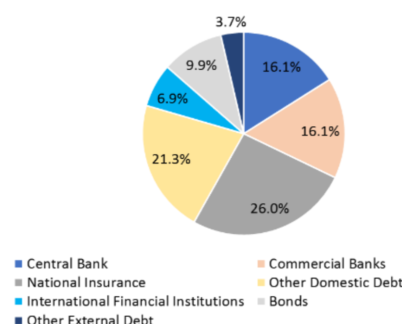
Barbados's high levels of public debt pose macro risks. As of end-June 2017, public debt stood at 106.2 percent of GDP, and around 143.6 percent of GDP when

Highlights

- *The ratio of debt to GDP remained elevated at 143.6 percent of GDP at the end of June 2017.*
- *Primary deficits and interest payments are the main drivers of debt growth.*

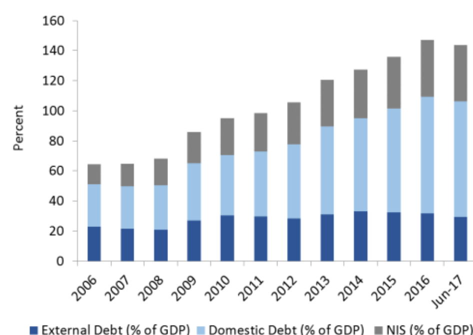
including holdings from the NIS (Figure 2). Considering that debt stood at 51 percent of GDP (64.5 percent, including the NIS) in 2006, this rapid rate of debt accumulation is unsustainable going forward. The build-up of debt, and the increasing costs of servicing it, are crowding out fiscal space and have had adverse implications for private investment and consumption decisions because of the high country risk. The IMF's August 2016 Article IV Report noted that there are sizable downside risks with regard to the country's public debt sustainability, ranging from low growth, continued significant recourse to short-term debt, rising arrears and contingent liabilities.

Figure 1. Debt Structure as of June 2017 (percent)



Source: Central Bank of Barbados.

Figure 2. Evolution of Public Debt (percent of GDP)



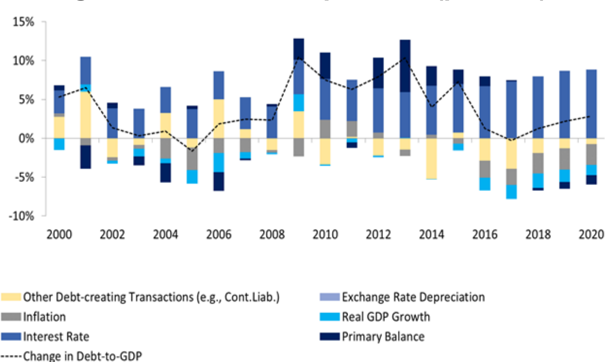
Source: Central Bank of Barbados.
Note: NIS: National Insurance Scheme.

The main factors contributing to higher debt were primary deficits and interest rates. A decomposition of Barbados's debt by its main components (primary balance, interest rate, real GDP growth, inflation,

exchange rate depreciation, and other debt-creating transactions) shows that interest rates, and particularly domestic rates, are the main contributor to higher debt. This is particularly the case since 2009, when the average annual change in the debt-to-GDP ratio stood at 6.9 percent, with interest rates contributing on average 5.7 percent. The primary balance followed closely as a driver of debt-creating flows. On the other hand, inflation up to 2009 had been an important debt-reducing factor but its impact diminished in recent years. Growth averaging -0.5 percent from 2000 to 2016 had a more neutral impact on the change in the debt-to-GDP.

Debt is forecast to remain elevated until 2020. The International Monetary Fund (IMF) projects that, even excluding NIS holdings, the debt-to-GDP ratio will reach 115 percent by 2020. The main drivers of debt would continue to be interest payments. Inflation and real GDP growth, on the other hand, are expected to be debt-reducing factors (Figure 3).

Figure 3. Debt Decomposition (percent)

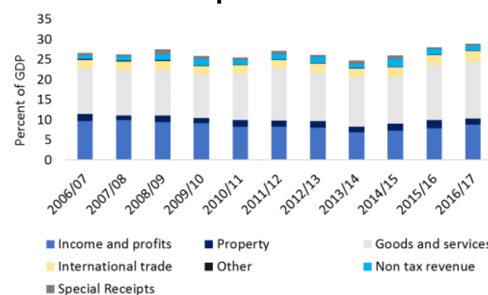


Source: International Monetary Fund, *World Economic Outlook* (April 2017).

Revenue

Revenue collection has fluctuated but remained relatively stable over the last decade. Barbados's major source of revenue has come from taxing goods and services, namely value-added tax (VAT) collections that account for almost half of total revenue (Figure 4). This is followed by taxes on income and profits, which represented on average around 30 percent of revenue from 2006 to 2016. After 2009, revenue in Barbados was challenged by weak domestic demand, the erosion of the revenue base over time, and tax administration. In particular, revenue collections were adversely impacted by a contraction of GDP and weaker tourism demand, with collections declining to 25.3 percent of GDP in FY2013/14 from 27.4 percent in FY2011/12. However, there has been a pick-up since 2014 as a result of new tax measures, with revenue increasing to an estimated 29.3 percent of GDP in FY2016/17.

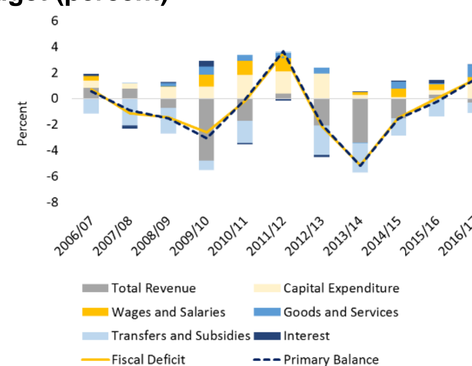
Figure 4. Revenue Composition as a Percent of GDP



Sources: Ministry of Finance; and the Central Bank of Barbados.

Revenue is generally overestimated when comparing actual to budgeted revenue. Lower-than-expected revenue has been one of the main contributors to budget underperformance in Barbados. Figure 5 indicates that there has been a systematic overestimation of fiscal revenues in most years under review. This is especially the case in 2009 and in 2013, when revenue deviations (actual versus budgeted) fell by 16 percent and 12 percent, respectively.

Figure 5. Deviation of Revenue and Expenditure from the Budget (percent)



Sources: Ministry of Finance; and the Central Bank of Barbados.

The contribution of tax revenue to total revenue reached around 95 percent in FY2016/17. Direct taxes contributed 37 per cent of total tax revenue, while indirect taxes represented 58 per cent, with non-tax revenue contributing the remainder. The significant contribution of indirect taxes to overall tax revenue is primarily based on the influence of the VAT, which represents around 34 percent of government revenue. Direct tax revenue is mainly based on personal income and corporate taxation, which together account for 27 percent of government revenue. As part of fiscal consolidation efforts in 2013, the government implemented a number of revenue-

raising measures, including an increase in the VAT rate, a tax on bank assets, a 2 percent foreign exchange commission, an increase in the excise tax on gasoline and diesel, and an increase in the National Social Responsibility levy (tax on imports) from 2 to 10 percent, among other measures.

The IMF recommended broad tax reforms aimed at improving tax administration and increasing compliance. Tax incentives in the form of concessions, waivers, and reduced rates narrowed the revenue base during the review period. The IMF suggested widening the tax base, mainly of the VAT. Reviewing exemptions and waivers for both the VAT and customs levies could increase revenue collection. In this regard, the government in its 2017 budget announced that the tax policy reform and tax administration upgrade project will be completed, including the final transition of the Customs Department into the Barbados Revenue Authority. In addition, a single taxpayer information technology system will also be implemented. The government also announced the establishment of a special task force unit within the Barbados Revenue Authority tasked with setting up a national tax administration registration initiative. This is aimed at ensuring that all taxpayers required to register are brought into the tax net.

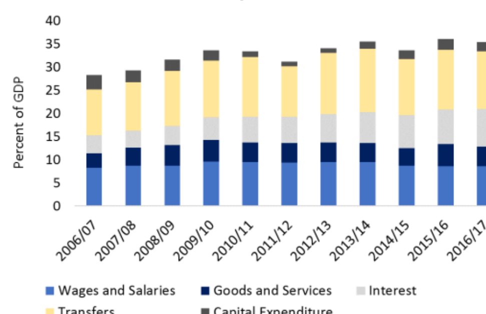
In spite of weak tax administration, taxation is not one of the main challenges in Barbados's business climate. The World Bank's 2017 Doing Business Indicators rank Barbados 117th out of 190 countries, down from its ranking of 115th a year earlier. With respect to the ease of paying taxes, Barbados stands at 85th in the ranking of 190 economies[1]. This compares favorably to Jamaica (116th) and Trinidad and Tobago (145th). Similarly, according to Compete Caribbean's 2014 Productivity, Technology, and Innovation (PROTEqIN) Survey, only 4.9 percent of firms reported tax administration as the most serious obstacle to business operations.

Expenditure

The growth of public spending in Barbados has outpaced revenue collection and stood at 35.6 percent of GDP at the end of FY2016/17. Expenditures are particularly rigid because wages and salaries and interest payments combined account for almost half of total expenditure. The largest expenditure items are transfers and subsidies and wages and salaries. As a result of fiscal consolidation efforts, the economy has seen a reduction in transfers from 13.7 percent of GDP in FY2013/14 to 12.5 percent of GDP in FY2016/17, while wages and salaries stood at 8.6 percent of GDP. Capital expenditures remained low throughout the period. Current spending crowded out public investment, which averaged around 2 percent of GDP over the review period (Figure 6).

[1] In terms of the overall distance to the frontier, it remained unchanged between 2012-2017 at 0.72.

Figure 6. Expenditure Composition as a Percent of GDP



Sources: Ministry of Finance; and the Central Bank of Barbados.

There has been an underestimation of expenditure in most fiscal years under analysis. A decomposition of expenditure variation suggests that spending on transfers and subsidies has been the major contributor to this deviation. On the other hand, capital expenditure has been systematically overestimated (Figure 5).

Conclusion and Policy Discussion

Over the period of analysis, current expenditure has outpaced revenue and has led to sustained primary deficits and elevated debt levels. The current debt trajectory is unsustainable going forward. At the same time, the government is seeking to accelerate the pace of fiscal adjustment and targets a balanced budget in FY2017/18. In this regard, the government is exploring a possible swap program with the NIS and the central bank that would result in up to US$35 million (0.7 percent of GDP) reduction in interest costs. The IMF recommends critical reforms that are needed to reduce debt and debt service costs and to restore sustainability and confidence. In particular, further adjustment is needed with respect to expenditure, namely transfers to public enterprises, interest, and the wage bill. Reduction in transfers to public enterprises must be supported by "structural reforms to reduce state-owned enterprises' operating costs, rationalize their programs, and raise their revenues," according to the IMF.[2]

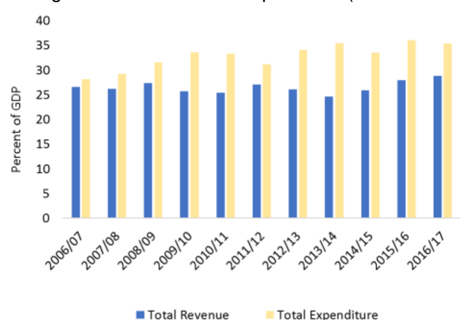
[2] "IMF Staff Concludes Visit to Barbados," IMF Press Release 17/255, June 29, 2017. Available at: https://www.imf.org/en/News/Articles/2017/06/29/pr17255-imf-staff-concludes-visit-to-barbados.

BARBADOS

FISCAL SNAPSHOT OF BARBADOS

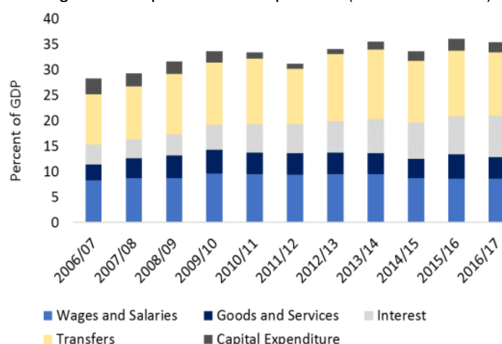
Expenditure has outpaced revenue

Figure A. Revenue and Expenditure (Percent of GDP)



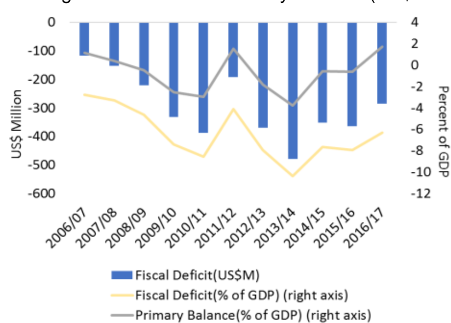
… due to elevated spending in transfers and wages

Figure B. Expenditure Composition (Percent of GDP)



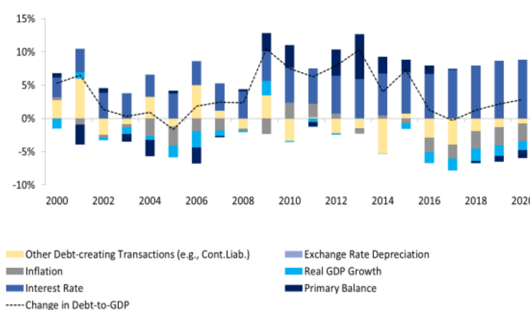
resulting in large sustained fiscal and primary deficits.

Figure C. Fiscal and Primary Balance (US$ M and percent of GDP)



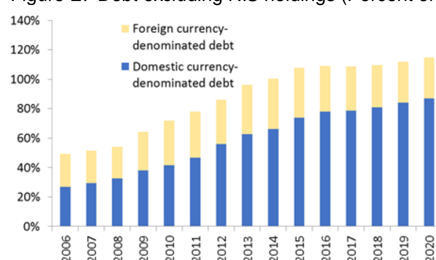
Primary deficits and interest rates are the main contributors

Figure D. Debt Decomposition (Percent)



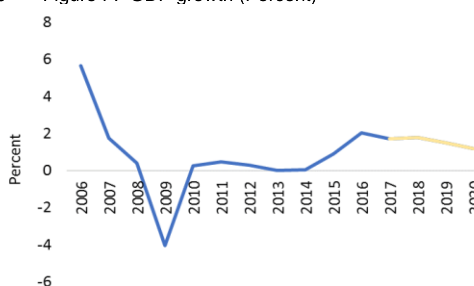
.. to debt growth which is unsustainable

Figure E. Debt excluding NIS holdings (Percent of GDP) 2006-2020



..and could hamper future growth.

Figure F. GDP growth (Percent)



Sources: Central Bank of Barbados; International Monetary Fund, *World Economic Outlook* (April 2017); and the Ministry of Finance.

Quarterly Bulletin September 2017

GUYANA THE FISCAL DEMANDS OF COMMODITY DEPENDENCE

Contributors: Mark Wenner and Dillon Clarke.

> ***Highlights***
>
> - *Guyana benefits from strong economic growth and low real rate interest rates paid on its debt, keeping the debt trajectory sustainable.*
> - *Guyana has an estimated tax buoyancy slightly greater than one, but tax policy and administration combine to create distortions and inefficiencies.*
> - *Current expenditure growth has been driven by transfer payments and increases in wages and salaries.*
> - *Regular discrepancies between planned and actual capital expenditures suggests procurement, project execution, and supervision issues.*

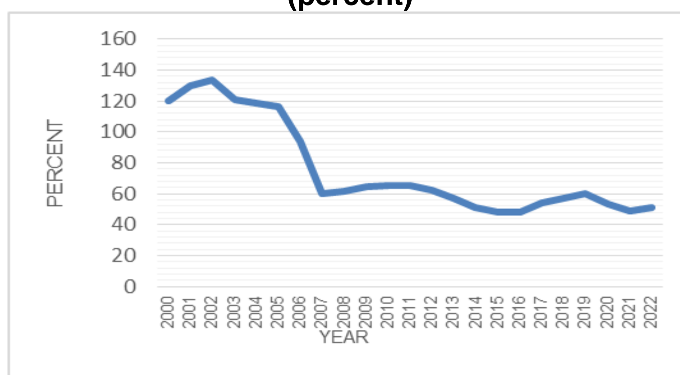
Overview

Guyana is a commodity exporter with a high degree of trade openness. Six primary commodities—gold, bauxite, rice, sugar, timber, and fish—constitute more than 80 percent of total exports in most years. As a result of this high level of commodity dependence and trade openness, the country is vulnerable to commodity price volatility and external shocks. The amount of government commodity-related revenue tends to be highly correlated with export growth performance. When world prices are high for these traditional export commodities and there are no major supply-side disruptions, the amount of royalties and trade taxes received tends to be high. The opposite holds true when prices and export volumes are low. As commodity prices have declined since the end of the super-cycle commodity boom, revenue volatility has increased. The coefficient of variation for government commodity-related revenue has increased from 0.48 in the period 2006–2010 to 1.92 in the period 2011–2016. Accordingly, commodity dependence requires more diligent fiscal and debt management.

Debt

Between the year 2000 and the medium-term forecast up to 2022, the evolution of Guyana's debt falls into three distinct periods. In the first period, 2000–2007, total public debt was high, exceeding 100 percent, and the debt-service-to-export ratio exceeded 150 percent. During this period, Guyana was participating in the 1996 Highly Indebted Poor Country Initiative and the 2005 Multilateral Debt Relief Initiative sponsored by the International Monetary Fund and the World Bank. Between 2004–2007, approximately half of Guyana's debt stock was forgiven. The public-debt-to-GDP ratio peaked at 133 percent in 2002 and fell to 59 percent in 2007. In the second period, 2008–2016, debt-to-GDP ratios stabilized and averaged 58 percent. In the last period, the medium-term forecast for 2017–2022, Guyana is predicted to face rising public debt from 2017–2019 and then take a slight dip from 2020–2022. From a level of 48 percent in 2016, the debt-to-GDP ratio is projected to rise to 60 percent in 2019. Some improvement is expected between 2020 and 2022 as the ratio is anticipated to fall due to 1) the inflow of oil revenues, which should alleviate much of the government's need to borrow, and 2) a significant increase in the size of the economy due to exports of oil (Figure 1).

Figure 1: Guyana: Public-Debt-to-GDP Ratio (percent)



Source: International Monetary Fund, *World Economic Outlook* (April 2017).

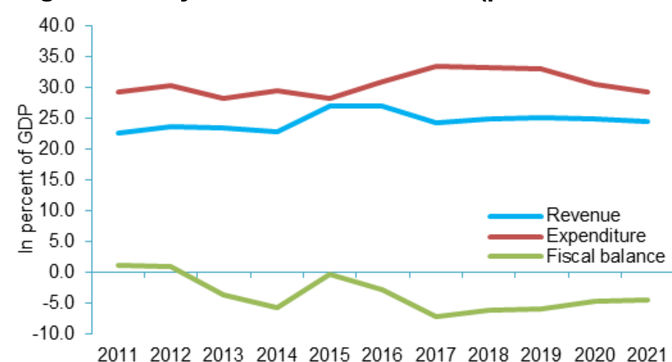
Drivers of Debt Accumulation

The main driver of debt accumulation in Guyana is the primary deficit. As expenditures outstrip revenues, the central government is forced to borrow to finance the gap. The government borrows externally, primarily from international financial development institutions and bilateral agencies, and it borrows domestically, primarily by selling Treasury bills to domestic commercial banks in the absence of a bond market.

Guyana's ability to mobilize tax revenue compares favorably with other developing countries in the region. The average tax-revenue-to-GDP ratio in the period 2011–2015 was 23.8 percent for Guyana, whereas the average for the entire Latin America and Caribbean region for the same period was 22.06 percent.[1]

Guyana has consistently exhibited a procyclical spending stance. During the periods of high commodity prices and participation in the generous rice-for-oil-swap program with Venezuela (2003–2014), Guyana did not consistently run a balanced budget or a surplus before grants (Figure 2).

Figure 2: Guyana's Fiscal Balances (percent of GDP)

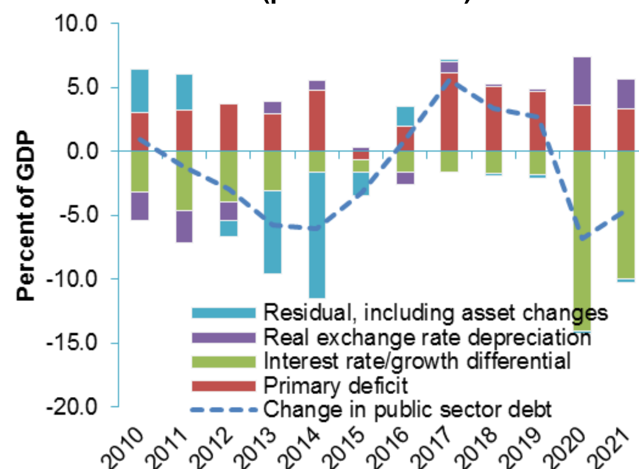


Sources: Ministry of Finance; and International Monetary Fund, 2017 Article IV Report.
Note: Values for 2017 to 2021 are projections.

Decomposition of Debt Drivers

As can be seen in Figure 3, the main contributor to the change in the public-debt-to-GDP ratio is the primary deficit. What reduces the rate of change is the differential between the interest rate and the growth rate. A high degree of concessionality in the external debt (65 percent of the debt stock is paying below market interest rates) helps maintain favorable and manageable debt dynamics. However, with the expected production of oil starting in 2020–2021, the possibility of reduced access to concessional funds may emerge, as gross national income (GNI) is bound to rise rapidly. GNI is often used by multilateral and bilateral development organizations as one of the criteria to allocate concessional funds.

Figure 3: Decomposition of the Public-Debt-to-GDP Ratio (percent of GDP)



Sources: International Monetary Fund, 2017 Article IV Report; and IDB calculations.

Revenue

Tax revenues have been steadily growing in Guyana (Figure 4) and there is tax buoyancy. The latter is critical for illustrating the role of revenue policy in ensuring fiscal sustainability in the long run, as it serves as an automatic stabilizer over business cycles in the short run, and in assessing how well the government is performing in keeping tax mobilization in line with economic activity. Tax buoyancy for Guyana is estimated to be slightly more than unity (1.07),[2] meaning that tax revenues are growing proportionally with the growth in national income and that the tax-to-GDP ratio will remain unchanged, ceteris paribus. If buoyancy were greater than 1, then the fiscal deficit could be reduced without relative changes in expenditures.

While the volume of tax revenue has steadily increased due to buoyancy, a partial amnesty program, and more aggressive collection of arrears, the composition of revenue has remained relatively unchanged over time (Figure 4). Consumption, trade, and non-tax revenue (i.e., commodity-related royalties) constitute a far larger share of total revenue than personal and corporate income taxes. In more advanced economies, these latter taxes are more important, indicating less regressivity. Over the forecast period of 2017–2021, non-tax revenue

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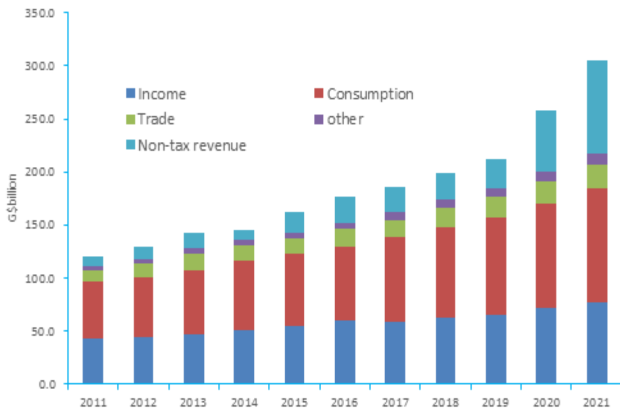
[1] Source: Organisation for Economic Co-operation and Development, "Revenue Statistics in Latin America and the Caribbean: 1990–2015," 2017.

[2] Source: G. Glenday and R. Kelly, "Guyana: Review of Tax System," Duke University, 2014.

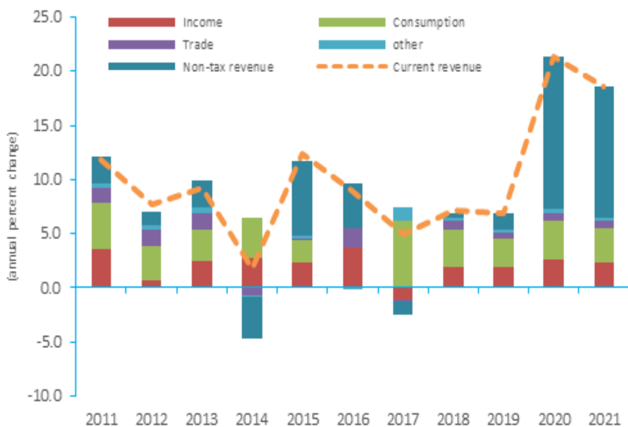
(commodity royalties) is expected to increase significantly due to the anticipated start of oil production in 2020 and 2021 (Figure 5).

Figure 4: Levels and Composition of Current Revenue (billions of Guyanese dollars)



Sources: Ministry of Finance; and International Monetary Fund, 2017 Article IV Report.

Figure 5: Contribution to Revenue Growth (annual percent change)

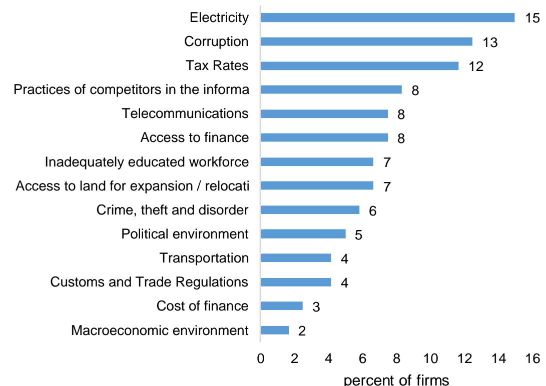


Sources: Ministry of Finance; and International Monetary Fund, 2017 Article IV Report.

The only revenue category that has shown annual volatility is commodity-related revenue (non-tax). All the other categories have increased steadily since 2010, showing no cyclical variation or secular decline. On an inter-annual basis, however, there is seasonality, depending on tax payment due dates, harvest periods, and peak shopping periods.

Tax policy is characterized by relatively high rates and a multitude of exemptions. For example, the tax rates as published by the General Revenue Authority website, are 45 percent for telecommunication companies, 40 percent for commercial companies, 28.5 percent for non-commercial companies, 30 percent for self-employed persons, and a 30 percent personal income tax rate for persons earning a salary less than US$871 monthly and 40 percent for those above after a subtraction of the threshold of G$720,000 (US$3,486). The high effective tax rates for some taxpayers result in low efficiency, distortions, and lack of equity. Exemptions have resulted both from offsetting the negative effects of excessively high tax rates as well as from discretionary powers of ministries. In 2014, these tax waivers amounted to G$43 billion, equivalent to 6.6 percent of GDP or 27 percent of total tax revenues. When the personal income tax is combined with the National Insurance Scheme (NIS) contribution, it implies a high tax burden, especially for middle-income earners.[3] The high average and marginal effective tax rates serve as a disincentive for formal employment and encourage tax evasion and informality.

Figure 6: Laments of Businesspersons 2014 (percent)



Source: Compete Caribbean, 2014 Productivity, Technology, and Innovation (PROTEqIN) Survey.

[3] NIS contributions (i.e., social security contributions) are levied at 14 percent of actual wages paid to the employee. This is derived from a 5.6% deduction from the Employee's pay, and the remaining 8.4% paid by the Employer on behalf of the Employee. The actual wages is, at present, subjected to a ceiling of $220,000.00 Guyanese dollars per month (equivalent US $1,065/month).

Tax Administration

In surveys, tax administration shows up as a major constraint for Guyanese firms. To pay taxes they spend 256 hours and make 35 payments annually, compared to 195 hours and 25 payments annually by firms in the rest of the small economies of the world that are commodity exporters, a grouping of 38 other economies with populations less than 1.5 million and high dependence on primary commodity exports. As can be seen in in Figure 6, complaints about high taxes represent the third most common complaint among businesspersons and contribute to a less-than-satisfactory business climate.

Expenditure

Expenditure as a share of GDP averaged 29.3 percent for the period 2011–2016. The level of spending places Guyana in the category of the highest-spending countries in the world. Compared to 2014 and 2015 expenditure levels—albeit years affected by one-off factors (prorogation of Parliament and a prolonged electoral cycle)—expenditure growth increased markedly. Fiscal expenditure increased by 18.7 percent between 2015 and 2016. The focus of the government has been on implementing an ambitious capital investment program as part of its stimulus plan.

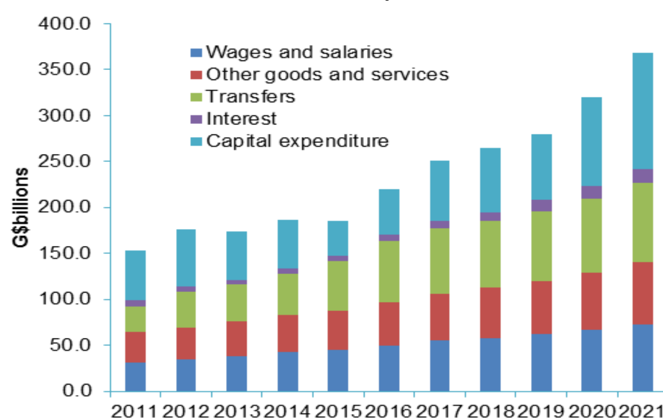
On the current expenditure side, wages and salaries increased in 2016 by 10.6 percent over 2015 due to a decreed 5 percent salary increase, but are projected to only increase slightly thereafter. Purchases of goods and services increased 8.5 percent, reflecting commitments to improve social services. Nonetheless, the largest increase came in the category of transfers. In 2016, transfers grew 2.62 percent to GS67.3 billion (9.5 percent of GDP). Most of the transfers were to provide support for loss-making state-owned enterprises, particularly Guysuco, the sugar corporation.

Expenditure Structure

As can be seen in Figure 7, capital expenditures (light blue) and transfers (green) have constituted the largest share of total expenditures since 2012. Over 2017–2019, these two categories are expected to range between 8.5 and 9 percent of GDP, then fall off in 2020 and 2021.

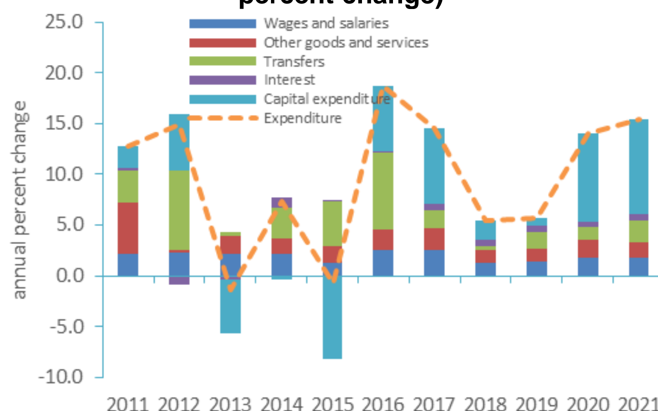
The main driver of change in fiscal expenditure in 2016 was transfers, and in 2017 it is projected to be capital expenditures. However, the projection may need to be revised by year's end, given the slow rate of disbursement under the Public Sector Investment Program (Figure 8). As of June 2017, the rate of disbursement was 27 percent, suggesting challenges in the areas of project design, procurement, contracting, execution, and supervision.

Figure 7: Fiscal Expenditures (billions of Guyanese dollars)



Sources: Ministry of Finance; and International Monetary Fund, 2017 Article IV Report.

Figure 8: Drivers of Fiscal Expenditure (annual percent change)



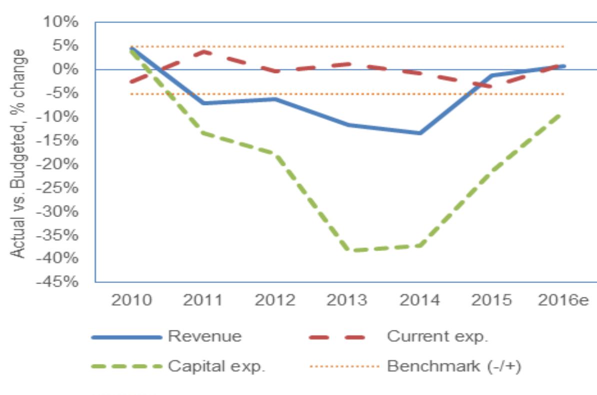
Sources: Ministry of Finance; and International Monetary Fund, 2017 Article IV Report.

Current and Capital Expenditure Performance

Budgeted and actual expenditure can differ substantially. As can be seen in Figure 9, the differences vary between what is planned and actually spent, what is expected to be mobilized as revenue, and what is actually captured. In the case

of current revenue there is little variation, but in the case of capital expenditure the deviations can be more than 20 percent. In the case of revenue, there was undershooting between 2011–2014, but collections have more closely coincided in 2015 and 2016.

Figure 9: Budget Variance (percent)



Source: Ministry of Finance.

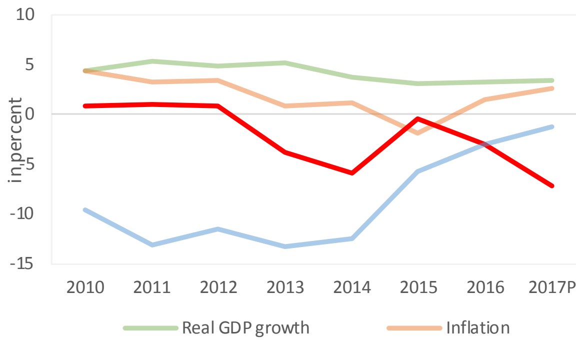
Conclusion and Policy Discussion

In summary, Guyana needs to improve fiscal management given that it is a small, open, and commodity-dependent economy that is vulnerable to terms-of-trade reversals, changes in market access, and natural disasters. While its level of public debt is currently manageable, the running of persistent fiscal deficits and weaknesses in its tax policy and administration regime serve to erode buffers. Therefore, authorities should attempt some fiscal consolidation, possibly via the adoption of a fiscal rule, prior to the receipt of oil revenues in 2020 and 2021. Improving tax efficiency, rationalizing expenditures, and improving the effectiveness and efficacy of public spending in the near term would represent steps in the right direction toward managing the emerging oil and gas sector that is even more prone to price volatility and to putting the country at risk of the resource curse.

GUYANA FISCAL SNAPSHOT

Economic slowdown in 2015 relieved fiscal pressures momentarily prior to stimulus…

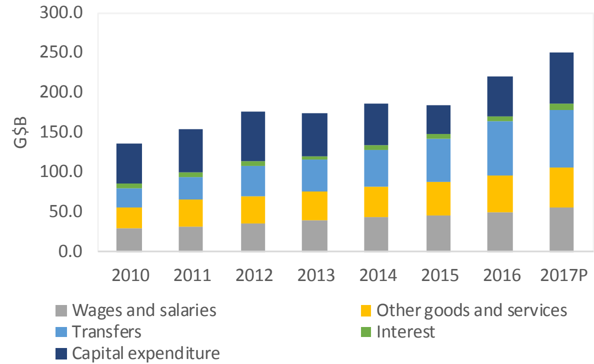
Figure a. Real GDP, Inflation, fiscal and external balances



Source: Ministry of Finance and IMF

...that focused heavily on transfers and provision of goods and services.

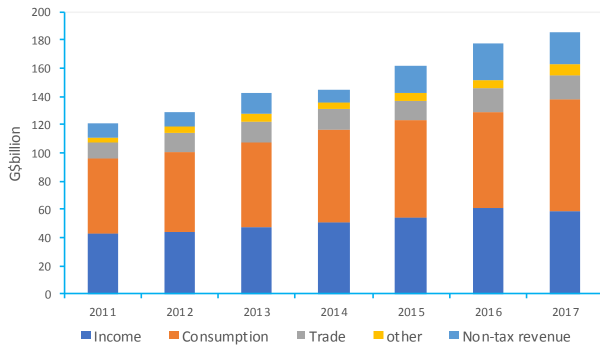
Figure b. Fiscal expenditure profile



Source: Ministry of Finance and IMF

Meanwhile, fiscal revenues remain bouyed by taxes on consumption and income.

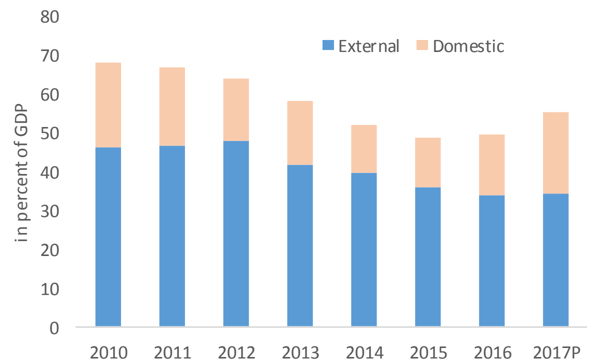
Figure c. Fiscal revenue profile



Source: Ministry of Finance and IMF

External debt levels have declined due to prudent management, however, reliance on domestic debt presents downside risks in the near term.

Figure d. External and domestic indebtedness



Source: Ministry of Finance and IMF

JAMAICA FISCAL PROGRESS BUT CHALLENGES REMAIN

Contributor: Juan Pedro Schmid.

Introduction

Jamaica is no stranger to fiscal challenges. Over the last 30 years, a fragile fiscal situation has been a mainstay of Jamaica, reflected in a debt-to-GDP ratio that was rarely below 100 percent. However, since 2013 Jamaica has made exceptional progress in addressing its fiscal issues. For the last four years, the primary surplus has been 7 percent of GDP or above, the debt-to-GDP ratio has been decreasing, and the country has been accessing international debt markets at ever-lower rates.

Jamaica has also recently made progress in strengthening its fiscal policy framework. Starting in 2010, and accelerating since the signing of the Extended Fund Facility (EFF) with the International Monetary Fund (IMF) in 2013, Jamaica's fiscal policy framework has evolved. Jamaica is the only country in the region with a legally binding fiscal rule that mandates a debt target and, resulting from it, calculates specific fiscal targets. In addition, the country's fiscal responsibility law regulates the budget process, mandates the publication of several policy documents that increase transparency, and mandates a decrease in public sector wages as a share of GDP.

Jamaica continues to focus on debt reduction. The legally binding fiscal rule foresees a debt-to-GDP ratio of 60 percent by March 2026 and defines fiscal targets accordingly. Current projections under the Stand-by Agreement with the IMF foresee a primary surplus of 7 percent for the next three years, but if performance remains strong that target could be relaxed in later years.

Jamaica's fiscal framework centers on containing expenditures while stabilizing tax revenues. Revenues as a share of GDP at over 25 percent, while appropriate by international comparison, do not allow much room for further increases. At the same time, expenditures are highly rigid, with over 80 percent of central government expenditure for interest payments and public sector salaries alone.

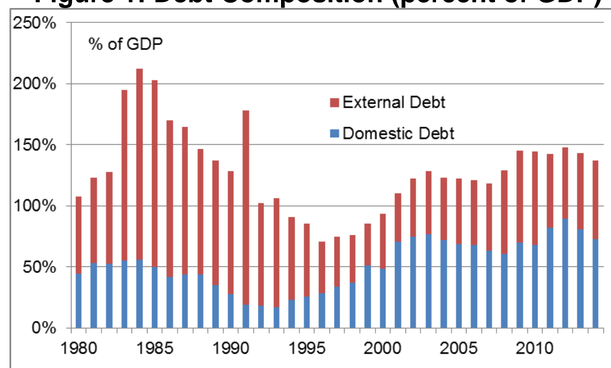
Debt

Debt has been high for several decades. Over the last three decades, the debt-to-GDP ratio has rarely been below 100 percent (Figure 1). The high level of debt brings several challenges. There is evidence that high debt causes lower economic growth, makes a country more vulnerable in times of crisis, and, combined with a low credit rating, implies high interest rates and thus a high share of revenues that must be allocated for debt servicing. This reduces the amount that governments can spend on productive investment in social and physical capital.

Highlights

- *While extraordinary progress has been made, fiscal challenges remain central for Jamaica.*
- *Debt has fallen from a peak of over 140 percent of GDP in 2013 and is on track to fall below 100 percent in 2020 and 60 percent in 2026.*
- *The main adjustment is on the expenditure side.*

Figure 1: Debt Composition (percent of GDP)



Source: IDB calculations based on data from the Ministry of Finance and Public Service.

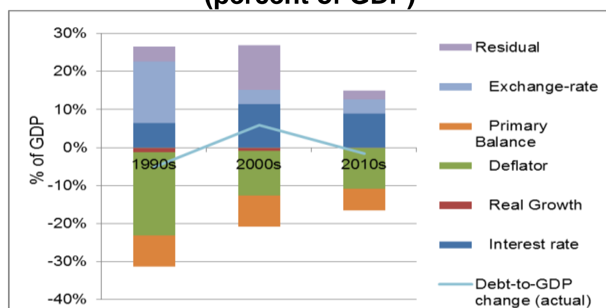
The global financial crisis threatened Jamaica's debt sustainability. Debt had been decreasing from high levels in the mid-2000s, but the turbulence surrounding the crisis led to a sharp increase in the debt-to-GDP ratio. This was only halted with implementation of the reforms and fiscal tightening introduced as part of the EFF in 2013. Since then, debt has retreated to an estimated 115.2 percent of GDP as of March 2017.

Historically, high interest payments and exchange rate movements have been the main contributor to the debt build-up. At the same time, debt was contained by high primary surpluses and inflation, while low growth rates restricted the effects of economic growth on the debt-to-GDP ratio (Figure 2). This situation is quite unique, as countries with high primary surpluses usually have low fiscal deficits or even surpluses. However, the Jamaican case is special, as the high level of debt led to high interest payments, which were only partly offset by the primary surpluses, leading to a vicious cycle of interest payments fueling debt, which in turn fueled higher interest payments.

Jamaica's debt is projected to decrease. Under current projections, a primary surplus of around 4 percent would suffice to keep debt-to-GDP at the current 115.2 percent

of GDP. As current and projected primary surpluses are above the level to stabilize the debt-to-GDP ratio, that ratio is thus projected to decrease in the absence of any significant changes.

Figure 2: Debt Decomposition by Time Periods (percent of GDP)



Source: IDB calculations based on International Monetary Fund, *World Economic Outlook* (April 2017).

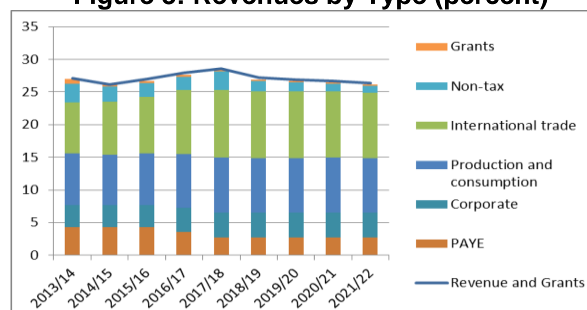
Jamaica will need to keep up the fiscal consolidation for an extended period to reach its debt targets. Jamaica's fiscal rule has a debt target of 60 percent of GDP by 2026. This target should be reached with a primary surplus of 6-7 percent as long as GDP growth continues as projected and the macroeconomic environment does not change fundamentally.

Revenue

Tax revenue as a share of GDP of over 25 percent is appropriate by international comparison and do not provide much room for further increases. As such, efforts regarding revenue are focused on stabilizing them while removing distortions. Toward this end, Jamaica introduced a comprehensive tax reform in 2014. The reform replaced many of the distortionary tax incentives–including discrete tax waivers and industry-specific special tax treatments–with tax incentives linked to employment and capital investment. Such incentives are less distortionary because they do not give preference to a company or sector, but rather support firms that are growing and investing.

The government is increasing its reliance on indirect taxes. The share of tax revenue from personal income taxes decreased in FY2016/17 and FY2017/18, as the government has been increasing the zero-threshold for its Pay As You Earn income tax.[1] As a result, taxes on international trade and consumption now provide over two-thirds of revenues (Figure 3). Projections are for tax revenue to remain at 25 percent of GDP, while non-tax revenue and grants will provide funds equivalent to 1-3 percent of GDP.

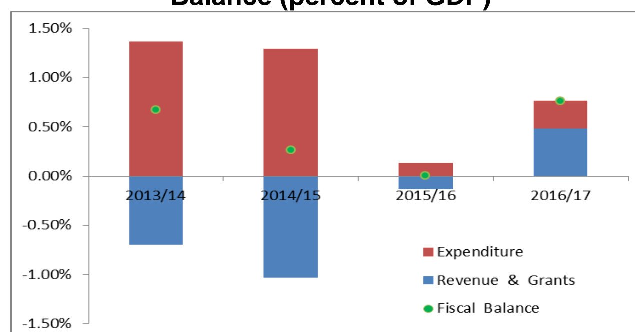
Figure 3: Revenues by Type (percent)



Source: IDB calculations based on on data from the Ministry of Finance and Public Service.
Note: PAYE: Pay As You Earn income tax.

Revenue performance has improved over the last four years. Comparing budgeted with actual revenues shows Jamaica's significant transformation. Since FY2013/14, Jamaica has not only increased tax revenues (Figure 3) but the actual revenue is also much closer to the budgeted revenue (Figure 4). Precise budget revenue estimates are important, as revenue underperformance has historically been a major reason for deviations in the fiscal targets and, thus, the build-up of debt. For instance, between FY2008/09, revenues have been on average 2 percent of GDP lower than projected.[2]

Figure 4: Effect of Budget Deviations on Fiscal Balance (percent of GDP)



Source: IDB calculations based on data from the Ministry of Finance and Public Service.
Note: A positive deviation improves the fiscal balance and a negative one worsens it.

Taxes are a burden for Jamaican businesses. The World Bank's Doing Business Survey and Compete Caribbean's 2014 Productivity, Technology, and Innovation (PROTEqIN) Survey highlight the burden that taxation poses for businesses. Jamaica was ranked 116th

[1] The income tax threshold was increased from JM$ 592,800 to JM$ 1,000,272 in FY2016/17 and to JM$ 1,500,096 in FY2017/18.

[2] See Juan Pedro Schmid, "Fiscal Unruliness: Checking the Usual Suspects for Jamaica's Debt Buildup, IDB Policy Brief 213. Available at https://publications.iadb.org/handle/11319/6053.

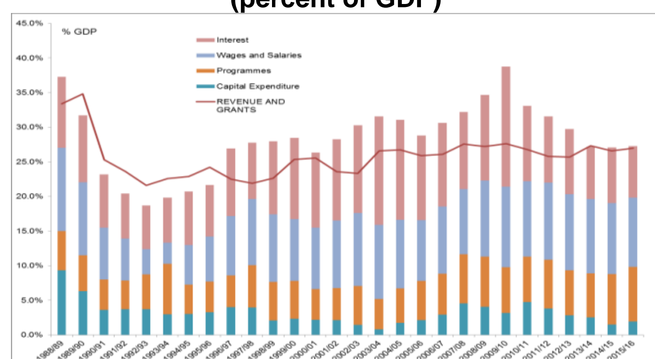
out of 190 economies for ease of paying taxes in the 2017 Doing Business ranking. Even though this marks progress from a year earlier (when the country ranked 155th), tax rates are high and time spent complying with tax laws and regulations remain a burden for businesses. Similarly, in the PROTEqIN survey, 58.3 percent of businesses considered tax rates a major or severe obstacle.

Fiscal needs require that revenues remain high. Reducing tax rates to make private sector investment more attractive is an important medium- to long-term goal, however it will require further advances in debt reduction. Until then, the main goal of tax policy and tax administration is to reduce distortions of certain taxes.

Expenditure

Fiscal deficits driven by recurrent expenditure are a characteristic of Jamaica's public finances. Starting in the late 1980s, capital expenditure fell below 5 percent of GDP and remained below that level thereafter. At the same time, Jamaica experienced deficits in every year after FY1995/96 (Figure 5). In terms of composition, interest payments have dominated Jamaica's budgets, accounting for up to 50 percent of total government expenditure in some years. Wages and salaries are the second-largest expenditure category, fluctuating between 7 and 12 percent of GDP. The remainder—program and capital expenditures—are the most flexible and thus have varied the most, probably in order to avoid larger deficits.

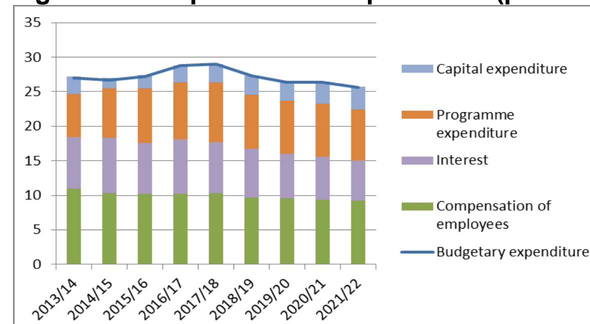
Figure 5: Government Expenditures and Revenues (percent of GDP)



Source: IDB calculations based on data from the Bank of Jamaica and Ministry of Finance and Public Service.

With revenues already high, the focus of the adjustment is on expenditures. The two main expenditure components—interest payments and public sector wages and salaries—can only be lowered with deep and slow reforms (Figure 6). Interest payments are decreasing because debt is decreasing and because fiscal stabilization also reduces country risks, lowering interest rates.[3] Public sector wages have stabilized but remain above the target of 9 percent of GDP.

Figure 6: Composition of Expenditure (percent)



Source: IDB calculations based on data from the Bank of Jamaica and the Ministry of Finance and Public Service.

Conclusion and Policy Discussion

Jamaica has made important strides towards fiscal and debt sustainability. Starting in 2010, and intensifying in 2013 under the IMF's Extended Fund Facility, Jamaica made deep adjustments in all areas that are relevant for fiscal sustainability. The country increased and stabilized revenues while decreasing distortions. On the expenditure side, fiscal consolidation has made a dent in the debt, while the visible commitment of the authorities has reduced interest rates. Together these measures have decreased interest rates from almost 11 percent of GDP in 2010 to a still-high but nevertheless significantly lower rate of 7.5 percent in the current fiscal year. Public sector wages surpassed 11 percent of GDP in 2011 but are projected to stabilize at 9 percent in FY2018/19 as part of public sector modernization.

Fiscal consolidation will continue. Between now and the target date of 2020, average growth is projected at 2.6 percent, which will result in a debt-to-GDP ratio of 94 percent with a primary surplus of 7 percent of GDP. Similarly, reaching the debt-to-GDP target of 60 percent by 2026 requires a primary surplus of around 6 percent between 2020 and 2026 under the baseline growth rate of around 3 percent. An acceleration of growth would allow for loosening the fiscal stance, while slower than projected GDP growth would require a stronger fiscal effort.[4]

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[3] The spread of Jamaican bonds over U.S. Treasury bonds declined by 87 basis points between September 2016 and 2017.

[4] See Juan Pedro Schmid, and Xavier A. Malcolm, "Debt, Fiscal Adjustment and Economic Growth in Jamaica," IDB Policy Brief 249. Available at https://publications.iadb.org/handle/11319/7438.

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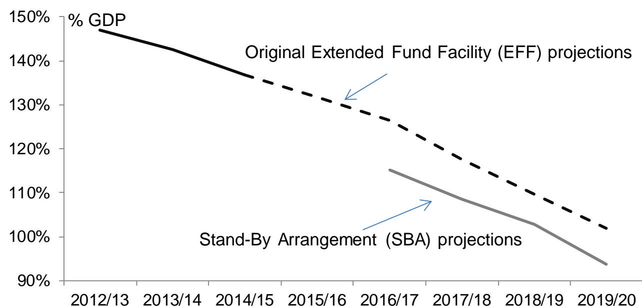
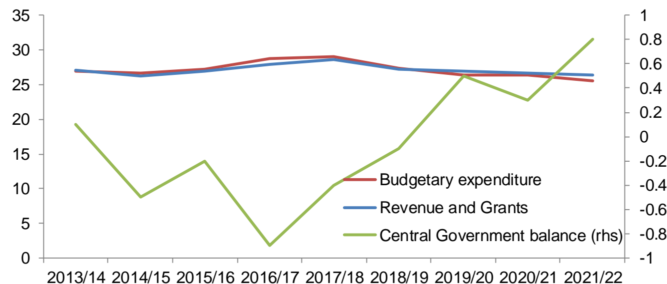
JAMAICA FISCAL SNAPSHOT

The Stand-By Arrangement will still focus on debt reduction …
Figure a. Debt-to GDP 2011/12 - 2019/20



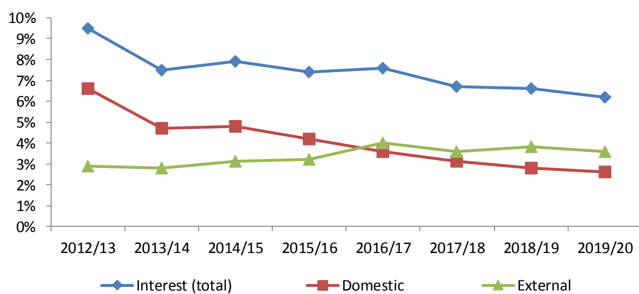
Source: International Monetary Fund (IMF)

…by achieving a balanced budget.
Figure b. Revenue, Expenditures and Overal Balance (% GDP)



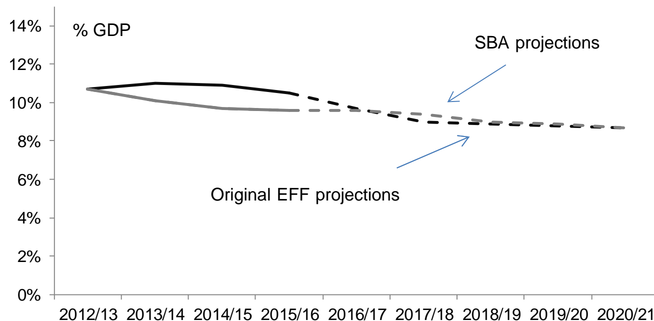
Source: International Monetary Fund (IMF)

Interest Payments are on a downward path…
Figure c. Interest Payments on Government Debt (% of GDP)



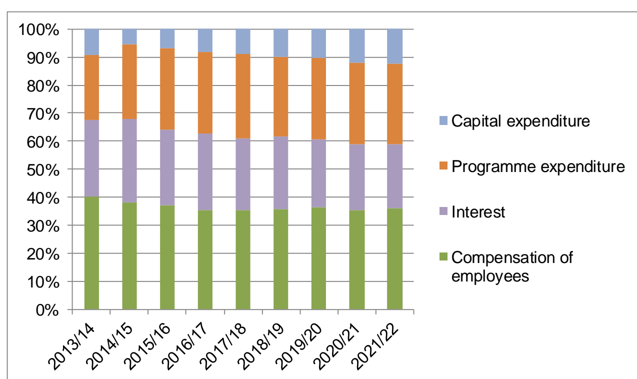
Source: International Monetary Fund.

while reduction of public sector salaries remains a target, both of which….
Figure d: Public Wages and Salarias (% of GDP)



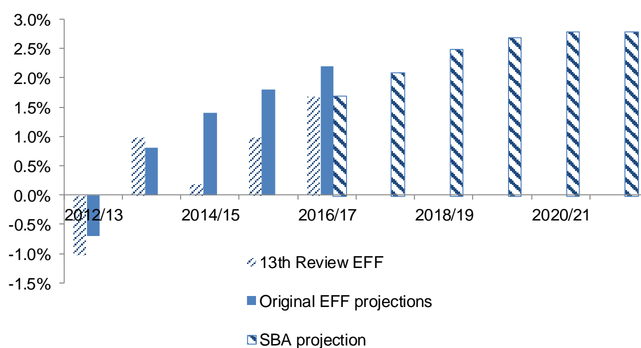
Source: International Monetary Fund.

… should allow a switch to more social and capital spending,….
Figure e. Contributors to Current Account Deficit (% of GDP)



Source: Bank of Jamaica.

… which would also support economic growth.
Figure f. Inflation and Its Main Components (y/y % change)



Source: Bank of Jamaica.

SURINAME CHARTING THE COURSE FOR FISCAL RECOVERY

Contributor: Jeetendra Khadan

Highlights

- *Suriname established a Savings and Stability Fund in 2017.*
- *Changes to the debt law constrain the fiscal deficit.*
- *There is considerable room for improvement in the areas of establishing effective spending policies, improving tax administration and tax reform, and overall strengthening of fiscal institutions.*

Overview

The 2015 commodity price shock revealed several longstanding weaknesses in Suriname's fiscal framework. The lack of fiscal buffers, ineffective expenditure policy, and weaknesses in tax policy and administration and fiscal institutions in general all contributed to a sharp deterioration of the country's fiscal performance. In this regard, this country review examines issues related to the conduct of fiscal policy in Suriname, particularly as they relate to the institutions and laws that are responsible for debt management, revenue and expenditure policies, fiscal buffers, tax administration, and budget performance. The analysis reveals that there is considerable room for improvement in the areas of establishing effective spending policies, improving tax administration and tax reform, and overall strengthening of fiscal institutions. The recent establishment of the Savings and Stability Fund and a proposal to undertake tax reform in 2018 are steps in the right direction.

Fiscal Framework and Budget Preparation

Fiscal policy is executed through the budget, so it is important to understand the design and preparation of the budget. Suriname's budget is drafted in a multi-year Medium-Term Fiscal Framework (MTFF) that outlines expenditure and revenue for a given period and serves as a basis for determining the budget ceiling of government ministries per budget year. The objective of the MTFF is to ensure effective, efficient, and transparent implementation of programs and projects. The MTFF also includes estimates of key macroeconomic variables such as economic growth, GDP, inflation, mining sector revenues, and other relevant indicators (Ministry of Finance 2017a).

The budget process begins when the Ministry of Finance sends a budget call letter to each government ministry. The letter is accompanied by guidelines for preparation and restrictions that will apply due to macroeconomic constraints. The individual ministries then prepare and submit a budget for the next year to the Treasury Department of the Ministry of Finance. After discussion and revisions, a first draft of the budget is prepared that is largely consistent with the guidelines established in the budget call and a five-year multi-year plan. Any remaining issues are decided on by the Council of Ministers, which approves the overall budget before it is submitted to the National Assembly via the Council of State. When the National Assembly approves the budget, the president authorizes its publication and then execution starts (Ministry of Finance 2017a).

Debt Management

Suriname's debt is governed by its National Debt Act. The government enacted the National Debt Act in 2002 and established the Suriname Debt Management Office in 2004. The National Debt Act specified a total debt ceiling of 60 percent of GDP: external and domestic debt were not to exceed 45 and 15 percent of GDP, respectively. Amendments to the National Debt Act were made in 2011, 2016, and 2017. In 2011, the act was amended to reflect new domestic and external debt ceilings: the domestic debt ceiling was changed to 25 percent of GDP and the external debt ceiling was changed to 35 percent of GDP. In 2016, the act was again amended to adopt the international definition of debt. Further changes in 2017 limits debt obligations to the budget deficit where the budget deficit is not to exceed 6.5 percent of nominal GDP in the first year (2017). In the following years, if debt is above the allowed ceiling the deficit can be at most 5 percent of nominal GDP. If the debt still exceeds the debt ceiling, after the fifth year, the Minister of Finance can only enter more debt obligations with approval by law (Suriname Debt Management Office 2017).

Fiscal Performance Debt Profile

Suriname has recorded persistent fiscal deficits over the last seven years. During the boom period from 2001–2014, the country's fiscal performance improved compared to the previous eight years. In fact, a small primary fiscal deficit averaging 0.7 percent of GDP was recorded during the period, compared to an average deficit of 2.8 percent of GDP for the period 1990–2000. However, the sharp decline in commodity-related revenues in 2015 contributed to a rapid deterioration of the fiscal accounts. In 2015, the primary fiscal deficit increased to 7.8 percent of GDP. To cover the fiscal gap, and to renegotiate and restructure debt at state entities, the government issued an international bond valued at US$550 million (equivalent to about 13 percent of GDP).

Suriname historically maintained a low debt-to-GDP ratio until it ballooned within the last few years. The country had one of the lowest debt-to-GDP ratios in Latin

America and the Caribbean at the beginning of the 2000s, with debt declining to a low of 15.6 percent of GDP in 2009 (see Figure a in the fiscal snapshot at the end of this country review). This period was characterized by high economic growth and strong mineral revenues as Suriname benefited from favorable commodity prices. The 2015 commodity price shock led to a sharp rise in the debt ratio from 29 percent of GDP in 2014 to 64.6 percent of GDP in 2016 (Figure a).

Drivers of Debt

The main drivers of Suriname's debt surge were the primary balance and changes in the exchange rate. Large fiscal deficits, currency devaluation, and weak economic growth have been the main causes of the increase in debt (Figure b). Suriname's primary fiscal deficit increased from 1.5 percent of GDP in 2010 to 4.4 percent of GDP in 2016, reaching a high of 7.8 percent of GDP in 2015. Real GDP growth declined from an average of 4.4 percent in 2001–2014 to an average of -6.6 percent in 2015–2016. Together with these factors, a currency depreciation of 127 percent from 2010 to 2016 raised the debt-to-GDP ratio by over 35 percentage points from 2014 to 2016. Using data from the International Monetary Fund (IMF), it is estimated that the interest rate and exchange rate will be the main drivers of Suriname's debt ratio over the medium term (Figure b).

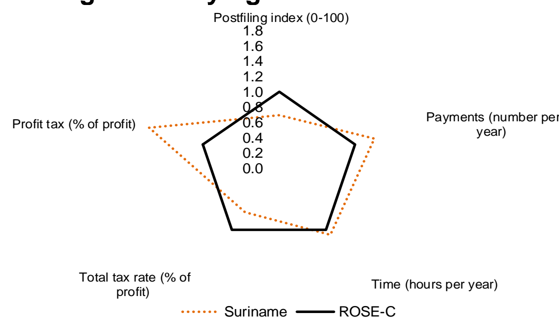
Revenue

Direct and indirect taxes contribute almost evenly to total tax revenue. Suriname's revenue averaged about 24 percent of GDP for the period 2001–2016, peaking at 29.8 percent of GDP in 2001 and reaching a low of 15 percent of GDP in 2016. In 2016, tax revenue was estimated at 11.1 percent of GDP, almost two-thirds of the 2014 level. As a percentage of GDP, direct taxes were 5.3 percent, indirect taxes 5.8 percent, and non-tax revenues 3 percent. Direct taxes include the corporate tax, wage tax, wealth tax, dividend tax, rental value tax, casino tax, and lottery tax. Indirect taxes include import duties; an excise on alcohol-free drinks, alcohol, beer, tobacco, and cigarettes; statistical fees and consent rights; and taxes on wood exports, public entertainment, fuel, and sales. Most direct taxes (77.5 percent of them) came from corporate and wage taxes, while the sales tax, import duties, and the fuel tax account for 81 percent of total indirect taxes (Figure c; see also Ministry of Finance 2017b).

Commodities and grants have been the main source of fiscal revenues, but with significant volatility. In the eight years following Suriname's independence, almost 30 percent of revenues originated from grants, but grants declined to less than 3 percent of revenues over the period 1983–1992. Then, from 1993 to 1996, grants increased and averaged 15.5 percent of revenues before declining to below 3 percent for the next decade (1997–2006). Commodities were also a major contributor to revenues over the period 2002–2015. Commodity-related revenues increased from 24 percent of general government revenues in 2002 to peak at 40 percent in 2011, before declining to 15 percent in 2015 (Figure c).

Tax administration in Suriname can be improved. Suriname ranks 103rd out of 189 countries for the ease of paying taxes as measured by the World Bank's Doing Business Index. To pay taxes in Suriname, the average firm spends 199 hours and makes 30 payments annually, compared to 183 hours and 24 payments annually in the rest of the small economies of the world that are commodity exporters (ROSE-C), a grouping of 38 other economies with populations less than 1.5 million and high dependence on primary commodity exports. In addition, the Doing Business Index shows that the tax on profits in Suriname is much higher than the average for the ROSE-C: 27.9 percent compared to 16.5 percent (Figure 1). Nonetheless, Suriname has a better ranking than ROSE-C on its total tax rate (percentage of profit), but it scores low on the postfiling index, which measures those processes that occur after a firm complies with its regular tax obligations, such as tax refunds, tax audits, and tax appeals.

Figure 1. Paying Taxes in Suriname



Source: World Bank (2017).
Note: ROSE-C: Rest of the small economies of the world that are commodity exporters.

Direct tax collection can be improved with better tax administration. Deficiencies relating to tax administration also extend to weak taxpayer education, which can affect compliance. In fact, tax compliance with respect to direct taxes is low, and estimated to be in the range of 40 percent of potential revenue (IDB 2016). In addition, due to resource constraints, the tax department is unable to identify all who should pay the wealth tax, which has resulted in a narrow base and low revenues (IDB 2016).

Expenditure

Expenditure is concentrated on the wage bill and transfers and subsidies. Suriname's expenditure averaged about 26 percent of GDP for the period 2001–2016, peaking at 30.1 percent of GDP in 2002 and reaching a low of 22.8 percent of GDP in 2016 (Figure d). Government expenditure has been rigidly focused on civil service wages and subsidies and transfers. Indeed, the government's wage bill is estimated to be roughly one-third of government spending and reflects its large public sector workforce, while subsidies and transfers account for another third. Capital expenditure averaged about 3.7 percent of GDP over 2001–2016, peaking at 5.7 percent of GDP in 2008.

After the commodity price shock, Suriname made significant cuts in expenditure, reducing it by 7 percent of GDP (Figure d). Budget cuts mainly occurred in the areas of goods and services (3.6 percent of GDP), subsidies and transfers (1 percent of GDP), and wages and salaries (2.1 percent of GDP). As fiscal consolidation continues in an environment of subdued growth, it is important to note that estimates of Suriname's fiscal multipliers indicate that capital expenditure and transfers and subsidies have a positive effect on growth, while expenditure on wages and salaries and goods and services impedes economic growth in the long run (Mungroo, Ooft, and Sim-Balker 2014).

Budget Performance

Budget preparation could be improved. Suriname is not included in the International Budget Partnership's Open Budget Index that provides information about central government budget preparation and transparency. Nevertheless, a partial indicator of budget credibility is the variance between budgeted and actual revenue and expenditure. The estimates for Suriname show high variances between budgeted and actual expenditure. In particular, capital outlays tend to be overestimated during the budget process (Figure e).

Fiscal Buffers

Fiscal buffers and institutions can be improved. Suriname does not have a fiscal council or fiscal rules (OECD 2014), and did not establish a sovereign wealth fund during the commodity boom period. Nevertheless, the National Assembly passed legislation to establish a Savings and Stability Fund (SSF) in 2017. The SSF is expected to receive windfall mining revenue starting in 2018. In principle, the SSF will address the problem of volatility in fiscal revenue collection. The authorities expect that the SSF's capital will reach roughly US$200 million by 2023. The SSF will help to support macroeconomic stability in the longer term. Looking forward, however, the authorities should also consider implementing fiscal rules and strengthening fiscal institutions, as research has shown that the effectiveness of stabilization funds also depends on the quality of institutions and may not itself contribute to greater fiscal discipline (Frankel, Vegh, and Vuletin 2012).

Conclusion and Policy Discussion

The 2015 commodity shock caused a rapid deterioration of Suriname's fiscal performance, but it also prompted much-needed reform that will help the country better deal with similar shocks in the future. IMF (2015) notes that fiscal frameworks in resource-rich countries should encompass four main priorities given their vulnerability to commodity price shocks: (1) appropriate levels of stabilization savings, (2) a strong institutional framework, (3) effective spending policies, and (4) effective use of taxation to reduce revenue volatility. Suriname is making strides in each of these areas. The recently established SSF, along with tax reform and improvements to tax administration that are expected to commence over the medium term, will help strengthen execution of fiscal policy, broaden the revenue base, and build up buffers to ease the impact of future shocks.

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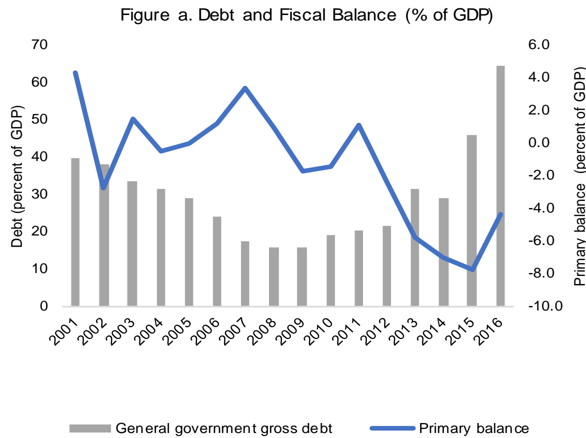
SURINAME

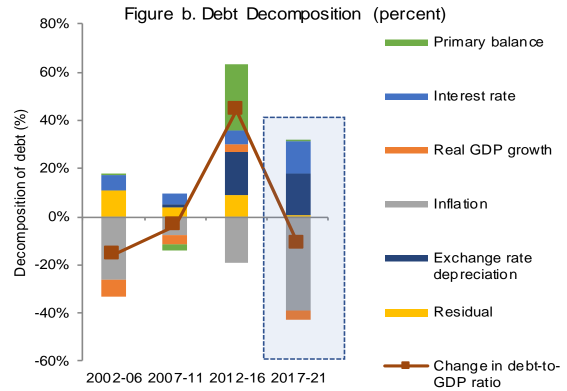
FISCAL SNAPSHOT

The debt-to-GDP ratio increased as the primary balance worsened



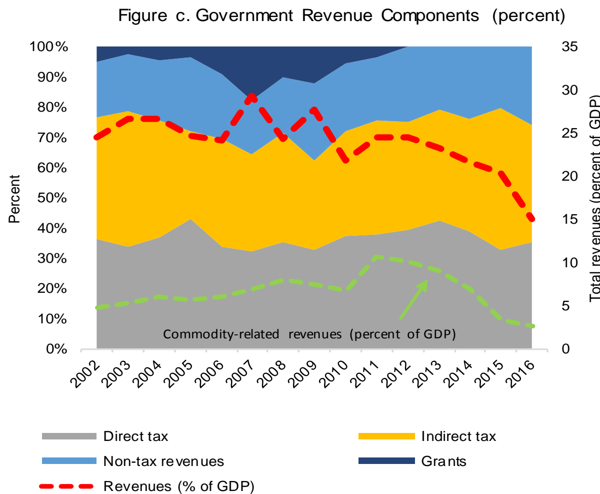
Source: International Monetary Fund, World Economic Outlook (April 2017).

The main drivers of debt were the primary balance and exchange rate depreciation.



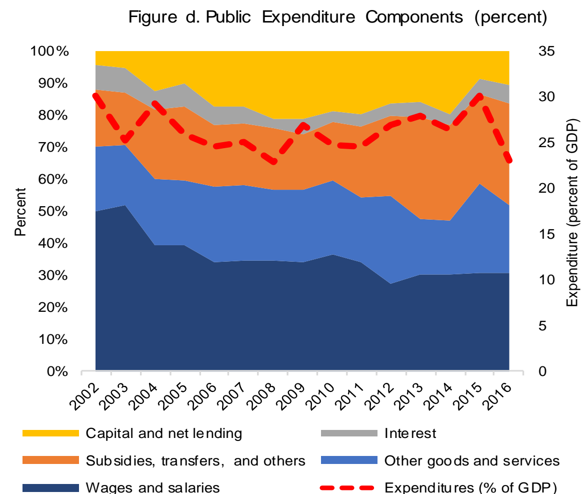
Source: International Monetary Fund, World Economic Outlook (April 2017).

Commodity-related revenues have declined significantly



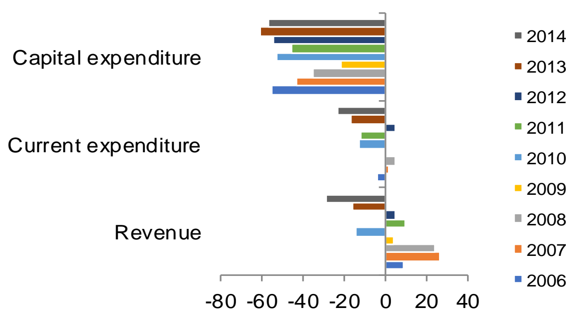
Source: Central Bank of Suriname; and International Monetary Fund.

…expenditure is concentrated on wages and subsidies and transfers



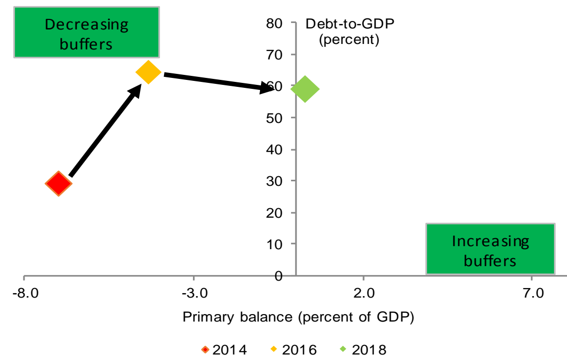
Source: Central Bank of Suriname.

Suriname's budget is affected by high variances between actual and budgeted estimates



Source: Ministry of Finance, Suriname; and the Inter-American Development Bank.

...but fiscal buffers are expected to improve.



Source: International Monetary Fund, World Economic Outlook (April 2017).

TRINIDAD AND TOBAGO FISCAL POLICY AND ITS IMPLICATIONS

Contributor: Juan Pradelli.

Highlights

- *Fiscal austerity is responding to a substantial loss of energy revenues that has followed the collapse of commodity prices since 2015.*
- *The government's fiscal strategy aims to balance the budget by 2020 and maintain public debt below 65 percent of GDP.*
- *Diversification of sources of government revenue, improved tax administration, rationalization of transfers and subsidies, and increased capital expenditures should be priorities in a fiscal reform agenda.*

Overview

Trinidad and Tobago's fiscal policy needs to address emerging challenges associated with the on-going macroeconomic adjustment and the necessity to diversify the domestic economy in the medium term. The loss of energy exports and fiscal revenues will persist in the next few years, and hence a macroeconomic adjustment is imperative to preserve fiscal and external sustainability. In the absence of imminent financing risks, and having sizable buffers available, a budget policy adjustment aimed at gradually reducing aggregate (public and private) expenditure can be undertaken in the next two to three years that includes smoothing out the negative effects of the adjustment on output and employment. Structural reforms are also required to support economic diversification and reignite long-term, inclusive growth. In this regard, the exhaustion of oil and gas resources in the long term reinforces the case for undertaking fiscal and structural reforms.

Fiscal Policy Is Fundamental for Economic Growth and Development

Taxes and expenditures are major tools for attracting investment towards the oil and gas industries, sharing natural resource wealth among the population at large, and stimulating the non-energy economy. Traditionally, tax policy is calibrated to attract private investment to the energy sector and thus monetize the country's natural resource wealth. The government's intake of the energy income generated constitutes a major source of budget revenues. These receipts are ultimately channeled to the rest of the domestic economy through transfers and subsidies to households and state-owned companies, public wages, and capital projects. Budget expenditures then play a prominent role in distributing the natural resource wealth among the population at large, as well as in stimulating economic activity and employment in non-energy sectors such as construction, distribution, and manufacturing. In addition, a heavy focus on taxing hydrocarbon companies has often allowed for imposing a relatively light tax burden on non-energy firms and individuals.

Fiscal policy tends to be procyclical and ties the dynamics of non-energy sectors to the performance of oil and gas industries. Historically, boom-and-bust cycles in the non-energy sectors follow the vagaries of global oil and gas prices and domestic volumes produced by the energy sector. The energy sector in this sense provides the government with sizable – albeit volatile – budgetary resources to be spent on non-energy sectors.[1] Thus, the periods of domestic economic growth (contraction) have been accompanied by an expansionary (contractionary) fiscal policy funded with booming (shrinking) energy revenue.[2] Compounding the challenge of volatile receipts is the political incentive to rapidly increase budget expenditure during commodity booms but slowly contract it when those booms collapse.[3]

Revenue

The revenue system is heavily dependent on the energy sector and vulnerable to commodity cycles. Energy revenue is chiefly comprised of the corporate income tax on hydrocarbon producers and the supplemental petroleum tax. During the 2002–2015 commodity boom, these resources represented half of the central government's total budget receipts and benefited from rising oil and gas prices together with growing volumes of natural gas and related industries. In particular, energy revenue increased from 10 percent of GDP in the early 2000s to nearly 20 percent in 2008, and subsequently fluctuated around 16 percent of GDP until 2014. When commodity prices collapsed, it plummeted to 12 percent of GDP in 2015 and further decreased to 5 percent in 2016.[4]

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[1] The capacity to import capital goods and technology, which is a crucial requirement for growth in small island economies, is also buttressed by the foreign exchange inflows associated with energy exports.

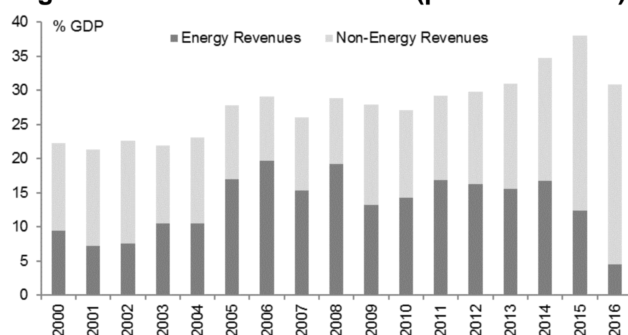
[2] On the relation between commodity cycles, economic cycles, and fiscal policy in Trinidad and Tobago, see the IDB's *June 2017 Caribbean Region Quarterly Bulletin* at https://publications.iadb.org/handle/11319/8331.

[3] Only a few years back, energy revenues started to be partly saved in the Heritage and Stabilization Fund. International experience shows that resource-rich countries often expand government expenditures when benefiting from a windfall of resource-related fiscal revenue, and some at least partially save these resources in sovereign wealth funds or similar arrangements. On this issue, see IMF, *Macroeconomic Policy Frameworks for Resource-Rich Developing Countries,* 2012; and IMF, *Fiscal Policy: How to Adjust to a Large Fall in Commodity Prices,* 2016.

[4] In nominal terms, energy revenue increased from TT$5 billion in FY2001/02 to TT$36 billion in FY2007/08, and fell to TT$17 billion in

Non-energy revenue traditionally was of secondary order, but initiatives to increase it have been undertaken in response to the collapse in energy revenue. Non-energy revenue consists of the corporate income tax (excluding hydrocarbon producers), personal income tax, value-added tax (VAT), custom duties, excise taxes, and capital revenues (e.g., asset sales). These resources averaged 14 percent of GDP throughout the 2002–2015 period, and exhibited lower volatility compared to energy revenue. Following the collapse in commodity prices, a number of asset sales, one-off transactions, and tax measures boosted non-energy revenue to 26 percent of GDP in 2015 and 2016.[5] Excluding asset sales and one-off transactions – which arguably are below-the-line financing operations in nature – the corporate income tax paid by firms other than hydrocarbon producers, the VAT, and the personal income tax account for 30 percent, 25 percent, and 25 percent of total non-energy revenue, respectively.

Figure 1. Government Revenue (percent of GDP)



Source: Central Bank of Trinidad and Tobago.

Energy revenue is currently constrained by lower world commodity prices and generous tax incentives, while non-energy revenue is limited due to legal loopholes and weaknesses in tax administration. Taxable income from hydrocarbon producers is reduced not only as a consequence of the companies' lower prices and profits but also because of tax incentives – most notably a scheme of accelerated depreciation allowances aimed at promoting investments in exploration and operations. The government is currently holding extensive consultations with oil and gas companies to agree on reforms to these benefits in order to mitigate the loss of energy revenue. In turn, the effective taxation on non-energy sectors is below its potential due to numerous exemptions granted in the VAT and corporate income tax legislation that narrow their respective tax bases.[6] Another binding constraint on non-energy revenue stems from industrial promotion regimes that grant generous, discretionary tax benefits. Revenue collection is also affected by inefficiencies in both tax administration agencies – the Bureau of Inland Revenue (BIR) and the Customs and Excise Division (CED) – that ultimately weaken their technical capacity to enforce tax obligations. The government has expressed its intention to address these issues by establishing a single Revenue Authority that would integrate functions currently fragmented between the BIR and CED.

Expenditure

Government expenditure is driven by the availability of energy revenue and a welfare-state-oriented approach to fiscal policy. Historically, public spending has been highly sensitive to the flow of budget resources originated by taxing the oil and gas industries. Thus, during the 2002–2015 commodity boom, total government expenditure expanded from 23 percent of GDP in the early 2000s to almost 40 percent in 2015.[7] In building a welfare-state-type economy, the expenditure policy is ostensibly biased toward transfers and subsidies to households and state-owned companies – and ultimately also benefits private firms by delivering highly subsidized goods and services (e.g., fuel, electricity, water). Provision of public employment – including "make-work" programs whose funding is recorded as a transfer to households – has been an important policy during booming periods. Capital projects undertaken by the central government largely support the construction sector, but arguably the bulk of public investment – including infrastructure – is conducted by state-owned companies with partial funding of capital expenses coming from budgetary transfers.

Expenditure policy priorities are reflected in the changing structure of central government spending. In the early 2000s, transfers and subsidies represented one-third of total expenditure, while by the end of the commodity boom in 2015, their share had increased to 50 percent. On the other hand, capital spending accounted

FY2008/09. It bounced back to TT$28 billion in FY2013/14 but plummeted to TT$7 billion in FY2015/16.

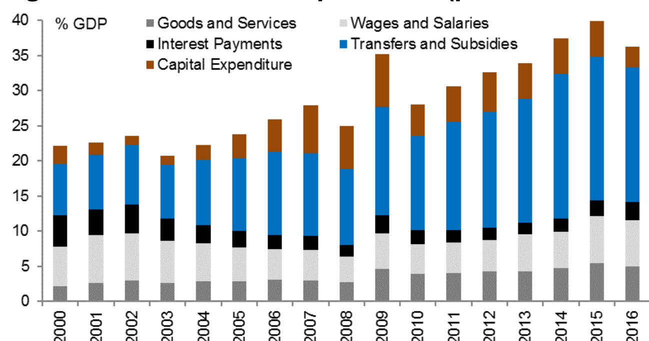
[5] In nominal terms, non-energy revenue steadily increased from TT$9 billion in FY2001/02 to TT$30 billion in FY2013/14. It peaked at TT$38 billion in FY2014/15 and FY2015/16, mainly on the back of one-off receipts such as asset sales, higher dividends from state-owned companies, and repayment of loans extended to public enterprises.

[6] A VAT reform in 2016 lowered the statutory rate from 15 to 12.5 percent and broadened the tax base, but several exemptions and zero-rated goods and services were maintained. The statutory corporate income tax applicable to most non-energy companies is 25 percent, but the legislation envisages several exempted bodies (e.g., hotel proprietors, commercial farmers, mortgage companies, public bodies, and state-owned banks) and exempted incomes (e.g., several forms of interest and income from venture capital), without a well-documented public purpose.

[7] In nominal terms, central government expenditure increased from TT$15 billion in FY2001/02 to TT$63 billion in FY2013/14. Budget retrenchment measures introduced in recent years reduced expenses to TT$53 billion in FY2015/16.

for one-quarter of total expenditure in 2007–2008, but only 13 percent in 2015 and 8 percent in 2016.

Figure 2. Government Expenditure (percent of GDP)



Source: Central Bank of Trinidad and Tobago.

Transfers and subsidies mask policy-driven inefficiencies in energy pricing and domestic use of energy resources. Buoyant energy revenue and the absence of well-established institutions to target and evaluate spending programs have contributed to the rapid growth of transfers and subsidies. These outlays peaked at 20 percent of GDP in 2014–2015, compared to just 8 percent in the early 2000s.[8] In particular, major drivers of this expenditure category have been domestic subsidies for fuel and electricity, and transfers to state-owned companies. Explicit fuel subsidies reached almost 3 percent of GDP during the 2010–2014 period, and subsequently were reduced to 1 percent of GDP in 2015–2016 as global oil prices dropped and the government adjusted pump prices upwards.[9] Implicit subsidies to the electricity sector result from the National Gas Company (NGC) granting a below-market (subsidized) price of natural gas to the Trinidad and Tobago Electricity Commission (T&TEC, the state-owned power utility). In practice, the country has very low gasoline and electricity tariffs by regional standards, which presumably leads to overconsumption of energy resources and discourages the development of energy-efficient technologies and renewable-energy sources. Another major recipient of budget support is the Water and Sanitation Authority (WASA, the state-owned water utility), which received transfers amounting to 1.2 percent of GDP in 2016. WASA tariffs have not been reviewed since the early 1990s and arguably do not ensure cost recovery. Ostensibly, there is no regulatory framework that permits oversight of budgetary resources transferred to state-owned companies to support their operation and capital expenses.[10] The government has already embarked on efforts to rationalize transfers and subsidies – the reduction of fuel subsidies being a first step – that are deemed no longer affordable in view of the current low level of energy revenue. It also aims to reduce current expenditure to create budget space for financing a higher volume of capital expenditure required to facilitate economic diversification.

Fiscal Deficits and Debt Financing

Riding the wave of booming commodity markets, Trinidad and Tobago has achieved either fiscal surpluses or moderate deficits. In the 2002–2008 period, as a consequence of rising energy prices and the flourishing of natural gas industries, revenue buoyancy allowed for expanding expenditure while still achieving an average annual budget surplus of 1.5 percent of GDP. Not surprisingly, the global financial crisis damaged the country's fiscal position, and a deficit of 7 percent of GDP was incurred in 2009. The commodity price boom resumed quickly and continued throughout the 2010–2014 period. Nevertheless, despite the sizable flow of energy revenue, the budget deficits persisted – albeit at moderate levels that never exceeded 3 percent of GDP. When the boom collapsed, the fiscal imbalance increased to 5.5 percent of GDP in 2016.

Public debt has been on a rising path since 2009. Prior to the global financial crisis, budget surpluses helped reduce net public sector debt from 60 percent of GDP in the early 2000s to just 22 percent in 2008.[11] Since then, however, public indebtedness has financed mounting budget deficits and the Colonial Life Insurance Company (CLICO) bailout, and guarantees have been provided to statutory authorities and state enterprises to facilitate their own borrowings. As a consequence, public debt steadily increased to 61 percent of GDP in 2016. Placing debt in domestic financial markets has been the preferred strategy to meet the government's financing needs. Overall, the stock of net public debt increased from TT$36 billion in 2008 to TT$90 billion in 2016. Banks and other financial institutions, which often hold sizable liquidity positions, absorbed TT$27 billion of the new debt issued, mainly through marketable securities. While the central government typically refrained from tapping global financial markets and aimed to preserve a low level of external public debt, two global sovereign bonds of

[8] In nominal terms, transfers and subsidies in the central government budget steadily grew from TT$5 billion in FY2001/02 to TT$35 billion in FY2013/14. Subsequently, they decreased to TT$28 billion in FY2015/16 as a consequence of budget retrenchment measures.

[9] For an analysis of fuel subsidies and pricing during the last commodity boom, see the International Monetary Fund's "2016 Trinidad and Tobago: Selected Issues Paper" at http://www.imf.org/en/Publications/CR/Issues/2016/12/31/Trinidad-and-Tobago-Selected-Issues-44035.

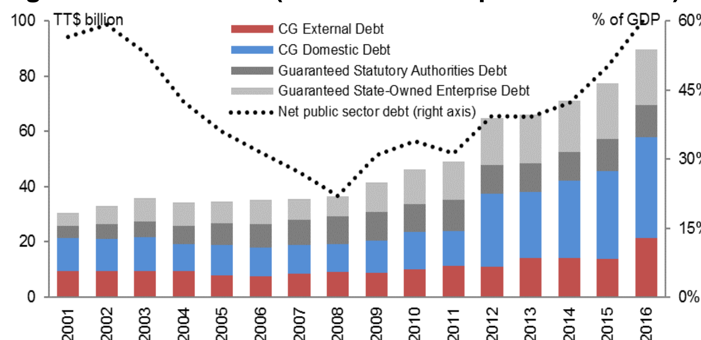
[10] State-owned companies and statutory authorities also pose significant fiscal risks, as their liabilities guaranteed by the central government are as large as 20 percent of GDP.

[11] Net public sector debt includes the central government's direct debt and selected contingent liabilities (e.g., guarantees), and excludes financial instruments issued for the purpose of monetary regulation.

US$550 million and US$1 billion were issued in 2013 and 2016, respectively. Another TT$14 billion of the new debt originated in guarantees.

Budget deficits and nominal GDP volatility largely explain the dynamics of the public-debt-to-GDP ratio in recent years. Net public sector debt increased from 22 percent of GDP in 2008 to 61 percent of GDP in 2016 – a 39 percentage point (p.p.) increase in the debt-to-GDP ratio. The single most important debt-increasing factor was the fiscal-deficit-to-GDP ratio, as it accounted for 25 p.p., of which 16.5 p.p. resulted from interest payments and the remaining share from the primary deficit. Next, the contractions in nominal GDP – particularly when the GDP deflator largely collapsed in tandem with energy prices in 2009 and 2015 – contributed 9 p.p. to the increase in the debt ratio on a cumulative basis. Non-recurrent transactions – most notably the CLICO bonds and the guarantees granted to public entities – also fueled the debt built-up by nearly 5 p.p.

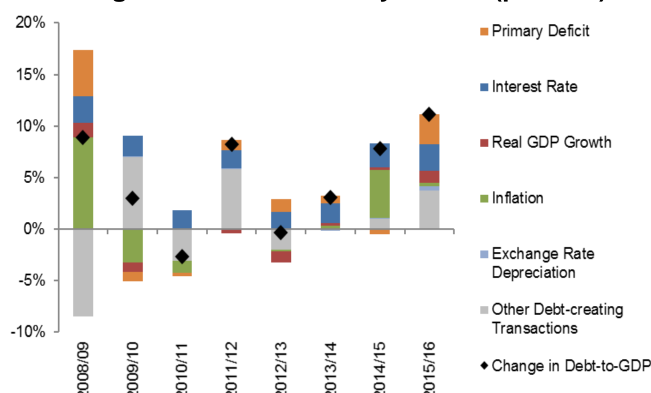
Figure 3. Public Debt (TT$ billion and percent of GDP)



Source: Central Bank of Trinidad and Tobago.

Public debt remains within manageable margins and is narrowly exposed to exchange rate and rollover risks. The current debt level of around 60 percent of GDP is fairly moderate by international and regional standards. Arguably, in view of the hefty foreign assets held in the Heritage and Stabilization Fund (which amount to nearly US$5.5 billion, i.e., 40 percent of the public debt stock), the risk of debt distress in the short term is negligible. In addition, the public debt portfolio exhibits a favorable risk profile: foreign-currency-denominated external public debt is only 15 percent of GDP; international bonds and foreign loans have long maturities; and local-currency-denominated domestic securities are held by banks that are liquid and often oversubscribe the regular Treasury paper auctions.[12]

Figure 4. Public Debt Dynamics (percent)



Source: IDB calculations.

Fiscal Adjustment After the Collapse of Energy Revenue

Budget expenditures have been adjusted downwards given shrinking energy revenue, although deficits are set to increase. Facing large energy revenue shortfalls, the new administration elected in late 2015 formulated a package of compensatory measures in the FY2015/16 budget (October 2015) and its Mid-Year Review (April 2016), as well as in the FY2016/17 budget (October 2016) and its Mid-Year Review (May 2017). The consolidation effort sought to cut current and capital expenditures as well as enhance non-energy revenues, including non-recurrent receipts (e.g., asset sales).

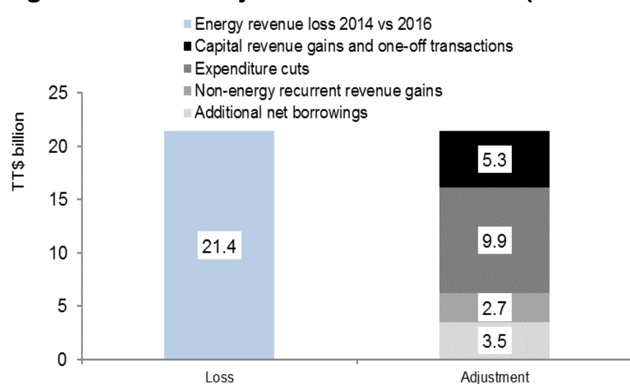
Throughout 2015–2016, austerity prevailed over macroeconomic stabilization as a guide to fiscal policy. Between FY2013/14 and FY2015/16, the central government budget suffered an energy-revenue loss of TT$21.4 billion while almost all sectors of the economy contracted.[13] Fiscal policy then had to strike a balance between consolidating public finances (i.e., austerity) and stimulating the domestic economy (i.e., macroeconomic stabilization). By and large, austerity has prevailed in the formulation of a fiscal response to current developments, as 55 percent of the energy revenue loss was absorbed by reducing government expenditures (with savings of TT$9.9 billion) and increasing non-energy recurrent revenues (with additional receipts of TT$2.7 billion). The objective of macroeconomic stabilization has been somewhat less prominent, as only 45 percent of the energy revenue loss was offset by expanding deficit financing (with additional net borrowings amounting to TT$3.5 billion, and capital revenues and other one-off transactions yielding TT$5.3 billion). The austerity-driven

[12] Sovereign rating agencies recently downgraded Trinidad and Tobago on the basis of widely held concerns about the policy response to the deterioration in energy prices and domestic economic conditions, as well as growing external and fiscal imbalances. However, in their rationale for the rating downgrades, the agencies did not imply any risk of an impending financial squeeze or debt default

[13] Energy revenue losses are due to lower oil and natural gas prices – which reduced companies' profit margins and earnings – but also to tax incentives.

spending cuts contributed to weakening domestic demand and output in non-energy sectors through both direct channels (e.g., a TT$4 billion reduction in capital expenses negatively affected construction activity) and indirect channels (e.g., a TT$7.2 billion cut in transfers and subsidies reduced households' disposable income, which then impacted retail and distribution activity). Thus, in 2016 government expenditure fell by 12 percent in nominal terms while non-energy economic activity contracted by 1.8 percent in real terms.

Figure 5. Fiscal Adjustment in 2015-2016 (TT$ billion)



Source: IDB calculations.

The FY2016/17 budget approved in October 2016 aimed to preserve consolidation efforts undertaken since late 2015. Budgeted revenue amounted to TT$47.4 billion (or 31 percent of GDP), including a conservative estimate of energy revenue (TT$2.6 billion) and an overly optimistic prospect for capital revenues (TT$8.7 billion).[14] Allocated expenditure was TT$53.4 billion (or 35 percent of GDP), including reduced capital spending (TT$5.4 billion). Overall, the planned budget deficit was TT$6 billion. For practical purposes, the government intended to freeze selected operational and capital expenditures at the lower levels already achieved earlier in 2016.

The FY2016/17 Mid-Year Budget Review suggests that fiscal authorities continue cutting expenditures to cope with revenue shortfalls. In the first half of FY2016/17, total revenue was TT$16.6 billion and implied a TT$6.8 billion shortfall relative to the original budget forecast. Delays in the quite ambitious program to sell state-owned assets explain most of the revenue shortfall. To cope with lower-than-expected receipts, the government introduced new expenditure cuts, and thus total expenses were TT$23.5 billion, or nearly TT$3.8 billion lower than the original budget allocation. The revenue loss has also led to a higher-than-expected deficit, which amounted to TT$6.9 billion and already exceeded the original budget plan for the whole fiscal year. Deficit financing involved net borrowings from domestic financial institutions (TT$3.7 billion) and a withdrawal from the Heritage and Stabilization Fund (TT$1.7 billion).

The Government's Medium-Term Fiscal Strategy: Implications for Debt Sustainability

The government intends to achieve a balanced budget by 2020 and maintain public debt below 65 percent of GDP. In the FY2016/17 Budget Statement, the government stated the objective of restoring fiscal health and preserving public finance sustainability by achieving a balanced budget by 2020 and maintaining public debt below 65 percent of GDP. Based on a fairly conservative economic outlook, the government intends to increase energy revenue by TT$12 billion and non-energy recurrent revenues by TT$8 billion over the next four years.[15] It certainly acknowledges the imperative to reduce reliance on one-off receipts such as asset sales and extraordinary transactions. While the expenditure policy should be consistent with the planned reduction in the budget deficit, the authorities intend to shift the composition of spending towards capital expenses and away from transfers and subsidies.[16]

The government's medium-term fiscal adjustment plan can help strengthen public finances, although it could also slow the pace of recovery of the domestic economy. If the government is successful in carrying out its fiscal strategy, the budget imbalances will be contained in the medium term and public debt will be maintained within manageable, safe margins. The domestic economic recovery is likely to be relatively slow, however. For illustrative purposes, we project deficits and public debt over the 2017–2020 period under unadventurous assumptions on energy prices and production as well as on the effect of government expenditure on non-energy output growth. We then assume that annual real GDP growth is just 0.5 percent in 2017–2018 and modestly rebounds to 1.5 percent in 2019–2020, and that a gradual budget consolidation improves the primary balance from a deficit of 2.9 percent

[14] The underlying macroeconomic assumptions of the FY2016/17 budget were fairly conservative: real GDP is expected to grow by 1 percent in 2017, and oil and natural gas prices are expected to remain close to 2016:Q3 levels, with the WTI oil price at 48 US$/barrel and the Henry Hub natural gas price at US$ 2.25/mmbtu. The FY2016/17 Budget envisaged one-off sales of state-held assets, including initial public offerings for TTNGL (TT$1.5 billion), First Citizen Holdings (TT$1.5 billion), and industrial estates of eTecK and Trinidad Generation Unlimited (TT$1.1 billion), as well as a divestment of Lake Asphalt.

[15] The medium-term fiscal plan is predicated upon moderate economic growth of 1 percent in 2017 and 2 percent per year over 2018–2020. Oil prices are expected to recover from 48 US$/barrel in 2017 to 60 US$/barrel in 2018, while natural gas prices are expected to increase from US$ 2.25/mmbtu in 2017 to US$ 3/mmbtu by 2020.

[16] Reforms to tertiary education subsidies, public employment programs, unemployment assistance, and financial support to public entities are being considered.

of GDP observed in 2016 to a surplus of 2 percent of GDP by 2020.[17] Given such an outlook, public debt is expected to slightly increase from 61 percent of GDP in 2016 to 65 percent by 2020. This is a fairly favorable outcome compared to the debt dynamics experienced during the last four years, when the debt-to-GDP ratio increased by 22 percentage points. Also, it is noteworthy that the government will have to undertake a significant budget retrenchment to keep public debt below 65 percent of GDP – which is an upper ceiling quite close to the actual level of indebtedness – and thus avoid a further buildup of financial vulnerabilities.

If political resistance to fiscal reform or adverse economic conditions prevent the government from achieving a balanced budget by 2020, public debt will continue rising towards admittedly risky levels. For illustrative purposes, assuming primary deficits as sizable as 5 percent of GDP are incurred in 2017–2020, public debt is projected to increase from 61 percent of GDP in 2016 to 80 percent by 2020.[18] Such a high level of government debt represents a significant vulnerability, and in addition, its stabilization would require a greater fiscal adjustment in the future.

Conclusion and Policy Recommendations

Given the new price environment facing Trinidad and Tobago's energy sector, the government must adjust its fiscal position. To bring budgetary income and spending back into balance, and thus preserve debt sustainability and creditworthiness, a fiscal consolidation program must be undertaken over the next two to three years. In the absence of imminent financing risks, and having sizable financial buffers available (e.g., the Heritage and Stabilization Fund and a low level of external public debt), the budget adjustment can proceed gradually, reducing aggregate (public and private) expenditure and smoothing out the likely negative effects of the adjustment on output and employment in the short run. The political approach taken so far, whereby the government embraces austerity while also being cognizant of the contractive pressures on the real economy, appears warranted and should be maintained. The government has leeway to continue borrowing but this should be done in the context of a credible medium-term fiscal consolidation program, perfecting the drive towards austerity already expressed in the FY2015/16 and FY2016/17 budget cycles.

The government's medium-term fiscal plan is certainly an important step forward as a policy guide, but it lacks important elements. Public debt can be sustained within safe and manageable levels provided that fiscal deficits are gradually narrowed following the government's plan laid out in the FY2016/17 Budget Statement. Nevertheless, the fiscal strategy can be improved as a guide for policymakers by introducing a number of elements found in international best practices, such as a detailed set of revenue and expenditure measures with a timeline for adoption and implementation; quantification of the budgetary impact of those measures; and a sequence of annual targets for revenue, expenditure, deficit, and borrowings that can be used for monitoring progress and compliance.

More broadly, the fiscal adjustment should be consistent with a more ambitious reform agenda. Both the current juncture of lower energy income and the country's fundamental challenge of developing new economic activities to reduce reliance on non-renewable natural resources impose the necessity to reform the existing fiscal institutions in sync with a gradual budget retrenchment. A comprehensive reform agenda should improve the quality of public finances and enhance revenues as well as expenditures. Measures to mobilize non-energy recurrent revenues (particularly the VAT, income taxes, and property taxes) can expand and diversify sources of government income, while reducing energy dependence. These measures should include increasing tax rates, amending loopholes and other shortcomings in the corresponding legislation, and strengthening tax administration and collection. A rationalization of expenditure programs should give priority to reforming the immense universe of (now unaffordable) transfers to households (which should be better targeted and means-tested) and some major state-owned companies (whose pricing policy and financial situation must be thoroughly reviewed). There are compelling reasons – rooted in economic efficiency and environmental sustainability – to further reduce fuel and electricity subsidies. On the other hand, the capital budget must be gradually scaled up in order to support infrastructure investments required to diversify the domestic economy and facilitate private sector development. In this regard, structural reforms to the fiscal policy framework are required to support economic diversification and re-ignite long-term, inclusive growth.

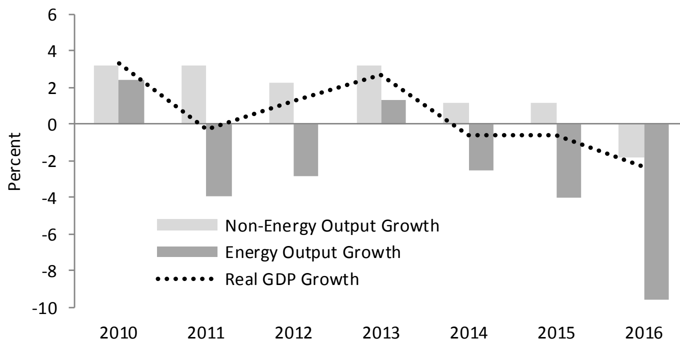
[17] The assumed budget consolidation path – which is consistent with the government's fiscal strategy – focuses on the primary balance and thus does not attempt to identify separate projections of revenues and expenditures. This is because in the FY2016/17 Budget Statement, the government expressed its intention to balance the budget by 2020 and broadly suggested it will seek to mobilize non-energy revenues and cut expenditures. However, a detailed analysis of the mix of revenue and expenditure measures was not made explicit.

[18] The FY2015/16 primary deficit was 2.9 percent of GDP, but it included capital revenues as large as 2.6 percent of GDP that are recorded above-the-line in the official budget reports. Therefore, if no further adjustment is made to government expenditure and one-off transactions (e.g., asset sales) no longer provide large cash inflows, it is plausible to envision primary deficits of 5 percent of GDP, as we assume in the debt projection.

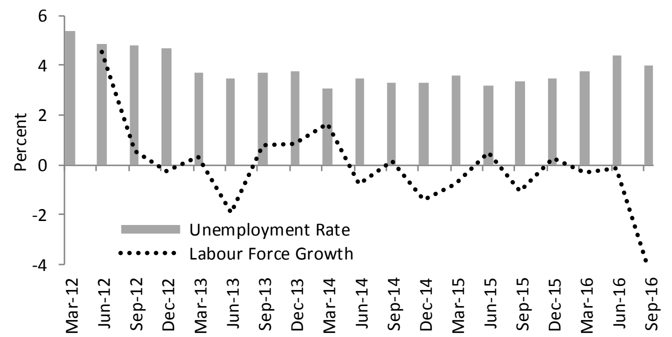
TRINIDAD AND TOBAGO

FISCAL SNAPSHOT

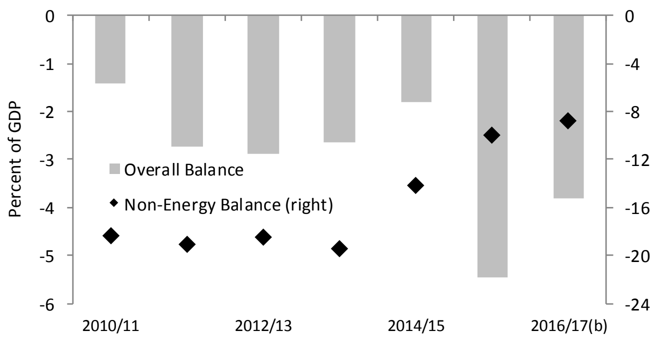
The economy entered into recession in 2015 …



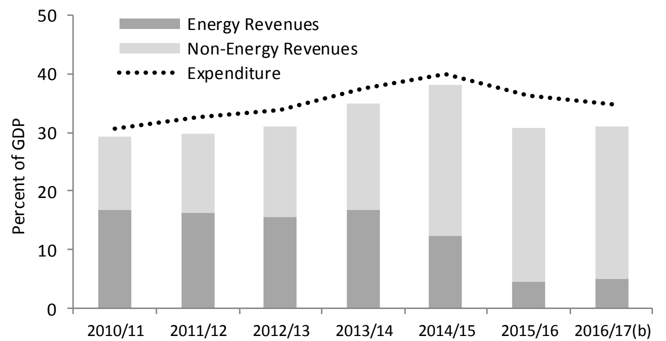
… and the labour market no longer creates jobs.



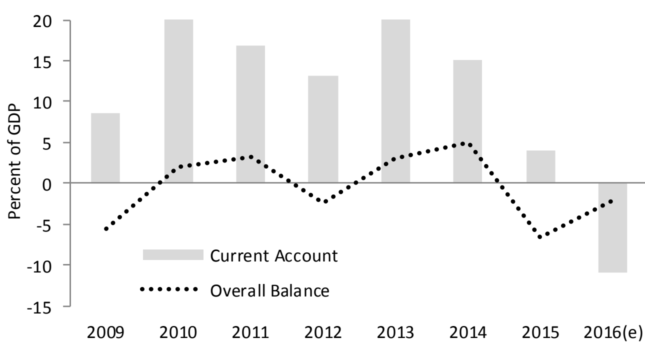
The Government's fiscal policy is geared towards consolidation …



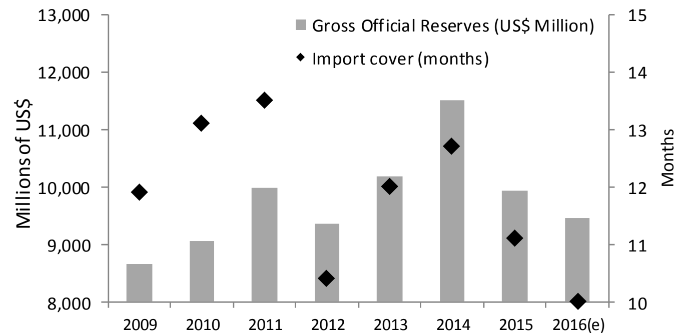
…with initiatives to boost non-energy revenue and cut expenditure.



Fiscal adjustment can help narrow external imbalances …



… and address uncertainties manifested in the FX market.



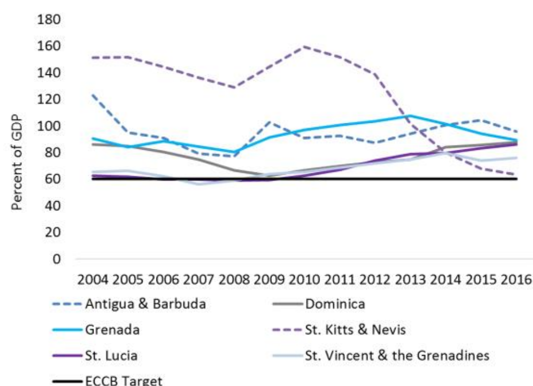
Source: Central Bank of Trinidad and Tobago

Contributors: Juan Pedro Schmid, Kimberly Waithe, and Kishmar Lorde.

Debt

Debt levels across the countries of the Organisation of Eastern Caribbean States (OECS) remained elevated at an average of 83 percent of GDP in 2016.[1] Throughout the review period, debt levels in the union were impacted by weak economic growth, higher interest rates and primary deficits, and frequent natural disasters, as these countries borrowed during reconstruction periods. After the global financial crisis, countries in the union received support from the International Monetary Fund (IMF) to assist in their fiscal consolidation efforts. Except for St. Kitts and Nevis, debt levels across the union are well above the Eastern Caribbean Central Bank's (ECCB) debt target of 60 percent of GDP (Figure 1).

Figure 1. Public Debt in the OECS (percent of GDP)



Source: International Monetary Fund, *World Economic Outlook* (April 2017).
Note: ECCB: Eastern Caribbean Central Bank.

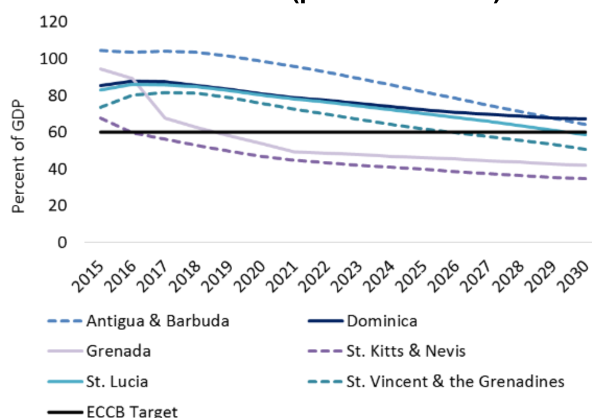
The primary deficit and interest payments are the main drivers of debt in the OECS countries. (see Annex 1). Primary balances contributed most to debt in Dominica, while in Antigua and Barbuda and St. Lucia interest rates were the leading debt-creating factors. Both of the latter two countries' debt composition relies more heavily on domestic instruments, which comes at increased interest rates. Domestic interest rates also contributed to debt growth in St. Kitts and Nevis, however, sustained primary surpluses realized after FY2010/11, buttressed by robust growth in FY2013/14, resulted in a debt-reducing effect. Higher external interest rates contributed to rising debt flows in Grenada and St. Vincent and the Grenadines. In years of high inflation, the GDP deflator led to a reduction in debt. With a fixed exchange rate, there were no effects from exchange rate movements.

Highlights

- *High public spending outweighed revenue collection and increased primary deficits.*
- *The primary deficit and interest were the leading debt-creating flows in OECS countries.*

Results of a debt sustainability analysis indicate that OECS countries would be on track to achieve their debt target by undertaking gradual and reasonable fiscal consolidation efforts. In Dominica, the adjustment required to meet the target by 2030 would be around 6 percent of GDP, with an average long-term growth rate of 1.7 percent annually (Figure 2). St. Lucia would require a more moderate adjustment of 2.7 percent of GDP. A front-loaded primary adjustment of 3.75 percent of GDP in Antigua and Barbuda would place debt on a downward trajectory to meet the ECCB target. On the other hand, with a 1.8 percent of GDP adjustment, St. Vincent and the Grenadines could meet the target by 2026. In contrast, St. Kitts and Nevis and Grenada are already on track to reach the target as a result of their respective IMF programs.

Figure 2. Projected Debt-to-GDP Ratios after Fiscal Consolidation (percent of GDP)



Source: IDB staff calculations.
Note: ECCB: Eastern Caribbean Central Bank.

The growth of government spending outpaced revenue collection and widened primary deficits. Since the global financial crisis, all countries in the region

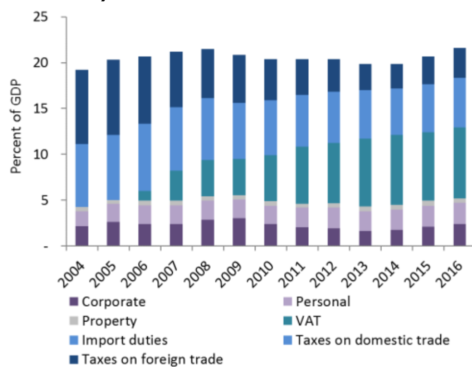
[1] This bulletin focuses on developments in the independent countries of the OECS: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Vincent and the Grenadines, and St. Lucia. Figures exclude territories that are members of the OECS.

with the exception of St. Kitts and Nevis experienced sustained fiscal deficits. The union's annual average stood at -1.2 percent of GDP from 2010–2016, which came with borrowing to close the revenue gap. The lower revenue receipts came with high wage bills for some islands, substantive public investment for others, and contingent liabilities. Sustained primary deficits at a time of elevated interest rates and weak GDP growth contributed to increasing trends.

Revenue

Revenue collection has varied throughout the region. During 2004–2016, Antigua and Barbuda recorded the lowest total revenue-to-GDP ratio, averaging 22.6 percent of GDP, while St. Kitts and Nevis had the highest at 35.3 percent. Tax revenue growth remained relatively constant over time. However, St. Lucia, Grenada, and St. Vincent and the Grenadines recorded higher tax collection over the last few years when compared with pre-crisis levels. The value-added tax (VAT)/sales tax has been a main contributor to revenue since its introduction in the OECS. As a share of GDP, VAT receipts accounted for 5.8 percent in St. Kitts and Nevis and around 9 percent in St. Lucia and Dominica in 2016 (Figure 3). Non-tax revenue has been boosted by implementation of Citizenship by Investment (CBI)[2] Programs in five OECS countries, particularly in St. Kitts and Nevis. As a percent of GDP, CBI receipts in St. Kitts and Nevis grew from 4.4 to 12.4 percent in 2015 and 7.2 percent in 2016,[3] transforming primary deficits into surpluses.

Figure 3. Composition of Tax Revenue in the OECS (percent of GDP)



Source: Eastern Caribbean Central Bank.

[2] CBI programs were launched in St. Kitts and Nevis in 1984, in Dominica in 1993, in Antigua and Barbuda and Grenada in 2013, and in St. Lucia in 2016.
[3] IMF Article IV Report, July 2017.

Tax Policy and Tax Administration

Tax policy in OECS countries is based heavily on indirect taxation. Indirect taxes consist of custom duties, excises, and the VAT. In 2016, they represented around 75 percent of total tax revenue collection, or 16 percent of GDP. The introduction of the VAT in the OECS countries altered the composition of revenue from a greater reliance on customs duties. The VAT accounted for almost 8 percent of GDP across the region. The VAT was introduced in Dominica in 2006, St. Vincent and the Grenadines in 2007, St. Kitts and Nevis in 2010, Grenada in 2010, and in St. Lucia in 2012, while Antigua and Barbuda introduced a sales tax in 2007. VAT rates across the region stand at 15 percent,[4] with the exception of St. Kitts and Nevis (17 percent). Direct taxation, including personal income, property, and corporate taxes, represent 5 percent of GDP. Corporate taxes tend to represent a smaller share, as they apply to a narrow base, with their collection ranging from 1.3 percent of GDP in Antigua and Barbuda to 3.1 percent in St. Vincent and the Grenadines in 2016.

The region has made efforts to improve revenue administration. Along with the introduction of the VAT, there was an improvement in the region's taxpayer services, collection administration, and assessments and appeals. Moreover, successful reforms were made in customs administration directed towards upgrading information technology systems and streamlining procedures to facilitate trade. In particular, several countries advanced their tax reform agendas, improving their institutional arrangements and the ease of administration. However, administration and compliance remain a challenge in the region. St. Lucia reviewed its corporate income tax regime, designed a presumptive tax for implementation in FY2017, and increased the VAT threshold to EC$400,000 effective on February 1, 2016. Dominica also reviewed its corporate income tax regime, designed a presumptive tax, and proposed an increase in the VAT threshold.[5]

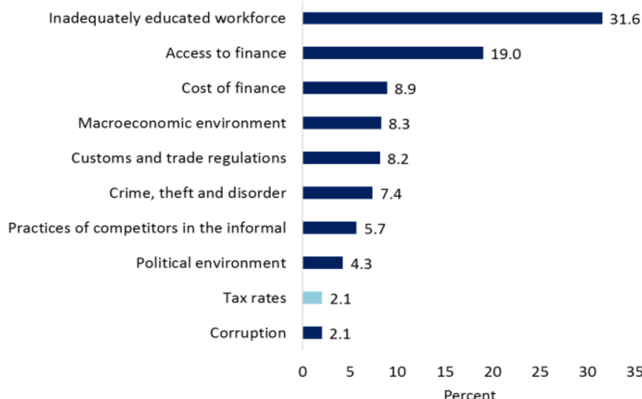
Taxation and the Business Climate

Taxation is not one of the most pressing constraints to doing business in the OECS countries. The World Bank's 2017 Doing Business rankings for OECS

[4] Grenada has a 15 percent tax rate for most goods and services, with a 20 percent rate applied to the telecommunications sector.
[5] International Monetary Fund, "Eastern Caribbean Currency Union: Discussion on Common Policies of Member Countries," October 2016.

countries range from 86th for St. Lucia to 134th for St. Kitts and Nevis, and 138th for Grenada out of 190 countries. When compared with 2010, the countries performed well with respect to: starting a business, enforcing contracts, and trading across borders. With respect to taxation, Dominica, St. Kitts and Nevis, and St. Vincent and the Grenadines made paying taxes less costly by reducing the corporate income tax rate. During the review period, the region also introduced the VAT to replace a number of existing taxes, which made paying taxes easier for companies. Data from Compete Caribbean's 2014 Productivity, Technology, and Innovation (PROTEqIN) Survey show that, on average, 2 percent of firms in the OECS consider tax rates a major constraint to doing business. In Antigua and Barbuda and St. Vincent and the Grenadines, around 1.5 percent of firms reported tax rates as a serious obstacle to doing business, while this rate stood at 2.4 percent for firms in Dominica and St. Kitts and Nevis (Figure 4).

Figure 4. Percentage of Firms in the OECS that Consider Certain Factors as Major Constraints to Doing Business



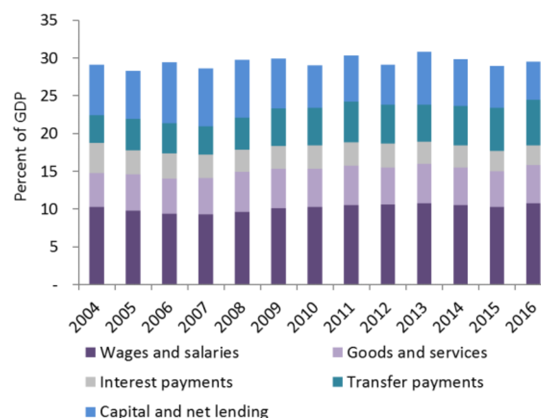
Source: IDB calculations based on Compete Caribbean's 2014 Productivity, Technology, and Innovation Survey.

Expenditure

The public sector wage bill is the largest budget item in the region, averaging almost 45 percent of current expenditure in 2016. As a portion of GDP, the wage bill ranged from 8.7 percent in St. Vincent and the Grenadines to almost 13 percent in St. Kitts and Nevis. (Figure 5). Transfers and subsidies are the second public spending priority in the region**.** The budget for transfers and subsidies increased to 6 percent of GDP in 2016, with Grenada allocating 4 percent of GDP and St. Vincent and the Grenadines 7 percent.

Capital expenditures were high, improving infrastructure and growth but also increasing debt. In the absence of monetary policy instruments to stimulate output, OECS governments pursued expansionary fiscal policy following the 2009 global financial crisis. This led to an above-average share of capital investment, averaging 5.8 of GDP percent from 2010–2016. Dominica reported the highest capital expenditure in the region, averaging 10.7 percent of GDP from 2010–2016. In contrast, in Antigua and Barbuda public investment averaged 1.9 percent of GDP annually over the same period. While these investments were growth-positive, the issue was one of affordability, with the expenditures contributing to higher public debt across the union.

Figure 5. Composition of Expenditure in the OECS (percent of GDP)

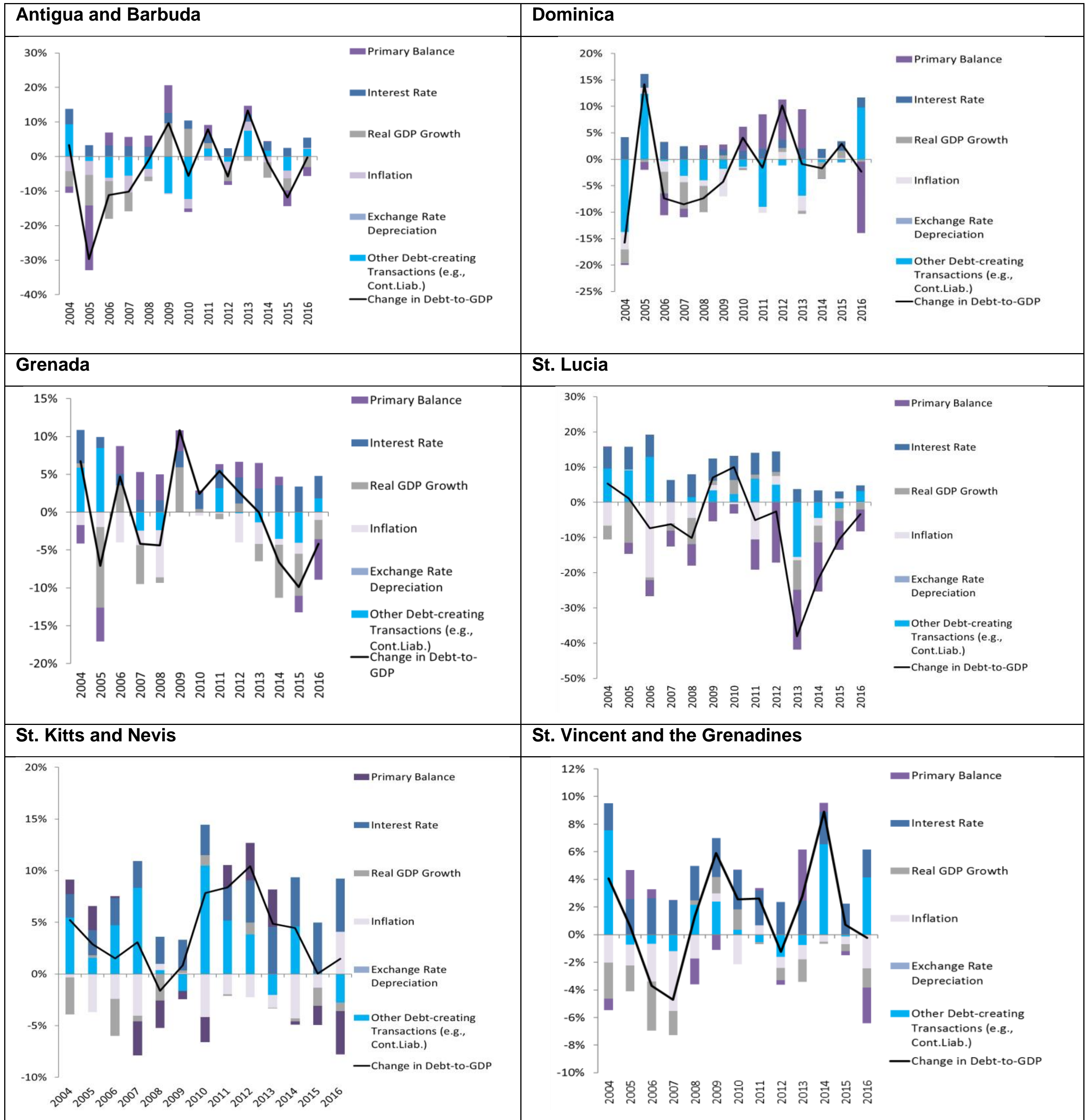


Source: Eastern Caribbean Central Bank.

Conclusion and Policy Discussion

Moving towards a path of long-term fiscal sustainability would provide greater fiscal space in the OECS. This space could be created through a continued focus on increasing efficiency in tax revenue collection and on improving allocative efficiency by way of changes in the composition of current expenditures. Measures to broaden the tax base include reducing tax incentives, limiting exemptions from the VAT, property taxes, and income taxes, and applying excise taxes to all traditional goods. With respect to tax administration, efforts to fight tax evasion and improve compliance and audit would benefit the union.

Annex 1: Debt Decomposition for the OECS Countries (percent)



Source: IDB estimates based on data from the Eastern Caribbean Central Bank and International Monetary Fund, *World Economic Outlook* (April 2017).

The Caribbean Quarterly Bulletin was prepared by the Caribbean Economics Lab, Inter-American Development Bank.

The Bulletin's production team is headed by Moises Schwartz (director), and includes Juan Pedro Schmid (editor and coordinator), Dana Payne (editor and distributor), Lynn Saghir (distributor) and David Einhorn (editor).

For questions or comments please email CET@iadb.org

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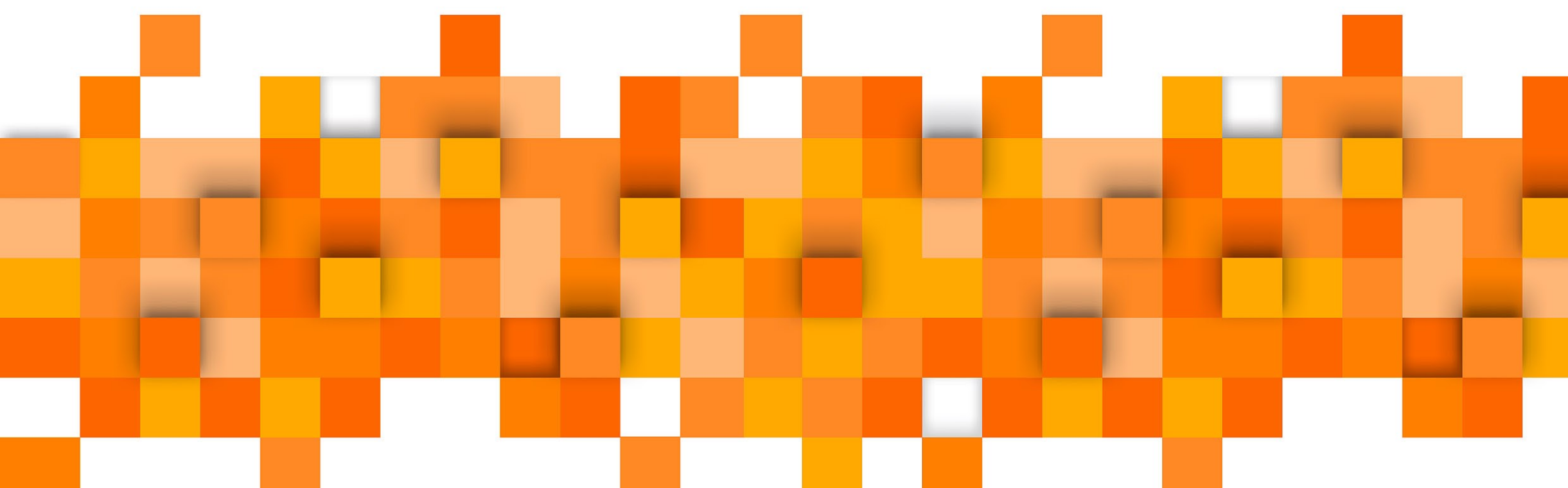

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