



To Bind Or Not To Bind

A Fiscal Policy Dilemma in the Caribbean

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Abstract¹

Given that the Caribbean region remains open to external vulnerabilities, fiscal policy is a critical tool in managing debt sustainability. But since fiscal outcomes have been persistently poor in the region, it is important to assess the appropriateness of fiscal rules as a device to impose fiscal discipline. This Policy Brief juxtaposes the historical fiscal outcomes against political outcomes to show that the current system is not functioning. It then develops a case for introducing fiscal rules over time but argues that a slow and deliberate movement to creating and implementing such rules may be the best approach for the Caribbean countries. However, it also points out the introduction of adjustment programs may also represent opportunities to quicken such implementation.

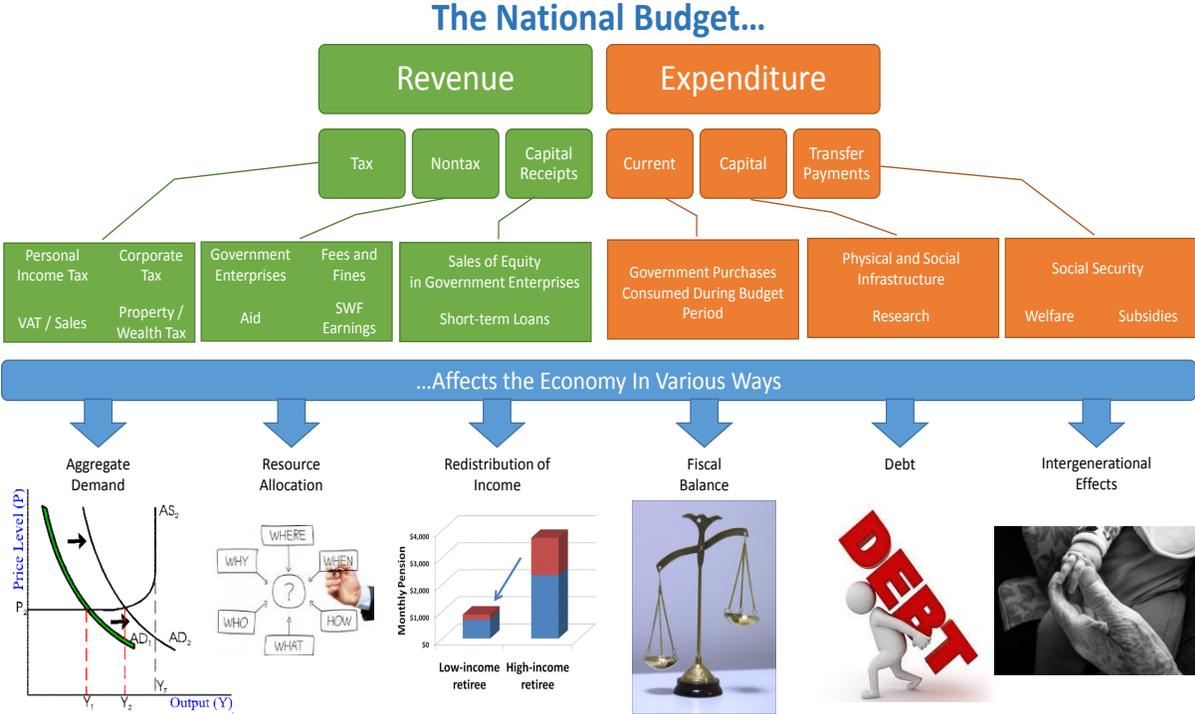
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No, this is not a brief on the practices of Marquis de Sade. This policy brief is about perhaps a more boring, definitely more arcane, but much more important topic as it affects directly (and indirectly) the welfare of all citizens through practices that govern national budgets. Specifically, we discuss the possible causes of persistent fiscal deficit bias and procyclicality—an unfortunate characteristic of the Caribbean economies—and explore whether the time has come to use fiscal rules to remedy the problem.

Figure 1. Importance of the National Budget in Macroeconomic Management



Budgets are more than just national housekeeping numbers. As the primary tool of fiscal policy, national budgets drive a government’s efforts to strategically manage the economy through taxing certain activities while supporting others. Few public decisions have a greater impact on people’s lives than those about public budgets considering that it is through the budget that governments make fundamental choices relating to the course of development and laying the groundwork for their national future (see Figure 1). For example, on the revenue side of the budget, a recent IDB study, “More Than Revenue: Taxation as a Development Tool,” shows that tax policy reforms can serve a strategic role in achieving development goals. On the expenditure

side, governments can (a) resolve market failure by providing public goods, (b) influence the supply side of the economy by providing services such as education and health, (c) mitigate negative externalities, and (d) redistribute income and—over time—wealth.

Worrying Symptoms: Persistently Bad Fiscal Outcomes

Budget outcomes in the Caribbean have been generally poor and show a deficit bias. Caribbean history is littered with serial drastic and painful fiscal adjustments that are often followed by fiscal indiscipline, which then necessitate another round of socially and politically uncomfortable adjustments. The problem is compounded by the fact that these recurring fiscal adjustments often burden the politically weak and economically vulnerable citizens more than those who are well off, given that the poor normally do not gain much during the postadjustment period. A look at the time series of a macroeconomic vulnerability index (Figure 2) shows that, among other factors, the persistence of a weak fiscal position has made the Caribbean economies more vulnerable than Rest of Small Economies (ROSE) as well as the Rest of the World (ROW).²

In the absence of any deficit bias, budgets would oscillate between the two states of surplus and deficit depending on the economic cycle and/or political conditions. Conventional wisdom holds that, over time, these fluctuations would be mainly driven by business cycles with fiscal policy primarily run countercyclically to create balance in the budget. Fiscal discipline is said to be present when, over the long run, the debt-to-GDP ratio is stationary (and stable), which implies that the country's expenditure and revenue collection is moving broadly in line with the growth level and cycle of the overall economy. However, the Caribbean fiscal policy is not countercyclical, and the debt-to-GDP ratio has not been stable. In fact, these ratios have risen sharply and, for several countries, have reached unsustainable levels.

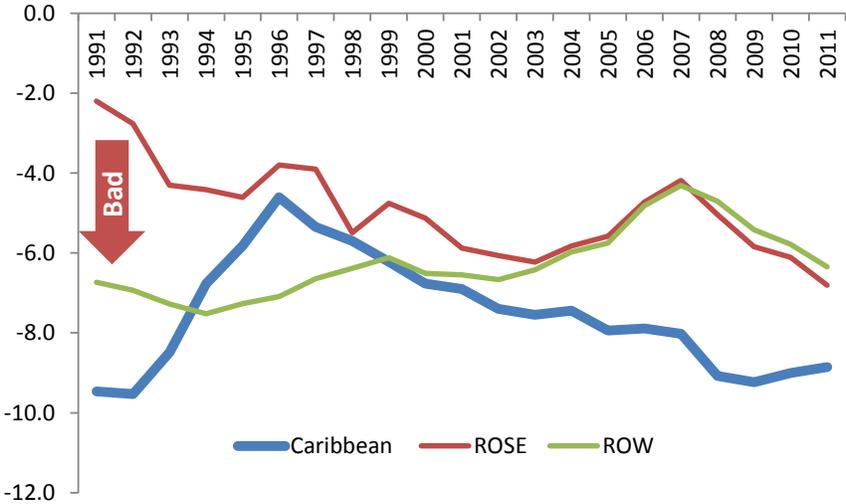
Here are the facts that support our assertions of inadequate budgetary-fiscal outcomes. Amo-Yartey and colleagues (2012) reviewed fiscal experiences in the Caribbean from 1980 to 2011. They defined a fiscal consolidation episode as one where the cyclically adjusted primary surplus (CAPS)-to-potential-GDP ratio improves by 1 percentage point in 1 or 2 years.³

² The index includes the consumer price index, exchange rate, reserves, imports, fiscal balance, and nominal GDP.

³ CAPS is the fiscal balance minus the interest payments on public debt and minus that part of revenue and expenditure that is due to temporary changes in economic activity. Potential GDP is the highest level of real GDP output that can be sustained over the long term. Usually estimated through a combination of production functions as well as time-series projections, the existence of a limit is due to natural and institutional constraints.

Furthermore, they defined the end of an episode as the year in which changes in CAPS became zero or negative. Also, they defined the consolidation effort to be successful where the debt-to-GDP ratio is reduced by at least 5 percentage points after 4 years. Their analysis is quite telling. First, it reveals the low level of success of fiscal consolidation efforts in the Caribbean; and second, it highlights the frequency of subsequent fiscal action even after achieving success. Viewed as a region, Caribbean countries spent a total of 43 years in fiscal consolidation with only 20 years leading to successful outcomes. Also, the average time for a return to adjustment was only 2.7 years (see Figure 3).

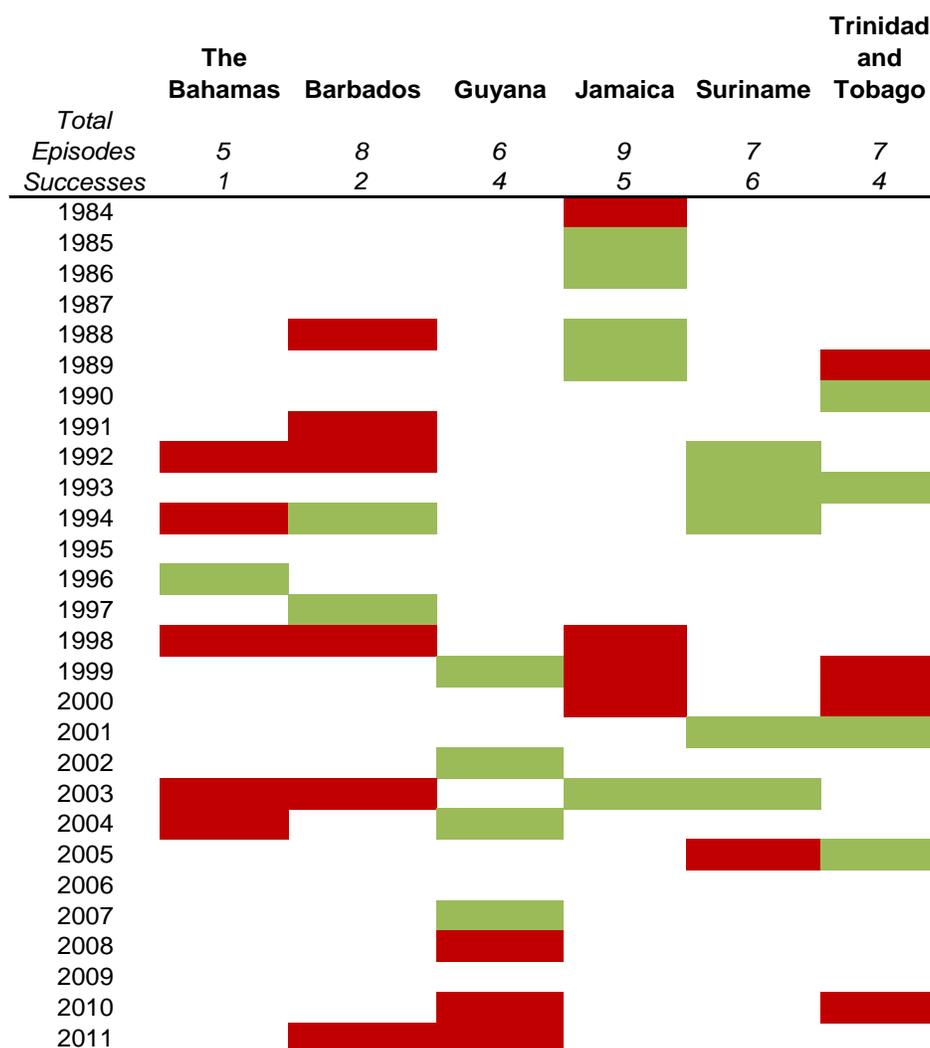
Figure 2. Macroeconomic Vulnerability Index, 1991–2011



Source: IDB (2014).

The cyclicity of fiscal policy in the Caribbean has been studied in depth by Samuel (2009). He found that most Caribbean countries’ fiscal policy has been generally procyclical—the direct opposite of what would constitute good fiscal policy. In principle, fiscal policy could be procyclical without deficit bias; however, he also found that increases in public debt are partially related to the ratchet effect of asymmetric fiscal deficits over successive business cycles.

Figure 3. Chronology of Fiscal Consolidation Efforts in the Caribbean, 1984–2011

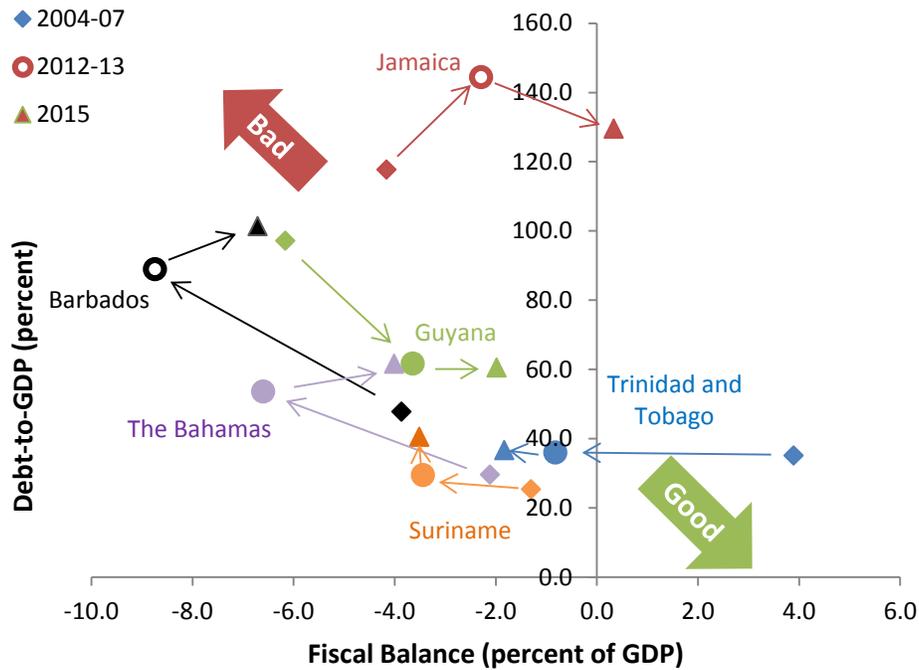


Source: Amo-Yartey (2012).

The fiscal situation in recent years has generally become even worse. Figure 3 shows the evolution of the fiscal balance and the debt-to-GDP ratio for selected Caribbean countries. Practically all countries except Trinidad and Tobago had fiscal deficits during 2004–07. In almost all countries, the fiscal deficit and debt ratio worsened between 2004–07 and 2012–13. The exception was Guyana, where both the deficit and debt fell. Instead of moving in a southeast direction (i.e., reducing both deficit and debt), the rest of the countries moved toward the northwest direction (i.e., worsening deficit and increasing debt). The outcome is that today the fiscal situation is worse relative to the prerecession period, and forecasts (World Economic

Outlook, April 2014) have indicated that, with the exception of Guyana and Jamaica, fiscal buffers (deficit and debt) are expected to worsen in the medium term.

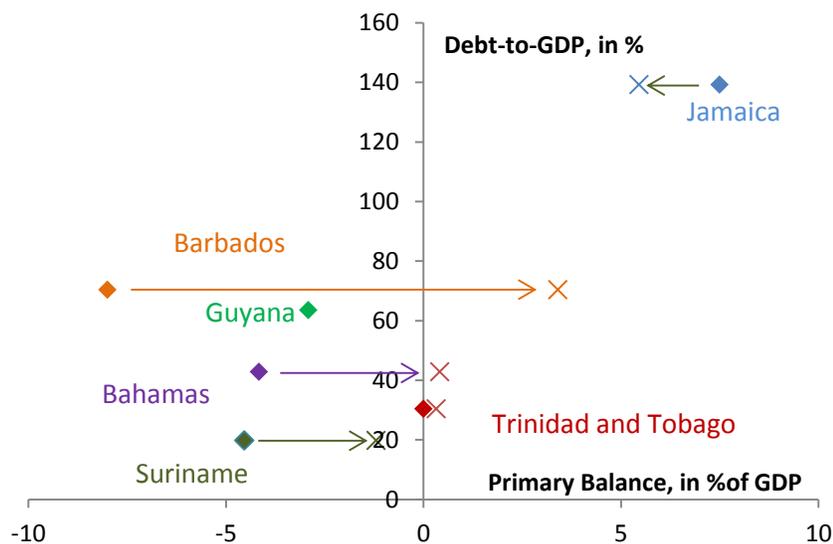
Figure 4. Recent Evolution of Fiscal Deficit and Debt, 2004–15



Source: IDB (2014).

Fiscal adjustment is again called for in several Caribbean countries. Figure 4 juxtaposes the actual primary balance with what would be required to stabilize the debt-to-GDP ratio at its 2013 level. Three of the five countries for which data are available need fiscal adjustment—increased tax, reduced primary expenditure, or both. For Jamaica, the primary fiscal surplus of 7.5 percent of GDP is higher than what is required to stabilize its debt ratio as its unsustainable debt levels require reduction, and for Trinidad and Tobago the current primary balance is on the mark.

Figure 5. Actual and Debt-Stabilizing Primary Fiscal Balance, 2013



Source: IDB (2014).

Diagnosis: Flaws in the Budgetary Process

Understanding the way budgets are currently put together is a crucial first step in determining whether the existing procedural rules and institutions need to be complemented by a numerical fiscal rule, fiscal council, or both.

The budget is the result of a political process. Within the executive, the role of a finance ministry is to coordinate and drive the budget process in accordance with an established timetable. In democratic countries, such as those in the Caribbean, constitutions require taxation and public spending to be approved by Parliament, primarily because fiscal policy is redistributive. Therefore, the role of the legislature is first to scrutinize and authorize revenues and expenditures, and then to ensure the budget is properly implemented. Taking from some to give to others is legitimate only if it results from a noncontested democratic process. Independent supreme audit institutions such as auditor-generals or audit courts carry out an audit of government accounts in order to determine whether government implemented the budget as passed by the legislature. Budgets have to be passed regularly, usually on an annual basis, to ensure that the government continues to operate. However, it is important to note that the annual budget has deliberately built-in flexibilities to take into account unforeseen events. This makes

them nonbinding in that there are often virements authorizing the transfer of funds within the budget and there is ex post regularization of unbudgeted spending through supplementary budgets.

So the question arises as to why does this well-defined process with its rules and institutional basis work in most democratic countries but not in the Caribbean? The answer lies in the argument that the very deficit and debt biases that fiscal policy attempts to eliminate, emanate from institutional weaknesses in the democratic political process itself. The well-known problems of time-inconsistent political and economic preferences and myopic views of the future are magnified by inefficiencies in both the electoral and budgetary processes (Drazen, 2002).

To illustrate this in the context of the Caribbean, we appended election outcomes to the Amo-Yartey and colleagues (2012) data to analyze whether the electorate rewarded incumbent political parties by reelecting them after successful consolidation episodes and punished them by electing some other party after an unsuccessful one, as defined by Amo-Yartey et al. (2012). Of the 25 elections after fiscal consolidation episodes, only 15 had “rational” outcomes. This strongly suggests that the electorates in the Caribbean do not adequately take into account the fiscal performance of a ruling government during a time of consolidation (see Table 1). There is a third possibility as well: the electorates are able to discern between good and bad fiscal outcomes and they are able to punish economic mismanagement, but they choose not to do so because they believe they will claw back more lost ground with the incumbent and so reelect. However, given data limitations it is not possible to test for this.

Table 1. Election Outcomes After Fiscal Consolidations, 1990–2013

Total Fiscal Consolidation Episodes	27
Successes	18
Elections After Consolidation	25
Incumbent Winner After Success	9
Incumbent Loser After Failure	6
Total Rational Outcomes	15

Source: Amo-Yartey (2012).

Bitter Medicine With Sweet Results: Is There a Role for Fiscal Rules?

Given this view about the inadequacy of the political process in several Caribbean countries to effectively put into place consistently countercyclical fiscal policy, as well as the poor track record, policy discussions have revolved around whether it is time to adopt numerical fiscal rules, and less frequently, the option of creating Fiscal Councils (see Ter-Minassian, 2010 and Perry, 2002).

A fiscal rule is a long-term constraint imposed on fiscal policy through legislated numerical limits on fiscal aggregates (Kinda, 2012). The central aim of fiscal rules is to provide a credible medium-term fiscal anchor by making the policy framework apolitical (Kopits, 2001). This allows for correcting distorted incentives and containing political pressures to overspend, especially in good times, with a view to ensuring fiscal discipline over time. To be effective, fiscal rules need to be legislated in a way that makes it difficult for them to be changed. In more extreme cases, this means constitutional changes but at the very least they need to be enacted and monitored in a way that binds the hands of the policymakers under potential political sway. Typically, four main types of fiscal rules are used to constrain fiscal policy (see Figure 6).

It should be noted that to allow for greater control on the execution of fiscal policy, a fiscal rule may include limits on disaggregated components such as tax expenditures. However, to avoid governments being constrained from responding to extraordinary events such as natural disasters or external economic shocks, aggregate limits may have escape clauses and/or include stabilization funds (e.g., the Heritage Fund in Trinidad and Tobago) with their own explicit saving and spending rules.

Given the troubles that several Caribbean economies currently face, recent International Monetary Fund Article IV surveillance reports mention fiscal rules as possible options in The Bahamas and Suriname. In the case of The Bahamas, the country authorities explicitly discussed the possibility of introducing a rules-based framework during the last surveillance discussions reported in 2014.⁴ A debt rule already exists in Suriname which limits the overall

⁴ See paragraph 16 of the IMF Article IV surveillance report (2013) for The Bahamas.

debt-to-GDP ratio at 60 percent, with sub-limits of 25 percent of GDP for domestic debt and 35 percent for foreign debt.⁵

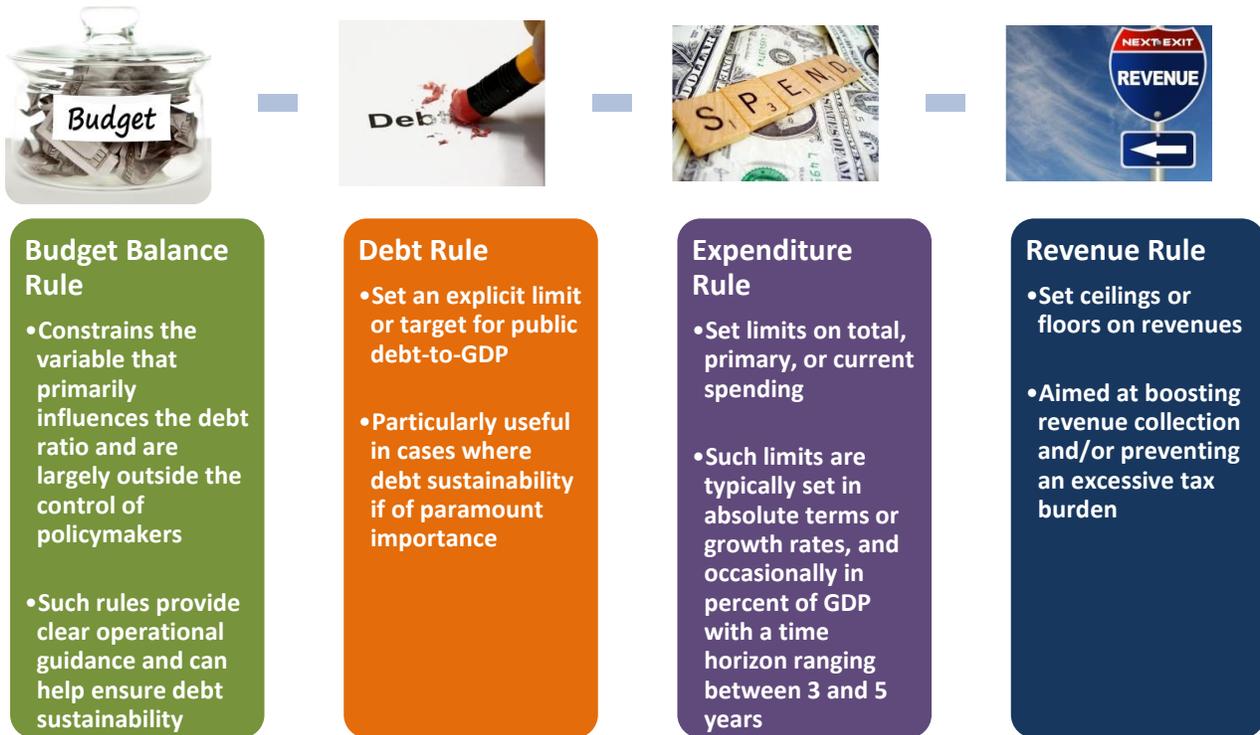
Although not a panacea, a fiscal rule adopted in conjunction with a consolidation plan may reduce the need to return to fiscal adjustment (Schaechter et al., 2012). For example, in Jamaica, as part of an International Monetary Fund program, a fiscal rule was adopted in March 2014 that limits the overall public balance in a way that would reduce the public debt to 60 percent of GDP by 2025/26 (see IMF, 2014). The law that put the fiscal rule into place also established a new permanent budget calendar under which the budget will be adopted prior to the fiscal year, thereby creating an environment for improved budgetary outcomes.

Given a history of fiscal indiscipline and macroeconomic vulnerabilities resulting from natural disasters as well as other exogenous economic shocks, we believe that effective implementation of fiscal rules can lead to a positive effect across the entire economy. More generally, this view is echoed by Schaechter and colleagues' (2012) review of the current literature in which they found the following:

- tighter and more encompassing fiscal rules are correlated with stronger cyclically adjusted primary balances in European Union countries;
- budget balance and debt rules have contributed to better budgetary outcomes than have expenditure and revenue rules;
- rules covering wider levels of government have been associated with more fiscal discipline; and
- a strong legal basis and strict enforcement also have a beneficial impact on fiscal performance.

⁵ It is worth noting that the national definition of debt, on which these rules are based, includes contingent liabilities and undisbursed commitments such as government guarantees, etc., which, in effect, makes this rule stricter than one based on the international definition of debt that does not include such contingent liabilities.

Figure 6. Types of Fiscal Rules



Source: Schaechter and colleagues (2012).

An alternative to legislated fiscal rules is the creation of a fiscal council—an independent publicly funded entity staffed by nonelected professionals mandated to provide nonpartisan oversight of fiscal performance and/or advice and guidance from either a positive or normative perspective on key aspects of fiscal policy (Xavier and Kumar, 2007). Various functions include public assessments of fiscal plans, an evaluation or provision of macroeconomic and budgetary forecasts. Their advice, although not binding—hence not tying the hands of politicians—aims at achieving fiscal prudence through fostering transparency, promoting a culture of stability, and raising the reputational and electoral costs of undesirable policies and/or broken commitments. Thus, its effectiveness depends upon citizens punishing the government during elections if there has been macroeconomic mismanagement. A variant of a council is the ad hoc committee, set up to monitor compliance of Jamaica with its program with the International Monetary Fund.

One very important caveat should be considered in a fiscal rules-based policy framework for the Caribbean: some preconditions need to be met to ensure desirable outcomes. These revolve around both design and implementation of fiscal rules. As Ter-Minassian (2010)

explained, foremost, a fiscal responsibility-based sociopolitical compact needs to exist in the country where such rules are being introduced. Second, policymakers must be clear about their objectives given that there is no one-size-fits-all approach to fiscal rules. Third, initial conditions—including the level and composition of debt, fiscal balance, degree of vulnerability to shocks, sociopolitical support for a rules-based fiscal regime, and depth of democratic institutions—matter. On the last point, for example, if the electorate is unable to effectively discern between good and bad fiscal outcomes and/or is unable to punish economic mismanagement, then a fiscal council approach may not be as effective as one that involves legally binding fiscal rules.

Conclusions

Macroeconomic fiscal outcomes have been poor in the Caribbean, and the region remains open to external vulnerabilities. Fiscal policy is neither countercyclical nor does it avoid deficit bias. As a result, it does not prevent debt from reaching unsustainable levels time and time again. Clearly, the existing rules-procedures-institutional framework is unable to achieve desirable fiscal outcomes. Perhaps, it is time to bind the hands of the government: both the executive as well as the legislature. The problem is that they will have to tie their own hands for the good of their citizens, but any hasty implementation will only be met with more fiscal failure.

A slow and deliberate—but not too slow—movement toward a rules-based regime that allows the Caribbean countries to satisfy the aforementioned preconditions, followed by a transition to the new regime, would effectively guard against fiscal myopia and political cycles as well as enhance the credibility of medium-term fiscal targets. However, in some cases it may make sense to be opportunistic in implementing a rules-based regime as opposed to try a slow and deliberate transition if the underlying political economic conditions so permit.

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