Matching the Mandate and Resource Envelope

Carl B. Greenidge

A note on the appropriate size of the public sector in the Caribbean

Introduction

The Caribbean's economic prospects are closely bound up with the speed at which the region is able to anticipate and adjust to the unfolding trends and events in global economic and political relations and arrangements. In addition to being small, open and trade-dependent, these economies rely on a relatively narrow range of products for their export earnings, GDP and employment. Since they also depend on foreign savings for a significant portion of capital formation, changes in the international economy, particularly as it concerns investment, aid flows and the global trading regime including dispute settlement, would be of special interest to them.

Major shifts in the ideology of development and international political relations have already necessitated many adjustments in Caribbean economic policies and in the structure of the regional economy. Many of these policy changes will need to be accelerated if the region is to maintain, let alone improve, the economic well-being of its citizens. Economic policies in particular, will need to be fashioned to enable the economies to meet the challenges. In order to do this, Governments need to have both a long term vision of where these trends are likely to lead and a notion of the path along which their economies should evolve.

There is for any Government a task of balancing the revenues available against the cost of the services which it or its supporters would like to see provided by the state. Due to the Caribbean's small size and open nature, managing that balance against the foregoing background is likely to be one of the greatest challenges facing Governments in the 3rd millennium. It will need to be effected without creating further macro-economic imbalances, particularly regarding the balance of payments on current account and price stability.

Although that balancing of the mandate against the means is often portrayed as an economic exercise, it is first and foremost a political issue.

Political Imperatives

On the one hand, there is a link between the wishes of the electorate (or its more influential elements) and the mandate which the political party or Government in office believes it has. The nature of this link is the subject of a long-standing controversy in public choice theory concerning how social preferences (a social welfare function) are transmitted to, and interpreted by, elected representatives. It involves the question of the appropriateness of current voting "rules" and the weight allocated to the votes of different constituents of the electorate. We cannot pursue that controversy here but it is necessary to acknowledge its relevance to the question as to what is an appropriate size for the public sector.

In practice, there is no mechanism for converting the views of voters into a set of specific economic policies or, better still, a set of instruments by means of which to achieve them. The components of the perceived mandate are arrived at by an iterative process involving intuition, approximations and trial and error. At the end of the day, a Government will be guided by a blend of what is ideologically acceptable and what it thinks it can "sell" to the public. This, rather than the inherent technical virtues of any particular measure, will largely influence the
attitude of governments. The debate over, and the criticism or support for those policies will then influence incremental changes in the basket of policies.

The elements of the basket in the economic sphere which influence the activities of the state and therefore its size may be grouped as follows:

i. Equity and social considerations

ii. Environmental protection

iii. Inventorying resources, particularly, mineral and natural resources

iv. Preserving internal law and order and national security

v. Ensuring the availability of an appropriate range of infrastructure

vi. Regulating economic activities so as to ensure a framework under which effective and competitive markets may flourish (handling the problems of externalities, public goods, monopolies and asymmetrical information) whilst at the same time protecting consumers and workers:

   (a) price, licensing and import controls, for example;
   (b) non-administrative competition policies;

vii. Prosecuting national interests in the international arena particularly in the critical area of economic diplomacy

viii. Promotion of private sector activities by way of extensive de facto subsidies and protection (tax holidays, etc.);

ix. Direct involvement in the production and delivery of services.

This list is not meant to be exhaustive nor to be analytically elegant but it assists in demonstrating the changing focus of public sector involvement.

It seems to be increasingly the case that influential opinion and trends favor a shift in the emphasis which the state is to give to these different areas. A number of the more important trends are mentioned below.

There is, in the context of the politics of development, a growing consensus that economic policies, to be sustainable, should seek, in their formulation and implementation, to facilitate structural change. Some of the necessary change can be facilitated by widening and/or deepening the productive base and extending the range of economic actors who constructively participate in enterprise. In the latter context, policy should facilitate greater mobilization and utilization of human resources by way of the removal of barriers and restrictions on the contribution of different groups to fully contribute their creative energies to economic activities. The persistence of extensive pockets of poverty in the region has often been attributed to the failure of policymakers to adequately take into account the needs of the poor, women, marginalized communities, small farmers and the like (cf. for example Beckford 1972; The West Indian Commission, 1992). At the same time there is something of a consensus that the priorities of the "middle classes" have tended to be given undue weight in the mix of Caribbean public policy over those of other socio-economic categories including those mentioned earlier (cf. Stone in Wedderburn 1991, 10; Brewster 1995).

The embrace of goals of social equity and decentralization of government will have implications for the nature and extent of state involvement in the economy. In other words, regulation or intervention to prevent the exclusion of specific and identifiable social groups from particular economic activities or economic activities in general appears to be warranted. These seem to find favor over attempts to use the state apparatus to say create jobs for a broad, or even less a narrow, swathe of employees. In that sense pursuit of activity (i) could imply a reduction in intervention at (ix) and possibly (v).

New political pre-occupations arising from concerns with protection of the environment, preservation of bio-diversity, mean that Governments will be increasingly called on to regulate and answer for the status of environmental developments. This applies equally to the tourist economies and mining economies where failure to maintain acceptable standards would threaten foreign exchange revenues and health. Two cases in point are
Surinam and Guyana where natural resources such as forests and fauna are regarded by some elements of the environmental movement as mankind's common property. For these countries a good deal of the pressure originates externally and may not be viewed favorably by the populace as a whole who see it as at best, eccentric or, at worst, as a means of denying them access to their national resources to earn a livelihood in the interests of future generations of foreigners who are already rich. Given the force of the pressure from these overseas sources, however, more and more resources will have to be devoted to monitoring, gathering information on and defending utilization of forestry and ultimately, fisheries resources. Though Government activities may be largely defensive (at least initially) it will nonetheless require resources.

The region is faced with a growing menace posed by the use, trans-shipment, and to a lesser extent production of dangerous drugs. At the same time, relatively high levels of unemployment² serve as a fruitful nursery for economic and other types of crime. There are therefore growing calls for greater attention to be paid to the restoration of law and order. This will have to be addressed because in addition to scaring off tourists and local skills, it constitutes a disincentive to invest.

The experience of the Pacific Rim reinforces the general perception that the existence of adequate infrastructural facilities is a fairly crucial element in structural change and that the state should be a pivotal role in ensuring the existence of such facilities. It is worth dwelling on this point for a little while because some changing trends need to be recognized.

In the context of future trade developments, spokesmen in the region seem reasonably united in the belief that the region has a capacity and a competitive advantage in knowledge-based services. Since services have become the driving force of a 'revolution' in international trade, it would be just as well to be clear about its requirements in terms of infrastructure. The basic requirements which Governments should seek to meet in relation to information technology (information processing and long distance telecommunications), for example, which many states in the region have already successfully entered, include not only the availability of equipment but its quality and efficiency, as well as its pricing. Indeed, a recent study of the East Caribbean suggested that non-competitive pricing of telecommunications services in those states put them at a disadvantage in the competitive market (IBRD 1994). Finally, all these areas require a population well enough educated to be receptive to technological changes.

The changes in the international trade regime, in aid ideology, and trends in investment which have already been highlighted are affecting the region because of the latter's dependence on western hemisphere markets and on a narrow range of commodity exports. Tourism, which has enabled some of the members of the region to ride out past storms caused by adverse terms of trade movements and the oil crisis, is not alone likely to suffice in the future. It will be necessary to look for or continue to seek out new trade and production opportunities and niches. In pursuit of those opportunities Governments will have to play a prominent role. This is what was referred to earlier as a vision of the future. They will need to combine considerations of regional integration with focused industrial programming and support of private sector initiatives in market research, product search, as well as restructuring and retooling of enterprises and industries to exploit the markets thereby unlocked.

It is in this regard that one can safely challenge conventional wisdom regarding the role of the state, especially as it pertains to the Pacific Rim countries such as Singapore, Malaysia and South Korea, to name but a few. In these countries experience has shown what is possible with a state which is activist but focused, committed to policies which are largely consistent, and which recognizes the need for continuity in policies over time. Apart from "inspired" regulation and the provision of reliable and relevant infrastructure, another key to their success has been their willingness and capacity to influence the direction taken by the private sector by way of high quality collaboration, research and diffusion of information and, from time to time, subsidies which can be financed, are time-bound and narrowly targeted to identified "winners".

Whilst political debate has favored the state as a catalyst in raising the rate of economic growth, there has been considerable disillusionment over the performance of the state as an entrepreneur. This, it might be added, is in the last analysis an ideological matter,
although it is the case that in many, and possibly most, LDCs and in many OECD states the operation of the public sector has been considerably less efficient than had been hoped (and than that of the private sector). Most of this can, however, be put in context when the empirical analyses is taken into consideration. Although the jury is not exactly in on this matter, the weight of evidence suggesting that, 'where public sector agencies are required to compete with the private sectors providers, the productivity differences often largely disappear' (Trebilcock 1995, 27).

Naturally, the different pressures for state involvement will have to be answered. Each Government will have to examine the menu of options open to it. But satisfying some of these demands can be costly. Due to the influence of political and social factors, expenditure is likely to be a most volatile element in the context of fiscal imbalance. In Guyana, for example, post-1980 regionalisation contributed to a significant loss of control over expenditures and declines in cost effectiveness due to problems of procurement and the award of contracts.

But the new priorities need not define additional obligations of the state. Equity, social considerations, environmental protection and pre-occupations with law and order may well involve incremental expenditure by themselves. But regulation is an old obligation of Governments and some old pre-occupations in this area have been made redundant by new managerial approaches and technological developments. The demands can be met by changing emphases say from external defense to internal law and order, for example, and from price controls and other forms of regulation to dependence on non-administrative competition policies. On the diplomatic front, the emphasis should shift to economic diplomacy in keeping with re-focusing on global rather than hemispheric markets and new sources of economic cooperation and investment. The area in which there should be an unambiguous net decline should be productive activities (categories (viii) and (ix) outlined earlier.

In seeking to meet the demands associated with new points of emphasis it will also be necessary to search for resources from outside of the Government budget if old priorities would not be displaced. Thus environmental protection/monitoring can be effected and financed jointly with NGOs and the relevant private businesses as occurs in fisheries, for example.

Additionally, in the struggle to keep the mandate within manageable bounds the importance of informed public debate should not be under-estimated. The formulation of the state's mandate is, as was pointed out at the beginning of this paper, a political matter involving the molding of consensuses.

The striking of a manageable consensus is a function of information and persuasion. The provision of adequate information by Governments can contribute to reasoned analysis in this regard. And, a public forum for debate in which the press, and more importantly, the political parties seeking office are obliged to address the problem of choice and the need to strike the necessary balance between capacity and dreams, would be very useful. Responsible politics, in other words, also has a crucial role to play alongside innovative management and sound economics.

Before leaving this section it would be useful to say word on the process of political decision-making in this context. Whilst it is true that the existing constitutional framework of the region does allow for control of and debate over the financial elements of public policy, it is evident to all and sundry that both the debate and control are inadequate. Without attempting a critique of the Westminster-type constitutions a few comments are offered: Public control of expenditure by Parliament in the guise of the Public Accounts Committee (PAC) and the bureaucracy in the form of the Department of audit is handicapped by two considerations:

1. Executive control of the Legislature by way of the Party Whip.

2. Pre-occupation of the Departments of audit with ex-post administrative accountability.

These considerations result in the mechanisms of control being pre-occupied with restraint rather than guidance or stimulation and loyalty over diagnosis and audit over performance analysis. The processes need to be amended to permit:

1. More careful and timely consideration of measures not merely on the basis of line items but the broader considerations
of economic policy such as inflation, monetary policy, debt fiscal policy etc.

2. Scope for recommendations and decisions by the legislature which are to be incorporated in the measures laid by the Executive and not merely in relation to increasing expenditures but say the modification of policies in the light of the lessons drawn from the reviews of previous years' economic policies

3. This means that the House will need to be provided not only with some technical support but it should be given scope to develop skills among legislators on both sides of the bench

4. Whether or not Central Banks are made "independent" they may be required to submit impartial technical reports and summoned to answer questions on critical parameters very much in the same way that the Auditor General is required to do before the Public Accounts Committee (PAC).

The Mandate and the Appropriate Size of the Public Sector

Adequate recognition and pursuit of common interests is required to maintain a consensus. The composition of the expenditure and the revenue packages can be positive elements in the formulation of the consensus.

Government having interpreted its mandate, has to decide on what specific measures would enable it to acquit itself of the mandate. The state may seek to enhance growth and employment by a mix of regulation of economic activities, the operation of enterprises, investment, financing and promoting development activities etc.

In arriving at those packages and mixes of policies and measures, what limits should Caribbean Governments recognize regarding an appropriate size of the public sector? What proportion of the economy's resources should the state seek to take by way of taxes and what proportion of GDP should the state exercise control over in providing goods and services?

In practice there can be no simple answers to these questions as to what constitutes an appropriate size for the public sector. The activities of the public sector may exert an important influence on the workings of the economy and in turn affected by the rest of the economy. The goals it seeks to pursue are both economic and social. From an economic perspective therefore, the size of the public sector should be consistent with the macro-economic and other objectives which the state is attempting to pursue.

W. Arthur Lewis was said to contend that the limit to the size of the public sector is the state's capacity to finance it. In a sense this is a valid argument. There is no theoretical limit to the share that the public sector can have in an economy once the state can ensure that the economy is in balance. In practice, such balance has been achieved under a range of sizes of public sector.

In the context of the region the main macro-economic objectives would probably be to ensure tolerable price, output and balance of payments levels. More explicitly, these would require that Governments:

i. avoid BOP and exchange rate crises

ii. control the level of inflation; at the same time, common political objectives would be to seek to

iii. raise the level of real incomes

iv. enhance employment levels

v. facilitate the vibrancy and buoyancy of economic and social activities.

Objectives (i) and (ii) would depend on appropriate macro-economic policies. Attainment of objectives (iii) and (iv) over the longer term would require that savings and, more precisely, savings/GDP ratios, be significantly increased from their current relatively low (international) levels of around 20% to close to 30%; a point recently emphasized by the President of the Caribbean Development Bank (CDB) in a widely publicized statement.

All of these points suggest that the capacity of the state to finance a given public sector size will be determined essentially by its capacity to:

1. raise revenues on the basis of moderate tax increases. Public revenues will need to meet the requirements of
sustainable growth and social targets and to service debt arising from conservative domestic and external borrowing programs;

2. raise non-inflationary domestic finance, i.e., there should be little or no central bank credit and such credit as is extended would be soon reversed;

3. raise domestic capital market finance without crowding out the private sector through lack of liquidity and/or high interest rates;

4. raise foreign capital without relatively large premia over base rates.

FISCAL POLICY

Whatever the broader objectives of fiscal policy, it has of necessity to be managed so as to ensure that over the medium term (and preferably in the short term also), expenditures are kept in line with the state's capacity to finance those expenditures. Failure to abide by this relatively simple rubric has been a major cause of many of the economic imbalances and associated difficulties experienced by some Caribbean states. Increasing expenditures in response to revenue windfalls and grandiose political goals against a background of inadequate fiscal effort and frantic borrowing from the banking system and the like have led states such as Guyana to a point where drastic and draconian policies have had to be implemented in order to restore economic balance. These rescue efforts have been especially severe in the face of restricted international financial support (Greenidge 1990).

Expenditures

An important question that should be addressed in considering the level of expenditure is its efficiency i.e., whether the expenditure yields sufficient value for money. Secondly, there is the question of whether the composition and level of expenditure is consistent with the state's role.

It has been suggested that from the expenditure perspective the region's public sector with some 30% of GDP is too large. This may be an accurate observation in comparative terms. However, whether much significance should be attached to this figure as such is a moot point. The appropriate level of expenditure is best derived not from examining expenditure/GDP ratios in isolation or even at all, but from examining the objectives of fiscal (and ultimately macro-economic policy).

The uses to which the resources are to be put will determine, by and large, the volume of resources which the state seeks to garner through its tax systems and other revenue sources. Expenditure is undertaken to regulate (enhance or moderate) current consumption or to create capital assets (investment) for the objective of raising future rates of economic growth. In this regard, the key question is whether a given level of expenditure is consistent with current rates of public savings (and on whether such expenditures, capital and current, yield value for money).

Regarding the relationship between revenues and expenditure, Parkinson (1960) has observed that "the public revenue is regarded as limitless and expenditure not only rises to meet income but tends to surpass it and always will..." It should be added that if the objective of fiscal policy is to enhance public savings - a current preoccupation of most states in the region - current expenditures should not be permitted to increase faster than public revenues, in absolute terms. Furthermore, this comparison should be viewed over a reasonable time period so that windfalls, which are short-term and not sustainable, do not stimulate or trigger long-term increases in expenditure which subsequently can neither be reduced nor financed.

The appropriate levels of capital expenditures are dependent on the growth target, the relative efficiency of public and private investment (ICORs), and the influence of one on the other. In any case, the levels should be consistent with rates of public savings.

Composition of Expenditure

This is a problem just as important as that of the level of expenditure. A considerable debate rages over whether the state should be providing education, health, subsidies etc.. And, if so, which elements. There is also a debate over the administrative or organisational dimension i.e., whether the proportion of resources devoted to the different cost centres is appropriate. This latter debate, which is essentially a management
problem, can benefit from the theoretical developments in the latter area as well as developments directed at making public sector management systems more responsive to flexible decision-making. The balance is a difficult one.

Current expenditures should be geared to meeting the provision of goods and services. The question of exactly which goods and services should be provided were explored in a preliminary way in an earlier section.

There can be little dispute over the need for current expenditure to be consistent with the capital investment programme. This means that it should be distributed in a manner which ensures that capital assets which are associated with services in demand are kept in good repair i.e., maintenance and repairs votes should attract a high priority. Secondly, the main element in current Government expenditures is usually wages and salaries and the related employment expenses and statutory charges. These expenditures should underpin the drive for a highly trained, well-committed human resource base including the Civil or Public Service.

Current Public Sector expenditures also cover the cost of providing complementary inputs such as fuel, transport, stationery, etc. (termed "Other Charges" in some countries). The challenge is usually one of providing enough of these elements to ensure that they are truly complementary.

Socio-economic infrastructure such as transport and communications (roads and ferries), potable water and basic health services have been long recognised as being important in underpinning efficient and competitive industries.

Over the years state intervention, particularly the provision of goods and services, has been justified on the basis of the nature of the industry or the market. I refer here to natural monopolies (decreasing cost industries), publicness and the existence of de-facto externalities or information barriers. We have seen over the last decade, in particular, that these characteristics are not immutable; they are subject to technological change. Thus, the structure of industries can change as can their cost, the composition of their output, etc., which may exhibit different market features are answerable to different management techniques. This has been most dramatically evident in the area of telecommunications and information services.

In effect, the production frontiers of private/public sector provision are being constantly shifted and expanded. As new needs for state intervention arise old ones may contract, change form or disappear. The bundle of state expenditures should reflect those shifts over time and those who stand to benefit from the expenditures should also be narrowed to correspond to those who are intended to be beneficiaries.

In the light of these factors, Governments need to revisit the areas in which they are currently involved as entrepreneur. As a purely illustrative device Table 1 provides a schema of some of the options and considerations that need to be taken into account in considering how a public commitment to cause particular goods or services to be provided, might be approached.
Table 1. Selected Options Under Different Product Market Characteristics/Preferences

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<th>PREFERENCES/CHARACTERISTICS OF SERVICE</th>
<th>NATURAL MONOPOLY</th>
<th>NON-MONOPOLY</th>
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<tr>
<td>Economies of scale &amp; monopoly</td>
<td>Government to pay</td>
<td>Fostering competitive discipline</td>
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<td>Contracting out</td>
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<td>Management contract</td>
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<td>Licensing</td>
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<td>Individual contracting</td>
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Expenditure Reduction

One clear principle to be observed in fiscal management is the avoidance of excesses. Most of the countries which have found themselves having to effect arduous and harsh programmes of adjustment have been victims of policies which have ignored this simple rule. Failing to adjust expenditures in line with capacity to finance over a sustained period is one such policy which can lead to very serious consequences. In this regard “the wages of sin is debt.” Fiscal excises leading to extreme imbalances leave Governments with little option but extensive and apparently indiscriminate expenditure reductions. In such circumstances, “crude cutting of expenditure becomes the main attraction for harried Finance Ministers.”

The most common responses to budgetary imbalances have been to restrain Government expenditures by across-the-board reductions. This has been applied to capital expenditures by way of slowdowns and occasionally modification or a scaling down of the existing public sector investment programme. Additionally, new programmes due to come on stream may be delayed or abandoned. This has sometimes been problematic in that in many countries where there is a clear need to restore physical infrastructure the effect of such an approach has been to further hasten the decline in the stock.

Much of the effort at reduction has been directed at recurrent expenditures, the most fruitful (or vulnerable) component of which has been emoluments and the wages bill. As a consequence, the bulk of the burden of such adjustment has fallen on the non-interest recurrent expenditures such as

i. subsidies
ii. transfers to public enterprises
iii. emoluments - restraining increases below current levels of inflation
iv. social services including education and health care delivery.

If the objective of development and industrial policies is to improve the position of knowledge-intensive services, it would not be appropriate to impose heavy cuts in services such as education and those which contribute to the efficiency of industry. Among the latter are reliable energy and water supplies, transport and communications as well as basic public health.

The reductions in education and health may have been excessive in many instances relative to growth needs. Additionally, these measures may halt or reverse desirable trends such as socio-economic mobility and social stability, less inequitable patterns of income distribution.

Not surprisingly, a considerable degree of dissatisfaction has been generated by such efforts. In Barbados, Guyana and Jamaica such policies have met with significant resistance from the labour movement and other segments of society.

In recognition of the possible conflicts or contradictions there have been calls for the targeting of expenditures.

Other options in relation to expenditure reductions should be carefully explored in the region. There are fruitful possibilities in this regard. Canada has been experimenting with the virtues of amending their financial regulations to allow the Public Service more leeway in pursuit of savings or more efficient use of resources. Under these arrangements greater freedom is granted to the bureaucracy to explore cost savings in their management of line item appropriations in the budget (cf. Trebilcock, 1995).

Targeting of Expenditure

Targeting involves attempts to restrict the total budgetary cost of a particular policy measure by restricting the beneficiaries to those intended. In a sense it is concerned with minimising the cost of delivering a particular programme. Related to this is the fact that transparent expenditure policies and the use of expenditure to counteract the undesirable side-effects of tax policies can help to make adjustment worthwhile and burden-sharing fair.

The persistence of poverty in the region in spite of relatively rapid growth rates in some countries is a matter of general concern and carries with it considerable risks for the stability of these small states. Judging from the interventions during the course of the last meeting of the Caribbean Group for Cooperation in Economic Development (CGCED), the growing incidence of poverty during structural adjustment, is the source of great concern within and outside of the region.

There are many causes of this poverty alongside extensive adjustment and rapid growth. It should be noted, however, that price
movements are among the most pervasive. A World Bank study has noted that in the context of ESAFs, 70% of exchange rate policy conditions were met by a number of countries under review, compared with 55% of trade. So it is hardly a surprise to find that changing relative prices tended to be more successfully implemented than those requiring institutional change (IBRD 1990). In Guyana, for example, the high inflation rates experienced in the 1980s have created an especially large cadre of "retired" poor and aged migrants, in addition to new working poor.

Some time ago, in response to such challenges, the IBRD launched a series of studies on the impact of adjustment and the design of programmes of poverty alleviation. In implementing its findings they proposed to redirect social expenditures to more equitable causes and to make such expenditures more, and to finance and support compensatory programmes (IBRD 1988; 1990). There can be no dispute with this approach.

However, the difficulty of designing expenditure programmes which would target all critically affected groups is much underrated (Greenidge 1994). Indeed, targeting becomes increasingly difficult the more severe the expenditure reductions, especially if it has to be implemented amid calls for simplicity in programmes. A lot more work therefore needs to be undertaken on this approach of targeting expenditure. Additionally, much higher rates of growth than those currently being achieved are needed to support effective targeting.

Measures to redistribute incomes by way of direct taxes and the provision of subsidized goods and services through the public sector are out of favour in the mainstream of political ideas and economic thought, but their perceived disincentive on savings and on work effort, as well as their encouragement of tax evasion should be assessed against the impact of better rewards on the labour supply of poor households.

Privatization

Properly managed, privatization can certainly relieve expenditure burdens and the likelihood of future claims on the public purse occasioned by the need to cover operating losses, the provision of equity and/or subsidized loans to public enterprises. It may also facilitate more efficient provision of the service in question. The claims on the Treasury can be reduced by full or partial divestment of enterprises which would be more profitably run in the private sector. Privatization is, however, an option which needs to be explored more dispassionately in the region than has been the case so far. Many of the concerns which have been used to rule it out of consideration as a viable option can be addressed to the satisfaction of those with genuine complaints.

As observed earlier, one of the important elements of public expenditure pertains to public enterprises. In considering the size and composition of the public sector, it is therefore appropriate to examine the appropriateness of these transfers. The options arising from a political mandate requiring the provision of a service or some set of goods are not usually restricted to state provision or supply.

It is now widely accepted that a range of options may be available to meet any given goal. The objectives of improving the quantum and quality of education or health, for example, does not define a set of associated and specific policies from which the share of the state and the private sector automatically emerges. Extensive privatization needs to be supported by an efficient public service and a supportive framework of regulatory agencies. This requirement runs counter to adjustment policies which have starved these services of resources and denuded them of much-needed skills. The result has in many cases been post-privatization problems.

**Recapitulation**

In looking at expenditure the main points are that Governments should

i. manage expenditure comprehensively;

ii. pursue the restructuring of the composition of expenditures more imaginatively and with an eye to developmental priorities including the need to keep income distribution patterns within tolerable and politically acceptable levels;

iii. avoid across-the-board reductions of expenditure which ignore industrial and developmental priorities;

iv. explore other avenues for savings and improved efficiency.
Expenditure composition should be constantly reviewed because those services/activities, which at one point in time make Government intervention imperative, are themselves changing over time as managerial and technological boundaries and opportunities develop.

**TAXATION**

Assuming for the moment that the efficiency and composition of expenditure are satisfactory, the fiscal system will determine the availability of resources for financing the goods and services which the state seeks to provide. Indeed, since the 1970s, capacity to raise revenues, other than in the short term or by unsustainable borrowing, has been the main restraint on long-term public sector expansion in most Caribbean states.

If, as has been observed, a major requirement in the region is to raise levels of saving, and if current expenditures cannot be sufficiently restrained, governments will have to increase revenues.

For present purposes it is useful to bear in mind the following revenue sources:

1. Taxation
2. Royalties rents and levies
3. Privatisation proceeds, dividends and related transfers

**Selected Features of Caribbean Tax Regimes**

The structure of each economy influences the types of taxes which may be effective. Tax effort for many Caribbean states can be considered to be low. In 1991/92, for example, only in 8 countries was the ratio of tax receipts to GDP in excess of 25%. For much of the Caribbean the range of significant economic activities and the number of economic actors is relatively narrow. In any one country the main contributors to GDP, ignoring Government services, are:

- agriculture
- tourism/manufacturing and
- mining

For most Caribbean states the import of these sectors is not even matched by their contribution to the tax take.

Given their open nature, trade-based taxes are easiest to administer. It is worth recalling that some of these sectors need to be transformed if the challenges mentioned earlier are to be met.

If fiscal, and more especially tax policies are to be consistent with development and industrial policies, taxes ought to facilitate the expansion of priority sectors. Relative prices should favour the expansion of economic activities - tradeables - on which these small, open economies must depend for viability. Taxes (and related economic measures) should therefore leave the industries facing relative prices that favour new activities. In this context, the Caribbean is likely to be looking to activities such as skill-intensive (including information) services, tourism, resource-based manufacturing and mining for future growth.

This means that the traditional, non-traded activities including agriculture should, other things being equal, attract relatively higher taxes. This is especially the case where agricultural sectors are large.

Furthermore, the premia (or terms of trade windfalls) arising from the preferential arrangements, of which Lomé is the most extensive, should be taxed heavily enough to allow them only an incentive to undertake cost-saving investments which can protect their market shares. Bananas, rice and sugar, for example, will face market problems of one kind or another in the longer term. It would be prudent therefore not to permit the economic rents that their producers currently enjoy to block diversification of enterprise and output (further processing for domestic use or export) or diversification of land use (into alternative economic activities).

Additionally, Governments need to ensure that the tax net captures industries which benefit from economic rents, including, windfalls associated with poor policies. The problem of taxing parallel market operators when the state is unwilling or unable to remove the conditions giving rise to parallel markets, is very relevant in this context. Apart from anything else, failure to effectively tax such activity tends to create hostility towards the tax system as a whole because of its contribution to visibly inequitable burden-sharing.
These observations imply three recommendations for tax policy:

i. equip the tax administration adequately to raise taxes from the traditional areas of economic activity;

ii. face squarely the need to treat their favoured constituencies in a manner consistent with the country's developmental imperatives;

iii. carefully explore the utility of fees and user charges. Whilst not unproblematic, such fees can be employed in tandem with practical (rather than theoretical) measures for either exempting the poor or for providing them directly or otherwise with access.

Tax Reforms

Most of the attempts at tax reform in the region have been prompted by the need to raise or to protect revenues and more particularly to create or restore current budget surpluses for stabilisation purposes or to increase capital accumulation.

In the implementation of tax reform two approaches can be discerned:

i. radical changes in the tax regimes by way of wholesale replacement of major taxes such as income taxes by turnover taxes, or

ii. a more gradualist approach within which three or four trends (mentioned below) can be isolated.

The most radical efforts at tax reforms were attempted in Grenada and Dominica and involved switches from one set of tax imposts to another. Barbados' efforts in 1986 and 1987, involving first a sharp decrease in tax rates and later equally sharp imposts, could be deemed to fall into this category also. The results of these experiments have been analysed elsewhere and we shall look at the problems associated with the specific taxes later.

The general assessment has been that the results were very disappointing in that all of these experiments failed to deliver the expected revenue benefit. The main lesson to be had from them is that "sweeping changes are likely to work best when the tax administration system is itself properly organised." Indeed, resource limitations and the low priority which revenue collection agencies attract have led one commentator to conclude that, "the whole question of tax reform for economic purposes seems somewhat premature."

In most states of the region reforms have been less radical than those of the three states mentioned earlier and have taken the form of incremental new taxes or the modification of existing tax regimes. The reforms have usually centred on

i. simplification of the tax system especially by way of fewer, and preferably single, rates and tax bands;

ii. liberalisation of personal and corporate income tax regimes involving additionally, attenuation of their progressivity;

iii. the increasing utilisation of indirect, particularly sales, taxes of which the value added tax has been the most popular and/or;

iv. the establishment of a single revenue agency.

The most popular approach to reform in the region has included the simplification of tax regimes. This applies to both corporate taxation and personal taxes. It has been a feature of reform in Jamaica and Guyana. Guyana's personal income tax bands have been reduced to three and that of Jamaica to one. Additionally, in keeping with the new positions in the fiscal community, high marginal rates have been frowned on leading to a closing of the gaps between marginal and average rates.

Elsewhere, there have been moves to reduce the discrimination between corporate entities - commercial, non-commercial and long-term insurance companies in the case of Guyana. Indeed, in Jamaica personal and corporate income tax rates were for a time made the same.

Simplification has advantages for both the taxpayer and the tax authority. In Guyana the Inland Revenue Department was especially wedded to this process because it freed resources for work on higher priority and more fruitful
areas. It also reduced the scope for fraud. It should also be said that a prevailing view was that simplicity appeared to be more important in the context of stimulating private investment (especially local) investment than fiscal incentives.

Over the last two decades the importance of indirect taxes has increased significantly in Caribbean tax regimes. This has been so notwithstanding the theoretical advantages of direct over indirect taxes. The latter include the scope for progression. In reality however, Caribbean Governments have proven to be unable and/or unwilling to tailor direct taxes well enough to exploit their revenue potential and equitable characteristics, so increased reliance has been placed on indirect taxes.

In the literature it has been argued that these shifts need not imply increasing regressiveness of the fiscal system as a whole (Tanzi 1989). It is true that an acceptable assessment would have to include an examination of the incidence of expenditures also. If equity is a major consideration, it may be met by a combination of revenue and expenditure measures. In other words, what matters is whether the fiscal system as a whole is managed with the equity objective in mind.

The combined effect of these measures tell their own story. The move to indirect taxes lead to greater horizontal equity but since they have been implemented in conjunction with reduced rates of personal and profit taxes, the overall result has been a decline in the equity of the system as a whole. In effect therefore, (direct) taxes on higher incomes have fallen while the burden of increases in the number of indirect taxes has been borne by low and middle incomes.

At the same time, restrictions on expenditures and the absence of effective safety nets have meant that there has been little or no scope to address, or more appropriately, to redress, adverse income distribution effects. These scissors can be seen in its most dramatic form in Guyana (Greenidge 1994). It is not however, a peculiarity of that country as the work of Rodriguez (1993) attests. Latin America’s Structural Adjustment efforts have been characterized by the same features. Elsewhere in the Caribbean, other than Guyana, few Governments exert sufficient control over expenditure to compensate for the adverse consequences of taxes which increase the fiscal burden on the poor.

At the same time, there is little evidence to support the assertion that rate reductions foster significant improvements in incentives to invest or compliance.

The conventional wisdom among the multi-lateral financial institutions strongly favours sales taxes and the value-added tax (VAT) in particular. The discussion on the merits of the VAT is well enough documented for it not to be necessary for us to dwell on it here. As far as the VAT is concerned the experience has been instructive. A study of its impact in 23 countries found some evidence that its introduction contributed to an increase in the tax ratio but not to the rate of growth of the ratio. The effect could be said to be once-and-for-all. Furthermore, the same result might have been achieved by combining a broad-based income tax with a consumption tax (Nellor 1987).

In the region the imposition of this tax has led to no dramatic impact on the tax/GDP ratio. It seems that a tax of this type, whatever the promise, could not be expected to dramatically increase the tax take without effort to ensure that the tax is tailored to meet the subjective situation in which it is to be levied. In the words of Farrel, "a good VAT is a country-specific VAT" (Theodore 1992, 101).

Given the characteristics of the region, the increased urgency being shown towards regional integration and the likely consequences of the Uruguay Round, it is imperative that trade tariff and tax reforms be coordinated. It is frequently assumed that trade liberalisation will broaden the tax base more than enough to offset the revenue losses resulting from the tariff reduction. Frequently, such offset have not occurred elsewhere.

Finally, judging from the public debate, many countries seem to be persuaded of the efficacy of a single revenue agency in place of Departments of Inland Revenues, Customs and Excise Departments and the like. There can be little doubt as to the potential advantages of a single unified revenue agency. If nothing else, it ought to reduce political interference or constraints on implementation of fiscal policy and to act as a restraint on the exercise of state power. However, while part of the problem arises from inefficiencies due to overlapping responsibilities and duplication of effort (and therefore waste of scarce human and material resources) these are not by any means the only major problems.
A major problem has been the unwillingness of some Governments to raise taxes or to adjust exchange rate regimes to ensure that net foreign exchange earners can earn adequate profits in domestic currencies.

Where external imbalances are permitted to continue for extended periods it is important to recognise that an exchange rate movement can by itself have a far more significant impact on tax effort than tax reform. Guyana's structural adjustment experience is witness to that as may be seen between 1991 and 1993. An over-valued currency, in addition to anything else, will result in taxes on foreign trade being collected at exchanges rates which are below those at which the transactions is conducted. Few taxes have proven to be flexible enough to permit capture of this windfall.

In such a situation, it is hardly surprising that many commentators have been seduced by the prospect of an independent, powerful revenue agency which would be responsible for collecting revenues and setting tax rates, etc. The revenue agency can be a foil in such situations. Taking this approach a step further, Hausmann of the IDB proposed the establishment of independent national fiscal councils, somewhat along the lines of Central Banks, which would have the responsibility for managing fiscal policy, and more to the point, powers to fix levels of public debt and the fiscal deficit.

It is unlikely that taxpayers would accept this for very long, however. Some political animal has to take the decision to levy taxes on some of those sectors currently not bearing burdens commensurate with national savings needs and some fair notion of burden sharing. A quasi-Government, unelected, non-accountable agency is not likely to be able to save Governments for long from the firing line since electorates traditionally require representation for their taxation. In this vein, Summers of the US has validly observed that fiscal issues are more political than those handled by Central Banks. For this reason, there could be no 'silver bullet' whether by way of independent national revenue agency or fiscal council. In the absence of some semblance of social consensus major fiscal issues cannot be resolved by these institutional silver bullets.

If the Caribbean reforms were intended to increase the rate of savings and/or to reduce the cost of administering the tax system at a given level of revenues then neither the gradualist nor the more radical approaches to reform have been very effective in the region. The efforts of Grenada and Dominica encountered serious problems as have those of Jamaica and Barbados, for example.

**Recapitulation**

This brief review of the experience of tax reform leads to several interesting guides for the future. First of all, there appears to be no panacea. The regimes which appear to have the greatest potential have to be carefully adapted to country needs if they are to realise that potential. That means implementation and design of such regimes will mitigate against simplicity.

In any case, the greatest prospect of returns in the future appears to lie with thorough-going reform of tax administrations within existing fiscal systems. Such reform could include net worth or what may be called investigative auditing and the thoroughgoing review of (leading to stiffer) penalties including those for evasion. Complementary reforms would include presumptive taxation aimed at bringing the informal sector, particularly agriculture, in some cases within the tax net. Additionally, broadening of the property tax base by re-valuations in line with inflation and in market values will also help to ensure that the well-off also contribute at levels more consistent with their ability to pay.

If such challenges are first tackled, more demanding regimes may be more effectively managed subsequently. Jamaica and Dominica appear to have been persuaded by the virtue of this route and have embarked on this type of reform with the financial support of IBRD and the Canadian International Development Agency (CIDA), respectively.

In so far as rates of growth are not expanding fast enough to adequately ameliorate concerns about problems of poverty, careful consideration should be given to a revitalised role for taxes based on property (owned and disposed of). This means that another look should be taken at capital gains/acquisitions taxes and death duties, inter alia.

Additionally, since much of the capital generated in the region is currently held abroad, each country should invest time and resources to attenuating and reversing capital flight.
points of attention may merit attention in this context i.e., stable macro-economic policies, the harmonisation of capital tax regimes and the political climate.

Finally, there is the question of political will as regards revenue efforts. Some years ago Northcote-Parkinson followed his well-known and popular book on Parkinson’s law with a second less successful but nonetheless interesting book, *The Law and the Profits*. In that amusing work on fiscal issues and taxation he contended that “there are limits to the collection of revenue and that evils multiply when these limits are ignored. However, the tendency to cross these limits appears to be universal, eternal and all but irresistible” (Parkinson 1960).

In effect, the state’s capacity to raise taxes is not only limited by technical considerations of tax design and collection but by political factors such as attitudes towards paying taxes which are in turn dependent on the transparency and the incidence of imposts and expenditures as well as perceptions about the regime’s fairness. The challenge is to raise that political ceiling and/or to spend that which is collected, more efficiently and effectively. We shall return to this political dimension.

**FINANCING AND DEBT ISSUES**

**Financing**

Some of the resources needed for financing the new priorities may be found in the private sector. Some may be found in the NGO element of civic society. The efficacy of a search in the latter area will depend in part on the existence of active and financially well-endowed actors in civic society such as NGOs and civic-minded businesses. Their existence is not to be taken for granted. Where they do not exist Governments need to consider whether any specific policy/ies may be a discouragement to their establishment.

During the 1990s there was a substantial decline in the net flow of official capital into the region. In the light of the factors mentioned earlier this situation can be expected to persist into the third millennium. The region will need to meet some of its new resource needs from increased domestic savings and private investment (portfolio and direct). Measures to facilitate the mobilisation of small savings and the legal and institutional framework for effective trade in equity stocks should be actively pursued. Finally, it is necessary to widen the region’s horizons for purposes of concessional aid and investment. The growing global import of the Pacific Rim states in this area should not be overlooked although, for the region as a whole, there is little reason to expect that such flows would be high over a sustained period.

Increased rates of savings can enhance growth rates as may be seen in the case of East Asia. Savings rates may be enhanced by financial sector reform, especially as regards measures to reduce crowding-out, social-security reform (which has virtues in its own right as was mentioned earlier) and, positive real interest rates.¹⁸

Financial reform and liberalization, it has often been asserted, have a very great potential for enhancing the link between interest rates and growth. However, recent research points to the need to handle financial liberalization with caution because in certain circumstances it may actually cause a decrease in net private savings - ‘liquidity effect’ by stimulating a boom in consumer credit and household borrowing (Ogaki 1996).

At the IBRD’s Annual Conference on Development Economics which examined, inter alia, the role of government in financial markets, Stiglitz argued that, whilst various forms of government intervention could be beneficial and welfare-enhancing in the context of ensuring solvency and stability, intervention involves problems. Examination of those problems argues for simple regulatory structures with relatively little scope for discretion.

Whilst there has been a great deal of debate about the exact import of the different factors influencing private investment there is reasonable certainty that additional consideration will have to be given in future to the role of the macro-economic environment, establishing a clear and comprehensible investment framework as well as an appropriate and supportive legal framework and practices.

There has been a long simmering controversy about the extent of wasteful tax competition by LDCs trying to attract investment. Attention needs to be paid in the Caribbean to devising common and appropriate income attribution rules to circumvent the shifting of income to low tax home bases or to tax havens.

The manner of meeting expenditures is quite important. There is some evidence, although not
definitive, that deficit financing, for example, contributes to increased real government spending (Diamond 1988). At the same time, few tax regimes in the region have proven to be flexible enough to enable Treasuries to avoid borrowing. One very important lesson from the debt crisis is the need for the careful management of both external and internal borrowing.

**Borrowing**

Traditionally, debt management in some parts of the region has been more concerned with debt recording rather than management. The latter involves both an overview of all Government guaranteed borrowing (including non-Central Government), as well as a capacity to realistically assess limits to capacity to service in the light of likely revenue trends (and risks). Failure to respect this requirement has led to problems for some countries. In this context, "the wages of sin is debt."

In the region, two countries in the middle income category are moderately indebted (Antigua and D.R) and another severely indebted (Jamaica). One of the two low income states (Guyana) is severely indebted.

Over the years too little attention has been devoted to the adverse impact of a large debt overhang on fiscal and expenditure options. Onerous debt service obligations adversely affect expectations about the future and trends in private investment. Measures which could reduce the quantum of resources devoted to external debt service would be of special benefit to the heavily indebted in the region because it could have a relatively direct and quick beneficial impact on the poor by relieving pressure to cut expenditure on those activities which are easy to cut but which have a disproportionately large impact on the well-being of poorer households (Greenidge 1990).

**Privatization**

In the present context the importance of privatization lies in privatization proceeds. The first claims on the proceeds of the divestment should be to reduce the stock of debt (starting with high cost debt) especially where such debts may have accrued from the operation of the public enterprise. For obvious reasons the proceeds should not be used to facilitate recurrent expenditure. In circumstances where tax, rents, royalties and other revenues are realized from privatization there could be no objection in considering their utilization for the latter purposes. In that case an assessment should be made of the probability of their being sustained over the long term.

**Conclusions**

The economic future of the Caribbean depends on the speed at which the region is able to gear itself to meet the changes taking place around the globe. The state needs to have a vision around which the economy can evolve. Although much of liberalisation and reform is directed against economic statism, the government will need to provide leadership in the reform process. In the face of these far-reaching and unpredictable changes, government's role is primarily to create the environment within which a wide-range of economic and social actors can have an opportunity, far more than in the past, to compete in the provision of a changing bundle of goods and services. The policy framework would need to be flexible enough to permit timely evolution of productive structures.

It is therefore imperative to provide the basic prerequisites for efficient industry and in as timely a manner as possible. Expenditure rather than revenue management may well turn out to be the more problematic course politically, because in many countries electorates are primarily concerned about improving their material well-being. Also once there have been fiscal excesses the "easiest" correction is expenditure reduction. Fiscal excesses, however, are harder to correct compared to the initial maintenance of fiscal balance through conservative policies.

The point attributed to Lewis suggests that the populace needs to appreciate that if a government is to avoid having to force its citizens to pay excessive taxes and user charges for utilities, the role of the state must of necessity be restricted in a fiscal sense. And, for the state to be more effective within that budget constraint, it has to shed some current activities. Otherwise, the public will receive less service for its buck or tax dollar.

Frequently, Governments come to power on the wings of "unfulfillable" promises to provide more and cheaper services without so much as a whisper about the means of financing. When
they do address the latter, the promises can be similarly unrealistic, as shown by some of the attempts at radical reforms. Yet, elsewhere the politicisation of taxation has left some communities with a view that they have a right to be tax exempt, making it difficult even for their own parties in Government to tax them. Apart from the need for responsible politics, this phenomenon may point to the fact that, although many countries have relatively high per capita incomes, their electorates suffer from inadequate access to basic services.

Then again, it may have to do with the adequacy of the electoral mechanism and the interpretation of mandates. Multi-party politics and the Westminster system concern majority decision-making, not necessarily consensus making. There is a tendency for the instruments of power to be appropriated by sub-groups within a majority. There can be no guarantee that the system will not yield an outcome under which the burden of taxes is borne by the poor whilst the benefits of Government services are directed disproportionately to those already relatively well-off.

The challenge even in the UK today is to devise a system which facilitates discussion and negotiation. Making either system work effectively will require some (a considerable amount in most cases) effort devoted to information dissemination and analysis perhaps with development of supporting communications. In other words, the political limits may need to be constrained or at least informed by a conscious effort at education and transparent consensus building. We have already adverted to the utility of a well-informed public service in the context of raising revenues and managing expenditures. Some countries have already taken the critical steps in this regard, as may be gleaned from the debates in the press and elsewhere. In others, debate remains shrouded by sectional political considerations. The debate needs to recognise that there are a growing number of institutional options and that the appropriate mix of state and public is time bound. It is therefore appropriate to constantly explore the ever-changing frontiers of public/private sector "comparative advantage" or efficiency in order to inform policy.
NOTES

1. I hasten to add that this is by no means a problem peculiar to the Caribbean economies nor is it unrelated to the economic policies commanding widespread acceptance over the years.

2. Among the worst are the DR, Grenada, Haiti and St. Vincent and the Grenadines with estimated rates of over 30%.

3. The Eastern Caribbean States (ECS) have since negotiated changes in the rates to make them more competitive.

4. Professor David Walker, formerly Head of the Department of Economics and Deputy Vice Chancellor, University of Exeter, was fond of citing this question as part of an example of Lewis in action whilst Walker was a Research Assistant at Manchester.

5. The relative size of the public sector (rather than the rate of change of size itself) will dictate the extent to which public sector is relatively large its condition can have a significant impact on macro-economic performance through low and negative public sector savings as a percentage of GOP (of which the worst have been Guyana, Surinam, Antigua and Barbuda) and on the balance of payments (BOP), the level of inflation, the interest rate and the exchange rate. Of course the private sector may also generate macro-economic disequilibrium via reactions to existing and/or anticipated public policy.

6. As defined earlier.

7. These include professional and technical, information technology, banking and insurance, healthcare and education.

8. Private communication; Sir Neville Nicholls of the CDB, who was kind enough to send extensive comments on the first draft of this paper, much of which is reflected in this section.

9. This tends to be the case in capital expenditures also.

10. Which is not intended to suggest either that such trends would necessarily have been maintained in the absence of adjustment or that the adjustment was inappropriate or unnecessary.

11. A special report on poverty in the region will be considered at the June 1996 meeting.

12. Raising public savings is not neutral in that it has a discernible impact on private savings. This means that some part of the effort is lost and that some distortions may be accentuated or created.

13. Accounted for more than 21% of GDP in 3 out of 15 Caribbean states, and 11-20 percent in another 5, and less than 10% in only 5. (Figures were not available for 2 others)

14. Contributed less than 10% of the GDP in 11 cases and over 10% in 4 cases.

15. Contributed more than 10% of the GDP in 7 cases.
16. As was mentioned earlier they are also relevant in the struggle to target expenditure.

17. Recent work on this area undertaken in relation to Sub-Saharan Africa suggests that there may be considerable scope for utilizing such taxes to address the collection and arrears problems of revenue authorities by requiring a pre-payment for tax liabilities; they can be structured so as to provide a strong incentive for potential evaders to register in order to enjoy lower tax rates (Taube et al 1996). In conjunction with withholding schemes, it may reduce tax administration costs through the reduction in collection delays and increased compliance.

18. Although recent studies point to the fact that many conditions encountered in our countries (low income levels and high priority devoted to meeting basic needs, rudimentary financial markets, supervision of government-owned banks) mitigate against a strong association between interest rates and savings.
References


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