

THE POLITICAL ECONOMY OF FISCAL DECENTRALIZATION IN A SUB-REGIONAL ECONOMY: THE CASE OF TOBAGO

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ABSTRACT

Fiscal decentralization is now widely recognized as a mechanism that governments can use to stimulate economic development. Over the last 25 years, the Tobago House of Assembly (THA) has enjoyed increasing levels of fiscal autonomy from the Central Government of Trinidad and Tobago. However, although significant progress has been made to stimulate economic activity on the island, there remain some fundamental challenges that must be addressed in the interest of Tobago's development. It is widely believed that these challenges are related to the nature and form of the decentralization process. In this context, this paper examines the main issues in the decentralization process between the Central Government in Trinidad and Tobago and how they evolved. More importantly, the paper examines the major fiscal policy challenges facing Tobago as a sub-regional economy and makes recommendations for confronting these challenges. The paper does this by looking at the challenges in two broad categories, namely, the expenditure-related challenges and the revenue-related challenges. As a background to all this, the paper examines the main characteristics of the decentralization process in Latin America and the Caribbean and the main advantages and disadvantages of fiscal decentralization. It argues that although decentralization can be justified on purely economic grounds, political circumstances have exerted the greatest influence on the process.

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1.0 Introduction

Fiscal decentralization is now widely recognized as a mechanism that governments can institute to facilitate and stimulate economic development around the world.² In the context of globalization and the formation of large trading blocs, fiscal decentralization is being viewed as a strategy for economic integration in that, when genuine fiscal decentralization exists, it tends to weaken calls for secession and separation. In other words, fiscal decentralization is seen as a tool for development and economic integration. Beyond this, some international funding agencies have been showing great interest and leadership in encouraging decentralized governments. In the context of Trinidad and Tobago, fiscal decentralization between the Central Government and the Tobago House of Assembly began in earnest in 1980 with the enactment of the Tobago House of Assembly Act, Act No. 37 of 1980 that established the Tobago House of Assembly (THA). Since then, this Act has been repealed and replaced by the Tobago House of Assembly Act of 1996, Act No. 40 which sought to deepen the process of fiscal decentralization.

This paper has two fundamental objectives. First, it seeks to examine the main issues in the decentralization process between Trinidad and Tobago and how they evolved. The second, and more fundamental, objective is to examine the major fiscal policy challenges facing Tobago as a sub-regional economy within the national economy of Trinidad and Tobago and to identify recommendations to confront these challenges. The paper argues that although over the period 1980 to the present, the THA has been given increasing levels of fiscal autonomy, there remain considerable challenges to the overall effectiveness of fiscal policy on the island. Along the way, it becomes quite evident in the paper that although the motives for decentralization were mainly political, there are highly rational economic arguments in favour of fiscal decentralization

2 The concept of fiscal decentralization used here is the one used by Davoodi (2001). Davoodi defined fiscal decentralization as the devolution of fiscal responsibilities from Central Governments to subnational levels of governments. Its level is measured by the subnational shares of total public sector expenditures and revenues.

from the Central Government of Trinidad and Tobago to the THA. The focus of this paper is on fiscal policy rather than monetary policy because, except in cases where moral suasion and informal negotiations are possible, the THA does not have any direct control over monetary policy.

In addition to this introduction this paper has six (6) sections. Section 1 examines the key issues in fiscal decentralization in developing countries with particular reference to Latin America and the Caribbean. Section 2 looks at the evolution of the decentralization process between the Central Government of Trinidad and Tobago and the THA. It does this by looking at the pre-1980 period, the post-1980 period and the post 1996 period. The next section, Section 3, sets out the economic case for fiscal decentralization between the Central Government of Trinidad and Tobago, and the THA. The following section, Section 4, looks at the fiscal policy challenges facing Tobago from the standpoint of expenditures and revenues. Sections 5 then highlights some key policy options available to the Tobago House of Assembly and the Central Government to achieve greater fiscal decentralization. The paper then concludes in Section 6.

2.0 Issues in Fiscal Decentralization in Latin America and the Caribbean

Since the 1980s issues of fiscal decentralization have gained new prominence in the literature on development economics. It is widely believed that many of the solutions to the many problems facing developing economies lie in greater decentralization and fiscal autonomy. It is in this context that this section of the paper seeks to look at the main issues pertaining to fiscal decentralization in the developing countries in general and Latin American and the Caribbean specifically. The section pays particular attention to the main arguments for and against fiscal decentralization as presented in the literature.

Since the classic works of Tiebout (1956), Musgrave (1959) and Oates (1972), fiscal decentralization has been a very important topic in the public finance literature. Over the last two decades it has become a major political and economic issue in Latin America and in the Caribbean, as well as in many other developing countries around the

world. Davoodi (2001) and Miller (2002) defined fiscal decentralization as the distribution of fiscal responsibilities from the Central Government to subnational levels of governments.

Miller (2002) went on to identify different degrees of fiscal decentralization. The first, deconcentration or bureaucratic decentralization, occurs when decentralization takes the form of a transfer of functions from the Central Government to regional offices and real decision-making is retained at the centre. It is the weakest form of decentralization. The second form is delegation, which occurs when Central Governments transfer responsibility for decision-making to semi-autonomous organizations, or executive agencies not wholly controlled by the Central Government, but ultimately accountable to it. Usually, these organizations have a great deal of discretion in decision-making. This represents a more extensive form of decentralization than deconcentration. The third form is called devolution. This occurs when Central Governments transfer the responsibility for decision-making, finance and management to subnational jurisdictions that are outside its direct control, and which have corporate status. Devolution in its purest form has two fundamental characteristics. First, local units of governments are autonomous and have clear and legally recognized geographical boundaries within which they can exercise their authority. Second, subnational governments usually have corporate status and the power to secure resources to perform their functions.

The literature on fiscal decentralization in developing countries in general, and Latin America and the Caribbean specifically, reveals several striking characteristics. First, fiscal decentralization is both an economic and a political process. From the standpoint of economics, fiscal decentralization is seen as a vehicle to improve and democratize the allocation and use of public resources. In other words, it is seen as an instrument of economic policy and the greatest motive is to seek more efficiency and efficacy in the allocation of public resources. From the perspective of politics, it is felt that the prevailing political circumstances and realities tend to exert very strong influences on the level of fiscal decentralization. In Latin America, for instance, fiscal decentralization has occurred very much in parallel with the democratization of government and the fall of military regimes. This may be because it is felt that fiscal decentralization and democracy are processes which complement and strengthen each other.

The second feature of fiscal decentralization is that it can be either supply driven or demand driven. If it is carried out by a strong Central Government in a top to bottom movement, it is called supply decentralization. For instance, the decentralization that took place in Chile in the 1970s was done to spread Central Government activity more efficiently over national territory and is viewed as an example of supply decentralization. By contrast, when decentralization takes place from the bottom upwards as a result of protest action by subnational governments against excessive powers of Central Government, it is called demand decentralization. An example of this was Brazil in 1988, where fiscal decentralization took place to weaken the federal government to prevent the re-installation of a dictatorial government. The experiences in Columbia in 1992 and Ecuador 1996 were quite similar.

The third feature of fiscal decentralization is that history has a significant influence on the expenditure assignment observed. In Latin America and the Caribbean, certain functions have remained at the sub-national level since colonial times e.g. control of markets, abattoirs or cemeteries (IDB 2000).

Fourth, in order to avoid the “the pendulum effect” whereby autonomy is given and the commitment is withdrawn redirecting effective power to the centre, the relationship between the various levels of government must be properly stated and entrenched in constitutional and legal frameworks. This is important as it offers local government bodies firm and consistent mandates and makes them less vulnerable to “interference” from the Central Government. It is also useful in that it allows for greater accountability.

Several arguments have been advanced for and against fiscal decentralization. One of the strongest theoretical arguments advanced in favour of fiscal decentralization is the economic efficiency argument. Tiebout (1956), Miller (2002) and Tanzi (2000) argued that fiscal decentralization may provide greater economic efficiency in the allocation of resources in the public sector because subnational governments are better able to match differing preferences across jurisdictions. It is argued that citizens can influence decisions about service provision through mechanisms which enable them to indicate the type, level, quality and mix of services which they desire, and the cost they are willing to pay for such services. Tiebout (1956) argued that the gains in efficiency are enhanced if taxpayers are mobile because they can

migrate or choose among the jurisdictions that best match their preferred tax-expenditure package.

Another related argument advanced for fiscal decentralization is that it provides a framework which facilitates and stimulates local sustainable development. Miller (2002) argued that fiscal decentralization allows regions to take the initiative for their own development and in so doing they will know of the opportunities, indigenous resources and comparative advantages on which development can be based. In addition, he argues that fiscal decentralization allows for local sustainable development in that it allows far more local participation and agreement on common goals strategies, plans etc.

It is also argued that fiscal decentralization facilitates a better division of labour in the management of public affairs. Miller (2002) contended that fiscal decentralization frees up the Central Governments to concentrate on higher level functions such as policy formulation, strategic planning, setting standards and monitoring. This improves efficiency and creates more effective checks and balances in governmental affairs.

Another argument in support of fiscal decentralization is that it provides opportunity for a wider diversity of innovations. Miller (2002) postulated that this is so because it allows many citizens and groups who were previously excluded to make a contribution to their own development. What this means is that the vast reservoir of talent, innovation, creativity, problem-solving capacity and leadership qualities which previously lay dormant in the local community would be able to find expression.

It is also argued that decentralization facilitates the mobilization of local resources for the development process. Miller (2002) contended that this occurs because local people are able to identify and mobilize indigenous resources which would not be available to a centrally-run programme, and because locals are often willing to volunteer free labour and expertise, and other forms of contributions in kind in order to support local initiatives.

Many arguments against fiscal decentralization have also been advanced. One of the strongest arguments advanced against fiscal decentralization is that it can create problems for macroeconomic policy coordination. Tanzi (2000) argued that with a decentralized fiscal structure, it becomes more difficult to coordinate fiscal policy in a counter-cyclical sense. He argued that at times a sub-national

government may pursue expansionary fiscal policy at a time when the national government is pursuing a contractionary policy. Also, sub-national governments may accumulate large debts if they believe the national government will bail them out, and thereby create debt service problems for the nation. For years this has been a problem in Argentina and Brazil. A study for Latin America by Burki, Perry and Dillinger (1999) suggests that most macroeconomic problems were related to the improper design of intergovernmental relations in these two countries. In addition, Dillinger and Webb (1999) noted that Argentina, Brazil and Columbia, which allow a high degree of sub-national borrowing autonomy, have experienced some of the largest sub-national deficits and debts in the region.

Another argument advanced against fiscal decentralization is that it creates opportunities for corruption. Tanzi (2000) argued that corruption is likely to be increased at the local level because there is more opportunity. Increased opportunity is related to weaker accounting systems and the human resource capacity problem usually associated with sub-national governments.

It is also argued that fiscal decentralization can cause inter-regional inequalities to increase, since different regions are differently endowed in terms of natural resources and levels of economic activity. As a consequence, some regions enjoy far better quality of service provision and quality of life than others. These disparities can cause destabilizing effects on the country (Tanzi 2000). Further, it is also argued that fiscal decentralization can be a major impediment to much needed tax reforms. Tanzi (2000) argued that Brazil has been trying to reform its Value-added Tax for many years, but has faced great difficulties because of the Value-added Taxes levied at the state level. It has been impossible to reach consensus among the state authorities for changes that would make the tax systems more efficient. Similar problems have been experienced in Argentina and India.

Another argument against fiscal decentralization is that it leads to a decline in the quality of service governments offer the public. This is related to the poor quality of local administration due to a lack of institutional capacity. It is argued that this will act to undermine the performance of local government bodies and their responsiveness to citizens' demands and social needs. The deficiencies are mainly

related to inadequate organizational structures, operational procedures, and staffing.

In conclusion several arguments have been advanced for and against fiscal decentralization. Evidently, whether or not fiscal decentralization would have the desired benefits would depend on the institutional arrangements, the legal environment and the human resource capacity.

3.0 Fiscal Decentralization in Trinidad and Tobago: A Historical Perspective

In order to appreciate the evolution of the decentralization process between the central government of Trinidad and Tobago and the THA, it is helpful to look at it in three distinct periods. These are the pre-1980 period, the 1980-1996 period, and the post 1996 period.

3.1 The pre-1980 period

In the post-hurricane Flora (1963) period, there were two basic governmental systems existing in Tobago. The first was the Ministry of Tobago Affairs and the second was the Tobago County Council, which was supposed to be a decentralized representative Local Government institution. The Ministry of Tobago Affairs was responsible for directing government's policy perspective on the island, and managed all government activities beyond those of the Local Government authority. The Ministry was, effectively, a coordinating arm of the Central Government in Tobago. It was plagued with problems, as essentially line ministries in Trinidad retained direct control over administration in Tobago. In 1976, because of the election results,³ the Ministry was dismantled and replaced by Central Administrative Services in Tobago. Ragoonath (1997) noted that the Ministry of Tobago Affairs was ineffective because Tobago relied on Trinidad for various services, which were not provided on a timely basis. What this meant was that Tobago lacked the capacity to implement and provide the services as required by the citizenry for its development.

3 The opposition DAC won the two Tobago seats in the General Election.

The fortunes of the Tobago County Council were not very much different. The Council, an elected body, operated under the guise of bureaucratic decentralization. The Council had little powers, as all recurrent and capital works had to receive approval and financing from the Central Government in Trinidad. Essentially, no powers were devolved to the elected Council, since the Councillors were only allowed to recommend policy perspectives to the Central Government, and only if the Central Government were sympathetic to the recommendations would the required finances for the Council to execute the approved work be granted. In addition, according to Ragoonath, the work agenda of the Council was severely handicapped by shortages of materials, manpower and equipment to service various projects. There were also problems of supervision and project management.

In 1977, the Member of Parliament for Tobago East, Mr. A.N.R. Robinson, moved a motion "...that all proper and necessary steps should be taken to accord the people of Tobago internal Self-Government..." The motion, after substantial debate, was unanimously passed on February 4th 1977, and based on the success of the motion, the government appointed a Joint Select Committee of Parliament to consider and make recommendations to operationalize the resolution. In "House Paper No.6 of 1978," the Joint Select Committee recommended that legislation be enacted to facilitate the institution of a Tobago Island Council.⁴ It was recommended that the Council be granted powers of finance (except external borrowing) and economic development. Further, it was recommended that the Council would have responsibility for the environment, infrastructure, physical planning and community services. Based on the recommendation from the Joint Select Committee, the Government commissioned the drafting of legislation for the establishment of the Tobago Island Council. However, in 1979, when the draft bill was presented to the government, it was unhappy with it because it was seen to be inimical to the maintenance of the unitary state of Trinidad and Tobago.

4 See Ragoonath (1997).

3.2. The 1980-1996 Period

In 1980, another Bill was drafted with a proposal for the establishment of the Tobago House of Assembly (T.H.A). The THA Bill was less contentious, as the Assembly could exercise only delegated powers with respect to policy formulation and implementation. The Bill was therefore passed in the Parliament so that. Act No. 37 of 1980 created a Tobago House of Assembly (THA) for the purpose of making better provisions for the administration of Tobago. The THA was given responsibility to formulate and implement policy on all matters referred to it by the Minister and had responsibility for implementing government policy in Tobago. Over the years there were major problems of interpretation and operationalization of the Act. In order to operationalize the various functions of the THA, the Assembly instituted an internal structure of “Secretaries”. The “Secretary” system ensured that there was a system of management in Tobago similar to Cabinet. However, the office of “Secretary” remained in dispute for many years as it was argued that the Secretaries had no legal status. The Tobago House of Assembly was effectively a mere implementation agency with no executive powers and was viewed as an agent to execute government’s policy in Tobago.

3.3. The Post 1996 Period

The year 1996 marked a turning point in terms of Tobago’s autonomy. With the passage of Act #40 of 1996, the process of decentralization to the THA was further strengthened. Section 5 (1) of the Act stipulates that the Assembly is constituted as a body corporate, thus conferring on it a legal identity. In addition, Section 25 (1) of the THA Act stipulates that without prejudice to section 75 (1) of the constitution, the Assembly shall, in relation to Tobago, be responsible for the formulation and implementation of policy in respect of matters set out in the Fifth Schedule. These matters include, but are not limited to: Finance, State Lands, Tourism, Agriculture, Fisheries, Town and Country Planning, Infrastructure, Highways and Roads, Industrial

Development, the Environment, Customs and Excise and Education.⁵ The responsibility to be exercised in relation to Tobago includes any part of the territorial sea, which lies within six nautical miles of the island of Tobago. Also, Section 26 (1) states that the Assembly shall not have responsibility for matters set out in the Sixth Schedule. These include areas such as National Security, Foreign Affairs, Judiciary, Immigration and Legal Affairs.⁶ These items remain the responsibility of Central Government. Section 29 provides for the making of Assembly Laws, which would play an important role in the implementation of policies of the Assembly. The Assembly debates these proposed laws, they are then transmitted to Cabinet, and subject to Cabinet agreeing with the proposed laws, they are then introduced into Parliament for debate and ultimately for the approval of Parliament. It is further stipulated that a Bill adopted by the Assembly shall not be contrary to any written law of the Republic of Trinidad and Tobago and the THA would not be allowed to impose any direct or indirect taxation of its own.

Section 43 stipulates that in considering Tobago's annual budgetary allocation, the Central Government must consider the:

- a) Physical separation of Tobago by sea from Trinidad and Tobago's distinct identity
- b) Isolation from the principal national growth centres
- c) Absence of the multiplier effect of expenditures and investments (private and public) made in Trinidad
- d) Restricted opportunities for employment and career fulfillment
- e) The impracticability of participation by residents of Tobago in the major educational, cultural and sporting facilities located in Trinidad.

5 See Appendix 1.

6 See Appendix II.

In summary, since 1963, the most striking feature of the decentralization process between Trinidad and Tobago was that political factors rather than economic factors were most influential. This is so largely because Central Governments have always seen the question of increased autonomy for Tobago through the lens of political expediency. Moreover, the decentralization that took place was mainly demand driven, in that it was largely inspired by activities in Tobago. Also, the decentralization in place now is more in line with devolution.

4.0 The Economic Case for Decentralization in Tobago

Although almost all of the arguments in favour of greater decentralization to the Tobago House of Assembly have been coloured by the politics, there are very potent economic arguments to support greater fiscal decentralization to the Tobago House of Assembly. The first, and probably the most important argument, pertains to the structural differences between the Tobago economy, and that of Trinidad. It is well known that the Tobago economy is heavily tourist-oriented. A recent report done by the World Travel and Tourism Council has shown that tourism accounts for 46 per cent of GDP, employs over 15,000 persons directly and indirectly, and accounts for 96 per cent of Tobago's exports. The Trinidad economy on the other hand is heavily dependent on oil and gas. As Henry (2003) has argued, the different economic structures call for different fiscal arrangements.

Henry (2003) went on to argue that the experience of Trinidad and Tobago over the last two decades has shown clearly that Tobago can operate counter-cyclically and positively in the national economy that is still dominated by oil and gas, which renders the national economy very vulnerable to fluctuation in that sector internationally. He argued that the tourism industry was a positive growth pole in the late 1980s and early 1990s in particular, at a time when the country as a whole had recorded an economic slump. Second, the Tobago House of Assembly will possess greater sensitivity to the needs of the people, and service provision is likely to be more efficient from the standpoint of allocative efficiency. The third economic argument in favour of fiscal decentralization between the Central Government of Trinidad and Tobago and the THA pertains to the fact that Tobago is a geographical and economic entity. Because of the physical separation of the two islands, economic development in

Trinidad does not necessarily benefit Tobago, since important economic resources are not freely transferable between the two islands nor can the fruits of economic development be equally enjoyed. The fourth economic argument in favour of fiscal decentralization relates to economic integration. In the context of twin-island states, such fiscal decentralization helps to dampen calls for secession and separation; it is thus a tool for economic integration. Fifth, it is well known that Tobago, because of its location, is much more susceptible to natural disasters, such as hurricanes, than Trinidad. In cases of natural disasters, a truly decentralized entity in Tobago would be better placed to respond quickly and effectively.

5.0 Fiscal Policy Challenges Facing Tobago

Despite the economic justifications for fiscal decentralization in favour of the Tobago House of Assembly, the proposed benefits may not accrue because of various problems related to the institutional arrangements, the legal environment and the human resource capacity. That is to say, the kind of environment determines the outcome of fiscal decentralization. It is in this context that this section seeks to examine the major fiscal policy challenges facing Tobago. The challenges are classified broadly into those that are revenue related and those that are expenditure related.

5.1. Revenue-Related Challenges

5.1.1 Transfers and the Dispute Resolution Commission (DRC)

A well designed system of inter-governmental transfer is an important prerequisite to ensure fiscal decentralization works well. The Tobago House of Assembly receives almost all of its revenues to finance its operations in the form of transfers from the Cabinet-controlled Consolidated Fund. In the past, transfers from the Central Government to the Tobago House of Assembly have been a major source of disagreement and contention. In this regard, almost all the arguments pertain to the quantum of the transfer and its predictability for planning purposes. In the period before 2000, the Tobago House of Assembly consistently argued that the allocations to Tobago were not sufficient to allow the

Tobago House of Assembly to efficiently carry out its mandate. It has also been argued that the allocations were too unpredictable to allow for meaningful planning. It is these arguments over the Tobago House of Assembly's budgetary allocations that led the Tobago House of Assembly in 2000 to trigger the Dispute Resolution Commission in accordance with Section 56 of Act # 40 of 1996. Section 56 stipulates that a body known as the Dispute Resolution Commission (DRC) be established to resolve disputes between the Assembly and the Government on budgetary allocations to the Assembly and related matters. In 2000, the DRC recommended that the Tobago House of Assembly receive a percentage in the range of 4.03% to 6.9% of the national budget, to cover both recurrent and development allocations for each financial year. Since that time, there have been some attempts to observe, but not strictly adhere to the recommendations of the Dispute Resolution Commission. Although the recommendations of the Dispute Resolution Commission have had the effect of bringing greater predictability of resources to the THA, it is far from perfect. The DRC has been criticized because it is not legally binding on the Central Government, and much of it depends on the goodwill and the good graces of the Central Government in Trinidad. In addition, it does not give due recognition to the need for Tobago to catch up with the national economy. Moreover, the THA is recognizing that by dialogue and moral suasion, it is possible to get resources beyond what is recommended by the DRC. It is noteworthy that in the post 2000 period, largely because of increased predictability provided by the DRC and the changing political circumstances, there have been far fewer arguments against the allocations.

5.1.2. Tax Evasion and Avoidance

A major problem facing the Tobago House of Assembly pertains to the issue of tax compliance. Act # 40 of 1996 mandates the Assembly to collect monies by way of taxes, fees, duties, levies and other imposts, in respect of operations in Tobago, and to credit these sums to the Fund recognized in the Act. However, there has been tremendous resistance from firms with head-offices in Trinidad and subsidiaries in Tobago, to pay taxes in Tobago on their Tobago operations. Chief among these are the banks and the insurance companies. It is argued that the tax

leaks from these sources could be quite substantial. Henry (2003) argued that this phenomenon may be indicative of some level of tax avoidance.

A significant source of tax evasion in the tourism industry in Tobago comes from the many foreign-owned villas in operation on the island. These properties are registered as residential rather than commercial, and consequently attract a much lower rate of property taxation. This is done even as these entities advertise publicly, soliciting guests for their establishments. To compound this situation, these so-called residential properties apply and acquire liquor licenses with the approval of the Inland Revenue Division. There is very compelling evidence that these entities are in effect operating businesses. In addition, these establishments evade withholding taxes. These are taxes non-residents should pay on the income they earn from these businesses. However, these establishments use local agents to conduct their business locally and avoid paying the withholdings taxes. In some cases, the revenues from these operations are collected outside of Tobago and this also poses special problems for tax collection. In addition to the withholdings tax, these villas do not pay the 10 per cent hotel taxes. Establishments in the hotel industry with five rooms and more are required to pay 10 per cent of the gross earnings per occupied room. In addition, there are many Dive Shop Operators and Tour Operators who pay no taxes on their earnings.

Also with regard to the hotel tax, there exists significant evasion from the hotels in Tobago. Many hotels deliberately undervalue accommodation expenses in their pre-paid packages to avoid paying the hotel taxes. In addition, they are not forthright with their occupancy rate, as well as their nightly rate, all in an effort to evade the hotel taxes. What is clear from all this is that the THA does not derive maximum tax benefit from Tobago's most profitable industry.

Generally, in the area of building taxes, there are significant tax leaks because of the failure of the Inland Revenue Division in Tobago to assess new buildings. The assessment of buildings in Tobago is conducted by the Valuations Division which is under the control of the Ministry of Finance in Trinidad. This poses special challenges in terms of expediting the assessment of buildings for taxation purposes. The situation is further compounded by the fact that the Valuations Division is short staffed. In some cases, it takes as long as 5 years for buildings

to be assessed. These problems certainly affect the tax collection efforts of the Inland Revenue Division in Tobago in a negative manner. This shows that revenue collection in Tobago remains a major challenge, which has significant implications for the fiscal autonomy of the THA, and represents a major challenge to the process of fiscal decentralization.

5.1.3. Uncollected Revenue

Another major challenge to fiscal policy and the decentralization process in Tobago pertains to the imposition of user fees for tourist attractions. With the exception of Argyle Water Fall and Pigeon Point most of the visitor attractions on the island can be accessed free of charge and the Tobago House of Assembly loses significant revenue opportunities. To illustrate the point, administrative data from the Roxborough Estate Visitors Services Co-operative show that in the year 2004, \$602,413.43 was collected from visitors to the waterfall. Further, data for the period January to September of 2005 show that \$543,913 was collected. When one considers the fact that this attraction is not among the most popular on the island, one can conclude that there exist significant opportunities for collecting revenues from our various tourist attractions.⁷

5.1.4. The Problem of Moral Hazard

One of the major fiscal problems in the relationship between the THA and the Central Government is related to the inherent moral hazard problem associated with the transfer mechanism. Section 47 of Act #40 of 1996 stipulates that monies appropriated by Parliament for the service of the financial year of the Assembly shall be released quarterly in advance en bloc. Section 49 (3) stipulates that revenues collected by the THA shall be set-off against annual allocation appropriated by Parliament. In addition, Section 50 (1) stipulates that if revenues collected in Tobago exceed its allocation, the THA should retain 50 per cent or such larger sums as the Minister may order. Because expenditure in Tobago by far exceeds revenues collected in Tobago, Tobago's

7 Policy Research and Development Institute (2005).

revenues basically form part of transfers. The implication of this is that there is no incentive for officials in Tobago to be efficient in terms of tax collection on the island since, whether revenue is collected or not, the THA receives its allocation. Henry (2003) identified this moral hazard problem as a main disincentive to revenue collection on the island. If this problem of moral hazard is not addressed with the appropriate legislative changes, it could seriously undermine the decentralization process in Tobago. The Table in Appendix II illustrates that on average, Tobago's tax take is less than 25 per cent of its budgetary allocations.

5.1.5. Community Empowerment and Action

The fact that Tobago is blessed with active and strong community organizations should not be ignored. Another major challenge facing the Tobago House of Assembly is to find mechanisms to assist community organizations to raise resources to be able to respond to certain problems in the community. In this regard, the fact that many of the credit unions on the island are community-based offers some interesting possibilities and should be exploited to the fullest. In addition, the Tobago House of Assembly needs to provide technical assistance in areas such as writing project proposals to assist community-based organizations access grant funding from local and international funding agencies. Recent trends have shown that many of the international grant agencies have been showing greater interest in the financing of projects conducted by community-based organizations and non-governmental organizations rather than those conducted by governmental organizations. The major challenge therefore is for the Tobago House of Assembly to assist Community-Based Organizations (CBOs) and Non-governmental Organizations (NGOs) to position themselves to benefit from the new trust by international agencies to fund NGOs and CBOs. The contention here is that decentralization would be more effective and meaningful if the communities have a greater involvement.

5.1.6. Financing Business Development

The development of an indigenous private sector is critical to financial autonomy and enhances the process of fiscal decentralization. This is so because a strong private sector creates greater possibilities for

self-sustained economic growth in any country. It is generally accepted that in Tobago, the private sector is weak. This is supported by Data from the Survey of Business Establishment (1997) which suggests that Tobago has a weak indigenous private sector. This situation is further compounded by the general unwillingness of financial institutions in Tobago to support new and innovative business ideas. By contrast, the private sector in Trinidad is much more developed and dynamic. In light of the prevailing circumstances, and given the critical role of government in Tobago's economic development, the Tobago House of Assembly has a responsibility to help to stimulate business activity. In this regard, the Tobago House of Assembly has established an Enterprise Assistance Fund to encourage the start up and development of business activities on the island. In addition, the THA is about to establish a Business Incubator Programme to assist young entrepreneurs. However, much more needs to be done to develop business activity in Tobago.

5.1.7. The Question of Borrowing

If properly designed, decentralization of borrowing powers can add to the gains in efficiency and governance expected from fiscal decentralization. Section 51 of the THA Act # 40 of 1996 stipulates that the Secretary of Finance may, *“(a) with the approval of the Assembly, borrow by way of overdraft such sums as the Assembly considers fit for the discharge of its functions, or (b) with the approval of the Minister, borrow sums by way of term loan for purposes of capital expenditures on the island.”* Since the passage of the Act, successive Central Governments have indicated their willingness to allow the THA to activate this provision; however, no meaningful use of the agreement/arrangement has been made in this regard, largely because of the problems of project implementation that will be discussed in greater detail later in this paper. As recent as in the 2006 national budget, the Prime Minister and Minister of Finance indicated that the government would allow the THA to borrow up to \$500 million to finance capital projects on the island, subject to the administrative requirements of the Ministry of Finance. The challenge, as far as borrowing is concerned, is for the THA to set up the kind of institutional arrangements that would identify appropriate capital projects to receive loan funds, and to expedite their implementation. What will also be critical is for the THA to

set up the required debt management systems to address the special requirements of loan funding.

5.1.8. Cost of Living Differential

Another major policy challenge facing the Tobago House of Assembly and an issue that has attracted great interest in Tobago pertains to the cost of living differential between Tobago and Trinidad. The difference in the cost of living is a clear reflection of the differences in the prices of commodities on the two islands. A study by the Policy Research and Development Institute in 2003 found that the average retail prices of food items in Tobago were 20 per cent higher than those in Port of Spain, Trinidad. Similarly, the average retail prices of building materials in Tobago were 26 per cent higher than those in Trinidad. Based on these findings the study concluded that the cost of living was higher in Tobago than in Trinidad. The study identifies several fiscal policy options to deal with the issue of the cost of living differential between the two islands. These are:

- The declaration of Tobago as a VAT-Free-Zone.
- A reduction of P.A.Y.E in Tobago.
- An increase in the tax allowance of first-time homeowners in Tobago.
- An increase in the cost of living allowance of persons working in Tobago.
- A higher wage/salary for persons working in Tobago.
- Providing incentives and encouraging competition incentives among merchants operating on the island.
- Improving the efficiency of the inter-island transportation systems, thus delivering cargo in a more timely manner and reducing storage costs.

This issue of the high cost of living in Tobago remains and represents a major challenge for fiscal policy on the island.

5.2. Expenditure-Related Challenges

5.2.1. The Critical Role of Government

Government plays a very dominant role in the Tobago economy. Government expenditure accounts for approximately 75 per cent of all expenditures in Tobago in contrast to 15 per cent in Trinidad. The Tobago House of Assembly is the primary employer in Tobago employing approximately 54.9 per cent of all paid employees in Tobago compared with a national average of 33.9 per cent.⁸

The evidence has shown that, in Tobago, government investment acts as a significant catalyst for private sector investments, that is, government spending “crowds in” rather than “crowds out” private sector investment on the island. To illustrate, the hotel and guest house construction boom in the south-western part of the island in the early 1990s was spurred on by government investment in the deep-water harbour, and the extension of the runway at the Crown Point Airport. What this illustrates is that despite the importance of the tourism industry to Tobago, the Tobago economy is heavily dependent on government spending. The implication of this is that any reduction in government spending in Tobago would adversely affect the employment and economic climate on the island, and can seriously undermine the process of fiscal decentralization.

5.2.2. Foreign Investment and Real Estate Investment Trusts (REIT)

In 1990, the government of Trinidad and Tobago in an effort to stimulate foreign direct investment in the oil and gas industry passed the Foreign Investment Act, which repealed the Alien’s Land holding Act that previously restricted foreign ownership of lands. The implication of this is that it led to increased pricing of land beyond the means of

8 Tobago House of Assembly 1998.

the average Tobagonian. In some places such as Pleasant Prospect and Englishman's Bay, foreigners now own the entire commune. Acts such as these further strengthen the case for greater fiscal decentralization and fiscal autonomy to the Tobago House of Assembly, given that the impact on Tobago can be different to the supposed national interest, as the policy decision may affect Tobago as a sub-region quite adversely. In an effort to deal with this problem, the Tobago House of Assembly has stated in its 2006 Budget its intention to establish a Real Estate Investment Trust (REIT). The operational details of this are still being worked out with a major financial institution in the country. However, it calls for the strategic purchase of key estates in Tobago.

5.2.3. The Weak Multiplier Effect

Another major problem affecting the effectiveness of government spending in Tobago, pertains to the weak multiplier. Although there are scarcely any data available to calculate impact multipliers for Tobago, an understanding of the structure of the Tobago economy allows us to form some judgments on how small the multipliers are. As argued by Henry (2003), because most of the inputs into the production process in Tobago are imported from Trinidad, the leakages from the circular flow of income in Tobago tend to be large, and the multiplier effect of increases in government spending in Tobago is experienced in Trinidad, rather than in Tobago. To illustrate, when businesses in Tobago increase investment demand, that is, demand for plant and equipment, only a small portion of this demand is satisfied by suppliers in Tobago. In addition, in the construction industry, because most of the skilled labour is imported from Trinidad and elsewhere, a sizable share of expenditure goes to imported labour services, and this represents another significant loss to the multiplier process in Tobago. What this means is that leakages from the spending stream in Tobago are very high, and the multiplier process is severely truncated. There is little trickle down. The implication of this is that the economic growth process in Tobago is retarded, and this acts to restrict the ability of the Tobago economy to catch up with Trinidad. This phenomenon remains a major challenge to the decentralization process.

5.2.4. The Recurrent and Development Expenditure Mix

Another major challenge facing the Tobago House of Assembly relates to the mix between recurrent and development expenditures. Most of the expenditure of the THA is directed at recurrent, rather than development expenditure. The challenge here is that, if Tobago needs to catch up with the national economy, there needs to be a fundamental shift in the expenditure patterns of the THA towards a greater share for developmental expenditures. The genesis of this problem lies in the way THA's request for development and recurrent expenditures are viewed by the Central Government. Recurrent expenditures are viewed as non-discretionary, and are more fully supported than developmental expenditures which are viewed as discretionary. To illustrate the point quite clearly, in the national budget for Trinidad and Tobago for fiscal 2004/2005, the THA was allocated 81 per cent of its request for recurrent expenditure and only 23 per cent of its request for development spending. Similarly, in the 2005/2006 budget, the THA was allocated 84 per cent of its request for recurrent expenditures and only 18 per cent of its request for development spending. The consequence of all this is that most of THA's expenditures are directed to recurrent expenditures rather than development expenditures. For instance, in this financial year, 2005/2006, 87 per cent of Tobago's allocation is for recurrent expenditures and only 13 per cent for development expenditures.

5.2.5. Human Resource Capacity Constraints

The execution of fiscal policy in Tobago is severely constrained by the inadequate human resource capacity on the island. Despite the existence of a major Financial Assistance Programme, to encourage studies in various academic disciplines, there still remain critical shortages in a number of professional designations. Key among these are areas such as engineering, quantity surveying, architecture and project management. These shortages significantly retard the execution of development projects on the island. In many cases, projects have been identified, but there are no systems in place for their implementation and appraisal, resulting in serious delays in project implementation, and cost overruns. This certainly has implications for the effectiveness of fiscal policy on the island. To compound matters, there exists a serious

shortage of skilled labour on the island, and labour has to be obtained from Trinidad and imported from elsewhere in the Caribbean. The human resource capacity constraint remains a major challenge in the process of decentralization between the Central Government in Trinidad and the Tobago House of Assembly. However, this is not only a Tobago problem; it is a national problem.

5.2.6. Procurement Issues

The Tobago House of Assembly's development programme is also significantly constrained by the statutory requirements of the Central Tenders Board. Section 28 of the Tobago House of Assembly Act #40 of 1996 stipulates that the Assembly, in pursuance of its functions, shall be subject to the Central Tenders Board Ordinance of 1961, until such time as there are in effect alternative provisions made by the Assembly under Section 52. Because the Tenders Committee of the Tobago House of Assembly is not yet established, significant project implementation lags are experienced by the Tobago House of Assembly, waiting for tenders to be awarded by the Central Tenders Board in Trinidad. This point was clearly illustrated in the case of the project to extend the Crown Point Airport Terminal and the New Scarborough Hospital. The start-up of these projects was significantly delayed because of procedural arrangements by the Central Tenders Board in Trinidad. Similar problems are being experienced with the Buccoo Integrated Project. This clearly points to the need for the Tobago House of Assembly to establish a Tenders Committee.

5.2.7. Accountability and Financial Management Systems

Issues of accountability and financial management systems are of utmost importance if fiscal decentralization is to yield maximum benefit. In the past there have been numerous arguments between the Central Government and the Tobago House of Assembly over the issue of accountability. Most of these arguments were related to unauthorized expenditures by the THA, including unauthorized investments. In many instances the THA was unable to pay its creditors, as well as public servant salaries. However, in the period after 2001, there has been overall

reform of the financial management systems in the THA, and there have been far fewer arguments over the issue of accountability.

6.0 Towards Greater Decentralisation: The Way Forward

The issues raised above point to a number of initiatives that need to be undertaken to deepen the process of fiscal decentralization between the Central Government of Trinidad and Tobago and the THA. With regard to revenues, the THA needs to put the necessary mechanisms in place to ensure that business establishments registered in Tobago do in fact pay their taxes in Tobago. The assistance and cooperation of the Central Government should be sought in this matter. In addition, the THA needs to establish its own Valuations Division to expedite the process of valuations on the island. Also, the THA needs to institute a major Tax Audit in Tobago to assess the tax base for purposes of appropriate taxation. There are too many establishments in the tourism industry, Tobago's largest industry, that evade taxes.

Similarly the problem of moral hazard that is inherent in Act No. #40 of 1996 needs to be addressed. Perhaps the necessary legislative changes are needed to ensure that taxes collected by the THA are retained in Tobago. This would give the THA the added incentive to collect taxes. Also, the THA needs to take action to institute user fees for access to the various tourist attractions on the island that are now accessed free of charge. The case of Argyle Waterfall, discussed earlier, illustrates very clearly what is possible in this regard. Moreover, as far as grant funding is concerned, the THA needs to work with NGOs and CBOs on the island, to assist them in meeting the special requirements of the various local, regional and international funding agencies. What is instructive here is that in the long run, this would reduce the pressures on the THA to fund the various activities of these organizations.

With regard to the question of business development, the THA needs to continue its initiatives to develop the private sector in Tobago. The Business Incubator Programme should be implemented with dispatch, and the Enterprise Assistant Fund be given the necessary quantum of resources. With regard to the question of borrowing, the THA needs to put the necessary safeguards in place to ensure that any borrowed funds are used for development expenditure, rather

than recurrent. In addition, the fact that the loans will be government guaranteed should not lead to fiscal indiscipline. Finally, the critical issue of the Cost of Living Differential needs to be addressed. In this regard, the THA has already established a Task Force, with the full support of the Central Government, to look at this issue and advise the Assembly accordingly.

On the expenditure side, urgent steps need to be taken by the THA, to shift the structure of expenditure in Tobago to give developmental expenditure a greater share of total expenditure in Tobago. In addition, the human resource capacity constraint needs to be addressed. In this regard, areas of critical shortages need to be identified and given the necessary financial support. Also, in keeping with the provisions of Act #40 of 1996, the THA needs to move with dispatch to establish the Tobago House of Assembly's Tenders Committee, to expedite project implementation on the island. Moreover, the THA needs to continue to put the necessary safeguards in place to protect the island's monetary and physical assets.

Beyond the specific concerns related to expenditures and revenues, the Assembly needs to upgrade its data archives, to allow for more meaningful evaluation of its economic and social performance as a sub-region. In this regard, the Central Statistical Office (CSO) in Tobago needs to be upgraded. Discussions in this regard have already started with the responsible Government Minister. The challenges ahead are enormous and will become more complicated with the advent of the CARICOM Single Market and Economy (CSME); however, they are not insurmountable.

7.0 Conclusion

In conclusion, there is no doubt that greater fiscal decentralization can be of benefit to Tobago and by extension, the national community. Fiscal decentralization is seen not as an end in itself but the means to greater economic development in Tobago. It is felt that if the Tobago economy must catch up with that of Trinidad, greater fiscal decentralization is critical. What is important is that the various legislative and other challenges identified above need to be addressed urgently. The discussion held here is quite timely as the country is at a constitutional cross-road, in that recently, there have been numerous

discussions on the issue of constitutional reform. It is hoped that some of the issues raised in this paper could inform these discussion.

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APPENDIX I

FIFTH SCHEDULE AREAS OF RESPONSIBILITY OF THE ASSEMBLY

1. Finance, that is to say the collection of revenue and the meeting of expenditure incurred in the carrying out of the functions of the Assembly;
2. State Lands;
3. Land and marine parks;
4. Museums, Archives, Historical sites and historical buildings;
5. Public buildings and the maintenance of the residences of the President and the Prime Minister;
6. Tourism;
7. Sports;
8. Culture and the Arts;
9. Community Development;
10. Co-operatives;
11. Agriculture;
12. Fisheries;
13. Food Production;
14. Forestry;
15. Town and Country Planning;
16. Infrastructure, including air and sea transportation, wharves and airports and public utilities;
17. Telecommunications;
18. Highway and Roads;
19. Industrial Development;
20. The Environment;
21. Customs and Excise;
22. Licensing;
23. Health Services;
24. Library Services;
25. Education including Curriculum;
26. Social Welfare;
27. Marketing;
28. Valuations;
29. Postal services and collection of revenue therefrom;

30. Statistics and Information;
31. Housing;
32. Plant and Animal Quarantine;
33. Such other matters as the President may, by order, assign to the Assembly.

SIXTH SCHEDULE
MATTERS FOR WHICH THE ASSEMBLY
SHALL NOT BE RESPONSIBLE

1. The President;
2. National Security;
3. Foreign Affairs;
4. Civil Aviation;
5. Meteorology;
6. Immigration;
7. Legal Affairs including the registration of legal documents;
8. Judiciary;
9. Auditor General;
10. Ombudsman;
11. Service Commission