The Barbados Economics Society

Response to the Prime Minister's Mini-Budget

Sentiments of the BES President, Mr. Shane Lowe

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Summary

On June 11th, 2018, the new Prime Minister and Minister of Finance, Economic Affairs and Investment, the Honourable Mia Mottley, delivered a suite of budgetary proposals to address ongoing economic challenges. During the last fiscal year – 2017/18 – the government reduced its fiscal deficit to 4.2% of GDP from 5.7% of GDP in the previous year. That adjustment benefited from greater revenue generated through new and higher taxes, and lower expenditure spending on physical infrastructure and assets. However, greater transfers to public institutions and higher interest costs from a growing debt burden pushed current expenditures even higher. Further, ongoing austerity has stalled economic growth since June 2017, and despite rising tourist arrivals, outgoing external debt payments and lower foreign private sector investment have now reduced the Central Bank's foreign exchange reserves to USD 220 million or approximately 7 weeks of import cover.

More recently, in response to escalating debt (now reported by the government at 175% of GDP including arrears of BBD 1.8 billion), and ongoing pressure on foreign exchange reserves from upcoming debt payments, the Prime Minister announced:

- Suspension of all payments on government's foreign debt; and
- The intention to restructure both foreign and domestic debt to reduce annual debt service costs.

The budget seeks to widen the tax base and shift the burden of taxation from the most vulnerable in society.

This prompted Standard and Poor's to lower the country's sovereign debt rating to 'selective default' and has led to a surge in Barbados' indicative borrowing costs for new foreign debt.

Thus, the Prime Minister announced a range of revenue-earning and expenditure-cutting measures aimed at reducing the fiscal deficit to BBD 140 million or 1.4% of GDP in 2018/19 before factoring in potential (but uncertain) annual savings from proposed debt restructuring. Including debt restructuring, the Prime Minister expects no additional funding needs for 2018/19 which implies interest expense savings of at least BBD 140 million for the remainder of the year. Going forward, the government intends to earn revenue in excess of annual expenditures to gradually repay outstanding arrears and reduce the debt stock to 115% of GDP by 2023 and 85% of GDP five years thereafter. In its recently published Article IV report for 2017, the International Monetary Fund (IMF) proposed that the government achieve a balanced budget by 2021 to push public debt from their estimate of 133% of GDP (excluding arrears and contingent liabilities which the government now includes in their estimates) at the end of 2017/18 to 105.5% of GDP by 2022/23. The Prime Minister's budget starts from a greater debt position (reported at 175% of GDP) and appears to have a more aggressive percentage point reduction based on achieving a balanced budget faster than the IMF had initially proposed.

The Barbados Economics Society, in a Nation Newspaper article published on Sunday June 10th, 2018 titled "'Bitter Sweet' Mini-Budget", had suggested that much of the fiscal adjustment should focus on a combination of reducing the government's major expenditure item - transfers and subsidies - and earning more revenues, not necessarily through higher tax rates, but by extending the tax base to capture more persons. Specifically, we noted that the government should seek to address inefficiencies in state-owned entities and consider new funding models for those entities that account for the largest shares of public expenditure. On the revenue side, tax measures should focus on improving tax administration to enhance compliance and spreading the tax burden over a larger number of persons to reduce the relative burden of taxation on the most vulnerable in society.

The measures in the June 11th budget generally appear to achieve the IMF's and BES' stated objectives, while simultaneously reducing (and potentially eliminating) the fiscal deficit in its first year. The new administration's decision to default on external debt, clear intentions to restructure domestic debt, and no preference to rely on future central bank financing suggest that the government had few options to finance a large recurring fiscal deficit going forward. Thus, potentially eliminating the deficit in one year reduces the need to ask both domestic and external creditors for additional financing over the next 9 to 10 months pending completion of debt restructuring negotiations.

The Health levy, Garbage and Sewerage Contribution and taxes on airfare, accommodation room rates and tourism products provide specified funding to key state-owned entities who normally consume a significant percentage of the government transfers to public enterprises – the Barbados Tourism Marketing Inc., Sanitation Services Authority, and the Queen Elizabeth Hospital – and reduce the level of annual transfers necessary to these entities.

The budget also seeks to widen the tax base and shift the burden of taxation from the most vulnerable in society. Direct taxes on higher-income earners such as the new 40% tax rate on workers' annual earnings over BBD 75,000 and the health levy imposed on all workers seek to shift the relative burden of taxation from low-income earners who are more likely to disproportionately consume public health care services to higher-income earners who have greater access to private healthcare and medical insurance. Additionally, announced taxes on tourists help to replace some of the lost foreign-earned revenue from the International Business and Financial Services sector and reduces relative taxation on locals.

However, shifting the tax burden to higher-income earners (including some workers in the middle class and corporations via a higher corporate tax rate) directly reduces their disposable income and may potentially reduce their level of spending. This could potentially have an adverse impact on economic growth. The increased economic activity from the proposed BBD 131.5 million additional to be spent on capital expenditure and greater disposable income for likely budget-constrained lower-income earners will need to more than offset any negative impacts on the middle class to ensure economic growth does not decelerate further. Additionally, the announced taxes on tourists will likely reduce Barbados' price competitiveness as a tourist destination. Therefore, the proposed upgrades to physical infrastructure and other enhancements to the quality of Barbados' tourism product are necessary to ensure no shortfall in growth in visitor arrivals and expenditure.