CFAL Local Economic Update

Quarter II 2018

Economic Highlights:

- The Government of The Bahamas, in particular the Minister of Finance, Mr. K. Peter Turnquest, presented their fiscal year (FY) 2018/19 Budget during Q2 2018. This is the second budget delivered by Peter Turnquest as Minister of Finance and probably one of the most controversial budget presentations in recent years.
- Following average annual economic growth of -0.66% over the five-year period, 2013 to 2017, the Government is forecasting growth of 2.50% and 2.20% for 2018 and 2019 respectively.
- Over the past five years (for the period 2013 – 2017) a healthy sum, on average $282.4M per year, has been allocated to capital expenditure.
- According to the Minister of Finance, government receipts for FY 2017/18 are expected to fall short of the budgeted amount by some $130.0M, settling at $2.02B, compared to the $2.06B collected during FY 2016/17.
- In 2018/19, government receipts are forecast to total $2.6B or 21.7% of GDP, which puts the Bahamas on par with its counterparts in Latin America and the Caribbean (LAC).
- Presently, the Government's highest source of revenue is VAT, which is expected to net in excess of $630.0M in 2017/18 and slightly over one billion dollars in 2018/19.
- In 2016/17 total government spending skyrocketed by $489.9M to $2.7B, compared to $2.2B in the previous fiscal year.
- Another big expenditure announcement was the reclassification of payments to Resolve as capital expenditure. The Minister of Finance reported that only 20% (or $20.0M) of the initial $100.0M in toxic loans transferred from Bank of the Bahamas to Resolve were considered recoverable.
- The Minister of Finance is on a mission to 'balance the budget' within a three-year period. Mr. Turnquest has committed the Government to reducing the Government Finance Statistics (GFS) deficit (which includes capital expenditure) to 1.8% of GDP in 2018/19, 1.0% in 2019/20 and 0.5% in 2020/21.

CFAL Economic Update Q2 / 2018

The Government of The Bahamas, in particular the Minister of Finance, Mr. K. Peter Turnquest, presented their fiscal year (FY) 2018/19 Budget during Q2 2018. This is the second budget delivered by Peter Turnquest as Minister of Finance and probably one of the most controversial budget presentations in recent years. According to the Minister, "for FY year 2018/19 the government is faced with stark and urgent fiscal realities that will require substantial enhanced revenues and the accompanying upward adjustments in certain taxes and fees." Against this backdrop, the Minister stunned many when he announced, during his 2018/19 Budget Communication Speech on May 30, 2018, an increase in Value Added Tax (VAT) to 12.00%, representing a 60.00% surge from the 7.50% VAT initiated in January 2015. The Government is estimating that it will collect an additional $400.0M as a result of the increased tax rate and an extra $100.0M from increasing fees on select public services, after netting off tax giveaways.

"According to the Minister, "for FY year 2018/19 the government is faced with stark and urgent fiscal realities that will require substantial enhanced revenues and the accompanying upward adjustments in certain taxes and fees."

Budget 2018/19 Fiscal Review:

Following average annual economic growth of -0.66% over the five-year period, 2013 to 2017, the Government is forecasting growth of 2.50% and 2.20% for 2018 and 2019 respectively. Achieving such growth is ambitious given the absence of significant infrastructure investments in the 2018/19 Budget. It is a known fact that one of the most strategic and powerful engines for economic growth is the investment in infrastructure, which includes, but is not limited to reliable energy, efficient transportation and communication, affordable and basic healthcare, food security and adequate housing. Over the past five years (for the period 2013 – 2017) a healthy sum, on average $282.4M per year, has been allocated to capital expenditure, however, not much in terms of economic growth has been realized during this period. This may be due, in part, to the perceived inefficiencies in capital spending. For instance, of the $299.0M allocated to capital expenditure in the 2018/19 Budget, a huge portion will be used for the upkeep and improvements of roads, airports, docks and government buildings. While these recurrent types of expenditures are essential for the economy to function in an orderly manner, such spending alone has not delivered the level of economic activity needed to improve the country's fiscal position

and economic performance.

According to the Minister of Finance, government receipts for FY 2017/18 are expected to fall short of the budgeted amount by some $130.0M, settling at $2.02B, compared to the $2.06B collected during FY 2016/17. This short fall in government receipts coupled with the recent upward revision in nominal GDP to slightly over $12.1B, may have provided support for the Government's position to increase the VAT rate and fees for various public services. In 2018/19, government receipts are forecast to total $2.6B or 21.7% of GDP, which puts the Bahamas on par with its counterparts in Latin America and the Caribbean (LAC). The average tax revenues to GDP for LAC in 2016, the latest year on record, was 22.7%. As revealed in 'Revenue Statistics in Latin America and the Caribbean, "tax-to-GDP ratios in 2016 range from 12.6% in Guatemala to 41.7% in Cuba. Most countries' tax-to-GDP ratios were between 17.0% and 26.0%. All LAC countries have a tax-to-GDP ratio below the OECD average of 34.3%, except for Cuba."

"Given the net increase in tax and non-tax revenues of around $500.0M, the 2018/19 Budget appears to be a continuation of the previous administration's fiscal consolidation strategy, which focused on regressive revenue measures while simultaneously increasing spending."

Presently, the Government's highest source of revenues is VAT, which is expected to net in excess of $630.0M in 2017/18 and slightly over $1.0B in 2018/19. Next in the level of importance, are excise and import taxes, which together are projected to generate around $570.0M. New revenues derived from public enterprises are estimated to produce an extra $100.0M in 2018/19 to net over $150.0M during the period. These other sources of revenues include increased taxation on gaming house activities; an increase in various immigration fees; new port fees; a hike in real property tax on foreign-owned vacant land from 1.5% to 2.0%; increased police record and fingerprinting fees, and licensing fees for commercial vehicles. Given the net increase in tax and non-tax revenues of around $500.0M, the 2018/19 Budget appears to be a continuation of the previous administration's fiscal consolidation strategy, which focused on regressive revenue measures while simultaneously increasing spending.

On the spending side, the status quo remains. In 2016/17 total government spending skyrocketed by $489.9M to $2.7B, compared to $2.2B in the previous fiscal year. This was due in large part to changes in how the government accounted for spending within a fiscal year. Prior to FY 2016/17 government expenditures were accounted for using the cash method, meaning expenditures were recorded in the respective fiscal year only if cash was disbursed. The new administration adjusted this policy with the implementation of the accrual method, which included spending commitments contracted but not funded within the fiscal year of the contract. This, according to the Minister of Finance, resulted in the government having to fund, over a three fiscal-year period, more than $360.0M in expenditure commitments contracted in

2016/17 by the previous administration. Some of these arrears that will be funded in 2018/19 include $17.0M to cruise line operators; $11.9M owed to the Bahamas Power and Light (BPL); $10.2M owed to the Bahamas Telecommunications Company (BTC); $13.5M payable on the Mortgage Relief Program; $6.0M due to Arawak Homes under a Public Private Partnership arrangement with the Government; $17.0M due to Bank of the Bahamas in settlement of contingent liabilities; $8.8M in provisions for Resolve; $3.5M owed on water bills; $13.5M due on rent; and, $10.7M VAT refund arrears. Another big expenditure announcement was the reclassification of payments to Resolve as capital expenditure. The Minister of Finance reported that only 20% (or $20.0M) of the initial $100.0M in toxic loans transferred from Bank of the Bahamas to Resolve were considered recoverable. The remaining $80.0M was written off against capital expenditure in FY 2017/18. Government spending continues to trend upwards with 2018/19 current expenditure expected to increase by $346.0M to $2.5B and capital expenditure to $299.0M for a net Government expenditure tab of $2.88B or 23.7% of 2017 nominal GDP.

The Minister of Finance is on a mission to 'balance the budget' within a three-year period. Mr. Turnquest has committed the Government to reducing the Government Finance Statistics (GFS) deficit (which includes capital expenditure) to 1.8% of GDP in 2018/19, 1.0% in 2019/20 and 0.5% in 2020/21. Attempting to better manage the GFS deficit and restore public finances is admirable, however, the excessive pace and timing of Minister Turnquest's fiscal consolidation strategy is concerning and could possibly lead to further economic contraction, given the fragile state of the economy. A more measured approach of gradually balancing the country's primary budget (recurrent revenues less recurrent expenditures) while allowing deficit spending for 'productivity-enhancing investments' may be a more feasible strategy. For such a strategy to work, funds must be directed to more productive sectors such as transport, energy, water, communications, waste and hurricane defence infrastructure and not the pseudo type capital spending classified as investments, which have proven not to yield the level of economic growth required to lay the foundation for a more prosperous future.

"Attempting to better manage the GFS deficit and restore public finances is admirable, however, the excessive pace and timing of Minister Turnquest's fiscal consolidation strategy is concerning and could possibly lead to further economic contraction, given the fragile state of the economy."

The GFS deficit skyrocketed in FY 2016/17 to $669.3M or 5.5% of GDP and is forecast to decline to $310.0M or 2.5% of GDP in FY 2017/18, and to trend even lower in 2018/19. To fill the ongoing fiscal gap, the Government borrowed, on a net basis, in excess of $695.0M during its first year in office (June 2017 to June 2018). Faced with the stark reality of borrowing more than $700.0M to fill the fiscal gap for the 2018/19 Budget, the Government made the controversial decision to hike the VAT rate. The Minister of Finance is likely hoping that his 'fiscal gamble' will

lead to lower deficits and by extension a lower debt-to-GDP ratio. This view is supported by debt-to-GDP projections made in the Minister's budget communication where he forecast that the ratio, which currently stands at 59.5%, will decline to no more than 50.0% over the three-year strategy period due mainly to ongoing growth in nominal GDP.

Conclusion:

There is no getting around it. The Bahamas is in dire need of real economic growth. Not just nominal growth, but 'real' economic growth. When the economy is resilient and real growth is positive, the deficit tends to be lower, as more tax revenues are generated and more citizens are employed. Thus resulting in the need for lower social services disbursements. The reverse is true when the economy is fragile and growth is relatively stagnant, which is more or less the current state of the Bahamian economy.

Investments drive growth. Therefore, if the Minister of Finance is to achieve his fiscal goals, in the timeframe indicated, the Government, in partnership with the private sector, must make significant and substantial infrastructure investments throughout the islands of the Bahamas. In addition to public-private sector partnerships, there must also be a commitment to improving local human capital skills, creating policies for domestic businesses to thrive, and not least of all, reducing the level of crime.