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To Cut or Not To Cut

Does the Caribbean Follow the Advice of Multilaterals?

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Abstract[1]

This policy brief defines the challenges of conducting appropriate fiscal policy over the past 20 years in four Caribbean countries (The Bahamas, Barbados, Suriname, and Trinidad and Tobago) and reviews international financial institutions' technical assistance and advice on tax and expenditures policies. The review finds that national authorities usually agree with the policy recommendations of the international financial institutions in most areas but disagree with the pace and scale of policy implementation. Moreover, delays in implementing required policy action at a suitable pace in many instances may have contributed to a procyclical fiscal stance and worsened the region's fiscal accounts. In future designs of technical assistance, some Caribbean-specific features need to be taken into account. The authors analyze current conditions and provide viable recommendations.

JEL codes: E6, H25, H62, O54
Key words: fiscal policy, tax revenues unproductive expenditures, IFIs, Caribbean, The Bahamas, Barbados, Suriname, Trinidad and Tobago

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1. Introduction

What technical assistance and policy advice have international financial institutions given regarding the selection of Caribbean countries in the area of fiscal sustainability? The International Monetary Fund in particular, the World Bank, the Inter-American Development Bank, and the Caribbean Development Bank are international financial institutions (IFIs) that have invested many resources in technical assistance and policy advice over the past 20 years, including advice to Caribbean countries on ways to improve fiscal sustainability. Stakeholders can agree that this is a necessary, albeit insufficient, condition for sustained growth. What advice have IFIs given, and how have policymakers in these countries reacted?

This policy brief summarizes the advice and uptake of policymakers in four IDB member countries (The Bahamas, Barbados, Suriname, and Trinidad and Tobago) in the context of their unique situation and sometimes differing economic structure. In studying various IFI reports over the years, we have found that the advice has been amazingly consistent and uniform across countries and time; however, the uptake has been spotty and sometimes ill-timed. This may be related to (a) the countries' small size and degree of openness, which means Caribbean countries are less able to react to and adjust to their economic environment; and to (b) the fact that unproductive expenditures—those that in theory will not hamper growth if eliminated—are not always easy to define in practice and can vary across countries and across time (see Andrian et al. 2012). We consider some Caribbean-specific features that need to be better taken into account in future designs of technical assistance because Caribbean countries tend to not be explicitly considered in IFI advice.

The policy brief is divided as follows: Section 1 discusses some background on the economic performance of the four IDB member countries, and some of the discussion covers results of an analysis by IFIs. Section 2 summarizes the policy advice of IFIs and the corresponding uptake. Using data from Seerattan (2014), we provide in the Annex a detailed analysis for each of the four countries. Section 3 characterizes fiscal policies in the Caribbean and highlights the special circumstances that could be better accounted for in future advice. Section 4 concludes.

2. Recent Performance of These Countries and Characterization by IFIs

The fiscal performance and policies over the past 20 years in these four countries has been significantly shaped by their lackluster relative growth performance. Much of the IFI advice has naturally focused on linking the growth performance to the macro, which we discuss in this section.

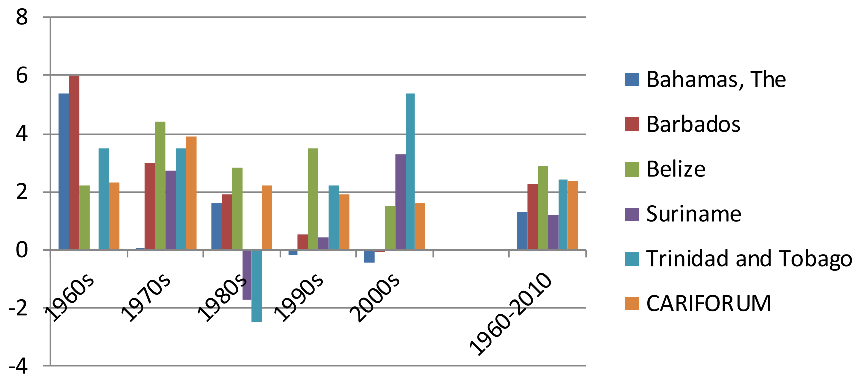
Independent of size, differences in the four countries analyzed should be highlighted from the outset. The small, open nature of Caribbean countries (here, The Bahamas, Barbados, Suriname, and Trinidad and Tobago) means that the international economic environment in many respects drives the performance of these economies.[2] This general economic feature of these countries shields the tremendous heterogeneity inherent in this group. In particular, the group includes a country with the highest per capita income in the Western Hemisphere (The Bahamas) and one country among those with the lowest (Suriname).[3] The countries also differ on credit ratings (ranging from selective default to investment grade), countries that are commodity-based economies, economies that are dominated by tourism and services, countries with a very high score in the Governance and Human Development Index (Barbados), and countries that rank among the lowest (Suriname) in this index. This inherent diversity, which is reflected in large differences in economic performance over time,[4] is driven not only by factors such as initial factor endowment, productivity, and competitiveness, but also by factors such as policy choices over time, vulnerability, and political and social stability. Finally, the four countries under review had different growth trajectories, as seen in Figure 1.

[2] This has been discussed widely in the literature on Small States (for a recent characterization, see Mercer-Blackman and Melgarejo 2013).

[3] The per capita GDP in the group ranges from US$454 for Haiti to US$18,168 for The Bahamas.

[4] This decline in average growth performance has been underpinned by significant disparities in growth across Caribbean countries with the gap between the best and worst growth performances being 7.3 percentage points of GDP in the 1960s and 6.18 percentage points in the first 10 years of the 21st century.

Figure 1. Per Capita GDP Growth in four Caribbean countries and CARIFORUM Member Countries 1960-2010

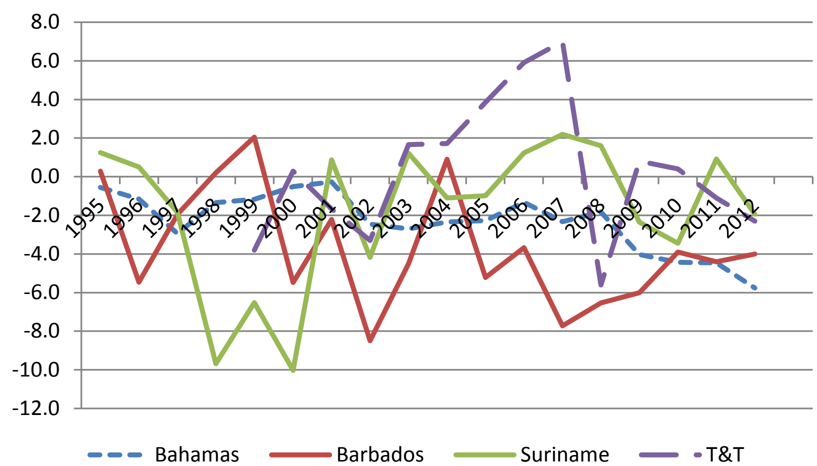


Note: CARIFORUM = Caribbean Forum. Sources: 1. World Bank: A Time to Choose: Caribbean Development in the 21st Century, 2005; 2. World Bank, World Development Indicators 2011; and author's calculations.

According to the World Bank (2005), in most cases, these periods of low growth coincided with periods of macroeconomic instability, particularly weaknesses in the fiscal accounts. Moreover, the general secular decline in relative per capita growth suggests that in terms of productivity, innovation, and competition, Caribbean countries may not have kept pace with the more dynamic economies. The same World Bank report highlighted the decline in productivity in the 1990s, which may partially explain the slowdown in growth in many countries during this period. It also suggests that the main factors driving this decline in productivity include large investments in low-productivity traditional agriculture sectors such as sugar and bananas, the channeling of significant investments to maturing sectors such as tourism, and unproductive public investments. Increases in unproductive public investments were reflected in the buildup of debt in many countries, which was not counterbalanced by improvements in productive capacity as represented by increased production, export volumes, or tourist arrivals (World Bank 2005). This situation developed also as governments sometimes practiced countercyclical spending in part to offset declines in private investments.

Fiscal performance differed significantly among countries. Of the four countries being reviewed, only Trinidad and Tobago was able to generate overall fiscal surpluses consistently over the 1995 to 2008 period, but global economic problems and low oil production have led to a deterioration of the country's fiscal position over the past few years. In Suriname, although the country experienced large overall fiscal deficits in the 1991 to 2000 period, since 2005 it has managed to stabilize its fiscal situation and has generated mostly surpluses on a regular basis. In contrast, The Bahamas and Barbados have not been able to generate consistent surpluses over the past 20 years; Barbados' fiscal balance has shown greater fluctuations over this period. The situation in The Bahamas in particular has deteriorated over the past 5 years. In Barbados, the deficit has remained negative, driven in large part by weak or nonexistent fiscal revenue growth as its large trading partners, the United States and Europe, continue to struggle (Figure 2).

Figure 2. General Government Overall Balance as a Percentage of GDP



Source: World Economic Outlook and official estimates.

Much of the policy advice from the multilateral institutions over the past decade has focused on the need to promote fiscal and debt sustainability. Recent International Monetary Fund (IMF) policy advice has generally highlighted the need for Caribbean economies to reduce public debt, increase savings, and resist pressure to increase wages and subsidies (IMF, April 2012). The IMF encourages greater efforts to generate fiscal savings to stabilize and reduce public debt over the medium term; their debt sustainability analysis suggests that the average Caribbean country will need to increase its primary balance by at least four percentage points of GDP by raising revenue, cutting expenditure, or doing both.[5] More recently, much of the policy

[5] The indebtedness and low fiscal buffers have been less of a problem in other small states such as the Pacific Islands, which have benefitted from considerably more generous aid from bilaterals such as the Australian Agency for International Development (see Tumbarello, Cabezon, and Wu 2013).

discussions have also centered on the growth implications of using revenue-raising measures (increased taxation); or reducing expenditures, given that renewed growth remains a central policy objective in Caribbean countries, particularly those where growth has been sluggish for some time.

Regardless, all stakeholders recognize that any long-term solution to the fiscal and debt problems will require renewed growth, but they still debate the causes. The IMF has presented some evidence that aggressive fiscal consolidation can significantly lower the Caribbean's economic growth in the short run (IMF, October 2010). This is likely to be the case in depressed economic conditions in which private demand has receded to historical lows. In normal times and even mild downturns, however, the situation is subject to much ambiguity.

In the next section, we review more specific policy measures proposed by the IFIs over the past two to three decades to determine whether there has been a significant degree of uptake by the authorities in these countries.

3. Fiscal Policy Advice From International Financial Institutions and Uptake

Was IFI fiscal policy advice implemented? We studied many technical assistance reports, staff reports, and policy reports from various IFIs to understand their advice over the years. It turns out, as we explain later, that the IFI advice has been consistent and uniform across countries and that the partial uptake and uneven timing may have exacerbated procyclicality: high expenditures in good times and tightening in low-growth periods. The Annex recounts the advice and uptake in each of the four countries, and more detail is presented in Seerattan's (2014) study, where the policy options are analyzed in the context of identifying unproductive expenditures. The following are findings across the four countries:

Regarding tax reform and revenue enhancement, the policy advice has been relatively similar across the four countries, but some components of the advice are particular to the resource-based economies of Suriname and Trinidad and Tobago. The general policy advice common in all four countries includes the following:

- Improving the institutional structures for tax and revenue administration

- Instituting tax reforms aimed at simplifying the rate structure and broadening the base by introducing value-added tax (VAT) where it did not exist or removing exemptions where it exists
- The reform of the property tax regime

In the case of the resource-based economies, the IFIs consistently recommended the following:

- The establishment of a revenue stabilization fund to facilitate intergenerational transfers and to smooth out volatility in revenue streams
- The reform of the energy tax regime to make it more revenue efficient and to encourage exploration and investment in the sector
- Improvement of the nonenergy tax regime (by improving or introducing VAT) to reduce the nonenergy deficit and vulnerability to reversals in revenues from the energy sector

The extent to which national authorities have taken the general advice of the IFIs has also been mixed. All jurisdictions have been receptive to the advice of the need to improve the institutional structures for tax and revenue administration and have implemented the recommendations in this area, often with technical assistance from the IFIs. In terms of tax reforms, The Bahamas and Suriname have only started considering implementation of the VAT, whereas Barbados and Trinidad and Tobago have not been able to make the recommended adjustment to their VAT regimes, especially in the area of removing exemptions. It is very noteworthy that no jurisdiction has been able to make recommended changes to their property tax regime, although there are some intentions to move in that direction by The Bahamas and Trinidad and Tobago.

In terms of the policy advice targeted at the resource-based economies, Suriname and Trinidad and Tobago have been receptive to the recommendation of setting up a revenue stabilization fund. In contrast, neither country has been able to implement a full reform of the energy tax regime. The national authorities have therefore generally adopted the advice from IFIs in one of the three general areas and one of the three areas for energy-based economies. In most cases, the national authorities' failure to implement the IFI recommendations were not due to any fundamental opposition to the measures but to the inability to reach political consensus on these measures and sometimes to the lack of resources in expertise and finances.

In terms of improving expenditure efficiency, again the advice has been relatively consistent across the four countries. The following are broad recommendations in this area:

- Restrain expenditure on wages in the public sector
- Reduce expenditure on subsidies and transfers, particularly transfers to inefficient public enterprises
- Improve targeting of expenditure on subsidies and transfers
- Control current expenditure to create more space for capital expenditure
- Rationalize capital expenditure by prioritizing projects and improving procurement procedures and project management over the life of the project
- Improve the budgetary process including limiting supplementary appropriations

One recommendation particular to the resource-based economies was the need to reduce expenditure to ensure that the nonenergy fiscal deficit was sustainable.

In general, all jurisdictions favored the IFI advice on cutting expenditures but often disagreed on the degree to which they should be cut. It was difficult to rationalize expenditures because it was not only an important economic initiative but also a highly sensitive political decision. It was also very difficult in some countries in the context of procyclical fiscal policy and robust growth, as well as in the context of economic fragility, where cutting expenditures may further weaken growth prospects. The fact that these recommendations continue to be part of the advice of the IFIs indicates that authorities' uptake may not have been sufficient.

Commodity exporters have been more lax in general about cutting expenditures. Depending less on resource-based revenue imposes a level of scrutiny and restraint that is not normally the case with commodity producers, which seems to result in less caution on the expenditure side (Deverajan, Minh Le, and Raballand 2010). The challenges of increasing the efficiency of public expenditure in these economies are therefore much greater and hinge on fostering transparency and accountability.

In general, all jurisdictions have not reduced the size of their public sector wage bill and expenditure on subsidies and transfers relative to other expenditure components, indicating that there has not been much uptake of the IFIs' advice in these areas. The significant increases in subsidies and transfers seem to have also been accompanied by a lack of focus on efficient targeting, indicating a lack of implementation of IFI advice in this area, which may have led in part to the large increases in this component of expenditure. In the area of controlling current expenditure to create more room for capital expenditure, the preference to cut capital expenditure rather than politically sensitive current expenditure components has meant that uptake of this advice has been low. This is reflected in the fact that capital expenditure is much more procyclical than current expenditure. In contrast, the authorities have been more receptive to the advice in the less politically sensitive areas of better project management and the administrative aspects of procurement procedures, as well as reducing supplementary appropriations. This may have to do with the fact that reform in these areas was in many cases accompanied by technical assistance and partial grants for setting up the required systems, particularly from the IDB and the IMF's Caribbean technical assistance arm (CARTAC).

Most countries have reacted by cutting capital expenditures, as presented in the budgets over the 2009 to 2011 period. The Bahamas, Barbados, and Suriname, which have less fiscal space, have concentrated on fiscal consolidation and debt reduction and restructuring given their already weak fiscal position.

To improve fiscal sustainability, IFIs have tended to recommend the front-loading of fiscal adjustment to place debt levels on a declining path, by using a combination of restraining wage costs, cutting subsidies to public enterprises, reducing expenditure on goods and service, and instituting revenue measure such as an increase in the VAT rate and the elimination of tax exemptions.

In general, the authorities have not been receptive to this recommendation; they have opposed front-loaded adjustment, arguing that it would negative affect social welfare and hamper already weak growth. Some of the jurisdictions have only belatedly started to acknowledge the need for such an approach in the context of severe problems with respect to debt sustainability. This is due in part to the recognition that the uncertainty that comes from unsustainable debt burdens can have a more debilitating impact on the economy than can the removal of fiscal stimulus.

One area that has not been documented as well but has been increasingly introduced by IFIS is the need to reduce tax expenditures. In general, tax expenditures (tax waivers and discretionary tax incentives in particular) are prevalent and large in the Caribbean, and some estimates—generally not publicized—put them between 6 and 9 percent of GDP. It is clear that the Caribbean countries are not the only ones that grant tax incentives, but the size and discretionary approach for granting them seems to increasingly stand out.[6] The nonuniform application of these incentives has an eroding effect on growth and fiscal revenues through their effect on business investment: Those who pay taxes pay at a high rate, which forces them, in many cases, to request waivers to maintain their competitive edge. The latest World Bank (2012) *Doing Business* report indicates that tax distortions and high taxes are impediments to business in the Caribbean and are possibly regressive. This issue has been more difficult to address as a fiscal sustainability issue because, by definition, they do not appear in the budget; thus, their size compared with other expenditures is not obvious. So far, policymakers in these countries have not openly tackled tax waivers.

4. Characterizing Fiscal Policy in the Caribbean: A Conundrum

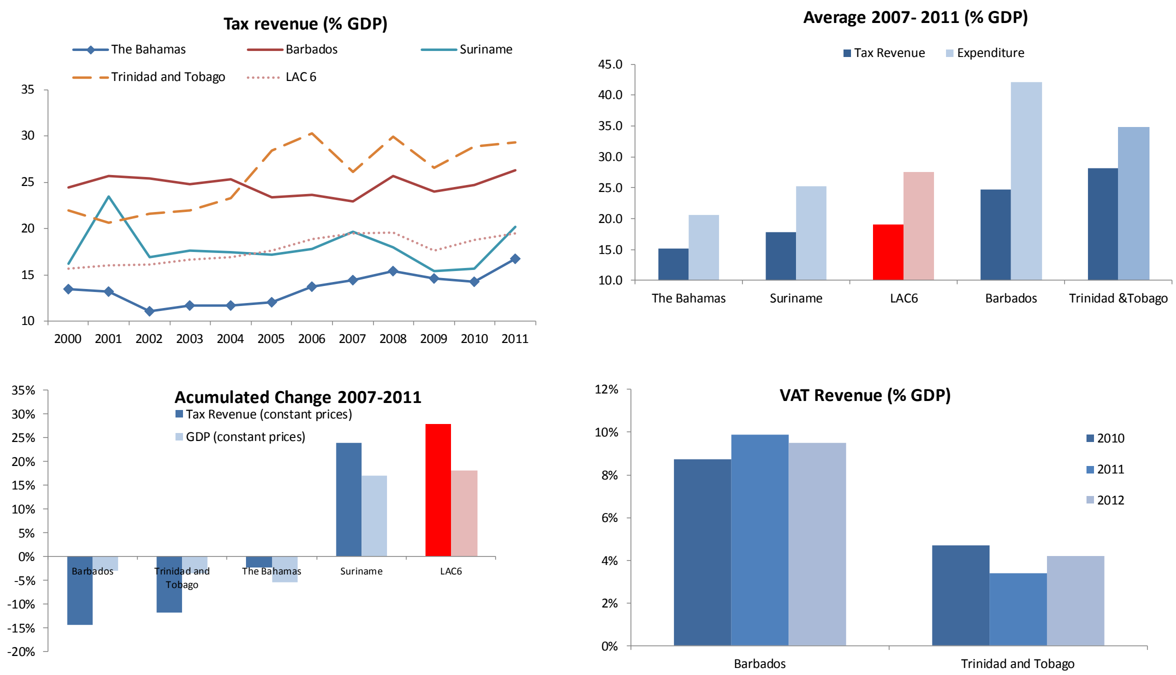
After the global recession, many countries faced fiscal challenges, and the Caribbean was no exception. One could also argue that arguments against IFI advice are applicable to most countries, not just to the Caribbean. The IMF conditionality programs and the World Bank Structural Adjustment Programs have been roundly criticized for not taking into account missing and imperfect markets, capacity to implement, and the political economy of the distribution of costs and benefits (for example, see Easterly 2001). Although it is beyond the scope of this policy brief to study the merits of IFI advice over the years or to assess whether high uptake led to improved outcomes, we discuss the main issues that could be better taken into account in future advice so that is tailored more to Caribbean-specific circumstances.

Some unique aspects in the Caribbean were seemingly not explicitly taken into account by IFI advice. For example, no consideration was given to the recent depleted fiscal buffers after the global recession given the small size of the economies and consequent vulnerability to outside shocks, nor to the consequent procyclicality caused in large part by their unavoidably high dependence on taxes from external income sources, nor to their relatively large (in comparison with local market) and rigid public expenditures. The following are some of the aspects that characterize fiscal performance and policy in the Caribbean that could have been better incorporated in the advice.

[6] If there were some order to the process of granting tax incentives, if they were temporary (with a sunset clause), if the fiscal costs were quantified in the budget and they were based on quantifiable benefits to the economy (increased exports or foreign exchange earnings or the diversification of the economy into new industries, and so forth), this would be a less egregious issue for IFIs. The IDB has shown how well-designed productive development policies can be beneficial by correcting an externality or coordination failure.

First, given the high propensity to import, countercyclical fiscal policy is limited. Caribbean governments have been wary of attempting to make up for lost jobs and income by expanding public works. Countercyclical fiscal policy can work in the United States because about 84 cents of every extra U.S. dollar spent by Americans buys products and services made in America by Americans, and only 16 cents goes for imported goods and services. (The marginal import propensity of the United States averaged 16 percent for the 2000–2011 period.) In the Caribbean, the proportion spent on local goods is much lower: In Trinidad and Tobago, 33 cents of every extra dollar goes for imports, in Barbados it is 66 cents. In The Bahamas, the increase in imports in this time period was about one and a third times higher than the increase in GDP. Over the past 5 years, many Caribbean countries spent more on average on imports than the average increase in their incomes.

Figure 3. Tax Revenues of Four Caribbean Countries Compared With Six Large Latin American Countries



Source: World Economic Outlook and country authorities**.**

Second, tax revenues fell disproportionately during the recent recession, further reducing the room to maneuver. Tax revenues tend to be high as a share of GDP by international standards (although expenditures are even higher). The top panels of Figure

3 compare these over the past 5 years with the average of some large neighboring countries (the LAC 6).[7] Tax revenues in these countries fell sharply during the most recent global recession, with revenues falling significantly more than GDP in all but Suriname, which was experiencing a mining boom (Figure 4). Revenues received a severe blow as a result of the small, open nature of these economies: not only did trade taxes fall as export demand plummeted, but the ensuing contraction in domestic demand lowered import taxes as well. As a result, while GDP fell in 2007–2011, tax revenues generally fell much more, particularly in The Bahamas and Barbados (see Figure 3, lower-right panel).

Third, the efficiency of the tax regime needs to be related to the bigger question of revenue buoyancy. In the Caribbean, several countries have undergone—or are considering—implementing a comprehensive tax reform. The notion that indirect taxes were more efficient in terms of revenue buoyancy but direct taxes lent themselves more to equity drove much of the discussion in the region, and much of the debate focused on balancing efficiency and equity. Research on this issue (Seerattan and Charles 2004) revealed that revenue buoyancy increased in Trinidad and Tobago but fell in Barbados after the reforms. The surprising result in Barbados appeared to be linked to the number of exemptions on the indirect taxes, which effectively reduced the effective tax rate in this area and hence the indirect tax revenue buoyancy.[8] This study also suggested that the reforms improved equity by making the direct tax system more progressive. However, more recently, Trinidad and Tobago has also introduced various exemptions and zero rating of the VAT that have effectively eroded the tax base further (Figure 3, lower-right panel).

Fourth, demand for public services in the Caribbean will tend to be higher given the small size of these economies.[9] The minimum size of the state required to provide the basic level of public services has been an issue that has not attracted the attention it deserves in the region.[10] The growing demands on the state to provide services in line with the welfare state model and the hike in the number of international forums in which

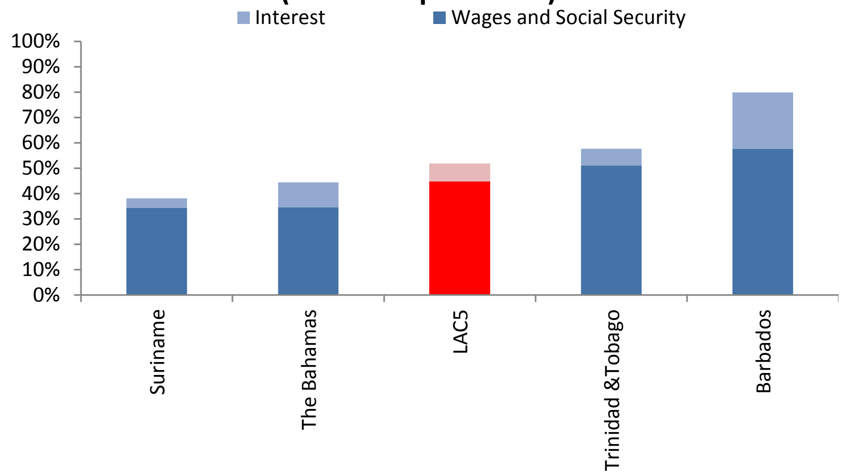
[7] LAC 6 consists of large Latin American and Caribbean countries: Argentina, Brazil, Chile, Colombia, Mexico, and Peru.
[8] Reforms significantly increased the direct tax revenue buoyancy.
[9] Small states tend to have relatively bigger governments (see Remmer 2010).
[10] Part of the problem relates to the lack of sufficient data availability about size for very small economies.

countries participate have put increasing pressures on small states that may not have the economic mass to support this complex apparatus.[11] In addition, small size and undiversified economic structures constrain the ability of governments to raise revenues.[12] In The Bahamas and Barbados, the impact of hurricanes during this period created problems in that it forced substantial fiscal injections around these events for rebuilding. In terms of revenue buoyancy, challenges with expanding it reflect the narrow economic base on which these tax systems depend. The highly open and narrow nature of these economies—in addition to cyclical factors driving revenue growth—also contributed to a level of revenue volatility in government revenues.

Consequently, a greater proportion of public expenditure in the Caribbean is being characterized as rigid. In other words, with the exception of Suriname, an increasingly greater share goes toward nondiscretionary payments (e.g., wages and salaries, pensions and interest payments, and some legally mandated subsidies and transfers). This was certainly true after the global recession: Figure 4 shows that between 40 and 70 percent of these four countries' expenditures can be considered rigid in comparison with the Latin American average.[13]

[11] This problem has also affected large industrialized countries since the 1960s (see Mussa and Masson 1995).
[12] See Ruprah, and Melgarejo.
[13] The need for the better management of expenditure programs has led to the increasing popularity of various technical assistance programs. Public expenditure management/performance budgeting programs has become increasingly relevant given the unsatisfactory outcomes from conventional budgeting approaches (Schick 1999). Many of these are provided by IFIs. These programs essentially aim to improve the allocative and productive efficiency in public expenditure (Robinson and Brumby 2005). A major part of these exercises consists of identifying expenditures that are the most unproductive, which is in itself a major challenge, but the biggest challenge is to stop this type of expenditure given that the beneficiaries of these expenditures are often well-connected politically. Once this is done, the remaining expenditures must be prioritized and then there must be tight cost controls on projects to be implemented.

Figure 4. Expenditure Composition 2007-2011
(% Total Expenditure)



LAC5 consists of Argentina, Brazil, Chile, Colombia and Peru. Source: WEO

In relation to their small size, Caribbean economies also have a weak institutional capacity to implement capital projects. It is less likely that there are highly skilled civil servants in all necessary areas of procurement, project design, and management. Although expertise can be imported for particular projects, the know-how is unlikely to remain in the public sector without a sufficiently large critical mass of people creating institutional memory.

The way in which these expenditures are implemented may also be important. Wasteful prestige capital projects with little functionality can be associated with low growth given that the debt associated with these projects add burden but little or no output. The many institutional challenges facing developing countries in the implementation of capital projects that result in significant lags and cost overruns may also contribute to slower growth being associated with capital projects while the immediate and universal impact of many components of current expenditure paradoxically have an immediate and substantial positive impact on growth in the short run. This, of course, abstracts from longer run productive efficiency issues that may be helped by a well-crafted capital expenditure program. Moreover, some of the projects may have been well-conceived and designed, but the implementation and absorptive capacity may have rendered them inefficient ex-post.

5. Conclusion

Using information from various reports, we show that the standard advice from the IFIs has been generally consistent over time and across countries, despite the different structure of some of the countries reviewed. The exception to this rule relates to advice on how to address the challenges created by volatile revenue flows in the commodity-based economies.

The national authorities have in most cases agreed with the policy proscriptions of the IFIs in most areas but have often disagreed with the pace and scale of policy implementation. In particular, the authorities have generally preferred to exercise more forbearance rather than use preemptive action where fiscal consolidation efforts were concerned, in many instances opting to put off adjustment until there was little room to maneuver. This tendency does not seem to have changed much over time. This perspective is informed by the political sensitivity of fiscal policy and the general unpopularity of fiscal consolidation, especially during periods of robust growth. The fact that the less sensitive policy advice concerning the need to upgrade the systems for tax administration and improving budgetary procedure has been almost universally adopted by jurisdictions highlights the fact that the authorities are mostly in agreement with the economics behind the advice, but other concerns have trumped economic logic.[14] This has led to a situation in which fiscal policy is generally procyclical and fiscal consolidation is generally implemented in periods when aggregate demand and growth is weak. The highest uptake of the IFIs' more sensitive advice therefore tends to occur when the economy is in a precarious state, precisely when it is very costly to do so.

The lesson from this is that efforts to improve fiscal management and encourage a longer-term planning horizon may be more appropriate. The common link must be to have a fiscal plan that enables each jurisdiction to stabilize and then improve its fiscal situation in a sustainable way. A workable policy strategy for fiscal consolidation must therefore be politically sustainable and would need to balance the need for short-run maintenance of spending on social services with the need for long-run spending on well-conceived capital projects to shore up sustainable growth in the long run.

Moreover, for countries that have some discretionary spending, more attention should be paid to the benefits and efficiencies of particular projects, rather than on overall headings of current or capital expenditures. Projects for which financing has already been approved should be brought forward, whereas projects that involve significant increases in

[14] These concerns may be related to political priorities, but not necessarily. They could reflect the inability to gauge the size and permanence of the shock, as well as the lack of institutional mechanisms to automatically counteract them (such as fiscal rules or unemployment insurance).

recurrent expenditure on an ongoing basis with little or no revenue streams to offset these increased recurrent costs should be avoided.

Finally, the appropriate mix of policy initiatives, and, more importantly, the timing of various initiatives over the economic cycle, are critical to the success of any fiscal consolidation program. Unfortunately, there has been procyclical spending and then tightening—possibly through an IMF program—precisely at a time when it can be very costly and unlike other countries, the possibility of a push from greater private sector demand is not there.

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Annex

Policy Advice From IFIs on Fiscal Sustainability: Individual Countries

The advice from the multilaterals has focused on a number of separate but related areas such as (a) tax reform and revenue enhancement, (b) public expenditure management programs to increase the efficiency of public expenditures, and (c) debt management policies. We focus henceforth on the first two areas.

A.1 Tax Reform and Revenue Enhancement

1.1 The Bahamas

In The Bahamas, the policy advice over the years has focused on reforms to the tax regime such as reviewing tax exemptions and concessions. The fact that some of the more dynamic sectors did not yield the kind of revenues during their periods of high growth (low revenue buoyancy) reflected the prevalence of exemptions and concessions. More fundamental advice to reform the tax system included shifting the tax base to target domestic demand by introducing a broad-based VAT or sales tax. Other recommendations to reform the tax system included simplifying the tariff system and strengthening the property tax regime. Simpler reform suggestions also focused on ways to increase nontax revenues such as increasing fees that have remained fixed for a long period such as license fees for offshore firms, road user fees, and business license fees for domestic firms. The IFIs also advised the government to improve the institutional structure for revenue administration.

Instead, the government instituted a series of small fees on an ad hoc basis and not part of a comprehensive reform effort that looked at the entire government revenue system. The most consistent progress seemed to have been made in the area of tax and revenue administration. This includes the implementation of a customs information management system in 2005, as well as efforts to introduce computerization, reduce tax arrears, and update the property tax rolls in 2007 and in fiscal year 2009/10. It is important to note that a new tax administration division was introduced in 2011 to streamline revenue collection and lead improvements in tax administration. The policy advice from multilaterals therefore has had significant uptake by the government in areas that were easy to implement and very importantly not politically difficult to implement. This is not the case, however, in the important area of the introduction of a VAT or sales tax, as well as in terms of a fundamental revision of the property tax regime. However, the government has sought funding from the IADB to reform the property tax regime and has announced the introduction of the VAT in 2014.

1.2 Barbados

In contrast with The Bahamas, Barbados implemented a comprehensive tax reform in the early to late 1990s. The direct tax system was simplified in that the number of tax rates and exemptions were removed while indirect taxes were also simplified in that the multitude of small taxes on different bases and at different rates were replaced by a VAT. The tax burden in Barbados is also higher than the burden in The Bahamas, implying that the scope for revenue enhancement from changes to the tax regime is lower in Barbados.

At the margin, however, adjustments can still be made to remove remaining distortions and improve the revenue efficiency of the tax system in Barbados. These remaining distortions have been the subject of policy advice from the multilaterals. The government has received advice to broaden the base by reducing exemptions and also increase the rate of the VAT. It was also recommended that the corporate tax on offshore companies be increased by 1 percent, which could raise additional revenues of up to 2 percent of GDP. The IMF has also recommended the removal of the cap on property prices, increases in tariffs charged by public utilities, and the reduction of tax incentives. This has been the standard advice from the IMF in the area of revenue enhancement since 2004. The need to improve tax administration has also been a consistent plank of the IMF's policy advice since 2004.

There was some degree of take up of advice by the Government of Barbados especially in the period after 2008. The most significant initiative in this regard was an increase in the VAT rate from 15 to 17.5 percent effective from December 1, 2010, albeit a temporary measure expected to last 18 months. This was somewhat disappointing for some policymakers as this additional rate increase did not yield the expected revenues. Also, fees on a number of services have been increased, including the annual license fee for financial institutions, liquor license, professional registration, and gaming and arcade fees. They have also aimed to increase revenues by raising water rates and bus fares. More recently, they eliminated the subsidy to tertiary education.

The government has not, however, adopted some of the more difficult recommendations such as the broadening of the base of the VAT by removing exemptions and zero-rated items. It also has not adopted an increase in the corporate tax rate for offshore companies and the reform of the property tax regim***e.***

1.3 Suriname

Multilateral advice on public revenue enhancement to Suriname in the past 10 years has focused mainly on the need for drastic improvements in tax administration to deal with widespread evasion and the uneven revenue collection effort. The need to diversify its revenue base and reduce the volatility of revenue was also a major part of the advice from IFIs. As a commodity-based producer and the related inherent volatility of government revenues, a major recommendation was that the government introduce a revenue stabilization fund to smooth out shocks to revenues and also to promote intergenerational equity. In this regard, it was also recommended that the domestic fuel tax be modified from a de facto variable residual tax to a specific tax to reduce the vulnerability of revenues to negative shocks to commodity prices.

The IFIs have also advised that the government should move to address the vulnerability of public finances to commodity revenue fluctuations by reducing the nonmineral deficit by strengthening the domestic revenue base. A major policy proposal in this regard is the recommendation for the introduction of a VAT to bolster nonmineral fiscal revenues.

The government has taken on the advice of the IFIs in many areas. It has moved to modernize its tax administration by improving custom administration and reforming the income tax regime by simplifying the system and reducing administrative costs. In terms of the indirect tax system, it has increased the rate on a number of items such as motor vehicles, alcohol, tobacco, and casinos. It has also introduced a new investment act that reduces tax exemptions. So far, the government has not, however, been able to introduce the VAT, which is a major part of the strategy to diversify its revenue base. The announcements are that the VAT would be introduced sometime in 2014. Also, the government recently announced its intention to establish a sovereign wealth fund that, if properly structured, would help smooth out revenue fluctuations over the medium term and save for future generations.

1.4 Trinidad and Tobago

Trinidad and Tobago undertook to comprehensively reform its tax system in the 1980s by streamlining its direct tax system, as well as reforming its indirect tax system by eliminating many small indirect taxes and introducing a VAT.

- Much of the policy advice from the IFIs over the past decade has focused on the reform of the energy tax regime. [15] The following were the IMF's specific fiscal recommendations: (a) the supplemental petroleum tax regime should be simplified and extended to gas production, (b) a uniform gas royalty should be adopted for all producers, (c) tax holidays for investments in the energy sector should be discontinued, and (d) tax exemptions for VAT on energy products should be removed. They have also recommended reducing or eliminating the subsidy on petroleum products to help increase the tax revenue from these products. These policy recommendations with respect to the reform of the tax system for the energy sector have proven to be difficult to implement.
- The IFIs have also noted that the nonenergy tax base has eroded over time with direct tax rates coming down, and revenue buoyancy in the indirect tax system was muted because of the numerous exemptions in the VAT. This has increased the vulnerability of the fiscal accounts to sharp falloffs in fiscal revenue from the energy sector. In this context, the IMF also recommended a reduction in the nonoil fiscal deficit given the trends in nonoil revenues and the vulnerability of the government accounts to a reversal in energy revenues. It was recommended that the erosion of the nonenergy tax base needs to be halted and reversed by a moratorium on new exemptions and then a closer look at existing exemptions.
- In addition, the IFIs have recommended simplifying and improving the system for tax administration to increase its efficiency and equity. Central themes to their policy advice have recently included reform of the property tax system, introduction of a capital gains tax to increase the equity of the system, and necessity to strengthen nonenergy revenues through better tax administration.

[15] The government in 1999–2000 introduced an interim Oil Revenue Stabilization Fund to help smooth out oil revenue flows, which was later converted in the Heritage and Stabilization Fund with set protocols (based in part on advice from the IMF) for deposits and withdrawals from the IMF.

In term of the policy advice that has been adopted, again it has been piecemeal. The government has made headway in improving tax administration by simplifying the personal income tax regime and removing a number of exemptions in 2006. In terms of more fundamental institutional reforms, there was a move to create a central revenue authority to replace the current government departments in place for collecting government revenues, but this move was strongly resisted by unions representing workers. After the incumbent government lost the election in 2010, the initiative was scrapped. In the important area of the energy tax regime, the government partially removed the subsidy on gasoline in 2004 and again in 2009. It also removed the subsidy for premium gasoline in 2012 and the jet fuel subsidy to Caribbean Airlines, but it has hesitated to move further given the negative political fallout of such a move. It also increased the levy on the gross revenues of petroleum producing companies from 3 to 4 percent in 2004, but this did not apply to companies producing less than 3,500 barrels per day.

Regarding the property taxation regime, the stamp duties on residential properties were increased in 2007. In terms of more comprehensive reforms, the government initiated moves to widen the base, rationalize the rate across different regions, and base the tax on more realistic market values in order to increase the take from this tax; however, these initiatives were shelved when the then-government lost the 2010 election. This issue is now prominent at the national level again given the revenue constraints faced by the new government, and there seems to be a growing consensus to follow through with most elements of the proposed property tax regime but with a lower rate and possibly with exemptions for retired individuals. The so-called Land and Buildings Tax will be introduced in three phases, starting with the valuation of commercial property in 2014.

2 The Efficiency of Public Expenditure
2.1 The Bahamas

The policy advice from the IFIs to The Bahamas in the area of the control and rationalization of expenditure has focused on the following:

1. Reducing the burden of inefficient public corporations on the treasury by privatization and better financial management
2. Restraining growth in the area of recurrent expenditure especially in the area of wages and subsidies and transfers
3. Better targeting of subsidies especially in the area of tertiary education

4. Controlling current expenditures to create room for much needed capital expenditure
5. Taking steps to improve the budgetary process and limit supplementary appropriations; in many areas, The Bahamas has adopted much of the advice on rationalizing revenues

The government has adopted much of the policy advice in the area of public corporations. The government has aimed to enforce more transparency in the affairs of public corporations and serious consideration has been given to privatizing the national airline, Bahamasair, and the state-owned Bahamas Telecommunications Company. The government has moved to cap increases in transfers to public corporations and the discussions on privatization eventually led in April 2011 to 51 percent of the shares in Bahamas Telecommunications Company being divested to cable and wireless.

In terms of restraining growth in recurrent expenditures, in 2007 the government aimed to enhance the credibility of the budgetary and fiscal planning process by limiting supplementary appropriations. They also committed to have a midyear review of budget implementation in Parliament and grant only thoroughly justified additional expenditures. In terms of actual implementation of budget cuts, it was not until the 2010/11 budget that the government took aggressive action in this regard. In that budget, government allocation to ministries and agencies was reduced by 2.6 percent from the level in the previous budget. In a symbolic move, the salaries of the prime minister and government ministers were reduced. The responsibility allowance of senior public servants and increments to all public servants were not paid that year and transfers to charitable organization, schools, and mail boats were reduced. The commitment to reduce expenditure was not sustained; many of these measures were reversed in the budget of 2011/12. Nevertheless, the government continued to restrain transfers to public corporations in the 2011/12 budget, and they looked to use public–private partnership arrangements for some infrastructural projects to limit government expenditure in this area.

The policy to restrain the growth in transfers and subsidies to public corporations and better targeting of transfers to social services is an area with some advances. Privatization was also implemented, but it has not been widespread because the government has argued that some of these public corporations—notably Bahamasair—is of strategic importance to transport and economic development. Even in these cases, however, better financial management and transparency has helped to limit the burden on the fiscal accounts and also helped make these corporations more efficient.

2.2 Barbados

Over the past decade, the policy advice from the IFIs to the government in the area of expenditure control has focused on three main areas: (a) reducing transfers generally but to public corporations in particular, (b) controlling the public sector wage bill, and (c) rationalizing of capital expenditure by better prioritization and controlling of public projects.

The IFIs have consistently advocated controlling and/or reducing transfers. This has generally involved recommending that closer control be exercised over inefficient public corporations to reduce the burden of transfers to these institutions to keep them operating. They have also advocated privatization of these entities to remove the burden of their cost overruns from government accounts. Policy advice from the IFIs in this area has also focused on better targeting of social programs to improve the efficiency of these expenditures and to reduce unnecessary outlays. The advice has often advocated keeping this category of expenditure within some percentage of GDP; in Barbados, the recommendation was that it should be 10 percent of GDP, which is often derived from a medium-term fiscal sustainability framework.

In Barbados, as in all countries being reviewed, because the state is the largest employer, a key factor in the control of government expenditure relates to the government's wage policy. Policy advice has generally focused on keeping wage increases in line with productivity improvements and the ability to sustain these expenditures over the medium to long term. The advice is also often focused on keeping the wage bill within some percentage of GDP and for Barbados the most recent IMF advice was for this ratio not to exceed 8.5 percent.

In the case of Barbados, another major area of IFI policy advice involves rationalization of capital expenditures because of the size of some of the projects undertaken in this jurisdiction in the past decade. During periods of economic downturns (early 2000s and post-2007), this became a major part of the policy advice of the IFIs, which recommended better prioritization of projects and postponement in some cases. Also, many of these large projects were off budget although ultimately generated large increases in public debt. The IFIs advised that these projects be consolidated and brought on budget so that realistic and effective medium-term fiscal frameworks could be crafted.

Reducing the wages and salaries bill proved to be more difficult. In terms of the degree of adoption of policy advice by the government, the IMF noted in its 2002 Article IV consultation report that the Barbadian authorities had heeded their policy advice in trade, banking, and pension reform but not in wage restraint and reduction of budget transfers to public corporations, even in recessionary conditions and weakened fiscal accounts. The authorities' argument was that wage policy in Barbados was based on tripartite accord, and they were loath to break this accord that has served the country well. In terms of transfers to public corporations, the government argued that they would take action over the medium term to improve the financial position of public corporations, but the authorities did not accept the IMF's advice to limit the government ownership role in the hotel sector because they considered this a strategic role to maintain the hotel stock in this critical sector. The IMF's view was that the reforms suggested by the government did not extend to address the need to reduce the debt and put the country on a sustainable fiscal path. The authorities preferred a more gradual adjustment because they felt that faster adjustment would jeopardize the social compact and could damage the recovery. They also felt that because most debt was held by residents denominated in local currency, it mitigated the risk associated with the rise in debt in recent years.

This difference of opinions about the appropriate scale of the fiscal adjustment required continued beyond 2007. In 2008, with the onset of the global crisis, the rising public debt led to the authorities gradually agreeing that a more significant adjustment was required. However, they were not ready to implement a drastic fiscal consolidation measure in the present depressed economic environment. Their position did not change until 2010 when they made some significant revenue adjustments. In the following year, the government finally made some significant adjustments on expenditures such as efforts to restrain the growth in wage costs, reduced spending on goods and services, and caps and cuts in transfers to public corporations. The authorities agreed with the advice that most of the adjustment would have to be on the expenditure side because there was not much scope for increased taxation given that the tax burden is already relatively high. The authorities have finally come around to adopting some of the advice from the IFIs, but not the full magnitude of the adjustment. Therefore, debt sustainability analysis suggests that the adjustments being made by the authorities under the medium-term fiscal framework will still leave the debt-to-GDP ratio at around 90 percent of GDP over the medium term. Delays in making necessary adjustments therefore imply that the scale of the adjustment required later could be more severe and long-lasting.

2.3 Suriname

The policy advice to Suriname from IFIs in the area of public expenditure control has generally focused on the following:

1. Rationalizing the public sector to cut the wage bill
2. Improving the composition of expenditure to create more room for capital expenditure
3. Ranking and prioritizing capital expenditure projects
4. Reducing the proportion of expenditure spent on transfers and subsidies

The specific advice on transfers and subsidies included better targeting of transfers to vulnerable groups and restructuring the inefficient public enterprises by privatizing some, increasing the fees charged by others and correcting the generally poor financial management practices at these entities.

The inconsistency of the fiscal stance and the unwillingness of the authorities to make adjustments on the expenditure side, especially around electoral cycles, over the years has been a characteristic of fiscal policy in Suriname, which often compromised fiscal and debt sustainability. The Surinamese authorities have had a checkered history in terms of adopting prudent policy frameworks. In the early 1990s, an adjustment program was adopted to correct severe imbalances and included a devaluation of the exchange rate, reform of the tax system, and significant cuts in government expenditure. The reforms helped bring a level of stability to the macro-economy, but in the second half of the 1990s, imbalances returned as the government granted significant increases in wages and ramped up capital expenditure. In an environment in which global economic weaknesses had caused a softening of commodity prices, export revenues fell off and the fiscal deficit rose sharply. By 2000, a major adjustment had to be undertaken to deal with imbalances, and the government once again devalued the domestic currency, increased taxes and reduced expenditure by scaling back subsidies. The adoption of the State Debt Act in 2002 also aimed to place limits on government borrowing. After a period of stability from 2004 to 2007, a combination of reduced revenues from the fallout from the international financial crisis 2007/08 and large wage increases led to a significant deterioration of the fiscal accounts after 2008. The government has so far responded primarily on the revenue side by increasing taxes, duties, and tariffs but plans to cut expenditure in the context of a medium-term fiscal framework by reducing subsidies and cutting transfers to inefficient public enterprises.

In terms of the uptake of policy advice from the IFIs on the government expenditure program, therefore, the authorities in Suriname tended to be more receptive when imbalances were severe (in the early and late 1990s). The government has attempted to rationalize the public sector by first reclassifying workers and adjusting pay scales to reflect expertise and training, but this has not resulted in any trimming of duplicative parts of the public sector work force to date and the net effect so far has been a significant increase in wage costs. In terms of devoting more resources to capital expenditure, in the early 2000s the government aimed to freeze wages and impose tight control on nonwage spending while increasing capital expenditure (even if it had to be finance by borrowing), but by 2006 capital expenditures were scaled back to accommodate public sector wage increases.

In terms of the better management of the public sector investment program, the government has aimed to implement better financial management with technical assistance from the IMF in 2006 and greater efforts to improve public expenditure management through technical assistance from the IMF and the IADB in 2011. The authorities have also supported the need to control the proportion of the budget spent on subsidies and transfers but have had mixed results in this area. In terms of public enterprises, they have reviewed the operation of these entities and have made efforts to privatize some in the banana and rice industries. They also liquidated one such entity and placed another under private management in 2007. In addition, in 2011, a reputable international firm was given the remit to audit public enterprises with a view to improving the accounting, transparency, and financial management at these companies.

The general aversion of the authorities to make adjustments on the expenditure side (they were generally more willing to effect fiscal consolidation by revenue-raising measures) was often justified by raising the possibility of social unrest, given the dependence of economic activity, especially employment, on government spending. In the latest episode of fiscal imbalances created by the fallout from the international financial crisis, the situation was different because the need for countercyclical spending was given priority over fiscal consolidation, a strategy that was generally supported by the IFIs once it was done in the context of a medium-term strategy to restore balance to the fiscal accounts. Commodity prices eventually strengthened in 2010, but large increases in expenditure on wages and infrastructure led to deterioration in the fiscal balance that year. This led to a devaluation of the domestic currency in 2011, which represents a real cut in expenditure. High expenditure by regional and international standards on wages, salaries, subsidies, and transfers, combined with high volatility of government revenues because of the dependence on the minerals sector, are serious fiscal vulnerabilities. The government has indicated that it will address these problems in the context of a medium-term fiscal framework that seeks to cut a wide range of subsidies, reduce support to inefficient public enterprises, and introduce a VAT by 2013. However, this framework has projected increased spending in most areas with deficits expected for the next 5 years, which raises concerns about debt sustainability even though Suriname at present has a low debt burden by regional standards.

2.4 Trinidad and Tobago

The benchmark advice of the IFIs in the area of government expenditure has focused on a number of key areas:

1. The reduction of transfers and subsidies to sustainable levels by better financial management rationalization of the state enterprise sector through divestment and privatization and improved targeting of expenditure on social programs
2. Increase of the efficiency of capital expenditure by better prioritization and phasing of the public sector investment programs to avoid duplication, supply bottlenecks, and cost overruns
3. Restraint of expenditure in ways that ensured that the nonenergy fiscal deficit did not become unsustainable
4. Adoption of a medium-term fiscal framework to ensure swings in expenditure over the economic cycle does not threaten fiscal and debt sustainability
5. Restraint of the growth of the public sector wage bill

This advice has been generally consistent over economic cycles. This benchmark advice was reiterated by the IFIs even in the context of the latest global economic and financial crisis and its aftermath, which required fiscal stimulus to compensate for a significant falloff in private demand. In this instance, although supporting short-term fiscal stimulus that weakened the overall fiscal deficit, they advocated this strategy in the context of a medium-term fiscal framework that would eliminate imbalances over time.

In addition, because Trinidad and Tobago is an energy-based economy, the main challenge for the authorities was how to address fluctuations in fiscal revenues from the

energy sector over time in the context of meeting social and infrastructural needs in a sustainable way. Energy-based economies are also more prone to practicing procyclical fiscal policy and generally find it more difficult to implement fiscal consolidation.[16] Much of the policy discussions between the IFIs and national authorities therefore focused on ensuring a sustainable nonenergy fiscal deficit. The logic of this approach was that if fiscal revenues suddenly registered a sharp drop, the requisite adjustment in expenditure would not have to be as sharp; imbalances would be smaller, which would make it easier to adjust, especially if carried out in the context of a medium-term fiscal framework.

In terms of the uptake from the authorities of the advice from IFIs to restrain wages, strong economic growth in the 2000–2008 period made wage restraint for public sector workers very difficult to implement in this period. In any case, the wage bill decreased from 6.7 to 5.5 percent of GDP between 2000 and 2011, indicating that wage costs did not constitute a serious threat to the sustainability of the fiscal accounts. In the context of weak economic growth and flat revenue growth after 2008, the government aimed to contain public sector wage increases in the 5–10 percent range in 2011.

In the area of subsidies and transfers, the government took some action to address the issue of inefficient public enterprises by closing the loss-making national sugar company in 2003, restructuring the state-owned airline in 2006 and mandating that all state enterprises publish biannual unaudited financials. This is an important area for policy intervention because these enterprises account for a large part of public debt accumulation (contingent liabilities and letters of comfort account for around 20 percent of GDP in 2012/13 fiscal year). Little action was taken to deal with state enterprises in the water and electricity sectors by way of restructuring or increasing tariffs to offset losses. This dynamic was reinforced with the introduction of 15 new special-purpose state agencies in the early-to-mid 2000s to drive the implementation of the government infrastructure projects, ostensibly because the public service did not have the capacity to efficiently implement the public investment program.

Key subsidies, in particular, have increased dramatically over the past decade or so. Since 2002, the level of expenditure on social services has increased sharply in education, health, and housing, with the provision of free tertiary education, free medicine for critical illnesses, and the accelerated housing program. The authorities made some headway in dealing with some

[16] See Devarajan et al. (2010).

long-standing state enterprises but laid the foundation for potential higher losses by adding a host of special-purpose state agencies and significantly increasing social expenditure on a wide range of largely untargeted subsidies to households. Expenditure on subsidies and transfers therefore increased from approximately 8.0 percent in fiscal year 1999/2000 to 17.2 percent in fiscal year 2010/11. It is very significant that expenditure on subsidies and transfers alone exceeded government revenues from the nonenergy sector by approximately 25 percent in fiscal year 2010/11, a situation that has existed since 2005 and that highlights the inherent vulnerability of the fiscal accounts and fixed transfer payments in particular to often volatile revenues from the energy sector.[17] Efforts to increase better targeting of subsidies were tentative and barely implemented. They included the partial removal of the subsidy on premium gasoline in the mid-2000s and in 2012 aimed at better targeting fuel subsidies.

There were some efforts at increasing the efficiency of capital expenditure by better prioritization and phasing. In 2009, the government aimed to introduce output-based budgeting in an effort to increase the efficiency of public expenditure. Before this, the government had also been working on new procurement legislation that aimed to increase the transparency in the award of government contracts for projects. The scale of the capital expenditure program was also cut back in 2010 when the new government took office and a number of flagship projects of the former regime were cancelled. In 2013, some progress was made to restart projects.

The government did not take on the advice of keeping the nonenergy fiscal deficit at sustainable levels. The government preferred to spend the energy windfall now to develop the public infrastructure and meet social needs for the period after 2005, such that the nonenergy fiscal deficit had increased to 17.2 percent of GDP in 2011, which is significantly off the level of the nonenergy fiscal deficit that is considered sustainable by the IMF.[18] The authorities did, however, agree to adopt a medium-term fiscal framework in 2008, and subsequent budgets target a zero deficit in 2016 in an effort to consolidate over the medium term. It is yet unclear whether the annual budget appropriations will be able to follow through with this target.

[17] It is not surprising that the nonenergy fiscal overall deficit has ballooned from 6.5 percent of GDP in fiscal year 1999/2000 to 19.6 percent of GDP in fiscal year 2010/11.

[18] The nonenergy fiscal deficit would have had to fall by approximately 4 percentage points in 2008 and about 10 percentage points in 2011 to reach sustainable levels.

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