

**Fiscal Federalism in the Caribbean:  
Implications for Fiscal and Monetary Policies**

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**I. Introduction**

Fiscal decentralization has been high on the agenda of reform in many countries in recent decades, reflecting a desire for more participatory forms of government. One view is that decentralization leads to improved efficiency but possibly less equity in the provision of public goods and services. Fiscal decentralization may also have implications for the effectiveness of macroeconomic management. One school of thought argues that by decentralizing decision-making, fiscal decentralization can lead to less effective management,<sup>2</sup> while another argues that it may improve management by bringing the government closer to its constituency, and requiring greater clarity in the roles of decisionmakers and transparency in government behavior.<sup>3</sup>

This paper examines intergovernmental relations in the Caribbean, primarily from the perspective of general principles of fiscal federalism and international practice, and considers the effects of intergovernmental design on macroeconomic management. It is hoped that the discussion may stimulate the thinking of policymakers in the Caribbean contemplating economic reforms in the area of intergovernmental finances. The paper is organized as follows: Section II discusses the structure of government in Caribbean nations. Section III examines revenue and expenditure issues. Section IV discusses intergovernmental transfers. Section V examines subnational government borrowing. Section VI presents the main implications for macroeconomic management. Section VII concludes.

**II. Structure of Government**

Intergovernmental issues are important in all nations. Although Caribbean nations are small, they still have several levels of government, and a complicating factor for some of the nations is that they are a confederation of separate islands so that there is a combination of both jurisdictional and geographic separation. Caribbean nations tend to

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<sup>2</sup> See Ter-Minassian (1997a,b).

<sup>3</sup> See Burki, Perry, and Dillinger (1999) and Shah (1998).

be characterized by a centralized form of governance in which the national level government typically encompasses most governmental activities. However, apart from the national government, there are subnational governments, encompassing a variety of forms, including islands, cities, towns, and villages, and special districts. Subnational governments play a relatively small role in Caribbean economic life, though they tend to be an essential element of the government, reflecting a tradition of participatory democracy and representative government.

Nations have different federal forms. Some nations are governed as federations, such as St. Kitts and Nevis, while others are governed in unitary form, such as Jamaica. Each nation is governed by its own separate constitution, establishing the legitimate spheres of the different levels of government. Although subnational governments are subordinate to the national government, the nature of the relationship varies from place to place. As an example, in 1888, Tobago was politically amalgamated with Trinidad. After the break-up of the West Indian Federation, the islands gained independence in 1962, and became a republic in 1976. The president is the constitutional head of state, with executive power vested in a prime minister and a cabinet. Parliament consists of a Senate, with appointed members and a House of Representatives, with elected members. Since 1980, Tobago has had its own 15-seat House of Assembly, with 12 elected members and three selected by the ruling party. Amendments to the constitution in 1995 gave Tobago greater autonomy over planning and administration in urban and rural development, health, education, and housing.

St. Kitts and Nevis offers a different history. St. Kitts and Nevis and Anguilla were united under British control in 1882 and were part of the West Indies Federation until its dissolution in 1962. St. Kitts-Nevis-Anguilla became an associated state of the U.K. in 1967. Anguilla seceded in 1980 and St. Kitts and Nevis became independent in 1983. In 1990, the premier of Nevis announced that he intended to end the federation with St. Kitts, but a local election in 1992 put that idea on hold. In 1998, 62 percent of Nevis voters favored a referendum for secession, but the vote lacked the required two-thirds majority. A Constitutional Commission is currently considering the provisions of the 1983 Independence Constitution that sets out the relations between St. Kitts and Nevis with a view to reforming these arrangements.

These examples indicate that the intergovernmental system in a nation is ever evolving and may bear little relation to that envisioned by earlier generations. Typically, there has been a conflict between those in favor of stronger national government rights and those in favor of devolving more responsibilities to the subnational governments. The constitution may leave unclear many issues regarding the assignment of roles and responsibilities among governments. As a result, over the years, the role of the different levels of government evolves in response to changing conditions.

In recent decades, the overall public sector in most nations has expanded, to a large extent driven by expansion of social transfers.<sup>4</sup> One dominant feature has been the continuing importance of the national level of government as the source of funds for public expenditures owing to its greater revenue raising abilities. There has also been growth in the level of intergovernmental grants from higher to lower levels of government corresponding to a shift of expenditure responsibilities to lower levels of government. In Caribbean nations, intergovernmental transfers amount at most to a few percentage points of GDP (Table 1). Only in Trinidad and Tobago, among those countries with available data, is the transfer to subnational governments significant at 2.3 percent of GDP.

Intergovernmental grants tend to grow most rapidly when the national government is in a strong fiscal position relative to subnational governments. It is possible to offer persuasive arguments that intergovernmental grants would produce a more efficient and equitable government system. Nevertheless, shortfalls at the national level then immediately impinge upon subnational governments and fiscal decentralization can lead to changes in the effectiveness of macroeconomic management.

### **III. Revenue and Expenditure Assignments**

#### **Revenue Assignment**

Every multilevel government must thus answer some basic questions regarding tax assignments: How to raise revenues? More specifically, which level of government is responsible for determining the bases, levels, and rate structures of various taxes? Also, which revenues should be collected at the national or subnational government level, and which should be shared among various levels of government?

In answering these basic questions, as an organizing framework, it is useful to think of several broad types of tax frameworks or tax assignments: centralized, decentralized, and shared. Each has advantages and disadvantages that depend heavily on a country's history and the institutional characteristics that define the intergovernmental relations in practice.

Centralized tax assignment essentially allocates most taxing powers to the national government. National governments determine most tax bases, levels of tax rates, and specific tax structures. By contrast, subnational governments receive most of their revenues from grants or transfers from the national government or from some form of

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<sup>4</sup> See Tanzi and Schuknecht (1995).

sharing of national government revenues. This type of centralized tax assignment is commonly found, including in some industrial countries (e.g., Italy).

The key problem with centralized tax assignment is that it severs the link between the revenue and expenditure responsibilities: subnational governments raise no revenues while often spending heavily on a myriad of local programs (e.g., public health, education, urban services). Hence, there are incentives for overspending in some and underspending in other local services, and there is generally little or no incentive to spend efficiently at the local level.

While the system may function seemingly well in a growing economy, such a centralized tax assignment is highly vulnerable under conditions of generalized fiscal stress. For example, many newly independent countries arising from the break up of the former Soviet Union experienced severe recessions (often driven by the collapse of the within-Soviet Union trade flows). As a result, central government revenues collapsed owing to the collapse of trade and worsening financial performance of many state enterprises that were the main tax contributors. Hence, the ability of the center to maintain the previous level of transfers to local government quickly eroded. In response, under pressure to keep the central government deficit under control, many central governments aggravated the situation by resorting to a quick fix: they “pushed the deficit down” to subnational governments by transferring more expenditure responsibilities without providing them with adequate sources of revenues.<sup>5</sup> This in turn caused severe problems of provision of basic local services and gave rise to systemic fiscal pressures from the local government level that often jeopardized fiscal management at the center. In a nutshell, the centralized tax assignment has a number of weaknesses, especially with regard to the efficiency of use of resources at the subnational level and the stability of the system under fiscal stress.

Decentralized tax assignment would consist of a system where all or most taxes are assigned to the subnational level. Under such a system, subnational governments have extensive taxing powers and the national government receives only what has been allocated to it the constituent subnational governments. Such highly decentralized systems, while practiced in some countries (e.g., former Yugoslavia), did not prove successful from the viewpoint of macro-economic management. Since fiscal policy was determined mostly as the sum of the subnational government finance decisions, and coordination among the member-states was lacking, the system had only a very weak central stabilization function allocated to the central monetary authority, but not fiscal policy.

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<sup>5</sup> See Bird, Ebel, and Wallich (1994) and Bogetic (1997).

There are also arrangements that represent intermediate positions. In some countries, some taxes are assigned to national and some to subnational governments. In others, some taxes are assigned to each level, while the national level shares part of some taxes with subnational governments as well. These arrangements require decisions about which specific taxes should be assigned to the subnational as opposed to the national government and how any sharing of revenues is to be designed. Fortunately, public finance and intergovernmental finance literature offers some guidance in this regard in the sense that there are good economic reasons why some taxes are more suitable for subnational governments and others are not. For example, taxes with relatively immobile bases (e.g., property taxes and to some extent personal income taxes) are good candidates for local taxation. By contrast, taxes levied on mobile bases such as capital or consumption (e.g., corporate income tax, general consumption or turnover taxes) are usually better suited for the national government or, in some cases, state or provincial governments.

In the context of the Caribbean countries, perhaps the relevant question is that of which taxes are good candidates for subnational governments, should there be a need for assigning greater revenue responsibility to them? Several criteria suggested by the literature should be kept in mind in answering this question.<sup>6</sup> First, as mentioned above, a local tax should be a tax on a base that is not very mobile across jurisdictions. Otherwise, the mobility of taxpayers across jurisdictions will limit the ability of governments to impose and maintain differential local taxation. Second, following the “benefit principle of taxation,” taxes and fees that clearly benefit certain geographic area or types of consumers are good local taxes because they establish a strong local link between the benefit (the service) and a given tax (the charge). Third, local taxes should be levied on bases that are visible, easily identifiable, and that are not difficult to administer, given the administrative capacity of local governments.

Starting from these principles, it is possible to single out the following taxes as good candidates for subnational taxation: property taxes (and land taxes as a special case), automotive taxes and various fees and licenses, and personal income taxes. These are also the taxes that would be likely looked at first by those Caribbean governments wishing to give more revenue responsibility to their subnational jurisdictions. For larger subnational jurisdictions, simple sales taxes and even corporate taxes may be useful complements to more local-based taxes.

Property taxes have the advantages of fixed and visible bases, being related to the services provided in a local area and thus having the “benefit tax” characteristics. In practice, however, their revenue yield has typically been below potential—averaging

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<sup>6</sup> See Musgrave and Musgrave (1980) and Oates (1972).

about 0.7 percent of GDP and never exceeding 3 percent of GDP—owing to several reasons (See Table 2 and also Norregaard, 1997). In the Western Hemisphere and, in particular, in the Caribbean, property tax revenues are even lower—less than ½ percent of GDP (see Table 3). The reasons include the smaller size of the base (e.g., exclusion of land or improvements and buildings; and the size and number of exemptions) and inadequate frequency and methods of assessments. To the extent that the coverage could be expanded and the local administrative capacity strengthened to allow more frequent and more accurate valuation assessments, property taxes could prove a promising, future source of local revenues in some countries.

Automotive taxes have similar advantages of visible bases that are easily identified and monitored for tax purposes within a given tax jurisdiction (e.g., by way of registration). The ease of administration and the assessment makes these taxes a good potential source of local revenues. While these taxes are primarily attractive as a local revenue source from the point of view of the ease of collection, their potential progressivity, owing to the strong correlation between car ownership and income, is likely to be a desirable feature in many countries. These taxes have not, however, typically been used for substantial revenues, suggesting that they are not politically very attractive, perhaps because of the influence of the non-poor on local tax decisions.<sup>7</sup> Many local fees and charges (e.g., water and electricity charges, market levies, ports and marine charges, various local licenses, and parking fees) also have attractiveness as local instruments for raising revenues.

Finally, personal income taxes may be shared among local and central governments.<sup>8</sup> Even though most countries tend to assign these taxes to the national government, some smaller European countries (e.g., the Baltic countries, Scandinavian countries, and Switzerland) assign them to lower levels of government. The key advantage of these taxes for subnational government is their revenue potential and buoyancy, especially for schedular income taxation where different types of incomes may be withheld at source (e.g., wages and salaries, interest) as is the case, for example, in Jamaica. However, the main disadvantage in countries that emphasize the distributional element in this tax is that this narrows the tax base and makes assigning the tax at a higher level more feasible.

Other taxes are often best left to the national government. A simple retail sales tax is acceptable for lower levels of government, but the value added tax tends to be a national tax because of its complex crediting mechanism, excise taxes because the tax base is mobile and therefore creates enforcement problems for small jurisdictions, and corporate income taxes, payroll taxes, and natural resource taxes (e.g., bauxite levy in Jamaica,

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<sup>7</sup> See Bahl and Linn (1992).

<sup>8</sup> See Bird (1992) and Martinez-Vasquez (1995).

petroleum levy in Trinidad and Tobago) because administration is difficult, and the base of the tax is often unevenly distributed within the nation.

### **Tax Administration**

The nations of the Caribbean tend to have a centralized tax administration, with local branches. This centralization gives subnational governments little fiscal independence and control over the base and rates of taxes. Given the high degree of concentration of economic activity in the main urban area in Caribbean nations, centralization may result in the greatest economies of scale for administration. This centralization may reduce compliance costs for taxpayers and administrative costs for the tax authorities in that they deal with only one unified set of laws and regulations. Subnational governments could be allowed to establish separate tax administrations and use separate taxes, which would give them greater fiscal autonomy. However, greater autonomy would lead to more varied and complex tax system and would increase compliance costs. In small countries, the shortage of trained administrators would also argue for a more unified administration. A counter argument is that decentralization could lead to more local input into the design of taxes and might lead to simpler taxes.

Ideally, a well-designed system of tax assignment should aim to assign at least one major tax instrument to each level of government. This would provide for stability of revenues in multigovernment setting, allow national governments some cushion in times of fiscal stress at the national government level. Economies of scale in compliance costs suggest, however, that in small nations, such as the Caribbean, most revenue assignment should remain at the national level.

### **Expenditure Assignment**

The question of which level of government should provide different public services is the question of expenditure assignment. It is also the one where economic theory offers only limited guidance and international practices vary widely. For example, some national public goods, such as defense, air traffic control and inter-state transportation, are clearly best provided at the national level, while others, such as those local services to which it is possible to apply the benefit principle of taxation (e.g., parking, garbage collection) are better suited for local governments or even private provision and finance.

Conceptually, the problem is that there is a wide grey area of services that could equally be considered good candidates for national and subnational governments. Should all public education be left to the national or subnational government or it should be shared? Should all public health be centrally provided or mainly by local facilities? And should social welfare programs be provided centrally or locally? These choices are also complicated by the historic patterns of provision and finance of these services, the

direction of change (centralization or decentralization) underway, and that they are multidimensional. Finance, provision, and administration need not be assigned to only one level of government as many different combinations of expenditure assignment are possible and, indeed, found in practice.

Without delving more extensively into these complex choices, some important choices and trade-offs in the areas of education, health, and social sectors are outlined below.<sup>9</sup> In education, in many countries, primary and often secondary education are provided free and higher education is heavily subsidized. But while the benefits of primary education still mostly accrue to an individual, there are important externalities in terms of links between literacy and health and the distributional consequences of primary education. As a result, both public and private provision coexist in most countries. So, on the equity grounds, public provision of primary education may often be called for, implying relatively low direct cost recovery. At the same time, the private rate of return to education is likely to increase with the level of education, implying the rising scope for cost recovery with the rising level of education. In practice, primary and secondary education is administered by subnational governments that are better suited to tailor local education services to the needs of the local population. Spatial dispersion of demand for primary and secondary education also calls for local administration of these services. Also, involvement of the local community and parents in primary education has been found to be important for the quality of primary education.<sup>10</sup> At the same time, however, financing primary and secondary school with subnational sources may be difficult when there are large differences in subnational government tax capacities, costs, and the distribution of students. And because of the general, long-term link between education and income over time, these differences may contribute to the differences in income levels. For these reasons, it may be desirable for higher level governments to take at least part of the financing function and also to set educational standards.

In health, the basic distinction between public health (providing basic diagnostic and preventive care such as child immunization) and curative health facilities, often translates into the distinction between subnational and national facilities. Public health should be close to users while for certain curative services, there are economies of scale in provision, given the lower frequency of demand. At the same time, however, public good characteristics of health services such as mass immunization suggest a greater role for higher level governments in at least ensuring minimum coverage of the population with these services.

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<sup>9</sup> See Ahmad, Hewitt, and Ruggiero (1997).

<sup>10</sup> See Jimenez et al. (1988).



## **Budget Formulation and Implementation**

The budget process is unique in each country, generally with a specific timetable established for completing each part of the budget process. This timetable is not always adhered to, and at times national governments enter the new fiscal year without a budget in place. Subnational governments normally harmonize their budgets with the central level, which is important to ensure that the consolidated budget is consistent with the overall macroeconomic goals of the budget. In Caribbean countries, it would be useful for national governments to set the framework for the budget and provide assistance and guidance to the subnational governments in preparing their own budgets. There are many aspects of budget management that aid in good governance, including the preparation of rolling plans, the use of transparent and meaningful budget classification and accounting rules, and the use of effective audit and evaluation.

National governments generally have more flexibility in budgeting than subnational governments in that they are able to run a deficit, while subnational governments have little ability to finance a deficit. The extent of deficit financing is limited by the need to preserve macroeconomic stability and to ensure long-term debt sustainability. Unlike the national government, subnational governments must generally run a balanced budget on the operating (or current year) portion of the budget. Operating expenditures include general expenditures for all functions, some utilities expenditures, pension contributions, and payments for debt service. Operating revenues include taxes, fees, intergovernmental aid, and interest on investments. The capital budget refers to expenditures and revenues for long-term capital projects, such as construction of schools and highways. Capital projects are typically financed by long-term borrowing. To avert cash-flow problems under normal budgetary conditions, some governments may issue short-term debt. But governments may create fiscal dilemmas if they issue large volumes of short-term debt and carry this debt over into subsequent years to hide persistent deficits, such as New York City in the 1970s. It is therefore important to monitor carefully the borrowing of subnational governments.

To sum up, in applying the principles of fiscal decentralization to the Caribbean, one must bear in mind that the small size of the economies matters. In the smallest island countries, there are probably important economies of scale from centralized public finances and benefits of decentralization, relative to the costs, may be limited. This applies equally to the tax assignment, tax collection, and the administration of expenditure programs. But in some of the larger Caribbean countries, such as that of Jamaica, Trinidad and Tobago, the Dominican Republic, and Haiti, there is greater scope for fiscal decentralization, especially with regard to specific social expenditures, such as education, health, and welfare programs.

In Jamaica, for example, until recently, the degree of centralization of public finances has been

very significant. Total local government revenues hardly exceeded 1 percent of GDP and in 1999, the local government budgets account for about 1.3 percent of GDP. Most of these revenues are collected from the property tax, and motor vehicle licences for which parishes collect two thirds of revenues from their territories. However, the property tax assessments have been lagging behind inflation, and infrequent valuation (every five years) limit the revenues from this tax (the last valuation was done in 1993). In addition, in public education and health institutions, there is limited cost recovery via user charges in secondary and tertiary education (mostly in the form of school fees) and health, mostly in curative services. There is little or no cost recovery in public primary education. In a nutshell, the overall degree of decentralization remains limited, as local governments still do not have stable, significant sources of revenues. As a result, local governments continue to rely heavily on transfers from the central government to implement their expenditure programs. On the expenditure side, since 1998, there has been some decentralization in education and health: Jamaica's 14 parishes are gaining more autonomy in the implementation of public sector spending in these sectors, as a part of the overall restructuring in these sectors. Partly, this is a response to the broader problems of the need to contain costs, limit excessive salaries for certain categories of medical personnel, and improve efficiency in delivery of services.

#### **IV. Intergovernmental Transfers**

As national governments collect most major taxes and expenditure responsibilities may be devolved to subnational governments, there may be a large residual financing need at the subnational level. Subnational governments may differ in their own capacity to raise revenues and in the need to provide public services and cost of providing them. Intergovernmental transfers are a means to address these imbalances. Intergovernmental transfers finance the largest share of subnational expenditures, such as in Trinidad and Tobago. Some of these national transfers may be direct payments to individuals through income-transfer programs, administered by subnational governments. In wealthier countries, these income transfers often come to dominate intergovernmental transfers.

In designing an intergovernmental system, there are two important issues: the vertical division of responsibilities (that is, the division among levels of government) and the horizontal division of responsibilities (that is, the division among governments at the same level). This division, which varies from one country to the next, determines the level of funding that must be made available, though not necessarily the structure of financing.

Intergovernmental transfers may also take the form of grants. General purpose grants are like revenue sharing in that they are usually distributed by formula with no or few restrictions on their use. Canada, for instance, makes use of equalization transfers. Block grants apply to broad categories of related functions and impose few restrictions on how

subnational governments allocate funds to activities within the block. Block grants might, for instance, apply to health or education expenditures as in the United States.<sup>11</sup>

Intergovernmental transfers take several different forms. Revenue sharing is commonly used to boost the spending abilities of lower level governments and for equalization purposes. Sometimes revenues may be shared on a tax-by-tax basis, with different allocations among the levels of government for each tax or for the total of all tax revenues. Revenue-sharing funds are typically distributed by statutory formula with no or few restrictions on their use. In Brazil, for instance, revenue-sharing arrangements are set in the constitution. Revenue sharing provides subnational governments with some regular recurring revenues but they may limit the ability of national governments to tighten the fiscal stance. Revenue sharing of this nature may tend to impart a procyclical fiscal impulse. Variable revenue sharing formulas could mitigate or reverse this procyclical impact. Revenue sharing among subnational governments is sometimes determined on the basis of derivation, where each community is returned the revenue collected in its jurisdiction. Some formulas may have redistributive elements to help equalize fiscal capacity among jurisdictions.<sup>12</sup>

Categorical grants provide money for specific programs, and take several major forms. Formula-based grants distribute money to subnational governments according to legislatively or administratively defined criteria. These criteria include factors that measure the needs of the community, its capacity to provide public services, the cost of providing public services, and the tax effort the community is already making to provide public services. Formulas vary from the most simple to very complicated but are typically related to population and per capita income of the community. The simplest formula might provide a fixed amount to each grant recipient regardless of the costs of providing that service. More typically, formulas provide amounts related to the costs of providing the service so the formula would have a variable amount (or a fixed and variable amount) related to the total population in the grant recipient's jurisdiction. For special purpose grants for education, the formula might vary with school enrollment; for prisons, the formula might vary with prison population. Formula grants include both open-end, matching grants, and closed-end, matching and nonmatching grants. Project grants do not distribute money in a general manner. Governments solicit applications for these grants and award the funds selectively. These grants are closed-end and may or may not have matching requirements. There are also mixed formula and project grants, which are discretionary grants that are constrained by a formula. Some categorical grants require

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<sup>11</sup> See Stotsky and Sunley (1997) and Krelove, Stotsky, and Vehorn (1997).

<sup>12</sup> See Ter-Minassian (1997a).

matching funds from the subnational governments. The matching rate is usually low. The link between central government aid and the fiscal capacity of lower levels of government—the potential ability to raise revenue relative to the cost of service—may often be weak, though transfers still tend to reduce fiscal disparities.

In the colonial period and afterwards, to a lesser extent, Caribbean nations that were British colonies received grants from the British government. Although the emphasis of the grants varied across the nations, grants comprised a significant component of spending in the period before independence.<sup>13</sup> Despite the reduction in this source of funding in recent years and in view of the success of the Eastern Caribbean Monetary Union in maintaining a coordinated approach to monetary policy among the nations of the Organization of Eastern Caribbean States, it may be useful to consider more harmonization in fiscal policy, perhaps in part through the creation of a common fund, to which all participating countries would contribute and then which would redistribute those funds, either as grants or loans, much as is done in the European Union.<sup>14</sup> Such a system may be difficult to design in practice as distributional issues can become quite controversial.

Considerable research has examined the effect of intergovernmental grants on the nature of state and local fiscal decisions.<sup>15</sup> The main conclusion of econometric research is that grants exert a powerful influence on both the level and composition of spending by recipient governments, emphasizing the important role grants can play in a fiscal system in determining the level and mix of public goods and services.<sup>16</sup>

## V. Local Borrowing

Whether subnational governments can borrow from either the central government or the banking system to finance their current and/or capital operations may have important implications for the conduct of overall fiscal policy and the inter-governmental fiscal relations. Worldwide practices differ widely. In some countries, such as Germany and the United States, state governments follow a simple “golden rule:” they are prohibited from borrowing for current expenditures, but may borrow for investment purposes. This solution may be desirable in developing countries where there is a danger that financial indiscipline at the subnational level may spill over into the national setting. But there is

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<sup>13</sup> See Jones-Hendrickson (1985), pp. 64-76.

<sup>14</sup> See Jones-Hendrickson (1985) who proposes the formation of a Revenue Diffusion Fund among Caribbean nations to lend to each other.

<sup>15</sup> See Craig and Inman (1982,1986), Gramlich (1977,1982), Inman (1979), and Stotsky (1991).

<sup>16</sup> Although intergovernmental grants are one mechanism by which higher level governments influence the actions of lower levels of government, mandates are another important mechanism.

no hard-and-fast rule. In some countries, this rule may not provide enough safeguards against circumvention or rules. In others, subnational government borrowing may allow these governments to invest in health and education, with beneficial long-term economic effects, that would be difficult in the presence of these limits. In fact, some countries, notably Canada and Brazil, rely more on market discipline to ensure sound subnational government borrowing. Others, such as Switzerland, implement debt-based rules that limit the local government borrowing within the local debt servicing capacity.

More generally, the limits on subnational government borrowing are a part of the general issue of debt control at all levels of government. In this regard, it is generally good practice to avoid government borrowing from the central bank at all levels of government. Furthermore, subnational borrowing from the international markets should be limited by the clearly established debt-servicing capacity of these governments and general macroeconomic conditions. Finally, while it is difficult to specify hard rules in this area, in developing countries, it is probably prudent to rely on a combination of rules or direct controls over subnational government borrowing and market discipline.<sup>17</sup>

## **VI. Implications for Macroeconomic Management**

Economic slowdowns cause budget problems for government by reducing revenues and increasing some expenditures above expected levels. During slowdowns, government spending rises above expected levels as people lose their jobs or face reduced workweeks, retire, and become eligible for unemployment compensation, welfare, pensions, and other income-transfer programs. The national and subnational governments share the impact of these cyclical changes because their revenues are derived largely from the same cyclical sources.

As the national government can run a budget deficit, its budget tends to exert a countercyclical influence on economic activity. When economic activity slows, the budget deficit widens, moderating a downturn. When economic activity increases rapidly, the budget deficit shrinks, moderating the stimulus. In principle, national grants (as distinct from income-transfer programs) could be used for explicitly countercyclical purposes, increasing during downturns and decreasing during upturns. There does not, however, appear to be any conscious policy of countercyclicity built into most national grant programs. In addition, the lags between recognition of an economic downturn, approval of additional spending, and actual spending may be too long for "public works" spending to be an effective countercyclical policy. Nevertheless, since sometimes a significant share of grants are for income-transfer programs, these grants would tend to exert a countercyclical influence on the economy.

As subnational governments generally cannot run a budget deficit on the current budget, their budgets have both countercyclical and procyclical elements. When economic

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<sup>17</sup> See Ter-Minassian (1997a).

downturns occur, such subnational governments must move rapidly to eliminate any emerging deficit caused by falling revenues and rising expenditures.

There are a variety of ways to finance a deficit.<sup>18</sup> Apart from raising fresh funds in financial markets, one way is to draw down reserve funds. Some subnational governments have “rainy day funds” in which they hold surplus revenues for times of budgetary stress. A generally accepted rule of thumb in state government budgeting in the United States is that reserves be equal to approximately 5 percent of the current budget. Cash reserves can be used to conduct a countercyclical fiscal policy. As revenues fall in a downturn, previously accumulated cash reserves can be used to cushion the impact of this shortfall. As revenues rise in an upturn, surpluses can be allowed to accumulate. As a practical matter, it is difficult for governments to maintain reserves, since there are always pressing needs and political pressure for government spending.

Large deficits, however, require spending and revenue adjustments that can either be short or long term in nature. On the spending side, the main problem is that subnational governments have little flexibility for cutting their budgets in the short term. A large proportion of subnational spending goes for goods and services, including contractual wages and salaries, leaving subnational governments with little room for discretionary spending cuts. Governments may cut aid to lower levels of governments. Although this may avert a budget problem for one level of government, it ends up pushing the problem onto another level of government. Subnational governments may also defer or eliminate capital expenditures, though delaying needed projects may raise their ultimate cost. Other methods include undermaintaining the infrastructure and underfunding the contribution to the employees' pension system or borrowing from it. But these tactics only thrust the problems onto future taxpayers.

On the revenue side, a large deficit may require governments to take short-term measures, such as accelerating the collection of taxes or raising taxes or other revenues. Governments can accelerate tax collection by reducing the interval for collection, creating a one-time revenue gain. Governments may also increase tax revenues by raising the rate of existing taxes, by broadening the base to which a tax applies, or by instituting a new source of tax revenues altogether. Unless the tax change is reflected in withholding or current payments, the change will not, however, increase revenues in the current fiscal year. Another way to raise revenues is by charging or increasing user fees for services. The extent to which budget management results in a countercyclical or procyclical influence depends in part on whether the stimulative effects of additional spending

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<sup>18</sup> See Eckl (1987).

outweigh the depressing effects of higher taxes and charges required to balance the budget.

While short term budget problems may largely reflect cyclical forces in the economy, to the extent that these problems represent longer term structural budget problems, they require governments to supplement short term measures with more fundamental reforms of expenditures and revenues. These reforms may take the form of cuts in the scope or extent of expenditure programs, greater efficiency in the provision of public services, expansion of the tax base, increases in tax rates, or introduction of a new tax.

Governments faced with persistent revenue shortfalls have taken a variety of adjustment measures, depending on the political and economic situation. Governments where voters are already discontented with the high level of taxes may have to rely on expenditure cuts. Elsewhere, voters may find tax hikes more palatable.

Given the inherent cyclicity built into government budgets, decentralization may lead to a loss of fiscal control for several reasons.<sup>19</sup> A loss of control over a significant or substantial portion of public expenditures may limit the ability of the national government to change the size of the deficit, either to increase it to stimulate aggregate demand or to reduce it to rein in excess aggregate demand and avoid overheating the economy. In part, the loss of fiscal control is linked to the revenue and expenditure assignments. If the national government is left with inflexible revenues and expenditures, such as interest payments or entitlements, the loss of control is greater. In addition, subnational government fiscal also alter the overall fiscal stance, especially when these governments are able to run deficits. Even if they must maintain a balanced budget they may still have an influence if the level or composition of their revenues and expenditures have implications for aggregate demand or financial markets, in general. If subnational governments are chronically underfunded, there is often a tendency for debt to accumulate, even in the presence of balanced budget rules. On the other hand, if subnational governments are overfunded, there is a tendency for excessive spending to emerge leading to an increase in the size of government and inefficiency. Overall, decentralization may lead to an excessive level of devolution of revenue assignments to subnational governments than would be optimal for macroeconomic management. This is an important considerations for Caribbean nations to keep in mind, which adds to the arguments previously made against excessive decentralization.

Countering this line of argument is the view that decentralization may improve overall macroeconomic performance by more closely connecting government to its constituency. Decentralization may lead to a more aware citizenry, which may impose stronger constraints on government spending and lead to a smaller, more efficient government.<sup>20</sup> However, decentralization does not necessarily lead to a closer connection between

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<sup>19</sup> See Ter-Minassian (1997b).

<sup>20</sup> See Burki, Perry, and Dillinger (1999) and Shah (1998).

spending and revenues, if there are substantial intergovernmental transfers. The design of that system influences the incentives, as noted in the earlier section. The transition period may be particularly difficult because imbalances are most likely to emerge at that stage. Empirical evidence suggests that decentralization combined with transfers tends to increase total government size; increases in subnational deficits tends to increase national level expenditures and deficits and hence contributes to macroeconomic instability; while decentralization based on local taxes does not increase government size in the steady state; and decentralization is not associated with larger deficits in the steady state.<sup>21</sup>

While fiscal decentralization has a clear influence on fiscal policy, fiscal decentralization may also have implications for monetary policy. Fiscal decentralization may lead to some loss of control over monetary policy because it disperses political and hence decision making power. There is some international evidence in this regard, especially in highly decentralized systems such as that of the former Yugoslavia. Specifically, while the former Yugoslav republics were required to run balanced budgets, they exerted considerable influence on the conduct of monetary policy and, particularly, interest rate policy. As a result, the monetary and exchange rate stability was often sacrificed under subnational government pressures for low interest rates and selective credits to enterprises on their territory. This led to systemic pressures on monetary and fiscal policy from the subnational level that was difficult to resist in the national political arena.<sup>22</sup> Independence of the monetary authorities not only from the national government but also subnational government pressures with regard to the objectives and instruments of monetary policy is important for maintaining of macroeconomic stability in the multigovernment setting. In some countries, even stronger rule-based systems, such as is found in the Organization of Eastern Caribbean States, may be desirable to ensure institutional underpinnings to macroeconomic stability.

In contrast, Huther and Shah (1998) argue that a more decentralized system leads to more independence for the central bank and hence strengthens central bank control of monetary aggregates. Decentralization leads to “more clarity” in the roles of economic entities.

## VII. Conclusion

The study of intergovernmental relations in the Caribbean has been relatively neglected. There are, however, many lessons that can be learned from other countries, including those in the region for the design of a more decentralized system of government. There are many issues of importance, including revenue assignments, expenditure assignments, debt management practices, intergovernmental grants design, and macroeconomic implications. It would be useful to gain greater insight into the existing practices to assess

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<sup>21</sup> See Burki, Perry, and Dillinger (1999), p. 39.

<sup>22</sup> See Bogetic and Heffley (1992).



how applicable other countries' practices may be to the Caribbean and what gains could thus be afforded to Caribbean nations.

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**Table 1. The Caribbean Region - Selected Central Government Indicators, 1998**

(In percent of GDP)

	Overall Balance	Total Revenues	Tax Revenues	Total Expenditures	Interest Payments	Transfers to Subnational Governments
Antigua and Barbuda	-8.8	25.3	17.6	34.1	3.1	n.a.
Bahamas	-0.4	20.7	16.8	21.1	2.3	n.a.
Barbados	-2.5	30.5	29.2	33.0	4.4	n.a.
Belize 1/	-3.3	24.7	19.3	28.0	1.9	0.5
Dominica 2/	-4.3	31.9	23.7	36.2	2.8	0.2
Dominican Republic 3/	-1.0	16.1	15.0	17.0	0.7	0.4
Grenada 4/ 5/	-6.6	27.6	22.3	34.2	2.5	0.3
Guyana 4/ 6/	-6.8	31.9	28.5	38.7	8.0	0.1
Haiti 4/	-1.3	8.3	8.1	9.6	0.7	n.a.
Jamaica	-12.8	30.1	26.5	42.9	18.7	n.a.
St. Kitts and Nevis	-5.0	31.3	21.8	36.3	3.1	n.a.
St. Lucia 7/	-1.6	28.5	21.8	30.2	1.4	0.2
St. Vincent and the Grenadines 8/	-6.4	29.8	26.0	36.2	2.0	0.3
Suriname	-11.1	30.1	23.0	41.2	0.6	n.a.
Trinidad and Tobago 9/	-1.6	26.9	22.0	28.5	5.0	2.3

Sources: Staff estimates.

1/ Transfers to subnational governments refer to "Current and Capital Transfers to Statutory Bodies."

2/ Transfers to subnational governments refer to "Transfers to Local Governments."

3/ Transfers to subnational governments include those to "Municipios y Ayuntamientos".

4/ Staff and government estimates.

5/ Transfers to subnational governments refer to "Current Transfers to Statutory Bodies". They exclude unclassified data from "Grants and Subventions".

6/ Transfers exclude unclassified data from "Current Transfers to Local and International Organizations". They also exclude capital transfers to subnational governments.

7/ Transfers to subnational governments refer to "Transfers to Towns and Villages".

8/ Transfers to subnational governments include those to district and village councils, small towns and Kingstown Board.

9/ Transfers to subnational governments include those to regional health authorities and nonprofit organizations.

Table 2. OECD Countries: Tax Structure, 1990-95

(In percent of GDP)

	Sample Size	Total Revenue	Tax Revenue	Other Revenue	Taxes on Income, Profits, and Capital Gains			Social Security Taxes	Payroll Taxes	Domestic Taxes on Goods and Services of which:			International Trade Taxes of which:			Property Taxes
					Total	Individual	Corporate			Total	General sales, turnover or VAT	Excises	Total	Import duties	Export duties	
Australia	1990-95	25.8	23.0	2.8	16.5	12.4	3.8	0.0	0.4	5.3	2.5	2.7	0.9	0.9	0.0	0.0
Austria	1990-94	35.8	32.6	3.2	7.0	5.6	1.1	13.4	1.9	8.8	6.0	2.1	0.5	0.5	0.0	0.6
Belgium	1990-94	44.0	42.3	1.7	14.9	12.5	2.2	15.5	0.0	10.8	7.1	2.3	0.0	0.0	0.0	1.2
Canada	1990-94	20.7	18.3	2.4	10.4	8.7	1.4	3.7	0.0	3.7	2.6	1.0	0.6	0.6	0.0	0.0
Czech Republic	1993-95	41.1	38.0	3.1	6.9	0.5	6.4	15.6	0.0	13.1	8.2	4.5	1.6	1.6	0.0	0.2
Denmark	1990-95	40.5	34.2	6.3	15.3	12.3	1.5	1.6	0.3	16.0	9.9	3.7	0.0	0.0	0.0	0.8
Finland	1990-94	32.4	28.8	3.6	9.5	8.7	0.8	3.5	0.0	14.5	8.9	4.6	0.3	0.3	0.0	0.9
France	1990-95	40.6	37.7	2.9	7.1	5.3	1.8	17.8	0.5	11.2	7.7	2.6	0.0	0.0	0.0	0.8
Germany	1990-95	30.8	28.9	2.0	4.8	4.0	0.8	14.8	0.0	7.6	4.3	2.8	0.0	0.0	0.0	0.0
Greece	1990-94	22.0	20.2	1.8	6.0	3.2	1.6	1.8	0.0	12.9	7.7	4.8	0.0	0.0	0.0	1.3
Hungary	1990	52.9	44.7	8.2	0.0	2.9	6.5	15.5	0.1	16.6	7.5	5.2	3.1	2.5	0.6	0.0
Iceland	1990-95	29.9	25.5	4.4	6.1	5.4	0.8	2.1	0.2	13.7	9.8	1.4	1.7	1.6	0.0	1.5
Ireland	1990-94	37.1	34.7	2.4	14.2	11.5	2.6	5.4	0.6	11.5	7.2	3.3	2.3	2.3	0.0	0.7
Italy	1990-94	40.7	38.8	1.9	14.6	12.1	2.3	11.6	0.0	11.5	6.0	3.0	0.0	0.0	0.0	0.5
Japan	1990-93	19.9	17.1	2.8	8.8	5.4	3.4	4.1	0.0	2.9	1.4	1.3	0.2	0.2	0.0	0.7
Luxembourg	1990-94	42.6	38.0	4.6	13.2	8.7	4.1	10.9	0.0	10.3	5.9	4.0	0.0	0.0	0.0	2.9
Mexico	1990-94	16.4	14.9	1.5	0.0	...	...	2.9	0.1	8.4	3.3	1.8	1.1	1.1	0.0	0.0
Netherlands	1990-95	48.5	44.5	4.0	14.1	10.8	3.3	18.4	0.0	10.5	7.1	2.7	0.0	0.0	0.0	1.1
New Zealand	1990-95	38.7	33.9	4.7	21.8	17.0	3.3	0.0	0.5	10.4	7.1	2.5	0.8	0.8	0.0	0.3
Norway	1990-94	41.0	31.8	9.2	6.6	3.7	2.9	9.8	0.0	14.8	7.9	5.5	0.2	0.2	0.0	0.4
Poland	1994-95	41.4	37.1	4.4	0.0	8.3	3.2	10.2	0.3	11.6	7.2	4.3	3.4	3.4	0.0	0.0
Portugal	1990-94	35.5	31.0	4.5	8.6	5.9	2.5	8.8	0.0	12.3	6.4	4.7	0.2	0.2	0.0	0.1
Spain	1990-93	31.5	29.1	2.4	9.9	7.5	2.3	12.0	0.0	6.8	4.3	2.3	0.3	0.3	0.0	0.1
Sweden	1990-95	41.8	35.2	6.6	4.4	2.4	1.9	14.5	1.4	12.9	8.2	4.0	0.3	0.3	0.0	1.6
Switzerland	1991-93	21.6	20.3	1.3	3.3	2.6	0.7	11.4	0.0	3.7	2.9	0.5	1.4	1.4	0.0	0.6
Turkey	1990-94	16.4	13.1	3.3	6.3	5.1	1.2	0.0	0.0	5.5	3.9	0.8	0.7	0.7	0.0	0.2
United Kingdom	1990-95	36.0	32.9	3.1	12.9	9.9	3.1	6.0	0.0	11.4	6.6	4.1	0.0	0.0	0.0	2.5
United States	1990-95	19.7	18.1	1.6	10.0	8.2	1.9	6.8	0.0	0.7	0.0	0.6	0.3	0.3	0.0	0.2
Unweighted average		33.8	30.2	3.6	9.0	7.4	2.5	8.5	0.2	10.0	6.0	3.0	0.7	0.7	0.0	0.7

Sources: IMF, Government Finance Statistics; and International Financial Statistics.

Table 3. Non-OECD Western Hemisphere Countries: Tax Structure, 1990-95

(In percent of GDP)

	Sample Size	Total Revenue	Tax Revenue	Other Revenue	Taxes on Income, Profits, and Capital Gains			Social Security Taxes	Payroll Taxes	Domestic Taxes on Goods and Services			International Trade Taxes			Property Taxes
					Total	of which:				Total	of which:		Total	of which:		
						Individual	Corporate				General sales, turnover or VAT	Excises		Import duties	Export duties	
Argentina	1990-92	12.0	10.2	1.8	0.3	0.0	0.0	5.1	0.0	2.8	1.6	1.1	1.1	0.4	0.4	0.4
Bahamas	1990-93	16.7	14.8	1.9	0.0	0.0	0.0	0.0	0.0	2.0	0.0	0.0	10.3	8.7	0.3	0.6
Barbados	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Bolivia	1990-95	15.1	9.8	5.3	0.6	0.0	0.4	1.1	0.0	5.6	3.9	1.6	1.0	1.0	0.0	1.3
Brazil	1990-93	29.7	18.1	11.6	4.2	0.2	1.0	7.3	1.3	4.9	1.4	2.5	0.5	0.5	0.0	0.0
Chile	1990-95	22.0	18.1	3.9	3.8	...	...	1.5	0.0	9.8	8.0	1.9	2.2	...	...	0.0
Colombia	1990-94	14.4	12.2	2.2	5.3	...	...	0.0	0.0	5.2	4.3	0.7	1.6	1.6	0.1	0.0
Costa Rica	1990-95	24.7	21.4	3.3	2.4	1.8	0.6	6.9	0.0	7.8	4.5	2.9	4.2	3.3	0.7	0.1
Dominican Republic	1990-93	14.2	13.3	1.0	2.4	1.1	1.3	0.6	0.0	3.9	0.0	3.2	6.2	5.8	0.0	0.1
Ecuador	1990-94	16.3	15.5	0.8	9.3	0.0	7.9	0.0	0.0	3.9	3.1	0.8	2.0	1.7	0.0	0.2
El Salvador	1990-95	10.9	10.2	0.7	2.4	1.0	1.4	0.0	0.0	5.3	4.1	1.1	1.9	1.7	0.2	0.5
Guatemala	1990-95	8.7	7.5	1.2	1.7	0.2	1.4	0.0	0.0	3.6	2.5	1.0	1.7	1.7	0.0	0.1
Honduras	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Jamaica	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Nicaragua	1990-95	22.4	20.5	1.9	2.7	...	...	2.5	0.0	9.7	2.5	7.1	4.3	4.3	0.0	0.2
Panama	1990-94	26.7	18.3	8.4	4.7	0.2	1.6	5.4	0.0	4.5	1.7	1.9	2.8	2.6	0.2	0.4
Paraguay	1990-93	13.1	9.3	3.8	1.3	0.0	1.3	0.0	0.1	3.5	1.7	1.4	2.1	1.8	0.0	0.8
Peru	1990-95	13.2	12.0	1.1	1.6	0.2	0.7	1.5	0.5	6.5	3.7	2.7	1.4	1.3	0.1	0.4
St. Kitts	1990-94	30.4	24.1	6.2	4.5	1.5	2.9	3.4	0.0	2.8	0.1	0.6	12.2	11.1	0.1	0.5
St. Lucia	1990-91	24.6	22.7	1.8	6.4	1.9	3.7	0.0	0.0	8.8	7.4	0.1	6.8	6.1	0.1	0.1
St. Vincent	1990-94	29.0	24.5	4.6	7.3	2.9	3.9	1.2	0.0	3.1	0.3	0.2	11.9	11.5	0.4	0.2
Uruguay	1990-95	29.8	28.0	1.8	2.1	0.6	1.5	8.8	0.2	9.7	6.1	3.4	1.8	1.5	0.1	1.4
Venezuela	1990-94	21.3	15.8	5.5	11.1	...	...	1.0	...	1.7	0.7	1.0	1.7	1.8	0.0	1.3
Unweighted average Caribbean 1/		23.0	19.9	3.1	4.1	1.5	2.4	1.0	0.0	4.1	1.6	0.8	9.5	8.6	0.2	0.3
Unweighted average WHD		19.8	16.3	3.4	3.7	0.7	1.8	2.3	0.1	5.3	2.9	1.8	3.9	3.6	0.1	0.4

Source: IMF, Government Finance Statistics.

1/ Encompassing Bahamas, Dominican Republic, St. Kitts, St. Lucia, St. Vincent, for which data were available.