FISCAL AND STRUCTURAL REFORMS IN SAINT LUCIA: TOWARDS A COMPREHENSIVE AGENDA

NOVEMBER 2016

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Dollars ($) throughout refer to Eastern Caribbean dollars unless otherwise stated

ABBREVIATIONS

bn	-	billion
CARTAC	-	Caribbean Regional Technical Assistance Centre
CDB	-	Caribbean Development Bank
CDP	-	Constituency Development Programme
CG	-	Central Government
CIP	-	Citizenship by Investment Programme
CIT	-	Corporate Income Tax
ECCB	-	Eastern Caribbean Central Bank
ECCU	-	Eastern Caribbean Currency Union
EE	-	Energy efficiency
FDI	-	Foreign Direct Investment
FY	-	Fiscal Year
GDP	-	Gross Domestic Product
GOSL	-	Government of Saint Lucia
IRD	-	Inland Revenue Department
LAC	-	Latin America and the Caribbean
mn	-	million
MSMEs	-	Micro, Small and Medium-Sized Enterprises
NCPC	-	National Competitiveness and Productivity Council
NICE	-	National Initiative to Create Employment
OECD	-	Organisation for Economic Cooperation and Development
OECS	-	Organisation of Eastern Caribbean States
OKEUH	-	Owen King European Union Hospital
p.a.	-	per annum
PCM	-	Project Cycle Management
PEFA	-	Public Expenditure and Financial Accountability Assessment
PFM	-	Public Financial Management
PIT	-	Personal Income Tax
PPP	-	Public-Private Partnership
PSA	-	Private Sector Assessment
PSIP	-	Public Sector Investment Programme
RE	-	Renewable energy
SEMCAR	-	Sustainable Economic Management in the Caribbean
SLASPA	-	Saint Lucia Air and Sea Port Authority
STEP	-	Short-Term Employment Programme
TA	-	Technical Assistance
T-bills	-	Treasury Bills
UK	-	United Kingdom
VAT	-	Value-Added Tax
WB	-	World Bank

EXECUTIVE SUMMARY

1. Notwithstanding the improvement in fiscal performance in the past four years (see Appendix 1), public finances remain on an unsustainable path (see Baseline scenario in Table 1). Sub-optimal economic growth performances[1], coupled with the relatively high cost of borrowing at around 5.6% per annum (p.a.) and primary deficits[2] averaging 1.6% of Gross Domestic Product (GDP) in the past 10 years, have resulted in an upward trajectory for the debt-to-GDP ratio. In addition, the high proportion of short-term debt in the portfolio (about half), due to the market's weak demand for instruments with longer maturities, has created a significant roll-over risk.

2. A study by Kevin Greenidge et al[3] indicates that a debt-to-GDP ratio that is greater than 56% impacts negatively on GDP growth. This negative impact results from the uncertainty among potential investors that is created by an increasing debt ratio, as well as the diversion of government spending away from developmental expenditures towards debt service that is occasioned by an increasing ratio. Moreover, Michael Binder et al[4] find that an increasing debt-to-GDP ratio increases the probability of debt distress. This suggests that restoring debt sustainability needs to be a key priority of macroeconomic policy going forward. In this regard, the imperatives are fiscal consolidation; structural reforms and strategic investments to spur growth; and strategic liability management to reduce debt cost and risks.

3. It is within this context that the tax reduction measures now being proposed by the Government of Saint Lucia (GOSL) in an effort to reduce cost of living and spur economic activity have to be assessed. Although the intention of the proposed policies is laudable, they could have the unintended consequence of undermining fiscal and debt sustainability in the absence of a more comprehensive approach to achieving these objectives. Notably, even if an increase in economic activity were to occur as a result of the proposed polices, given low fiscal multipliers for Saint Lucia, it is not likely that such increases would be of sufficient magnitude to compensate for the revenue loss (see Scenario 1 in Table 1). Consequently, the implementation of compensating measures would be necessary in the near term so that fiscal sustainability is not compromised. The implementation of these compensatory measures should be used as an opportunity for GOSL to close revenue leakages, and reduce inefficiencies that, under normal circumstances, should have been addressed to ensure fiscal and debt sustainability. Such structural reforms would also provide an avenue for GOSL to address some of the deep-seated and binding constraints that have stymied growth.

4. A broader set of policy actions are considered in Scenario 2, which suggests that with some adjustments, GOSL could still meet its debt objective of 60% of GDP by 2030. This scenario outlines three broad groups of measures that should be used to bring about fiscal and debt sustainability. These include: improving the primary balance; enhancing strategic liability management; and promoting economic growth.

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[1] Over the past 10 years, real economic growth averaged just 0.9%.

[2] The primary balance is the overall balance, excluding interest payments, and is a measure of the underlying fiscal effort of GOSL.

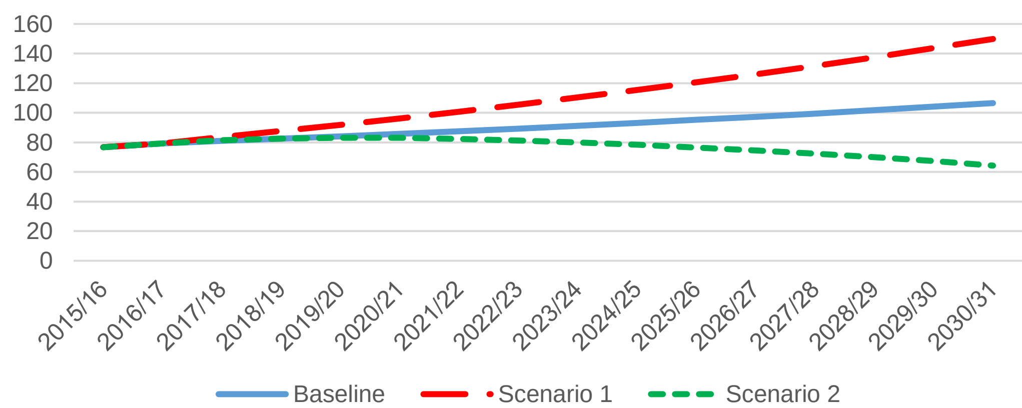
[3] Greenidge, K, L. Drakes, C. Thomas and R. Craigwell (2012) Threshold Effects of Sovereign Debt: Evidence from the Caribbean, IMF Working Paper No. 12/157, International Monetary Fund.

[4] Binder, M., S. Kripfganz and T. Stucka (2015) determinants and Output Growth Effects of Debt Distress, CESifo Area Conference on Macro, Money and International Finance, Munich, Germany.

Table 1: Summary Assessment of Policy Scenarios

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2025/26	2030/31
Baseline Scenario								
Real GDP (% change)	1.2	0.5	1.2	2.0	2.0	2.0	2.0	2.0
CG Debt to GDP Ratio (%of GDP)	76.8	79.3	81.1	82.6	84.1	85.7	95.2	106.5
Primary Balance (% of GDP)	1.5	0.6	0.5	0.3	0.2	0.1	-0.3	-0.4
Overall Balance (% of GDP)	-2.5	-3.5	-4.1	-4.3	-4.4	-4.6	-5.3	-6.1
Scenario 1 - Policy Measures with No Adjustment								
Real GDP (% change)	1.2	0.5	1.2	2.0	2.0	2.0	2.0	2.0
CG Debt to GDP Ratio (% of GDP)	76.8	79.3	83.6	87.7	91.9	96.2	120.7	149.9
Primary Balance (% of GDP)	1.5	0.6	-2.1	-2.1	-2.2	-2.3	-2.7	-2.9
Overall Balance (% of GDP)	-2.5	-3.5	-6.7	-7.0	-7.2	-7.5	-9.1	-11.0
If a higher rate of growth is assumed:								
Real GDP (% change)	1.2	0.5	2.7	2.7	2.7	2.7	2.7	2.7
CG Debt to GDP Ratio (%of GDP)	76.8	79.3	83.5	87.0	90.6	94.3	115.5	140.7
Scenario 2 - Policy Measures with Mitigating Measures								
Real GDP (% change)	1.2	0.5	1.2	2.0	2.0	2.0	2.5	2.5
CG Debt to GDP Ratio (%of GDP)	76.8	79.3	81.4	82.6	83.1	83.1	76.5	64.3
Primary Balance (% of GDP)	1.5	0.6	-0.2	0.1	0.5	0.9	1.8	2.7
Overall balance (% of GDP)	-2.5	-3.5	-4.4	-4.0	-3.4	-3.0	-1.3	0.2

Chart 1 - Debt Trajectory Under Policy Scenarios (% of GDP)



5. With respect to improving the primary balance, efforts should focus on:

(a) enhancing the efficiency of collections by revamping the system of generous exemptions, incentives, deductions, allowances and other derogations; and

(b) containing expenditures on wages/salaries and transfers and subsidies, and limiting capital spending to priority areas with high development impact.

6. Strategic liability management should focus on lengthening the maturity structure of debt and reducing the cost of borrowing. While some emphasis can be placed on seeking longer-term bonds, greater importance must be placed on concessional debt, which typically has a longer maturity structure and is contracted at a lower cost than bonds.

7. In addition to prudent fiscal management, an important element to ensuring fiscal and economic sustainability is unlocking the country's economic growth potential. At present, Saint Lucia's growth potential is around 2%, which is inadequate to reduce the stubbornly high unemployment and raise the standard of living of its citizens. Unlocking growth will require a heavy emphasis on institutional reforms and strategically selected infrastructural expenditure.

8. Some reforms which GOSL should consider include:

(a) exploring the linking of wages increases to productivity in the public sector;

(b) raising labour productivity by enhancing private sector participation in curriculum development to address current skills mismatches;

(c) reducing energy costs and improving energy security by utilising concessional resources and exploring the opportunities for public-private partnerships (PPPs) in the area of renewable energy (RE);

(d) improving access to finance by encouraging financial entities to work closely with entrepreneurs to incorporate adequate flexibility in loan contracts, and supporting the necessary enabling environment to expand equity financing;

(e) encouraging stakeholder participation on national and sectoral issues;

(f) improving business facilitation by addressing institutional inefficiencies, particularly in those agencies that interface directly with the private sector; finalising and enacting insolvency legislation; and removing the barriers that inhibit the process of registering property; and

(g) implementing the central beneficiaries roster to ensure proper targeting of vulnerable groups.

BACKGROUND

The Request

1. During the Caribbean Development Bank's (CDB) mission to Saint Lucia on July 13, 2016, the new government outlined its plans for the future growth and development of the country. One component of the plan was a reduction in the cost of living for its citizens and, in this regard, GOSL determined that the following measures would be beneficial:

(a) A reduction in the rate of the Value-Added Tax (VAT) as a first step towards eventual elimination.

(b) An increase in the Personal Allowance (income tax) from $18,000 to $25,000.

(c) A reduction in the Corporate Income Tax (CIT) to 25% from 30%.

(d) A three-year exemption from the payment of Residential Property Tax.

(e) A 50% reduction in the increase in vehicle license fees[5].

2. An important caveat to these measures, however, was that they should not place undue burden on public finances, compromise fiscal and debt sustainability, or derail economic growth. GOSL requested that CDB conduct a preliminary analysis of the current fiscal and debt situation, and provide policy options to mitigate some of the adverse effects of the proposed policy measures on public finances, in order to achieve its fiscal, debt and growth objectives.

3. In keeping with GOSL's request, the objective of this Paper is to assist policy makers by:

(a) conducting a diagnostic of the current fiscal and debt situation in Saint Lucia;

(b) identifying policy options that could neutralise the adverse effects of the proposed policy measures on public finances; and

(c) outlining the foundation for the design of a comprehensive fiscal and medium-term growth strategy for Saint Lucia.

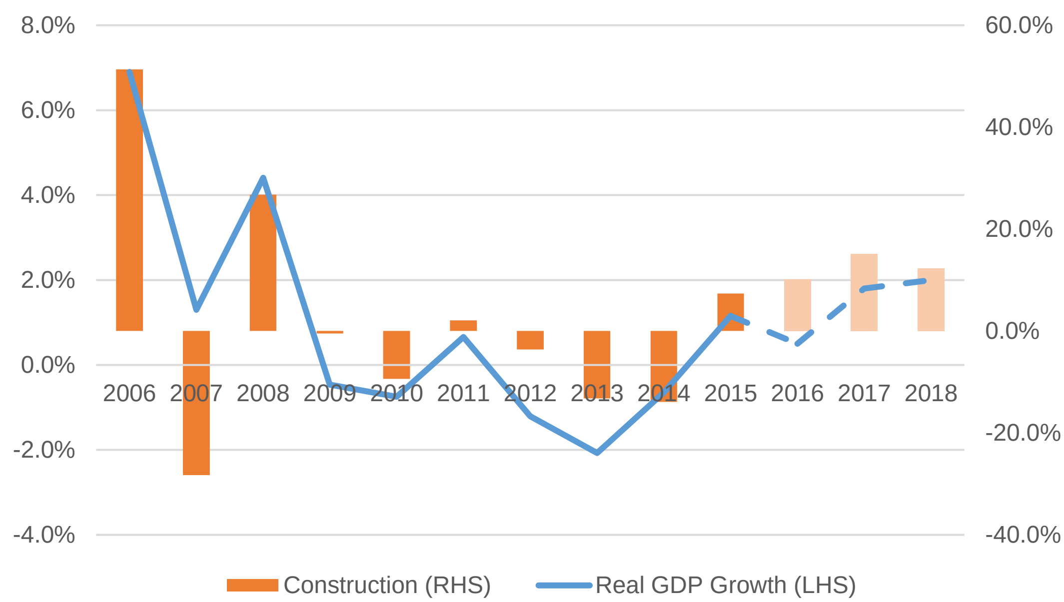
[5] The increase in license fees came into effect June 2015. This increase was halved in September 2016.

1. THE STRUCTURE OF PUBLIC FINANCES

Overview

1.01 In the decade ending 2015, average growth in the economy of Saint Lucia was 0.9% (see Chart 1.1). Over the last five years, Saint Lucia's economic performance has been generally weak, with real output averaging negative 0.4%. Provisional estimates for 2015 show growth of 1.2% but forecasts for 2016 have been revised downward due to the effects of Tropical Storm Matthew. Growth in 2016 is now expected to be around 0.5%, largely on the basis of the damage caused to the agricultural sector. Over the medium term, growth is projected to converge towards 2%, driven by ongoing construction projects; foreign direct investment (FDI)-financed, tourism-related plants; and, to a lesser extent, public infrastructural projects, including roads and bridges. Nevertheless, a higher level of economic activity is critical to improve and sustain social and economic outcomes.

Chart 1.1: Real Gross Domestic Product Growth



1.02 Fiscal policy in Saint Lucia in the past five years was initially expansionary, reflecting GOSL's efforts to incentivise growth following a painstakingly slow emergence from the Great Recession. In 2012, GOSL initiated its three-point plan, which focussed predominantly on short-term job creation through the increased provision of government services and an 18-month stimulus to the construction sector which included, *inter alia,* removing duties and taxes on construction-related items. The third aspect of the plan included efforts to raise collections and simplify tax administration (introduction of VAT) while providing relief to vulnerable groups. Notwithstanding these efforts, structural impediments and relatively weak FDI resulted in lower-than-anticipated growth. With the fiscal deficit widening and debt burgeoning, GOSL adopted more of a restrictive stance as evidenced by the negotiated wage freeze, removal of items from the VAT-exempt list, an increase in the fuel surcharge, and reduction in expenditure on goods and services[6]. There was also some curtailment in capital expenditure which reflected not only a deliberate attempt to contain spending, but also increasing concerns about the ability of GOSL to raise the requisite financing. Indeed, the lack of appetite for medium-to-long term debt, led to an over-reliance on short-term instruments, which now comprise about half the stock of debt. The result of this more restrictive stance, which coincided with an increase in global and domestic economic activity and a pickup in revenues, has been a notable improvement in overall and primary balances and a slowdown in debt accumulation (see Appendix 1).

Revenues

1.03 Revenues from taxes account for 88% of GOSL's annual inflows. Though generally adequate, collections have been undermined by exemptions, zero-ratings, and high deductions and allowances in the major tax categories of VAT, corporation and personal income taxes (PITs). The tax-to-GDP ratio was 24% in 2015, which is consistent with those found in developed countries such as: Luxembourg (25.9%); France (22.6%); the United Kingdom (UK) (25.5%); and above the average of 20.3% for the Organisation of Eastern Caribbean States (OECS) countries in 2015. Further, for the same time period, the tax buoyancy ratio (which is a measure of the responsiveness of tax revenues to changes in economic activity) was found to be relatively high, with a calculated buoyancy coefficient of 1.22, although lower than some other OECS countries such as Antigua and Barbuda (1.36) and Dominica (1.43).

1.04 The tax system has, over time, shifted from reliance on an income-based system to one that is consumption-based. The introduction of VAT in 2012 marked a significant milestone in GOSL's efforts to improve administration and sufficiency. VAT is levied at a rate of 15%, with a threshold of $400,000, and replaced several taxes such as: Consumption Tax; Hotel Accommodation Tax; Cellular Tax; and Environmental Levy. VAT accounts for approximately 50% of indirect tax collections and 37.1% of total tax revenue. This notwithstanding, its performance has been undermined by a plethora of exemptions and the zero-rating of goods. Preliminary indications are that VAT revenue forgone on goods and services in 2014 was around $117.4 million (mn). This amounts to approximately one-quarter of total potential VAT revenue and 3.1% of GDP. In 2015, it was estimated that revenue forgone from zero-ratings and exemptions on goods alone was $44.5 mn or 1.2% of GDP.

1.05 In terms of direct tax collections, there are also high levels of exemptions and allowances related to corporate and PIT. In particular, PIT which account for 11.2% of revenues suffer from a schedule of deductions and allowances which appear to: (a) disproportionately benefit the middle and upper-income levels; (b) provide inadequate support to vulnerable groups and educational advancement; and (c) be susceptible to abuse, as some deductions are without limit or do not require documentation[7].

Some consideration should be given to raising the deduction for higher education ($5,000) as an inducement for post-secondary education, especially as one of the root causes of unemployment is the undersupply of skills at the post-secondary level. Also, as the dynamics of households change and the number of single-parent households increases, so too can the financial burden of caregiving, especially those headed by females (on whom the responsibility tends to fall). A

[6] In March 2016, in an effort to improve administration and reduce the compliance burden of small tax holders, the VAT threshold was raised to $400,000.

[7] Some examples of deductions which could be reviewed include those for mortgage payments ($18,000); insurance premia on owner-occupied residential property ($10,000); and deductions for costs incurred for the up-keep of owner-occupied property ($10,000). See Appendix 2 for details.

view toward raising the deduction for child maintenance ($2,000), as well as that for dependent relatives ($350), could help to ease the burden on single-parent households, especially for female-headed households. Lastly, there are those deductions which are open to misuse. These include: (i) medical expenses without a claim form ($400); (ii) medical expenses without a limit that are only claimable if it exceeds $400; and (iii) deductions for professional subscriptions (no limit).

1.06 Corporation taxes currently levied at 30% are another important source of revenue and account for an estimated 32% of tax receipts. There is, however, some evidence to suggest that performance of this category is being undermined by derogations in the form of, *inter alia,* the Fiscal Incentives Act; Micro and Small-Scale Business Act; Tourism Incentive Act; Special Development Areas Act and the temporary Cricket World Cup Incentive Act. Tax holidays of up to 25 years, as well as reduced corporate tax rates, have been used to incentivise private sector investment in the manufacturing, agricultural, and tourism sectors. In addition, incentives can also be granted by Cabinet Conclusion, as in the case of the construction stimulus package of 2012.

1.07 In light of the preceding discussion, GOSL should seek to review the system of taxation with the aim of enhancing efficiency, equity and transparency. Closing revenue leakages in the major tax categories such as VAT, PIT and corporation tax should be an imperative, particularly in light of proposed policy actions. With respect to PIT, there may also be scope to further address the needs of vulnerable groups, namely females and their dependents through gender-responsive budgeting. This would ensure, among other things, the more equitable use of deductions/allowances. Additionally, the use of Cabinet concessions to incentivise private sector activity, and especially where these decisions are not made publicly available, should be limited, as it does not promote transparency or ensure predictability. In this regard, GOSL should consider the use of omnibus legislation to cover the range of concessions across various sectors, and in the event that a Cabinet Conclusion is required, the publishing of these decisions. Lastly, GOSL should seek to conduct and publish annual tax expenditure reports to better engage in cost-benefit analysis of incentives.

Expenditure

1.08 Total spending (approximately 30% of GDP) is consistent with that of the other OECS countries, but remains in excess of revenue collections. The composition of spending exhibits a similar pattern to that of other OECS countries, with a preponderance of spending on recurrent items. By far, the most significant component of recurrent spending is wages and salaries, which accounts for 9.7% of GDP, or 0.43 cents of every tax dollar. This was mainly attributed to negotiated salary increases and growth in the public sector. Over the period Fiscal Year (FY) 2005/06 to 2010/11, wages and salaries grew on average by 6.5%, with inflation over the same period averaging 3.1%. Notably, over the past four years, wages and salaries have stabilised at about $380 mn, reflecting marginal declines in employment (less than 1%) and the wage freeze for the last triennium. Going forward, GOSL needs to implement additional measures to either reduce recurrent spending and/or improve the efficiency of government spending. Related to the latter, the issue of public sector productivity needs to be addressed frontally, in particular the linking of wages to productivity (see Appendix 2 for further details).

1.09 In the past five years, the ratio of interest payments to current spending has gradually increased from 13.6% to 17.8%. This is largely due to the rising stock of debt, which increased by 34.5% to $2.8 billion (bn) over the same period and, to some extent, the growth in the average effective interest rate, which increased from 5.2% to 5.8%. Upward pressures are also evident in current transfers, which have been increasing steadily as a result of rising retirement benefits and transfers to statutory corporations. This trend is likely to continue in the foreseeable future, especially with the Owen King European Union Hospital (OKEUH) coming on stream. GOSL has kept the level of spending on goods and services in check. Indeed, this category of expenditure has managed to decline from about 5% of GDP in FY 2012/13 to 4.4% in FY 2015/16. Nevertheless, these expenditures could increase over time, owing to goods and services required for the maintenance of new facilities in the health sector, as well as leasing/rental arrangements, owing to the unsafe working conditions of some Government buildings which required the relocating of some staff.

1.10 Capital spending has been declining almost consistently since 2011-12, driven in part by a desire to rein in the deficit but also, to some extent, the inability to raise required financing. Over the period 2008-09 to 2012-13, the deficit had deteriorated from 1.1% to 9.3% of GDP. There are two fundamental, but related, challenges which seem to be affecting capital spending: (a) strategic relevance; and (b) low returns.

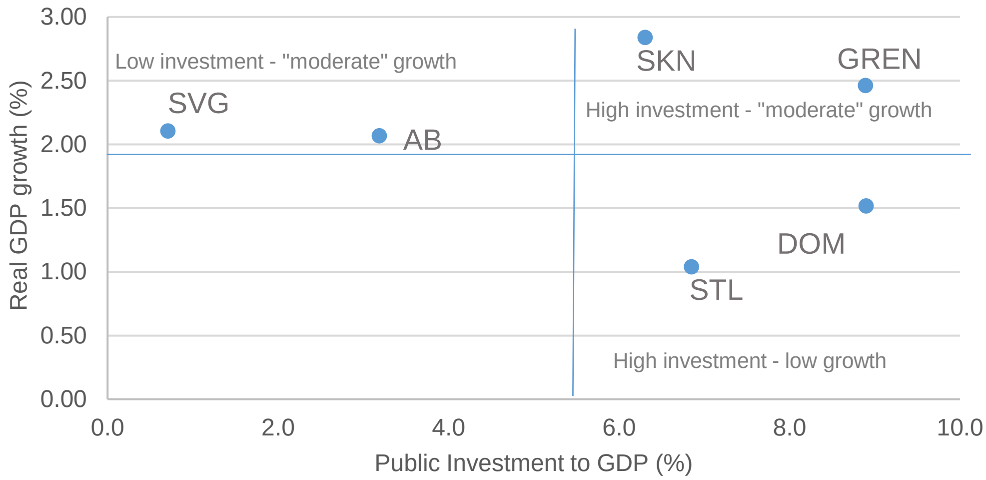
With respect to strategic relevance, there is need for a sound planning framework that clearly articulates the development priorities of GOSL and feeds into a well-formulated, properly-costed and monitored public sector investment programme (PSIP). Indeed, reviews of the PSIP and macroeconomic frameworks conducted by CDB (2012 and 2016, respectively) point to the need for greater coordination between planning agencies and linkages of the various planning and budget documents, as the present fragmentation is leading to inefficiency. Concerns have also been raised about the returns to capital investment. With an incremental capital output ratio[8] of nearly 7 over the period 2000 to 2015, compared to 5.6 for the United States, 3.9 for Singapore and 2.8 for Trinidad and Tobago. There appears to be some level of inefficiency in capital investment. This may be reflective of a sub-optimal mix of projects, the need to strengthen project cycle management and existing structural rigidities.

1.11 Chart 1.2 plots average real growth against public investment across OECS over the period 2000 to 2015. Apart from the non-achievement of growth above 3% for OECS over the period, the chart reveals that for the given level of expenditure, growth in Saint Lucia has been particularly low and may suggest the need for investment in projects with greater development impact. A review of the capital expenditure outturn indicates that, as a group, small-scale construction and short-term employment initiatives received $43 mn, or about one-quarter of major capital spending in FY 2015/16[9], suggesting that there may be some room for streamlining and targeting of expenditures in areas of greater development impact. These interventions included the Short-term Employment Programme (STEP), the National Initiative to Create Employment (NICE) and the Constituency Development Programme (CDP).

[8] The incremental capital output ratio is a measure of the ratio between investment to growth. It is the additional capital required to increase output by one unit.

[9] Source: Social and Economic Review 2015.

Chart 1.2: Real Gross Domestic Product and Public Investment



Debt

1.12 In tandem with the gradual improvement in public finances, there has been slower growth in the debt stock with a very gradual rise in the domestic component. Currently, the majority of domestic debt is held by financial institutions, such as commercial banks and insurance companies, and is being sourced at higher interest rates compared with those obtained externally. Indeed the effective interest rate on external debt was found to be around 3.7%, compared with 7.5% for domestic debt. Additionally, almost 70% the stock of domestic debt consisted of short-term obligations and stood at $1.5 bn at the end of 2015. On the external side, the majority of debt is held by the multilaterals and commercial market, and tends to be long term (in excess of 10 years). Government-guaranteed debt has been declining consistently for the past five years and is relatively small, amounting to less than the equivalent of 2% of GDP.

1.13 Although GOSL engages in active debt management, market appetite for short-term debt has resulted in GOSL having to roll over $337.4 mn in short-term debt. During FY 2015/16, GOSL found it difficult to raise the budgeted amount of bond financing, falling short by $112.6 mn[10], an indication of the ongoing preference by investors for shorter-term financing. Cognisant of this, the debt strategy proposed over the medium term seeks to lengthen the maturity structure. More specifically, the strategy speaks to the gradual minimisation of Treasury Bills (T-bills) in favour of longer-term bonds with a lengthening in the maturity from 2-year bonds in the first instance, to 5, 10, and 15-year bonds by FY 2020/21. Notably absent, however, is the targeting of concessional resources to keep down the cost of debt, which could be invaluable in improving the cost and maturity profile of the debt.

[10] Source: Medium-term Debt Strategy.

Public Financial Management

1.14 Saint Lucia has been making some strides to strengthen public financial management (PFM). GOSL receives ongoing support from: the Caribbean Regional Technical Assistance Centre (CARTAC) in the area of customs and administration; the Eastern Caribbean Central Bank (ECCB) in the area of debt management and financial programming; the World Bank (WB) in the area of debt reporting; and, more recently, the Sustainable Economic Management in the Caribbean (SEMCAR) in drafting the PFM Bill. The Inland Revenue Department (IRD), with the support of CARTAC, is also being restructured and streamlined for efficiency. Currently, the Department is divided along operational lines, as opposed to tax category, which existed previously. There are now dedicated units which monitor large and medium-sized taxpayers, as well as a small and micro taxpayer section. Dedicated units have also been put in place to monitor filing compliance and collections. The reform process is expected to be completed by June 2017. Also, in 2015, Saint Lucia enacted procurement legislation which, *inter alia,* should facilitate improved competition for Government contracts and help to ensure value for money.

1.15 Notwithstanding the strides made thus far, there are other PFM issues which still need to be addressed and include: quality and timeliness of annual financial statements; the incorporation of a multi-year perspective in fiscal planning expenditure policy and budgeting; closing the gap between actual aggregate expenditure, compared to original approved budget; and reducing the levels of accounts payables, which stood at $22 mn at the end of December 2015. See Appendix 2 for a more fulsome discussion on the structure of public finances.

2. ASSESSMENT OF POLICY FRAMEWORK

The Proposed Policy Measures

2.01 Against the backdrop of its objective to stimulate economic growth in a demand-centred Keynesian approach, GOSL has indicated its intention to: (a) reduce VAT[11]; (b) increase the PIT threshold; (c) reduce the corporate tax rate from 30% to 25%; (d) grant an exemption from the payment of residential property tax for three years; and (e) reduce licenses (implemented September 1, 2016).

2.02 In assessing the proposed policy changes, consideration is given to: (a) technical feasibility, which speaks to the practicality of the proposed measure; (b) fiscal viability, which seeks to identify direct and indirect costs and benefits; (c) administrative operability, which encapsulates issues of monitoring and compliance; and (d) social acceptability which speaks to the tolerance of the citizenry for the proposed measure. The assessment of the proposed measures using these four criteria is summarised in Table 3.1.

Table 3.1: Tax Measures Against Selected Criteria

Proposed Policy Change	Technically Feasible	Fiscal Viability	Ease of Administration	Socially Acceptable
VAT Reduction	Yes. Legal and regulatory framework should be easily able to accommodate.	No. Will cost an average of 1.6% of GDP. Significant revenue loss will further compromise fiscal and debt sustainability. Low fiscal multipliers suggest negligible positive impact on growth. Any small impact on economic growth is likely to be through import-led consumption, which is unsustainable over the long term (see Appendix 3).	Yes. Reforms currently being undertaken in IRD should also facilitate administration.	Yes. Improves the progressivity of the system.
Increase in Personal Income Threshold	Same as above.	Moderate. Will cost approximately 0.4% of GDP. Similar economic impact to above.	Same as above.	Yes. Will benefit poorer households.
Reduction in CIT	Same as above.	Moderate. Could cost an average of 0.3% of GDP. Similar economic impact to above.	Same as above.	Yes. Profitability could increase *ceteris paribus*, and/or a small component could be passed on to the customer.
Property Tax Exemption	Same as above.	Yes. Minimal impact at just over 0.1% of GDP.	Same as above.	Yes. However, given that there was an adjustment to property taxes just two years ago, measure could create perverse incentive as taxpayers may expect further adjustments
Reduction in License Fees	Same as above.	Yes. Minimal impact at less than 0.1% of GDP.	Same as above.	Yes. Will facilitate private and commercial business especially MSMEs.

[11] It is the intention of Government to reduce VAT in the near term with a view toward the elimination and replacement with another consumption-based tax which will be announced in due course.

Scenarios

2.03 In this section, two scenarios are contemplated based on the tax policy proposals enunciated in the 2016 manifesto and discussions with GOSL. The third scenario, which contemplates mitigating measures to offset revenue losses, is presented in Chapter 4 within the proposed policy framework for fiscal and debt sustainability. In developing the scenarios, the implications for medium- and long-term fiscal and debt sustainability, and the attainment of specific objectives articulated by GOSL, were assessed. The specific objectives include: (a) the reduction of the debt-to-GDP ratio by 5 percentage points in 5 years and; (b) a reduction in the debt-to-GDP ratio to 60% by 2030, as agreed to by the Eastern Caribbean Currency Union (ECCU) Monetary Council. Reinhart and Rogoff (2010) and Greenidge *et al* (2012), show that a debt-to-GDP ratio above 60% acts as a drag on economic growth by: reducing fiscal space and diverting resources away from priority areas, such as infrastructural and institutional development and the provision of social services for vulnerable persons. Insufficient fiscal space reduces government responsiveness in the event of an exogenous shock such as a natural disaster and acts as a deterrent to private sector investment by fostering expectations of adjustment policies that can alter risk-return profiles.

2.04 The debt dynamics utilised in the framework are based fundamentally on the following equation:

$$\Delta d_t = \left[\frac{i_t - g_t}{1 + g_t}\right] d_{t-1} - pb_t$$

where:
'Δd_t' represents the change in the total debt stock expressed as a percentage of GDP;
'd_t' is the stock of debt as a ratio to GDP;
'g_t' represents the growth in nominal GDP;
'i_t' represents the average effective interest rate on debt; and
'pb_t' represents the primary balance as a ratio to nominal GDP

2.05 The equation provides a framework for assessing the impact of GDP growth, average effective interest rates, and the primary balance in relation to GDP on the evolution of the debt-to-GDP ratio. It also indicates the policy imperatives for reducing the debt-to-GDP ratio. The equation emphasises the importance of GOSL generating adequate primary balances in order to reduce the debt-to-GDP ratio, and the importance of the relative rates of economic growth and interest rates, i.e. interest rates in excess of the nominal growth rate puts upward pressure on debt, while a higher growth rate relative to interest rate has the opposite effect.

Baseline Scenario

2.06 This scenario assumes that there is no policy change. It also assumes that Saint Lucia maintains a medium-to-long-term real economic growth rate of 2%, which is consistent with its current long-term growth potential, and that nominal growth is in the vicinity of 3.6%. Additionally, the average effective interest rate on new borrowing is assumed to be 6.0%, given the increase in average effective interest rate over the past five years. Table 2.1 and Chart 2.1 show that in the existing policy environment, debt dynamics are unsustainable with the Central Government (CG) debt increasing steadily over the forecast horizon, reaching 106.5% of GDP by 2030. While GOSL could conceivably generate primary surpluses initially, they are eventually eroded and contribute negatively to debt dynamics. Also contributing adversely to debt is the inadequate growth in the face of the relatively high cost of borrowing.

Chart 2.1: Central Government Debt to Gross Domestic Product (%)

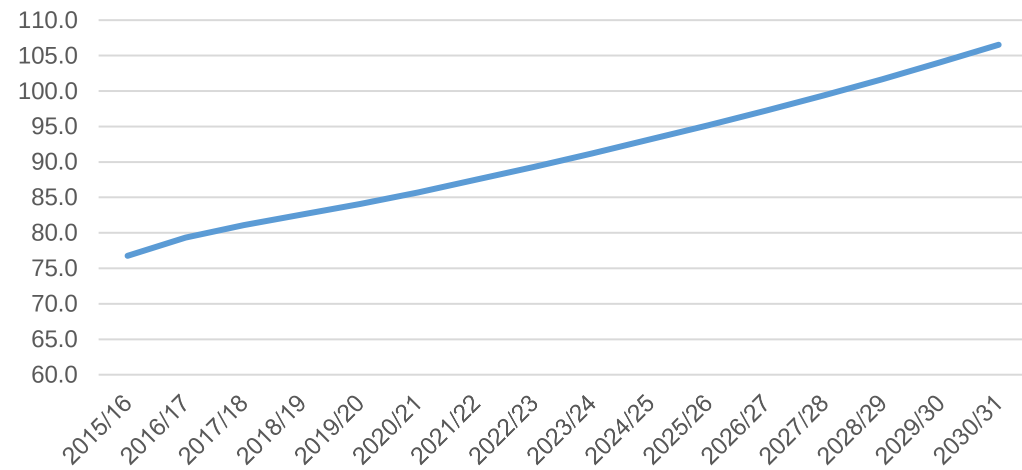


Table 2.1: Baseline Scenario

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2025/26	2030/31
Real GDP (% change)	1.2	0.5	1.2	2.0	2.0	2.0	2.0	2.0
CG Debt to GDP Ratio (% of GDP)	76.8	79.3	81.1	82.6	84.1	85.7	95.2	106.5
Primary Balance (% of GDP)	1.5	0.6	0.5	0.3	0.2	0.1	-0.3	-0.4
Overall Balance (% of GDP)	-2.5	-3.5	-4.1	-4.3	-4.4	-4.6	-5.3	-6.1
Endogenous Debt Dynamics	1.7	3.5	2.2	1.6	1.4	1.4	1.3	1.4
of which:								
Contribution from Interest Rate	4.1	4.0	4.5	4.5	4.5	4.5	4.9	5.5
Contribution from Growth	-2.4	-0.6	-2.2	-2.8	-2.9	-2.9	-3.3	-3.6
Memo Item:								
Growth Rate (Nominal) (% change)	3.2	0.8	2.8	3.6	3.6	3.6	3.6	3.6

Scenario 1: Implementation of Proposed Revenue Measures

2.07 This scenario considers the effects of major policy changes[12]. These include: (a) a reduction in VAT to 12.5% effective FY 2017/18; (b) a reduction in CIT from 30% to 25%;
(c) an increase in the threshold of PIT from $18,000 to $25,000; (d) exemption of residential property taxes for three years; and (e) a reduction in motor vehicle licenses[13].

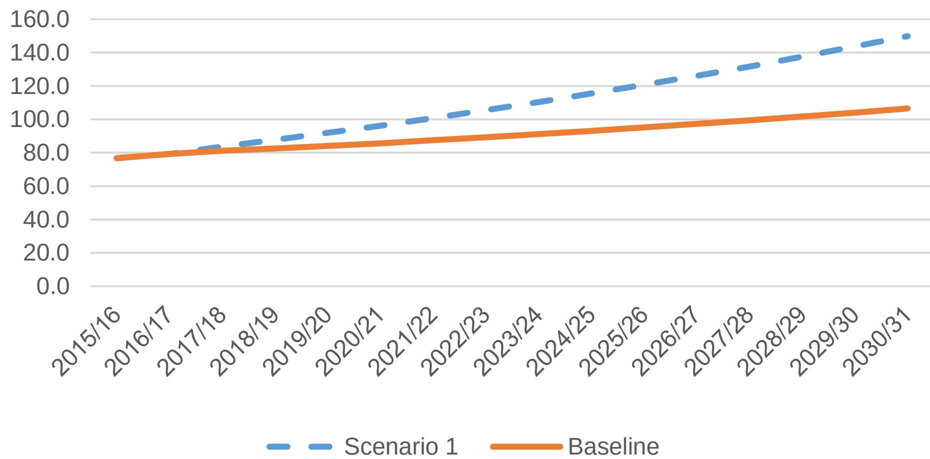
[12] Notably, an April 1 implementation for VAT was deemed more practical than implementation in the third quarter of FY 2016/17, due to the high inventory levels that would already have been accumulated in preparation for Christmas.

[13] In estimating the effect of a VAT reduction, the principle assumption imposed was that vatable sales increased in line with GDP and that the level of compliance remains unchanged. With respect to PIT, revenue calculations were based on the assumption that an additional 3,000 persons were removed from the tax net, *ceteris paribus*. Lastly, property taxes were forecast on the assumption

With the exception of the reduction in license fees, which took effect September 1, 2016, policy changes are assumed to take effect April 1, 2017.

2.08 Chart 2.2 and Table 2.3 indicate that, in the face of negligible fiscal multipliers, significant revenue leakage and no curtailment in expenditure, GOSL would not be able to attain its debt objectives of a 5 percentage point reduction in the debt-to-GDP over five years, or 60% of GDP by 2030. On the contrary, debt levels will could reach 150% of GDP by FY 2030/31. In the first year, the cost of reforms is negligible, assuming that the only measure implemented is the reduction in license fees (0.04%). For the full implementation of the measures, which begins in FY 2017/18, the average cost p.a. is 2.55% of GDP over three years (see Table 2.2).

Chart 2.2: Central Government Debt to Gross Domestic Product Ratios (%)



2.09 Notably, even if the assumption of 12% cumulative real growth over 5 years is imposed on the framework as a stated objective of GOSL, it would be insufficient to alter the trajectory of debt (see Table 2.3 memo item). In order to reduce the debt-to-GDP ratio to 60% by 2030/31 under this scenario, the economy would have to grow between 10 and 12% p.a. in real terms. In practice, while the tax measures could provide some relief to vulnerable groups initially, the increasing debt stock would require some fiscal adjustment at a later date due to challenges in meeting critical payments such as wages, social services, debt service or capital investment. The debt dynamics of Table 2.3 suggest that while the running of primary deficits over the forecast horizon will contribute to the accumulation of debt, the main contributor is the relatively high interest rate, particularly in the face of low growth. Under these circumstances, CDB estimates that GOSL would need to maintain a primary surplus of around 3% of GDP p.a. in order to reach its debt target of 60% of GDP by 2030. In the past 10 years, the largest primary surplus attained by GOSL was 1.9% in FY 2008/09.

that approximately half of revenues were collected from residential properties, while license fees were reduced by 50% of the previously announced increase.

Table 2.2: Impact of Tax Measures (% of Gross Domestic Product)

Policy Measures	2016/17	2017/18	2018/19	2019/20	2020/21
VAT Reduction		1.58	1.62	1.66	1.71
Increase in PIT Threshold		0.45	0.43	0.42	0.40
Reduction in Corporation Tax		0.34	0.34	0.34	0.34
Amnesty on Property Tax		0.13	0.13	0.13	0.00
Reduction in the Increase in Licenses	0.04	0.06	0.05	0.05	0.05
Total	**0.04**	**2.56**	**2.57**	**2.6**	**2.50**

Table 2.3: Scenario 1 – Policy Measures without Adjustment

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2025/26	2030/31
Real GDP (% change)	1.2	0.5	1.2	2.0	2.0	2.0	2.0	2.0
CG Debt to GDP Ratio (% of GDP)	76.8	79.3	83.6	87.7	91.9	96.2	120.7	149.9
Primary Balance (% of GDP)	1.5	0.6	-2.1	-2.1	-2.2	-2.3	-2.7	-2.9
Overall Balance (% of GDP)	-3.5	-6.7	-7.0	-7.2	-7.5	-3.5	-9.1	-11.0
Endogenous Debt Dynamics	1.7	3.5	2.3	1.8	1.7	1.7	2.1	2.8
of which:								
Contribution from Interest Rate	4.1	4.0	4.5	4.7	4.8	5.0	6.2	7.8
Contribution from Growth	-2.4	-0.6	-2.2	-2.9	-3.1	-3.2	-4.0	-5.0
Growth Rate (Nominal) (% change)	3.2	0.8	2.8	3.6	3.6	3.6	3.6	3.6
Memo Item: If GOSL's objective of 12% cumulative growth is realised:								
Real GDP (% change)	1.2	0.5	2.7	2.7	2.7	2.7	2.7	2.7
CG Debt to GDP Ratio (%of GDP)	76.8	79.3	83.5	87.0	90.6	94.3	115.5	140.7

Conclusion

2.010 Under the baseline scenario, the objectives that GOSL has set for itself will not be realised, as fiscal balances and debt are set to become even more unsustainable. Taken on their own, the proposed measures to reduce taxation will exacerbate already unsustainable debt dynamics and, in so doing, impede GOSL's ability to provide the enabling environment for growth and support to vulnerable groups. The implementation of mitigating measures will be necessary so that the functions of Government are not compromised. Importantly, these measures can be viewed as an opportunity for GOSL to close revenue leakages and reduce inefficiencies, which are needed to ensure fiscal and debt sustainability.

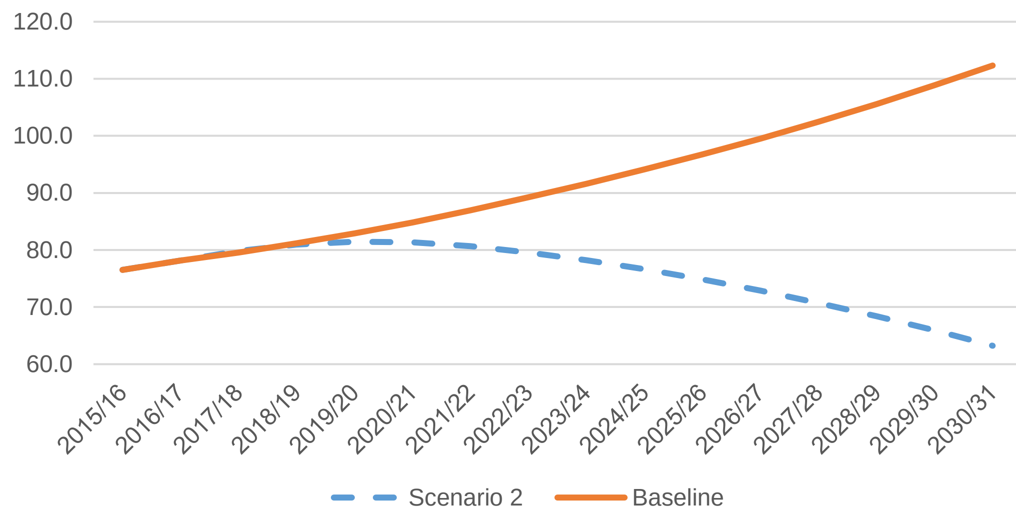
3. ACHIEVING FISCAL AND DEBT SUSTAINABILITY: A SUGGESTED POLICY FRAMEWORK

3.01 In light of the previous discussion which highlighted the unsustainability of proposed tax measures on their own, mitigating measures will need to be implemented to ensure that public finances remain sound, and that GOSL can adequately provide goods and services. Consequently, Scenario 2 contemplates the same tax adjustments in Scenario 1, but with mitigating revenue and expenditure measures. All quantifiable mitigating efforts are assumed to take place in FY 2017/18. Additionally, a higher level of real GDP growth is also assumed in this scenario on the assumption of a pickup in global economic activity and greater private investment. Notably, there are some measures that cannot be currently quantified, as more specific and detailed assessment would be required (e.g. the use of the central beneficiaries register as the primary avenue of providing support to vulnerable groups). Proposed mitigating measures, along with the likely impact on public finances, are summarised in Table 3.1. While the following measures should help to strengthen public finances and place the country on a path to fiscal and debt sustainability, structural measures to enhance competitiveness and growth will also be paramount and are summarized in the following chapter. This is not an exhaustive list of reforms, but an indication of the type of correction that is needed to bring about long-term fiscal and debt sustainability.

Table 3.1: Scenario 2 – Summary of Mitigating Measures

Policy Measure	Average Impact on Fiscal Balance over Forecast Period (% of GDP p.a.)
Reducing by one quarter, the revenue loss from VAT-exempt and zero-rated goods and services. In taking items out of the tax-exempt and zero-rating category, priority consideration should be given to educational needs, as well as specific vulnerable groups such as: children; women; the elderly; and the disabled.	+1.7%
Limiting the growth in the wage bill to inflation until a performance-based pay system is implemented (FY 2020/21).	+2.6%
Cap transfers to statutory corporations at 2016/17 levels.	+0.7%
Prioritise capital expenditures to focus on projects with high development impact. For the purpose of analysis this was proxied by holding capital expenditure constant at FY 2016/17 levels as a ratio to GDP. Prioritisation will require improvements in project cycle management and management of PSIP to ensure that strategically relevant projects are identified and executed in a timely fashion.	+1.0%
Reduce the cost of borrowing by utilising more concessional resources (assumes a reduction of 1.5 percentage points on new borrowing from 6% in baseline scenario).	+1.5%
A 15% reduction in import duties forgone	+1.0%

Chart 3.1: Debt to Gross Domestic Product (%)



3.02 Chart 3.1 and Table 3.2 illustrate that with added fiscal effort, GOSL can approach the 60% of GDP target by FY 2030/31. An important assumption, however, is about stepped-up growth over the medium term, which, along with the stabilisation measures taken above in Table 3.1, have a positive impact on the dynamics of debt to reduce the stock over time. As can be seen from Table 3.2, the attainment of primary surpluses along with the higher contribution of growth relative to interest rates, acts to reduce the stock of debt. While under this scenario the stock of debt nears 60% by the target date, the 5 percentage point reduction in five years (by FY 2021/22) is not attained. To meet this target would require extraordinary fiscal effort with unacceptable social consequences and/or exceptional growth.

Table 3.2: Scenario 2 – Policy Measures with Adjustment

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2025/26	2030/31
Real GDP (% change)	1.2	0.5	1.2	2.0	2.0	2.0	2.5	2.5
CG Debt to GDP Ratio (% of GDP)	76.8	79.3	81.4	82.6	83.1	83.1	76.5	64.3
Primary Balance (% of GDP)	1.5	0.6	-0.2	0.1	0.5	0.9	1.8	2.7
Overall fiscal balance (% of GDP)	-2.5	-3.5	-4.4	-4.0	-3.4	-3.0	-1.3	0.2
Endogenous Debt Dynamics	1.7	3.5	1.9	1.2	0.9	0.8	0.0	-0.1
of which:								
Contribution from Interest Rate	4.1	4.0	4.1	4.1	3.8	3.8	3.1	2.6
Contribution from Growth	-2.4	-0.6	-2.2	-2.9	-2.9	-2.9	-3.1	-2.7
Growth Rate (nominal) (% change)	3.2	0.8	2.8	3.6	3.6	3.6	4.1	4.1

3.03 Essentially, the attainment of fiscal and debt sustainability rests on three pillars: (a) enhanced strategic liability management; (b) improvement in the primary balance; and (c) faster economic growth. These are each discussed in turn below.

Strategic Liability Management

3.04 Strategic liability management is critical to long-run fiscal and debt sustainability. As was shown prior, the interest rate contribution to the evolution of debt, assuming current interest rates obtain, can be significant. Although GOSL's medium-term debt strategy contemplates the lengthening of the maturity structure by seeking longer-term bonds, focus should also be placed more explicitly on securing concessional financing. These resources have the advantage of both lengthening the maturity structure and lowering the cost of debt. Indeed, some concessional loans available, particularly from multilateral financial institutions, have repayment periods of up to 25 years with interest rates at less than 3% and in some instances, 0%. In pursuing multilateral credit, it is necessary to have a proper planning framework in place, as high importance is placed on the procurement process, which can take some time. Having a supportive planning process in place, including a robust project cycle management system, can help to ensure that funds are available in a timely manner. In addition to spending on priority capital projects, multilateral finance can also be a useful form of budget support in the presence of a robust home-grown reform programme.

Primary Balance

3.05 The primary balance is an important determinant in the evolution of debt. If it assumed that the interest rate will continue to exceed nominal growth, as has generally been the case in Saint Lucia, then primary balance becomes even more critical to the time path of debt. The measures proposed above should place Saint Lucia on the path towards attaining a primary surplus while, at the same time, helping to reduce the interest rate growth differential. Nevertheless, there are other measures that could be implemented that would further help to improve primary balances. These are provided in Table 3.3:

Table 3.3: Policy Measures

Policy Measures
Over the medium term, utilise the central beneficiaries register as the primary conduit to support poor and vulnerable groups and, in so doing, remove existing broad-based subsidies on liquid petroleum gas, flour, sugar and other items currently benefitting from this policy.
In the near term, require tax clearances for all companies seeking exemptions, incentives or any form of support from GOSL. Over the medium to long term, the issue of incentives and exemptions could be addressed through omnibus legislation, which should also limit the use of ministerial discretion and enhance transparency.
Review the training policy in the education sector to grant salary increases only to those persons who undertake additional training in areas GOSL deems critical.
Review rental/lease arrangements which are currently costing GOSL approximately $37 mn per year.
Set aside a portion of flows (no less than 10%) from the Citizenship by Investment Programme (CIP) in a sovereign wealth for stabilisation in the event of an exogenous shock, namely economic downturn, financial sector risk or natural disaster. This fund could also have a second component with the added objective of saving for posterity.
Consider increasing the excise tax rate on vehicles over a certain engine size, e.g. 1800cc

Policy Measures
Consider increasing the excise tax on cigarettes and alcoholic beverages
Consider reducing spending on foreign missions

Facilitating Growth

3.06 In addition to prudent fiscal management, the key to ensuring long-run fiscal and economic stability is fully unlocking and raising the country's economic growth potential. At present, Saint Lucia's growth potential is around 2%, which is inadequate to reduce stubbornly high unemployment and raise the standard of living of its citizens. Addressing this will require a heavy emphasis on institutional and, to a lesser extent, infrastructural reforms. Some specific interventions will be required to maximise growth in those sectors with the most export potential. For example, in the agricultural and manufacturing sectors these may include measures to: address the low rates of technology adoption; promote proper product labelling, presentation and packaging of goods; and engage in trade facilitation in target markets. In the tourism sector, this can include: a greater effort to tap into emerging markets; taking advantage of emerging opportunities in medical tourism; and enhancing the provision of services and skills to the yachting sector. These and other issues and opportunities are expected to be more fully ventilated in the proposed strategic planning framework CDB is seeking to provide.

3.07 The slow rate of economic activity in Saint Lucia can be attributed in part to the sluggishness in the global economy, but structural factors are also at work and include: (a) low labour productivity; (b) weak governance systems in policymaking (transparency, accountability and predictability); (c) high energy costs; (d) insufficient access to finance; (e) inadequate infrastructure; and (f) institutional fragilities, especially those interfacing directly with the private sector.

While these are mentioned separately, they are all inter-related and, as such, complementary, and will be elaborated upon in the following section.

4. ENHANCING GROWTH FOR ECONOMIC AND FISCAL SUSTAINABILITY

4.01 The need to accelerate and sustain economic growth and development is particularly challenging for small island economies like Saint Lucia's, given limited resource endowments, labour market rigidities and, importantly, the high degree of vulnerability to exogenous shocks. The small size of the domestic market suggests that Saint Lucia should pursue a more export-oriented strategy if the growth trajectory is to be elevated and sustained. At the same time, vulnerabilities to a plethora of shocks suggest that it must also seek to reduce exposure to risks, both natural and economic, while improving resilience. Fundamentally, this will require countries accelerate reforms that will broaden the economic base, spur competitiveness and reduce export concentration. The following sections attempt to identify those areas CDB believes can accelerate economic growth.

Productivity

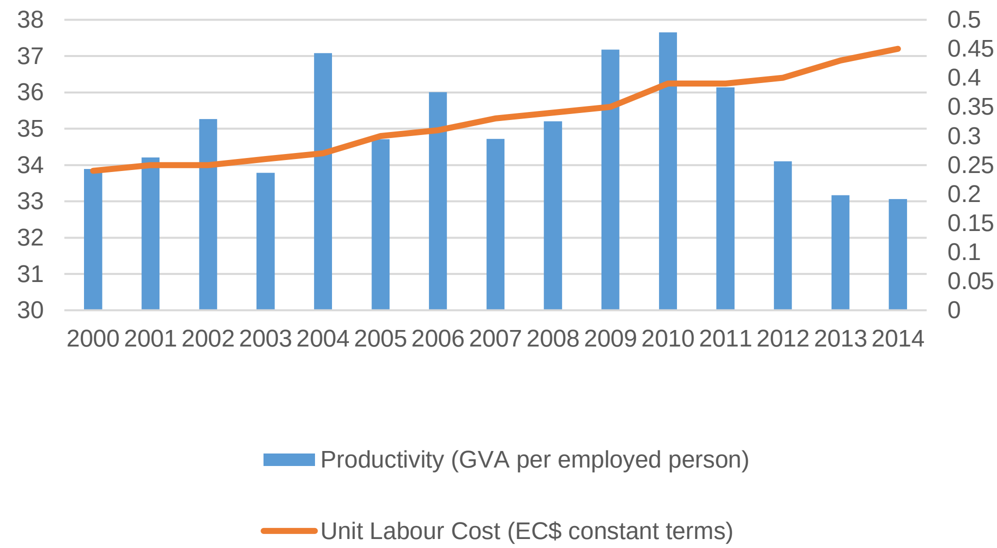
4.02 The Saint Lucia Productivity Summary Report (2000-2015) indicates that due to faster employment growth of 1.3% relative to that of gross value added (1.1%), productivity levels have fallen by an average of 0.21% p.a. over the 15-year period. The Private Sector Assessment (PSA) of Saint Lucia (2013) and discussions with key stakeholders have suggested that the following factors may have contributed to the decline in productivity:

(a) **Low rate of technological adoption**: The adoption of new technology can be a critical success factor, particularly in a dynamic and increasingly competitive environment. The adoption of new technology can reduce costs, improve efficiency, decrease the time to market, and improve product quality. While this was raised as an issue hindering both public and private performance in discussions with the National Competitiveness and Productivity Council (NCPC), the most recent data is from WB's enterprise survey of 2010. In the manufacturing sector, none of the firms surveyed used licensed technology from foreign companies; less than 1% obtained international quality certification on production processes, compared to the OECS average of 13%; and only 15% had their own website, compared to 34% for their comparators. The adoption of new technology as a challenge for the public sector, was also corroborated by mission findings which indicated that there were efficiency opportunities in the adoption of technology that would allow a shared interface between the Inland Revenue and Customs Departments, as well as the implementation of International Public Sector Accounting Standards which could improve overall management and planning.

Recommendations*:* GOSL, through its small business funds, should further incentivise existing small businesses to adopt new technologies (possibly through more favourable repayment terms), once the appropriate qualifying criteria have been met. In the public sector, GOSL should seek to obtain concessional financing to support the upgrading or adoption of new technologies.

(b) **The need for an appropriately trained and skilled workforce**: The shortage of requisite skills in Saint Lucia is reflected in high unemployment, particularly among the youth. At March 2016, the unemployment rate was around 22.1%, with youth unemployment at 45.3%. Although a number of programmes have been implemented over the last four years to create jobs for young persons, the unemployment rate averaged over 24%, due to large annual inflows into a labour force with very little absorptive capacity. In a 2012 survey of firms, 44% and 31% of the demand for new employees was for persons with tertiary and secondary (CXC) level education respectively. However, 60% of job seekers possessed below secondary education while 33% held CXCs and only 7% had tertiary qualifications. This variance between the demand and supplies of skills in the labour force remains a fundamental issue, and has also contributed to low productivity levels (see Chart 4.1). Interviews from the PSA (2013) corroborate the above findings, in addition to suggesting that there was also an unmet demand for softer skills, namely in communication and work ethic.

Chart 4.1 - Productivity and Unit Labour Cost



Recommendations: Enhance private sector participation in the determination of curriculum and mainstream work ethics in the curriculum across-the-board. Streamline existing training and employment creation programmes which, at present, are fragmented across several ministries. Implement a targeted cash transfer system at the secondary and post-secondary levels to encourage children to stay in schools A CDB (2015) study on youth unemployment provides some useful recommendations including: (i) a dual system of technical and vocational education and training where institutional instruction is coupled with on-the-job experience and remuneration (ii) governmental support to firms expanding opportunities for youth; (iii) employment service centres with particular emphasis on the youth to inform of vacancies; and (iv) subsidized credit to young entrepreneurs.

Governance

4.03 Good governance is essential in all aspects of social and economic management. A well-functioning governance system is able to effect change through policymaking that is predictable and inclusive, operating professionally, and is rules-based. According to WB's governance indicators for 2014, Saint Lucia generally performed below the level reached in 2009. However, in the area of government effectiveness, the score turned negative[14] (see Table 4.1). The private sector also identified the lack of a long-term strategic vision for the country and specifically for the private sector, as major constraints to economic growth. This view was, to some extent, corroborated by a CDB study (2016) of the regional micro, small and medium-sized enterprises (MSMEs), which noted that there was no working agenda for the development, modernisation, expansion or regulation of MSMEs[15]. Further engagement with the private sector, and in particular MSMEs and labour, should be formalised through a process of continuous dialogue and information-sharing in crafting effective and sustainable policies. (A more structured private sector involvement in the development process could also help to build a strong framework for PPPs[16]. Saint Lucia, in the past, has benefited from Build, Own, Lease and Transfer agreements and should continue to develop that platform to enhance private sector investment).

Recommendations*:* Involve stakeholders (labour unions, civil society, private sector) in all aspects of the formulation of the medium-term strategy and vision plan. Also, try to garner parliamentary opposition support for the strategies to ensure broad-based buy-in and continuity.

Table 4.1: Governance Indicators

	Control of Corruption: Estimate	Control of Corruption: Percentile Rank	Government Effectiveness: Estimate	Government Effectiveness: Percentile Rank	Political Stability Estimate	Political Stability Percentile Rank	Regulatory Quality: Estimate	Regulatory Quality: Percentile Rank	Rule of Law: Estimate	Rule of Law: Percentile Rank	Voice and Accountability: Estimate	Voice and Accountability: Percentile Rank
2004	0.3	64.4	0.1	60.0	1.3	93.3	0.2	59.8	0.7	70.8	0.7	69.2
2009	1.2	85.6	0.9	76.1	0.7	71.6	0.5	67.5	0.8	74.9	1.2	90.5
2014	0.4	67.3	-0.02	53.8	0.9	78.2	0.2	61.5	0.5	71.6	1.2	86.2

Source: WB

Cost of Energy

4.04 High input costs can be a major impediment to growth and, for the Region, one of the main obstacles is energy. Although prices are currently low at around USD44 a barrel, after peaking at USD132.6 in July 2008, energy costs remain a major concern for most producers, as it is a significant production cost. According to a 2016 survey conducted by the Caribbean Electric Utilities Services Corporation, Saint Lucia falls about mid-range with respect to the typical bill for commercial customers among the countries surveyed, but slightly at the higher end with respect to industrial customers (see Table 4.2). Currently, Saint Lucia imports fossil

[14] Government effectiveness is defined as "perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the Government's commitment to such policies".
[15] "The Ministers of Trade, Industry and Commerce in Antigua and Barbuda, Barbados and Saint Lucia indicated that no policy was in place to guide Government's agenda for, and interface with, the MSME sector. Only Belize, Jamaica and Trinidad and Tobago had Cabinet-approved MSME policies in place." CDB (2016) Micro-small and Medium Enterprise Development in the Caribbean: Towards a new frontier.
[16] CDB launched a PPP helpdesk to provide technical assistance (TA) to member governments.

fuel to meet its energy needs, leaving the country vulnerable to rising price and volatility on the international market. Given the potential for alternative energy, including wind, solar and geothermal, Saint Lucia has indicated a target of 35% renewable energy (RE) by 2020, and efforts to reach or exceed this target should be maintained.

Table 4.2: Regional Electricity Charges

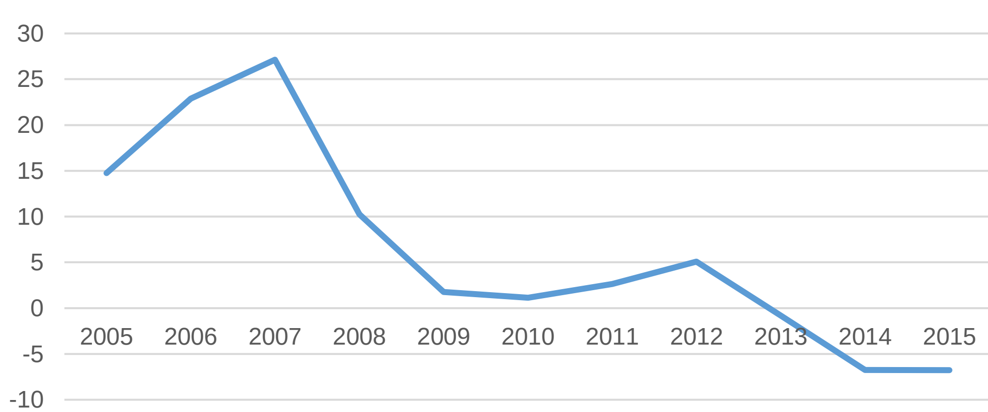
Country	Typical Bill for Commercial customer using 2000kwh per month (USD)	Typical Bill for Commercial customer using 5000kwh per month (USD)	Typical Bill for Industrial Customer Using 10,000kwh per month (USD)
Jamaica	496.06	1226.65	1814.84
TCI	688.33	1720.83	2321.67
Grenada	544.89	1362.24	2226.99
Suriname	202.92	495.80	1024.40
Antigua and Barbuda	770.52	1895.54	3824.21
Belize	715.20	7162.50	3846.00
BVI	499.90	1244.65	2485.90
St. Lucia	578.60	1446.49	2893.00
Dominica	758.43	1891.50	3407.62

Source: Draft CARILEC March 2016

Recommendations: Continue to strive for the attainment of the RE target utilising concessional resources and PPPs to keep costs down. GOSL should utilise resources from development partners in the area of RE/energy efficiency (EE) geared towards improving the operations of small businesses. GOSL should also continue to utilise alternative energy to reduce its own cost of operations.

Access to Finance

Chart 4.2: Growth in Private Sector Credit (% Change)



4.05 Access to finance is a fundamental requirement for private sector growth and development. However, chart 4.2 shows that credit to the private sector has been declining consistently for the past three years. Survey respondents from the PSA indicated that financing was too difficult to obtain because of collateral requirements, and that interest rates were too high. These findings were supported by a more recent survey of small businesses in ECCU, in which 52.3% of respondents reported that access to finance was an obstacle to operations[17]. These views are consistent with the increased level of risk averseness on the part of banks, following the turmoil of the Great Recession and the high level of non-performing loans. Interestingly, banks have also indicated a perceived dearth of bankable projects either due to the nature of the project itself, or in the formulation of the business plans owing to inadequate management or business skills. The CDB 2016 study on MSMEs found that, while there were some specialty financiers as well as banks that provided small-business services, there were no lease finance or equity financing options available. It was further estimated that microfinance institutions provided less than 10% of total loans and advances. Challenges in accessing finance are highlighted in the doing business indicators for which Saint Lucia ranks 152nd out of 189 countries in "getting credit", largely owing to unavailability of information on creditors in the form of a credit bureau or registry.

Recommendations: (a) continue to support training of small businesses in the formulation of business plans; (b) consider establishing a credit bureau/registry to facilitate data gathering on creditors; and (c) create the enabling legislative and regulatory requirements to expand equity financing, including angel investment and venture capital; and (d) actively encourage the training of staff at financial institutions in the appraising of MSME projects.

Strengthening Infrastructure and Institutions to Facilitate Investment and Trade

4.06 GOSL recognises that investment in infrastructure is necessary to ensure the development of the private sector and raise the overall growth prospects of the country. Projects such as the North-South Link Road, improvements to the waste water management system, and enhancing water access and reliability, are already in various stages of project cycle. Upgrades in these areas will serve to enhance Saint Lucia's attractiveness for investment and can also improve the country's ability to withstand the impact of weather-related shocks by factoring-in climate change into designs. GOSL should continue to engage in these and other transformative projects through the use of concessional resources and/or PPPs, as feasible.

4.07 A recent study completed by CDB analysing the efficiency of port services in the Region, found that while Saint Lucia is the most efficient in the OECS, scoring high on the quality of infrastructure, availability of equipment and the implementation of information technology systems, there is room for improvement. More specifically, berth productivity measured as moves per berth hour (which is linked to vessel waiting time and cost) was found to be particularly low, at less than 10 compared to the Bahamas at 24.6, while the cost of importation of a 20-ft container was quite high at USD2,280 per 20-ft. container (see Table 4.3 below) The Study also determined that weaknesses in the institutional framework, such as the requirement of Ministerial approval, in some instances, hampered efficiency of the Saint

[17] ECCB (2016) – Financing for small and medium enterprises in the ECCU Region.

Lucia Air and Sea Port Authority (SLASPA). These findings also give some support to the relatively low rank of 72, as it relates to trading across borders in the Doing Business report.

Table 4.3: Selected Regional Port Indicators

Borrowing Member Country	Productivity (Berth moves per hour)	Cost to Import 20-ft container
Antigua	13	1520
The Bahamas	25	1770
Barbados	12	1615
Belize	12	1580
Dominica	11	1600
Grenada	8	2170
Guyana	11	720
St. Kitts	14	2615
Saint Lucia	8	2280
St. Vincent	8	1425
Suriname	11	1190
Trinidad	13	1260

Source: CDB (2016) "Transforming the Caribbean Port Services Industry".

Recommendations: (a) procure an additional mobile harbour crane to improve berth productivity by reducing vessel waiting time. However, a feasibility study of Berth 5 should be undertaken prior, in order to determine whether it can accommodate the mobile harbour crane, and if not, seek to make the necessary enabling upgrades; and (b) review the institutional framework of SLASPA with a view to improving efficiency, while safeguarding the needs of the private sector and the wider society.

Other Reforms to Improve Business Facilitation

4.08 In addition to the institutional reforms alluded to earlier, other measures will be necessary to strengthen institutions, especially those that interface directly with the private sector in order to improve business facilitation. In this regard, those aspects of the Doing Business survey in which Saint Lucia perform poorly may provide some guidance. Apart from access to credit, other critical areas were in resolving insolvency and registering property, where Saint Lucia ranks 109 and 104, respectively.[18]

4.09 With respect to resolving insolvency, legislation is currently being drafted to strengthen the framework. However, it would be particularly beneficial to incorporate provisions to facilitate some level of ongoing activity to mitigate the effects of a total cessation of services and to support businesses which are fundamentally viable but which, through extenuating

[18] The ranks for the other indicators are as follows: starting a business (67); dealing with construction permits (50); getting electricity (26); protecting minority investors (66); paying taxes (83); trading across borders (72); and enforcing contracts (67). All of the ranks with the exception of enforcing contracts are lower than in 2015. Source: WB.

circumstances, have become insolvent. Involvement of the creditors in the reorganisation of the business, as well as in the treatment of assets, should also be considered.

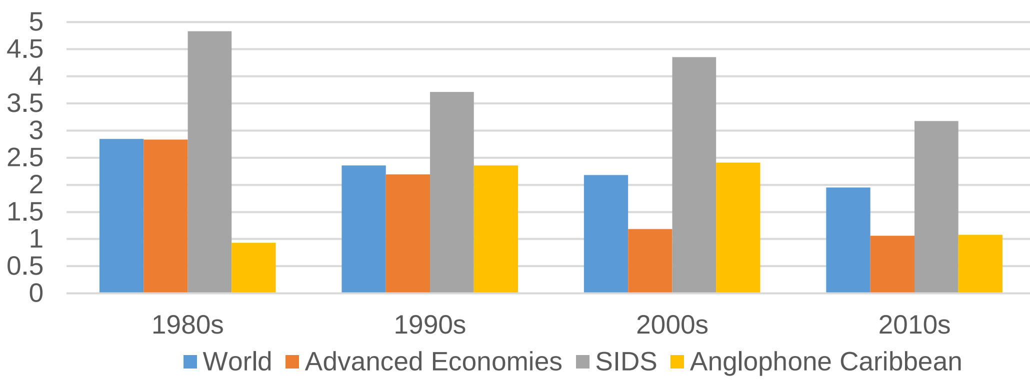
4.10 There is also scope to improve property registration as a fundamentally important measure in supporting businesses. Those sub-components in which there is greatest room for improvement are in the length of time to: (a) obtain a certificate of good standing from the registry of companies; and (b) register the title deed with the Land Registry. Additionally, the absence of a single electronic database for, *inter alia:* (i) checking for encumbrances; and (ii) recording boundaries, checking plans and providing cadastral information, also impede business operations.

Recommendations: (a) expedite efforts to finalise and enact insolvency legislation; and (b) conduct an assessment to determine institutional and infrastructural (e.g. single electronic database) requirements to accelerate the process of registering property.

5. CONCLUDING REMARKS

5.01 In conclusion, the recession in Saint Lucia has bottomed out, and the country is poised for further growth as the gradual return of investor confidence has resulted in an improvement in FDI and an upswing in private sector construction. However, a number of rigidities exist, which could undermine the ability of the country to capitalise on positive developments. These include: fiscal and debt unsustainability; vulnerability to volatile and rising oil prices; labour market rigidities; governance structures; institutional capacity weaknesses; private sector inefficiencies, particularly with respect to finance mobilisation; and vulnerability to natural hazards and exogenous shocks. GOSL needs to tackle these issues head-on if the country is to increase its level of competitiveness. This presents not only an issue for Saint Lucia but across the Caribbean, as growth in the Region lags that of other small island developing states (see Chart 5.1).

Chart 5.1: Average Growth Rates for Selected Economies (%)



Source: UNSTATS

5.02 As a critical first step towards accelerating and sustaining economic growth, it is necessary that GOSL get its fiscal house in order. Currently, debt dynamics are on an unsustainable path due to the confluence of an inadequate primary surplus, slow growth, and high interest rates. Over time, this could result in critical spending being compromised, such as those for capital investments and social protection. In the current circumstances, implementation of the proposed tax measures in the absence of mitigating measures will exacerbate an already unsustainable situation. The decision to reduce VAT and other tax-reducing measures provides an opportunity for GOSL to tackle other revenue and expenditure inefficiencies that have been weighing on finances. It also provides an opportunity to address much-needed structural reforms which could propel growth. Measures to improve productivity are central, but must take place in a facilitative environment, inclusive of sound governance structures and supportive institutions. Table 5.1 summarises the reform measures advanced in the document.

Table 5.1: Summary of Reform Programme

Area	Proposed Measures
Governance	(a) Involve stakeholders frontally in the formulation of the 15-20 year vision plan and medium-term strategy. Also, try to garner parliamentary opposition support for the strategies to ensure broad-based buy-in and continuity. (b) Publish Cabinet conclusions (discretion may be required on issues of national security). (c) Engage stakeholders (labour, private sector and civil society) on issues related to productivity enhancement, e.g. labour flexibility and performance-based pay for public servants. (d) Enshrine the objective of fiscal and debt sustainability in fiscal responsibility legislation. (e) Conduct and publish annual tax expenditure reports.
Fiscal	(a) Reduce the list of VAT-exempt and zero-rated goods. In taking goods out of the tax-exempt and zero-rating category, priority consideration should be given to educational needs, as well as specific vulnerable groups such as: children; females; the elderly; and the disabled. (b) Technical assistance study to examine the linking of wages to productivity in the public sector, and the appropriate institutional framework needed to facilitate the new modality for wage increases. (c) Limit the growth in the wage bill to inflation until performance-based pay system is implemented. (d) Explicit policy of attrition for the public service. (e) Freeze on new hires in selected areas, except in areas where completed structures will need to be staffed. (f) Cap transfers to statutory corporations at 2016/17 levels and conduct review of major state-owned enterprises. (g) Prioritise capital expenditures to focus on projects with high development impact. Subsequently, revamp planning process to ensure consistency between the medium-term development plan, the medium-term fiscal and debt strategy, PSIP, and the Budget. (h) Reduce the cost of borrowing by utilising more concessional resources and making use of PPPs, as feasible. (i) Reduce tax incentives granted by Customs in the near term. (j) Increase the excise tax rate on vehicles over a certain engine size e.g. 1800cc (k) Increase the excise tax on cigarettes and alcoholic beverages (l) Reduce spending on foreign missions.
PFM	(a) Completion of Inland Revenue restructuring exercise (June 2017). (b) Conduct geo-mapping exercise to support property tax reform, followed by revaluation exercise. (c) Formulate and begin implementation of PEFA Action Plan following assessment to be conducted later this year.
Structural	(a) GOSL, through its small business funds should further incentivise existing small businesses to adopt new technologies, once the appropriate qualifying criteria have been met. (b) Enhance private sector participation in the determination of curriculum and mainstream work ethics in the curriculum across the board. (c) Streamline existing training and employment creation programmes, which at present are fragmented across several ministries and appear to be in low value-added areas. (d) Continue to utilise concessional/grant resources from development partners, as well as own-resources to support the upgrading of management skills and increase promotion of state facilities that provide managerial support to small businesses. (e) Commission detailed studies in the area of labour force flexibility to improve efficiency, while ensuring that workers' rights are maintained.

Area	Proposed Measures
	(f) Government should also continue to utilise alternative energy to reduce the cost of its operations. (g) Encourage greater uptake of RE/EE technologies to help reduce the cost of energy as an input and to reduce energy cost volatility. (h) Continue to support training of small businesses in the formulation of business plans. Facilitate dialogue between businesses and commercial banks so that the needs of each group can be addressed. Encourage financial entities to work closely with entrepreneurs to incorporate adequate flexibility in loan contracts. (i) Feasibility study of Berth 5 should be conducted to ensure that it can accommodate a mobile harbour crane. If berth is structurally sound, procure harbour crane. If not, make necessary improvements and then procure crane. (j) Review the institutional framework of SLASPA with a view to improving efficiency while safeguarding the needs of the private sector and the wider society. (k) Expedite efforts to finalise and enact insolvency legislation. (l) Conduct an assessment to determine requirements to accelerate the process of registering property. (m) Enactment of omnibus legislation to comprehensively address the incentive regime over the medium to long term.
Social	(a) Accelerate implementation of the new central beneficiaries roster. (b) Maintain floor on social sector spending. (c) Implementation of the Social Protection Policy. (d) Conduct a new poverty assessment (scheduled for 2017).

Appendix 1

Fiscal Year Central Government Operations as Percentage of Gross Domestic Product

	2011/12	2012/13	2013/14	2014/15	2015/16
TOTAL REVENUE AND GRANTS	26.2	25.0	25.6	25.7	26.7
Grants	2.2	1.8	1.5	1.4	1.3
Capital Revenue	0.0	0.2	0.0	0.0	0.0
Current Revenue	23.9	23.0	24.0	24.3	25.4
Tax Revenue	21.9	21.5	22.8	23.1	24.0
Non-tax Revenue	2.0	1.5	1.3	1.1	1.3
TOTAL EXPENDITURE	32.7	34.3	31.6	29.5	29.4
Capital Expenditure	10.5	9.8	7.4	6.2	6.0
Current Expenditure	22.2	24.5	24.2	23.3	23.3
Current Balance	*1.7*	*-1.5*	*-0.1*	*1.0*	2.0
Primary Balance	-3.5	-5.8	-2.1	0.1	1.5
Overall balance	*-6.5*	*-9.3*	*-6.0*	*-3.8*	-2.7
CG Debt	*65.7*	*72.2*	*74.2*	*75.3*	76.5

Source: GOSL.

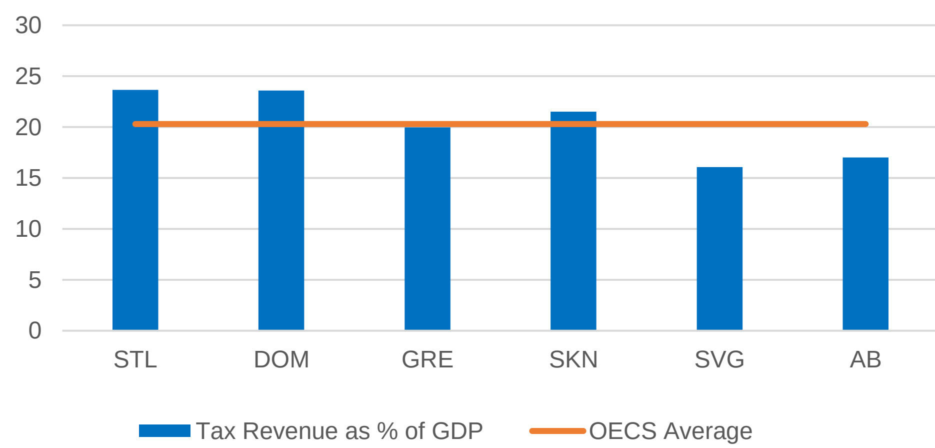
Appendix 2
The Structure of Public Finances

Revenues

1. Total revenue and grants collections in Saint Lucia are generally thought to be adequate, at around 27% of GDP, with the bulk of these inflows coming from tax revenues (88%). The importance of non-tax revenues, however, could change substantially in the future with the commencement of CIP. The contribution from grants, though small at 2% of total revenue, has also supported the development agenda, particularly in the areas of health, agriculture, community and disaster risk reduction, and were provided primarily from Alianza Bolivariana para los Pueblos de Nuestra América, the European Union (EU), CDB, and bilaterals.

2. With a tax-to-GDP ratio of 24% in 2015, the tax burden is consistent with those found in developed countries such as: Luxembourg (25.9%); France (22.6%); and UK (25.5%), although it lies above the average for OECS countries for 2015 (see Chart 1). *Prima facie*, this could suggest an acceptable level of competence in tax administration, and compliance on the part of tax payers. However, it is also indicative of a high cost of providing goods and services to maintain a relatively modern, services-centred, open economy. Tax buoyancy[1] for Saint Lucia was calculated at 1.22 over the 15-year period and suggests an acceptable level of responsiveness, although it is not as high as Antigua and Barbuda, and Dominica at 1.36 and 1.43, respectively.

Chart 1: Tax Burden across the Organisation of Eastern Caribbean States (% of Gross Domestic Product)

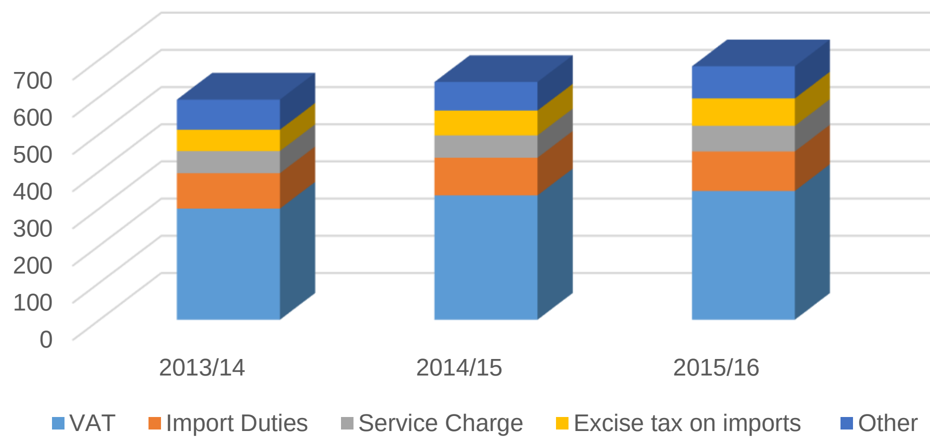


[1] The tax buoyancy, which is a measure of responsiveness of tax revenues to changes in economic activity.

Indirect Taxes

3. Like most other countries, Saint Lucia has gradually shifted from reliance on an incomes-based system to one that is consumption based, reflecting prevailing views that notwithstanding their regressivity, indirect taxes, *inter alia,* were less likely to distort the choice between work and leisure, were less easy to avoid and relatedly, provided a more stable revenue base during cyclical fluctuations.

Chart 2: Indirect Taxes ($ mn)



4. GOSL has made significant strides to improve revenue sufficiency and administration, the most notable of which was the implementation of VAT in 2012. VAT levied at 15%, with a threshold of $400,000, replaced several taxes such as the Consumption Tax, Hotel Accommodation Tax, Cellular Tax and Environmental Levy. The performance of VAT in the first year was exemplary, as estimates suggest that VAT yielded an additional revenue of 2.8% of GDP.

5. While VAT now accounts for 50% of indirect taxes and 37.1% of all tax revenue, performance has been undermined by a plethora of exemptions and the zero-rating of goods. One measure of VAT revenue productivity, the C-efficiency ratio, calculated in 2014 at around 0.36, suggested that were inefficiencies in the system. These could be driven by: (a) a policy gap where there are a high number of exemptions or VAT is not applied at a single rate; or (b) a compliance gap where VAT implementation is imperfect. With a ratio of 91%, VAT compliance was found to be generally reasonable (although it has been declining gradually)[2]. In 2014, preliminary estimates suggest that approximately $117.5 mn in revenues were lost in exemptions and zero-ratings. Approximately 71 headings under the Harmonised System for the classification of goods were exempt, while there were an estimated 164 goods on the zero-rated list. Some areas where there may be scope for closing loopholes include: (i) the zero-rating and exemption of some goods for consumption, both processed and unprocessed; (ii) the exemption of pharmaceuticals, including both prescription and over-the-counter medicines; (iii) from an environmental sustainability perspective, as well as a revenue one, the zero-rating of electricity services could also be reviewed; and (iv) the treatment of water

[2] Source: VAT Office. Data to October 2014.

and sewerage services that, in the presence of an efficient targeting mechanism, could also be re-assessed. One of the underlying motives for these derogations from VAT is the alleviation of the burden on poor and vulnerable groups. The challenge arising is that persons from middle- and high-income brackets tend to benefit moreso in absolute terms, given greater disposable incomes.

6. Import duties and service charges represent 15.6% and 10%, respectively, of indirect taxes. Indications are that these collections also suffer from exemptions. An IMF study completed in FY 2013/14, suggested that exemptions from import duties and service charges were significant, amounting to 5.4% and 1.6% of GDP, respectively. Of particular note is that the revenue forgone was greater than, or almost equal to, the actual amounts collected in that year. The majority of these derogations were again in the area of food stuffs. Excise taxes, the other major category account for another 10% of indirect taxes. However, this does not seem to succumb to exemptions to the extent of other taxes, with exemptions amounting to around 0.1% of GDP.

Table 1: Imports and Services

	Actual Collected	Revenue Foregone	
	($ mn)	($ mn)	(% of GDP)
Import Duties	95.1	193.5	5.4
Services	59.6	59.4	1.6

Direct Taxes

7. Direct taxes account for a little over one-quarter of tax revenues, of which 40% come from PITs (see Chart 3). The threshold for low-income taxpayers has gradually been increased to $18,000 and the tax structure is generally viewed to be quite progressive (see Table 2).

Chart 3: Composition of Direct Taxes in 2015/16 (%)

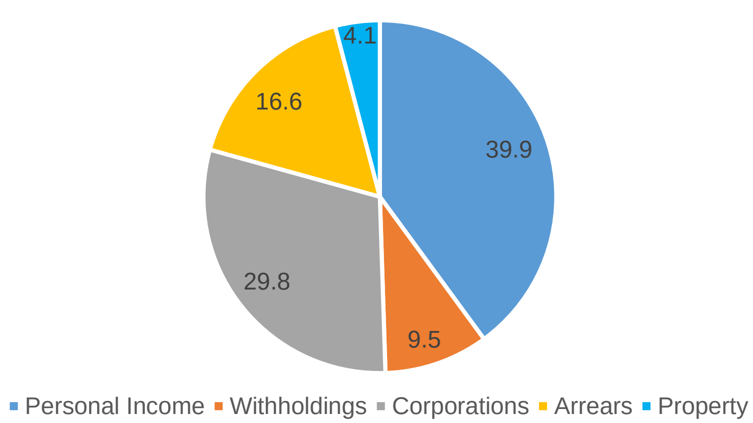


Table 2: Personal Income Tax Structure

Income Tax Brackets (XCD)	%
0 - 10,000	10
10,001 - 20,000	15
20,000 - 30,000	20
30,001 +	30

8. One of the main characteristics of the PIT system, however, is the schedule of deductions and allowances which appear to: (a) overly benefit those who could possibly forego them; (b) provide little support to vulnerable groups and educational advancement; and (c) be susceptible to abuse, as some deductions are without limit or do not require documentation. Some examples of overly generous deductions include those for mortgage payments ($18,000); insurance premia on owner-occupied residential property ($10,000); and deductions for costs incurred for the upkeep of owner-occupied property ($10,000). In contrast, the education deduction for qualifying children and higher education seems relatively low at $2,000 and $5,000, respectively. This low deduction for higher education is also inconsistent with reducing structural unemployment, one of the root causes of which is the undersupply of skills at the post-secondary level. As the dynamics of households change, and the number of single-parent households increases, especially those headed by females, so too can the financial burden of caregiving. A view toward raising the deduction for child maintenance ($1,000), as well as that for dependent relatives ($350), could help to ease the burden on single-parent households, especially for women on whom the responsibility of care generally falls.

9. Lastly, there are those deductions which are open to misuse. These include: (a) medical expenses without a claim form ($400); (b) medical expenses without a limit and only claimable if it exceeds $400; and (c) deductions for professional subscriptions (no limit). With respect to exemptions, there are some which may warrant a review as they either appear to benefit a few persons who would not ordinarily be categorised as vulnerable and/or subject to the discretion of the Ministry of Finance. These include the: (i) income from sale of rental residential property under $200,000; and (ii) exemption of the withholding tax on business and professional income earned by certain contractors, in addition to which contractors can apply to the Revenue Comptroller for exemptions.

10. Corporation taxes currently levied at 30%, are another important source of revenue and account for an estimated 32% of tax receipts. There is, however, some evidence to suggest that performance of this category may be undermined by derogations. *Inter alia*, these have been in the form of: the Fiscal Incentives Act; Micro and Small-scale Business Act; Tourism Incentive Act; the Cricket World Cup Incentive Act; and the Special Development Areas. Tax holidays of up to 25 years, as well as reduced corporate tax rates, have been used to incentivise private sector investment in the manufacturing, agricultural, tourism sectors. In addition, incentives can also be granted by Cabinet Conclusion, as in the case of the construction stimulus package of 2012. Apart from revenue loss, an important issue relates to dependency, as some firms reluctant to be weaned off the incentive and citing a lack of competitiveness, can simply request an extension. While this may be indicative of underlying structural issues in the economy, if a business cannot compete under normal economic conditions then it should restructure or exit the market. Similarly, tax holidays carry

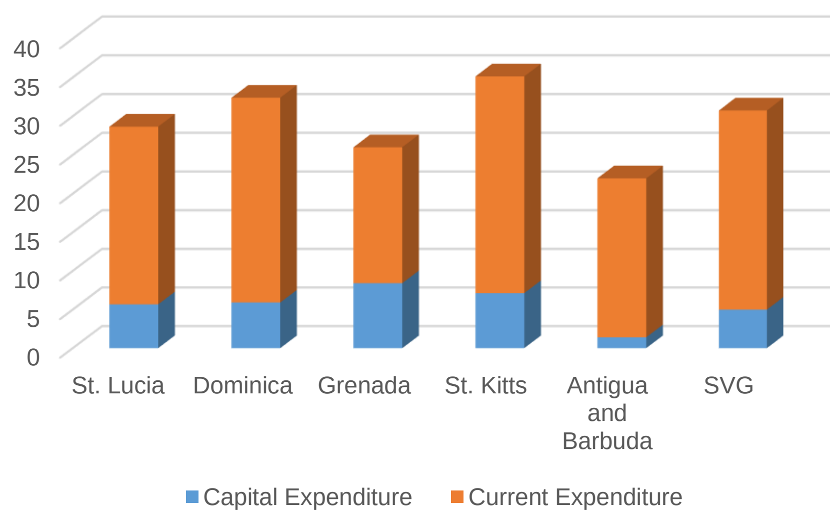
the inherent risk of exploitation by firms with no long-term desire to remain in the country. Cabinet Conclusions, while intending to introduce flexibility and responsiveness in the system, can undermine predictability and transparency in the process, especially if decisions are not published.

11. Arrears, another significant component has also been increasing and is likely reflective of the administrative improvements being undertaken by IRD. Property tax collections are small and appear to be administratively challenging. While there was a doubling in revenues coinciding with the shift to rental value to market-based assessment in 2012, revenues remain small, on average less than $10 mn. Mission findings suggested that property tax coverage was low, at 50% or less, and there was a concern that some properties were undervalued. Consequently, a revaluation exercise is recommended, which should be supported by findings from a geomatics exercise.

Expenditure

12. On the expenditure side, at about 30% of GDP, total spending is consistent with that of the other countries in OECS. So too, the composition of spending exhibits a similar pattern with the preponderance of spending on recurrent items[3].

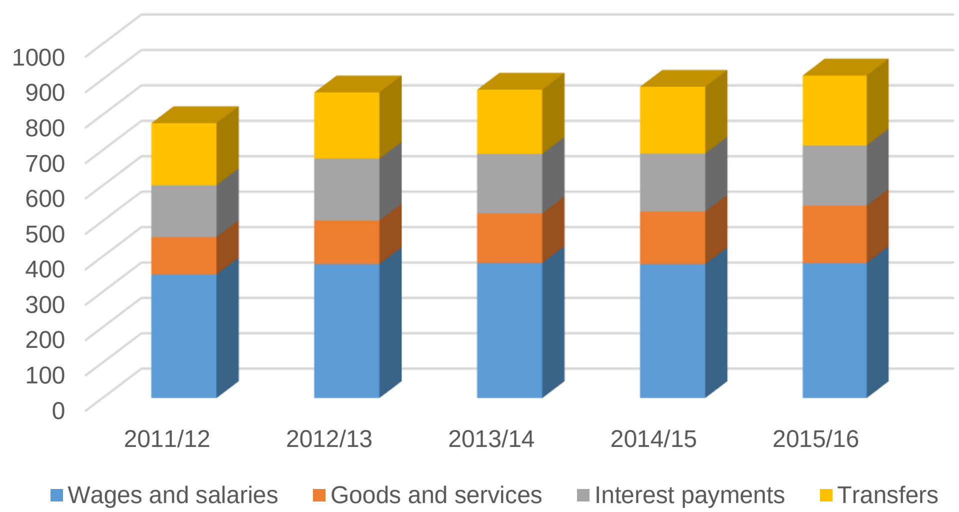
Chart 4: Composition of Expenditure across the Organisation of Eastern Caribbean States



[3] The exception being Antigua where the ratio is 14 to 1.

Recurrent Expenditure

Chart 5: Composition of Recurrent Expenditure



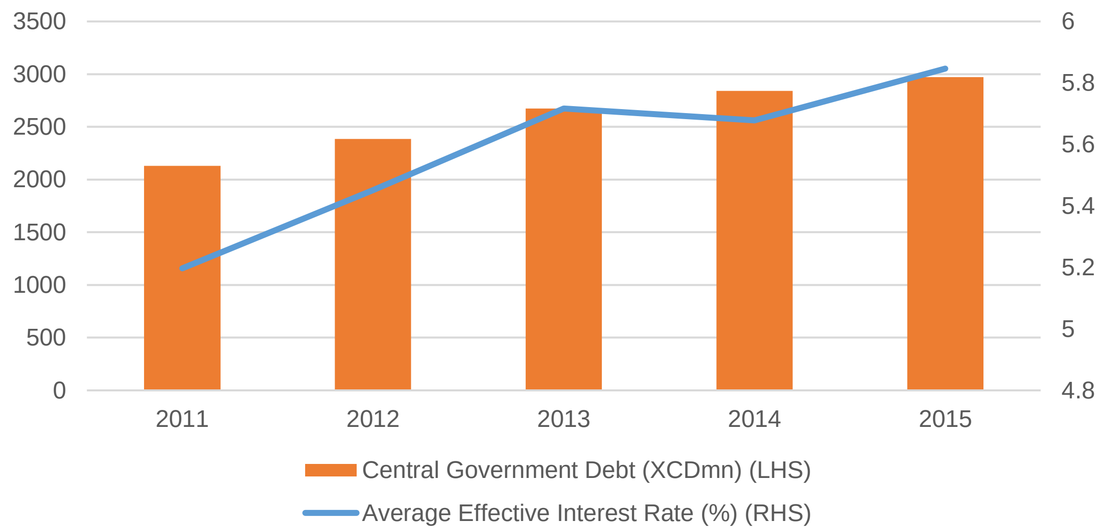
13. By far, the most significant component of recurrent spending is wages (see Chart 5), which accounts for 9.7% of GDP, or 43 cents of every tax dollar. This was attributed mainly to negotiated salary increases and growth in the public sector. Over the period 2005/06 to 2010/11, wages and salaries grew an average of 6.5% with inflation over the same time averaging 3.1%. Notably, however, in the past four years, wages and salaries have stabilised at about $380 mn, reflecting marginal declines in employment (less than 1%) and the wage freeze for the last triennium. One of the main challenges for Saint Lucia going forward, will be to maintain control over wages and salaries particularly following the wage freeze. The current fall in the general price level[4], if sustained, could help to keep the demand for higher wages in check, but GOSL should also consider the policy of attrition, and restrictions on new hires, except where completed projects will need to be staffed, for example in the health sector. GOSL would be well advised to: (a) reduce duplication across the public sector, for example, in the provision of social services and employment programmes, which are spread across several agencies; and (b) respond to the changing country context, for example in the provision of education services where inadequacies in the provision of early childhood education are contributing to suboptimal outcomes at the primary and secondary levels, resulting in students not pursuing post-secondary education. Compounding these issues is the need for training in areas such as multi-grade teaching and differentiated instruction in order to be able to adequately address the needs of students. Additionally, the policy of automatic salary increases for teachers who pursue additional studies in areas which may, or may not, be of strategic relevance for the education sector should be reviewed.

14. The issue of public sector productivity needs to be addressed frontally, in particular the linking of wages to productivity. Performance-based systems for the public sector have been adopted across the world including Singapore, Estonia, Hungary and parts of the United States, and, in addition to strengthening the nexus between wages, productivity and competitiveness, generally keep the public sector wage bill in check. Notably, NCPC has already started some important work in this area by looking at possible indicators for public

[4] As measured by moving average inflation which was -1% in 2015 and -3.2% for the first half of 2016.

sector output at the departmental level. More specifically, preliminary work has been done for the departments of Customs and Excise, Inland Revenue, Transport and Physical Planning. This is critical, as one of the fundamental challenges in instituting a performance-based system for the public sector is the determination of an output metric.

Chart 6: Selected Debt Indicators



15. In the past five years, the ratio of interest payments to current spending has gradually increased from 13.6% to 17.8%. This is reflective of rising debt, which increased by 34.5% to $2.8 bn over the same time period and a rise in the average effective interest rate. Although the composition of interest payments has fluctuated over time, domestic outlays account for the majority of payments (55%), consistent with the larger share of domestic debt in the stock.

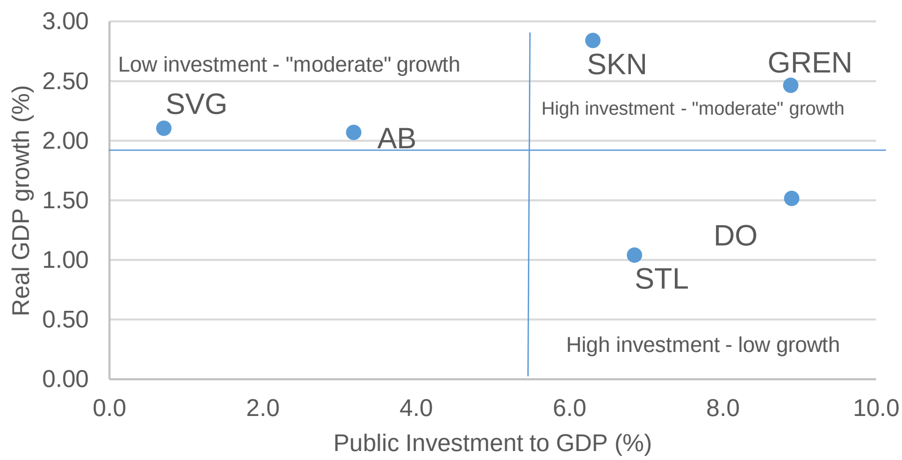
16. Upward pressures are also evident in current transfers which have been increasing steadily as a result of rising retirement benefits and transfers to statutory corporations. This trend is likely to continue in the foreseeable future, especially with the coming on-stream of OKEUH. GOSL could seek to implement a cap on transfers, while functional reviews of statutory corporations are undertaken with a view to improving efficiency. With respect to retirement benefits, an actuarial assessment may need to be conducted to determine the level of contributions required to ensure viability of future benefits packages.

17. In recent years, GOSL has managed to keep the level of goods and services in check. Indeed, this category of expenditure has managed to decline from about 5% of GDP in 2012/13 to 4.4% in 2015/16. Nevertheless, there are impending push factors which could reverse this trend. These include goods and services required for the maintenance of new facilities in the health sector, as well as leasing/rental arrangements owing to the unsafe working conditions of some Government buildings, which required the relocating of some staff.

Capital Expenditure

18. Capital spending has been declining almost consistently since 2011/12, driven in part by a desire to rein in the deficit and, to a large extent, constraints in financing as the deficit had deteriorated from -1.1% of GDP in 2008/09 to 9.3% by 2012/13. There are two fundamental challenges which seem to be affecting capital spending: (a) strategic relevance; and (b) low returns. With respect to strategic relevance, there is need for a sound planning framework that clearly articulates the development priorities of GOSL and feeds into a well-formulated, properly costed and monitored PSIP. Ideally, there should be some sort of performance criteria in the selection process to determine eligibility of projects for PSIP. This, in turn, should feed into the annual budget process as it ensures that yearly budgeting is not only strategically relevant but also reduces the over-budgeting of resources. For example, the 2015/16 estimates contemplated a capital programme of $414.2 mn but only $266.1 mn was spent, an implementation rate of 64.2%. The issue of proper project cycle management (PCM) is also vital in ensuring value for money and reducing cost and time overruns. One of the main challenges encountered in PCM is the integrity of the procurement process and ensuring the most qualified individual or firm receives the contract. Importantly, GOSL recently passed procurement legislation which should help to ensure value for money, including the provision to accommodate new modalities of financing, e.g PPPs.

Chart 7: Real Gross Domestic Product and Public Investment



19. Concerns have also been raised about the low returns to capital investment. With an incremental capital output ratio[5] of nearly 7 over the period 2000 to 2015, compared to 3-4 for some emerging Asian economies, there appears to be some level of inefficiency in capital investment[6]. Chart 8 shows the general correlation between growth and public investment across OECS over the period 2000 to 2015. Apart from the non-achievement of growth above 3% for OECS over the period, the chart reveals that, for the given level of expenditure, growth in Saint Lucia has been particularly low and may suggest the need for investment in projects with greater development impact. It also suggests that some countries have been able to

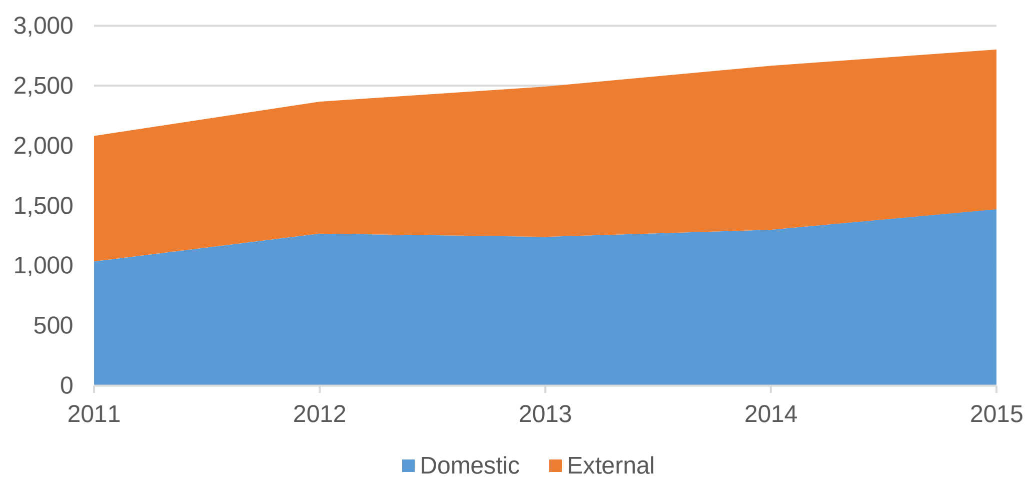
[5] The incremental capital output ratio is a measure of the ratio between investment to growth. It is the additional capital required to increase output by one unit.
[6] OECD Development Centre for Emerging Asia 1995-2011.

achieve higher growth rates with perhaps more targeted expenditures. A review of the capital expenditure outturn suggests that, as a group, small-scale construction and short-term employment initiatives received $43 mn, or about one-quarter of major capital spending in FY 2015/16[7]. These included STEP, NICE, and CDP.

Debt

20. In tandem with the gradual improvement in public finances, there has been slower growth in the debt stock, with a very gradual rise in the domestic component (see Chart 9). Currently, the majority of domestic debt is held by financial institutions, such as commercial banks and insurance companies, and is being sourced at higher interest rates, compared to those obtained externally. Indeed, the average effective interest rate on external debt was found to be around 3.7%, compared to 7.5% for domestic debt. Additionally, more than half the stock of domestic debt consisted of short-term obligations and stood at $1.5 bn at the end of 2015. On the external side, the majority of debt is held by the multilaterals and the commercial market. Government-guaranteed debt has been declining consistently for the past five years and is relatively small, amounting to less than the equivalent of 2% of GDP.

Chart 8: Composition of Central Government Debt (XCD mn)



21. Although GOSL has managed to contain borrowing costs, the rolling over of $337.4 mn in short-term instruments is inherently risky. Indeed, during FY 2015/16, GOSL found it difficult to raise the budgeted amount of bond financing, falling short by $112.6 mn[8] and this is likely reflective of the ongoing preference by investors for shorter-term financing. Cognisant of this, the debt strategy proposed over the medium term seeks to lengthen the maturity structure. More specifically, the strategy speaks to the gradual minimisation of T-bills in favour of longer-term bonds, with a lengthening in maturity from 2-year bonds in the first instance to 5, 10, and 15 year bonds by FY 2020/21. Notably absent, however, is the targeting of concessional resources to keep down the cost of debt. Concessional loans were highlighted in the debt strategy as contributing to interest rate risk due the variable portion of the Loan,

[7] Source: Social and Economic Review 2015.
[8] Source: Medium-term Debt Strategy.

and the uncertain interest rate environment. Nevertheless, according to Saint Lucia's Social and Economic Review for 2015, the discount rate on bonds has consistently been higher than loans (see Table 3) and, in some cases, more than double. Additionally, if the aim is to lengthen the maturity structure of the debt, concessional loans with a repayment of around 25 years should be accommodated. In pursuing concessional support, a proper planning framework will be required to ensure that financing is available for projects when it is due.

Table 3: Average Cost of Government Instruments

	2011	2012	2013	2014	2015
Bonds	7.3	7.0	7.0	7.1	6.8
Loans	2.8	3.5	3.1	3.2	3.1
Treasury	5.5	5.1	4.8	4.9	4.6

Source: GOSL

Public Financial Management

22. Saint Lucia has been making some strides to strengthen PFM. GOSL receives ongoing support from CARTAC in the area of customs and administration; ECCB in the area of debt management and financial programming; WB in the area of debt reporting; and more recently, from SEMCAR in drafting the PFM Bill. IRD, with the support of CARTAC, is also being restructured and streamlined for efficiency. Currently, IRD is divided along operational lines, as opposed to tax category which existed previously. There are now dedicated units that monitor large- and medium-sized tax payers, as well as a small and micro taxpayer section. Dedicated units have also been put in place to monitor filing compliance and collections. The reform process is expected to be completed by June 2017. Also, in 2015, Saint Lucia enacted procurement legislation which, *inter alia,* should facilitate improved competition for Government contracts and help to ensure value for money.

23. Notwithstanding the strides made thus far, there are other PFM issues which still need to be addressed and include: quality and timeliness of annual financial statements; multi-year perspective in planning and budgeting; the aggregate expenditure outturn, compared to original approved budget; and reducing the levels of accounts payables which stood at $22 mn at the end of December 2015. PEFA is scheduled to be conducted in October 2016.

Conclusion

24. Notwithstanding the improvement in recent fiscal performance, public finances are still on an unsustainable path. An initial assessment of the fiscal situation shows that there is tremendous scope for improvement. On the revenue side, generous exemptions, incentives, deductions and allowances are undermining efficiency and leading to reduced collections. Challenges on the expenditure side highlight the need for greater strategic planning to ensure that resources are targeted to their most productive uses, and is evident in both recurrent and capital spending. With respect to the debt situation, GOSL has managed to keep down interest rates thus far. However, risks abound with the high concentration of short-term debt. Given that the debt strategy speaks to the need to lengthen the maturity structure, and given the low cost of concessional resources, some consideration should also be given to multilateral support.

Appendix 3
Points to Consider

Fiscal Multipliers

1. One of the main assumptions in the scenario analysis is that fiscal multipliers are negligible. Gonzalez-Garcia J., Lemus A., and Mrkaic M., (2013) estimated fiscal multipliers for ECCU. The policy variables under investigation were: government consumption expenditure (wages and salaries, goods and services, and transfers); government investment (infrastructure); and tax revenues. Notably, the study found that only government investment expenditure had a positive and significant fiscal multiplier (0.62). Multipliers associated with changes in tax revenue and government consumption were not found to be statistically different from zero.

2. Several factors have been advanced for countries having small fiscal multipliers. In particular, Batini, Eyraud, and Weber (2014)[9] suggest that countries which exhibited structural features of: (a) high degree of openness to trade; (b) the existence of large automatic stabilisers; (c) high debt levels; and (d) experienced difficulties in public expenditure management and revenue administration, tended to have smaller multipliers, largely as a result of revenue leakage and, in the case of debt, high risk premia which can negate the fiscal impact. Conversely, labour market rigidities and the existence of a fixed exchange rate regime are consistent with larger multipliers in the absence of countervailing exchange and wage rate movements to adjust to the shock.

Stimulating Consumption vs. Investment

3. The Saint Lucian economy is driven primarily by consumption, which accounts for approximately 82% of GDP. With private final consumption accounting for 69% of national disposable income, it is likely that if there is a GDP response from adjustments to tax policy, it will come through the consumption channel from the income effect of the reduction. In a small, open economy where a significant portion of the goods consumed will be imported with attendant adverse implications for net international reserves, stimulating GDP growth through consumption is not sustainable. This is due mainly to the small size of the domestic market and the foreign exchange constraint. While the foreign exchange implications could be partially mitigated by Saint Lucia's membership in ECCU, if all members adopted a consumption-based approach to GDP expansion, exchange rate stability could be undermined. Two of the main benefits of reserve pooling in a currency union of small, open economies are: (a) increased access to reserve holdings; and (b) a reduction in reserve variability. For small, open economies like those in ECCU, it also provides confidence in the commitment of the monetary authorities to support the value of the domestic (or in this case sub-regional) currency[10]. Importantly, international reserves can be viewed as a type of self-insurance against current and capital account shocks and, as such, measures to improve that coverage through the adoption of export-oriented policies should be pursued, inclusive of measures to enhance productivity and innovation, business facilitation and infrastructure development.

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[9] Batini N., Eyraud L., Weber A., (2014), "A Simple Method to Compute Fiscal Multipliers", IMF Working Paper WP/14/93. Gonzalez-Garcia J., Lemus A., and Mrkaic M., (2013), "Fiscal Multipliers in the ECCU," IMF Working Paper, WP/13/117.

[10] Dehesa D., Pineda E., Samuel W., (2011) "Optimal Reserves in the Eastern Caribbean Currency Union", IMF Working Paper, WP/09/77.

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