CONCEPTS PAPER

GRENADA CASH TRANSFER

UNITED STATES OF AMERICA

THE REGIONAL DEVELOPMENT OFFICE
TO THE CARIBBEAN (RDO/C)

April 21, 1986

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GRENADA

ECONOMIC STRUCTURAL ADJUSTMENT I

CONCEPTS PAPER

I. SUMMARY AND RECOMMENDATION

A. Recommendation

It is recommended that this concepts paper be used as the basis for a delegation to the Director, RDO/C to approve the Program Assistance Approval Document (PAAD) to authorize an Economic Support Grant of $4.5 million to Grenada. The Grantee will be the Government of Grenada (GOG) acting through the Ministry of Finance.

B. Summary

With the introduction of a major tax reform package in February, 1986, the GOG has embarked on a course of structural reform designed to promote economic growth and efficiency. RDO/C proposes to support this program by financing most of the one-year revenue shortfall of approximately US$5.0 million resulting from the changeover between the old and new tax systems. Conditionality attached to this program is designed to ensure timely management of any additional fiscal deficit arising from the expenditure side of the budget or from failure to collect revenues at projected levels. Through our policy dialogue RDO/C will encourage the GOG to begin negotiations with the World Bank to develop a medium term structural adjustment program that will allow the GOG to utilize newly established multilateral structural adjustment facilities.

II. BACKGROUND

Since the Grenada rescue mission in October 1983, AID has financed a continuing flow of technical assistance to provide the economic analysis necessary to allow the Government of Grenada (GOG) to develop improved economic policies. The Economic Stabilization Program, at a level of $17 million to date, and AID's policy dialogue with both the interim Government and the democratically elected Government of the New National Party, has assisted Grenada in making a constant transition from a state directed economic system to an open, market oriented economy. Although there have been differences over the speed and timing of reforms, the objectives of our two Governments have been the same. A review of the three Economic Stabilization Grants (ESG's) indicates the progress to date.

A. Economic Stabilization Grant I

An initial economic stabilization grant of US$5 million was provided to the Interim Government in FY1984 for urgently needed foreign exchange and budgetary support resulting from the policies of the previous Peoples Revolutionary Government. The first tranche of $2.5 million was released in January 1984; the second of $2.5 million was released in June 1984.

As a Condition Precedent to disbursement of the second tranche the GOG was required to present evidence of progress in implementing reforms to: "(1) take affirmative, necessary steps to assure the rights of agricultural producers of cocoa, bananas and nutmeg to democratically elect their representatives to the cocoa, banana and nutmeg associations and (2) examine critically (a) the role of public enterprises, including an assessment of the possible divestiture of each, (b) rationalization of the public sector investment program, (c) current expenditures and revenues to bring the current budget into balance in CY 1984, and (d) opportunities to eliminate existing constraints to productive private sector investment activity."

In addition the GOG covenanted to avoid an increase in public sector debt from private commercial banks during 1984 and to reduce special Government deposits required by the commercial banks in the equivalent of US$2.5 million in order to shift resources into the private sector.

Under the program the Interim Government took the necessary action to provide for and carry out election of representatives to the producer associations, reduced their special government deposits with the banks, took the steps necessary to provide increased liquidity needed by the banks for financing to the private sector and moved forward with development of policies to meet remaining Covenants.

B. Economic Stabilization Grant II

In May 1984, an AID task force undertook a comprehensive assessment of economic policies and institutional conditions to determine what further policy recommendations the USG should make to the GOG. The Executive Summary of the task force report identified policy impediments to private investment and production which required reform, as follows:

1. Government domination of decisions on direction of investment, particularly foreign investment.

2. Fiscal management (taxation, budgeting, and expenditure) policy that penalized private investment, saving, and production, as well as consumption.

3. Government ownership of assets such as hotels, factories, and farms, that are only tangentially related to the provision of public goods, while critical public infrastructure such as roads and sewerage and water systems, was seriously lacking in quality and quantity.

4. Financial markets in which maximum lending rates were fixed by government fiat.

5. Direct government control of the prices of a myriad of goods and services, without serious reference to real resource costs or the intensity of demand.

6. Broad ranging restrictions on the movement of goods and export of financial capital between Grenada and the outside world.

An economic stabilization grant of $5 million was provided in August, 1984 to continue budget support and encourage adoption of economic measures necessary to stimulate private investment. The grant was disbursed in three tranches over an eight-month period from September, 1984 to April, 1985.

The work of the Task Force and assessments by the Interim Government, as required by the Covenants to ESG I, resulted in a set of Conditions Precedent to each disbursement that were significantly more specific than those of the first economic stabilization program. Basically, the Interim Government committed itself to carry out reforms as follows:

1. Develop and initiate implementation of fiscal reform.

2. Relax foreign exchange controls.

3. Revise the Investment Code so that it is no more restrictive than the CARICOM Fiscal Incentive Guidelines.

4. Amend the Usury Law to raise interest rate limits on loans and by the third tranch take a decision to eliminate or further raise interest ceilings.

5. Eliminate the 1984 unfinanced budget gap and provide a sound basis for future budgeting.

6. Relax market restrictions by developing a plan to eliminate import monopolies, remove price controls on domestically produced items, liberalize import licencing.

7. Submit a plan for divestiture of agricultural lands and, by the third tranche, divest itself of five state owned enterprises.

Several of these reforms were implemented by the Interim Government before the election of December 3, 1984 brought to power the New National Party under the leadership of Prime Minister Herbert Blaize. Among them it:

1. Requested technical assistance to implement fiscal reform, and provided a list of specific tax and budget reforms to be carried out.

2. Eliminated foreign exchange approval requirements, and lifted limits on vacation and business travel allowances.

3. Revised the investment code as required, although AID still considered further clarification of the code would be required.

4. Raised interest rate ceilings from 12.5% to 16%. With world interest rates falling, the maximum rate was no longer an effective market impediment for most lending.

5. Took actions including deferent of debt payments to the GDR and Libya, which closed the projected fiscal gap.

6. Provided a plan to eliminate the four import monopolies between December, 1984 and December, 1985. Removed prices on some, not all, domestically produced goods, discontinued the import licencing system instituted on April 1, 1982 thereby reducing the list of goods requiring licencing.

7. Committed itself to divest 5 state owned enterprises and approved plans to sell the GOG's interest in six public enterprises. Returned 10 farms to their previous owners, agreed to compensate 5 others, and developed a plan for divestiture of government held farms.

In December, 1984 the new Government of Prime Minister Blaize took the position that it could not adopt wholesale those reform commitments of the Interim Government not yet carried out without assessing for itself the economic and political implications of policy changes. AID withheld disbursement of the third tranche until satisfied, through its consultations with the Government, that implementation of relevant policy reforms would be continued after proper assessment.

C. Economic Stabilization Grant III

A third economic stabilization grant of $7 million was approved in August, 1985. Funds were disbursed in three tranches by December 31,1985. Sensitive to the concerns of the new Government, the purpose of the new grant was to assist the GOG to rationalize its economy and thereby promote private sector led growth. Concommitant with this Grant, A.I.D. also provided technical assistance to advise the government on fiscal and budgetary reform, analyze the behavior of financial intermediaries, and advise on the process of privatization.

Conditions Precedent to the second tranche required the GOG to establish a plan to eliminate its 1985 fiscal gap, not increase its commercial debt borrowing during the program, and balance its recurrent budget during the last semester of 1985. These requirements were met, although it was necessary to use funds provided under ESG III to ensure the budget was balanced as shown in Table 3 of this concepts paper.

Emphasis on the policy dialogue with the GOG shifted to clarifying action plans for reform. As Condition Precedent to the disbursement of the third tranche A.I.D. required an assessment and implementation program consisting of the Grantee's intended actions in six economic policy areas. The GOG has made excellent progress in each of these areas, although implementation is in various stages as follows:

1. Designing A Comprehensive Development Strategy. A draft Comprehensive Development Strategy (CDS) has been written and is currently being reviewed by the Grenada National Economic Council(NEC). The NEC is composed of Government Ministers and representatives of the Banking sector, Hotel Association, Grenada Chamber of Industry and Commerce, trade unions and farming community. The CDS will be submitted to Cabinet for approval. Once approved, it will set the guidelines for establishing policy and investment priorities over the next few years. Its major importance to date is that it has established a vehicle for discussion between the Government and private sector on public policy.

2. Implementing Fiscal Reforms. By mid-December, 1985 a comprehensive tax reform was presented to Cabinet for consideration. By eliminating a large number of small taxes the package was designed to simplify the structure. By eliminating export taxes, income taxes, and company taxes and substituting a value added tax on consumption and an improved land tax, the reform package proposed to shift the economy toward increased rewards for work effort, investment and export oriented growth. With the added provision of a reduced Business Levy on profits,the package was adopted by the Cabinet and passed into law with the submission of the 1986 budget to Parliament on February 28, 1986. The reform package went further in meeting the above goals than anything proposed by the A.I.D. Task Force in 1984 or other experts prior to the advent of the present Fiscal Reform project.

3. Streamlining the Investment Approval Process. The GOG has established a committee to review bottlenecks that inhibit investment which are outside the purview of the Industrial Development Corporation. Legislation to repeal the Investment Code Incentives Law of 1983, in order to avoid conflicting interpretation of the Investment Code and previous legislation, is before Cabinet.

4. A Privatization Plan That States the Grantee's Decision Regarding Privatization of Each State-Owned Enterprise. The GOG has made significant efforts toward the privatization of State-owned enterprises (SOE's). The major accomplishment has been the leasing of the Grenada Beach Hotel which has now reopened with a total private sector investment of US$17 million. The Horseshoe Bay Hotel has been sold and all other properties of the Grenada Resorts Corporation have either been leased or sold. The spice processing plant has been divested along with property of the National Fisheries Company. The Grenada Dairies has entered a joint venture with a private sector company, Viking Enterprises. The GOG has taken the decision, in addition to the above, to privatize nine other SOE's.

In January, 1986, the GOG agreed to an implementation plan that will study nine SOE's, including the major utilities and state owned banks, with a view towards privatization in some form. The study of the Grenada Electric Company is being financed by AID and will be completed by June 1986. The degree of privatization will depend in each instance upon the economic and political feasibility demonstrated in the consultant's findings. The GOG is committed to privatization once it is demonstrated that there are real economic gains to be made resulting in the improved efficiency of essential public services. Along these lines, the stated goal in the GOG's draft Comprehensive Development Strategy for reforming State-owned enterprises is to "(1) reduce the drain on public funds; (2) improve management practices; and (3) deliver essential public services more effectively."

5. Privatizing Government-Held Agricultural Land. During 1985, the Government moved to establish a Model Farms Program that would divide Government lands into family size farms and turn them over to farmers under a registered lease purchase agreement. By February, 1986, eleven preliminary land-use surveys of eleven farms had been completed, with plans for providing initial infrastructure soon to be finalized.

Applications by farmers are being accepted and reviewed by a committee to select applicants. There is a full commitment by the Government to divest almost all agricultural lands under the control of the Grenada Farm Corporation through this program within the next three years. This program will be a major undertaking by the Ministry of Agriculture.

6. Reduction of market restrictions. There were no specific requirements under the program. The Government has however, proceeded to eliminate the import monopoly on cement along with import licencing and price controls on cement. As reported in Grenada 575, dated February 28, 1986, price controls and import licences continue to be eliminated on a selected basis. The AID financed study on credit availability in Grenada with special reference to the money lending ordinance found relatively high spreads between deposit and lending rates for financial institutions and recommended against eliminating the Money Lending Ordinance at this time (Usury Law). They did recommend providing for adjustable maximum rates that follow world market conditions, raising deposit rates to attract new funds, and providing a risk guarantee fund to encourage banks to lend long-term for investment. Given higher priorities, the Government has taken no action to date but has indicated its desire to study the problem further. In his budget speech for 1986, the Prime Minister stated the Government would consider giving policy directives to the nationalized banks on deposit rates and lending policy. Taken over a two year period, the gradual reduction of controls has been a major factor in generating improved economic performance.

III. OBJECTIVES OF THE CONTINUED ECONOMIC SUPPORT PROGRAM

RDO/C proposes that for FY 1986 a fourth economic support grant, to be called Economic Structural Adjustment Program I (ESAP I), be made to the GOG. We propose to recognise in this program the need to support the Government of Grenada as it moves from a policy of stabilizing the economy and planning change to more comprehensive structural adjustment. ESAP I will recognise the primary importance of fiscal reform for CY 1986. Timely reform is essential if the GOG is to reach its stated objective to ensure that recurrent revenues are greater than recurrent expenditures and debt payments by 1988. Prime Minister Blaize, in his 1986 Budget Speech set the following targets to achieve this goal: 1986, EC$18 million deficit (US$6.6 million); 1987, EC$12 million deficit (US$4.4 million); 1988, EC$6 million deficit (US$2.2 million); 1989, EC$ 4.2 million surplus (US$1.5 million). The program will include a continuing policy dialogue on acheiving these targets through new policy initiatives. RDO/C will use ESAP I conditionality to encourage the GOG to move as rapidly as possible, on the basis of the comprehensive development strategy they have already prepared, to develop a plan for working with the World Bank and other donors to design an acceptable "Tight Consultant Group," medium-term structural adjustment program. With such a program in hand the GOG will be able to obtain access to the new IMF Structural Adjustment Facility and to IDA VIII funds. (see Appendix B)

A. Goals

1. To ensure timely implementation of fiscal reform and provide financing to support that part of the budgetary deficit resulting from revenue shortfall arising from the 1986 tax reform package.

2. Our policy dialogue will encourage the GOG to begin preparing for negotiations with the World Bank to develop a medium-term structural adjustment program in the context of the "tight consultative group" mechanism.

As discussed in the budgetary analysis below, implementation of the 1986 tax reform program will leave a wide margin of error in the Government's cash flow analysis over the next several months. By September 1986, enough of a record should be established to enable relatively accurate prediction of revenues to be obtained under the new tax reform program and will give the Government a good basis for estimating 1987 revenues. By that time, the Government will have gone through a shake-down period, personnel will have been trained, revenues will be collected efficiently, losses due to implementation problems should be overcome, and the Government will be able to take actions necessary to adjust the tax reform package in light of any unforseen developments. In the meantime, the GOG has taken a bold step and is necessarily concerned about its credibility. Timely payment of obligations is of prime importance during this period. Prime Minister Blaize has repeatedly said that his Government has gone out on a limb with major reforms, as opposed to marginal adjustments, and the success or failure of the program will depend, in part, on continued USAID budgetary support. Other Caribbean countries have requested information on the Grenada program which, if successful, could become a model for fiscal reform in the smaller Caribbean nations. We believe we should make funds readily available during 1986 in recognition of the tax reform program already implemented. At the same time, we want to move the GOG towards a well conceived medium-term structural adjustment program qualifying for multilateral donor support. RDO/C's strategy for the program is developed with this in mind.

B. Strategy

RDO/C's proposed schedule calls for a PAAD and PROAG to be approved and authorized by RDO/C in May and the PROAG negotiated soon thereafter. Disbursements will be made in two tranches. We anticipate the first disbursement of US$2.5 million will be made in June to help cover the GOG's first half-year budgetary deficit. An analysis of the budget through May, and monthly projections of recurrent expenditures and revenues through 1986, will be developed with the GOG for inclusion in the PAAD. The second disbursment of US$2.0 million will be made no later than early September. RDO/C estimates that the GOG's budget deficit through September will fully utilize all local currency generated (see fiscal analysis below). Prior to disbursement of the second tranche, RDO/C will review with the GOG (1) a program to ensure all policy decisions and implementation actions required to ensure completion of the fiscal reform program by early 1987 will be carried out, and (2) a revised budget and monthly cash flow analysis to ensure that the GOG has taken timely actions to eliminate any remaining unfinanced gap.

IV. PROGRAM DESCRIPTION

A. Tax Reform

In the 1986 Budget, the Government of Grenada introduced a major tax reform package which became effective March 1, 1986. With the assistance of the AID financed Fiscal Reform project, the reform package was designed to promote economic growth and employment by increasing incentives for saving and investment and increasing rewards for risk taking and hard work. The new system replaces a complicated system which stifled the capacity of the Grenadian economy to perform and grow. In order to provide AID/W with the basis to judge the extent of the reforms being attempted, a summary review of the tax reform package is included in Appendix A.

The advantages of the proposed system are clear. Agriculture producers gain most, particularly at the margin. With exports exempted from the new valued added tax (VAT) and export taxes eliminated, the farmer will now keep 100 percent of any marginal profit from increased output being exported. On the other hand, land and permanent capital structures may be taxed at a level twelve times the level actually collected now, making it more expensive to hold lands for speculation. Corporate taxes (previously paid by very few heavily taxed companies) and income taxes (widely evaded except for those working in Government and the formal sector) have been dropped and a broader base tax has been created through a VAT paid by producers and merchants. As normal for VAT, these taxes should not be perceived by workers as affecting earnings. Most importantly, the system of tax collection and monitoring should be simplified in all cases except the collection of land taxes. It is expected that an acceleration in the economic rate of growth by one or two percentage points can be obtained over the next few years if the program is successfully implemented.

B. Fiscal Analysis

1. Tax Reform and Revenue Shortfall. Table 1 presents an estimate of tax revenues to be collected under the new tax reform package as compared to the previous tax package. Columns 2 through 5 are based on estimates compiled in November 1985 by the AID financed Fiscal Reform Team as the basis for analyzing the shortfall effects of tax reform. It has been updated by RDO/C to incorporate changes in the tax package (such as the addition of the Business Levy) as approved by parliament on February 28, 1986. The tax reform package was designed to be revenue neutral within a year of its introduction. However, it was recognized that there would be a revenue shortfall in the first year due to the changeover between the old and new tax systems with the greatest loss due to the time required to implement collection of the Modified Land Value Tax (MLVT) scheduled for January 1986. The estimate of revenue shortfall for 1986 shown in table 1 is approximately EC$14 million (US$5.2). During our bilateral negotiations with the Government of Grenada, the GOG asked RDO/C to consider financing this revenue shortfall in support of the major structural reform represented by the GOG's tax reform initiative.

2. Revenues. Given the new tax reform, the first step in analyzing the Government's budgetary situation, and projecting fiscal deficits for 1986, is to obtain a clear picture of expected revenue performance. Table 2 compares the GOG's 1985 revenue estimates to actual revenues collected. The third column presents the GOG's 1986 budget estimate which includes arrears and collections for the first two months of the year on taxes repealed on February 28, 1986. The fourth column presents RDO/C's estimate of the revenue picture for 1986 based on GOG legislative changes in March that effect revenue collections and our analysis of general economic activity.

GOG revenue estimates for 1986, showing an 8-percent increase over actual 1985 revenues, appear too optimistic by about EC$ 15 million. Three major items account for the reduction in revenue projections. Import duties are reduced to a level consistent with a 12 percent increase in imports as projected by the IMF. There is a reduction of EC$ 8.4 million in VAT collections for 1986 due to the zero rating of certain commodities and a 61 day moratorium on the collection of VAT at the retail level. The moratorium was granted in order to allow tax relief to those businesses carrying inventory on which taxes had already been paid under the old system. Finally, the business levy has been amended to allow exemptions of business expenses thereby lowering revenues by EC$3 million. Thus, although the GOG revenue estimates suggest that growth and the timing of reforms provide for revenue increases in 1986 over 1985, RDO/C estimates to date indicate that revenues will be EC$15 million less than projected and EC$7 million below 1985.

3. Recurrent Expenditures. As presented in the budget, recurrent expenditures in 1986 decline about 2 percent from 1985(see Table 3). Recurrent expenditures of EC$98.4 million includes EC$11.1 million in interest payments. Once interest is deducted, recurrent expenditures for 1986 are EC$87.3 million as compared to EC$90.1 million for actual 1985 recurrent expenditures excluding interest. This reduction in non-debt recurrent expenditures is basically due to estimated reductions in the wages bill expected from reform of the civil service and reduction in government employment. Throughout the Budget, reductions in personnel costs have been made under the heading "revision for retrenchment". These deductions total EC$12.7 million. They represent 20 percent of the wages bill and seem very high since implementation of reforms have not yet begun four months into the budget year. Given the political pressures associated with any reduction in Government employment this may be the most explosive issue facing the GOG in the near term. In estimating the probable budget outcome, RDO/C re-added the entire reserve for retrenchment with the caveat that expenditures could be less depending on the speed with which civil service reform can be implemented. It should be noted, however, that no provision is made in the budget for termination pay. We then deducted an EC$3.0 million provision for wage increases that might be given to specific salary and job categories as the civil service reform proceeds, and EC$1.0 million provision for additional pension funding. The resulting expenditure estimate is that which the Government will have to finance at current wages if civil service reform is not implemented. Based on this adjustment, RDO/C estimates non-debt recurrent expenditures increase 8 percent in 1986 over 1985.

4. Capital Spending. Capital expenditures plus principal repayments included in the 1986 budget total EC$138.0 million. This represents an increase of 49 percent over the 1985 actual level of $EC92.3 million. However, the capital budget typically includes projects which are attributed to donor financing but not yet arranged. For example, of the EC$55.2 million in capital projects attributed to A.I.D., only EC$28.2 million actually have financing agreed to by A.I.D. In addition, approximately EC$11 million of these unfinanced requests, represent counterpart funding for donor projects mainly as wage payments

to local labor. Even assuming a lower than projected level of project implementation, RDO/C estimates the GOG will need to finance EC$8 million in counterpart funding. The GOG will provide limited financing (EC$5.4) for the capital budget through sales of treasury bonds to the National Insurance Scheme. External budget financing will finance additional counterpart needs. Other than this, capital projects not obtaining financing from external donor assistance will be delayed. Accordingly, RDO/C has reduced the estimate of capital expenditure to EC$85.5 million and external project support to EC$72.4 million. RDO/C estimates that actual amortization payments will be about EC$ 15.5 million versus the EC$ 27.6 cited in the 1986 budget. We expect that the GOG will not actually make amortization payments on debt to the GDR and Libya. Debt rescheduling additional to that negotiated in 1985 may bring this figure down even further.

5. The Overall Budget Position. As shown in table 3, the GOG's 1986 budget shows a recurrent account surplus (excluding debt repayments which the GOG includes in the recurrent budget) of EC$9.6 million. This represents a contribution to the capital account as covenanted in ESG III. The balance requiring financing that remains in the budget is EC$ 23.4 million and the unfinanced gap for which the government is seeking bilateral donor financing is EC$18.0 million.
However, after making the adjustments discussed above, RDO/C estimates the overall balance requiring financing to be EC$42.4 million and that the recurrent balance requiring financing could be as high as EC$13.8 million.

6. Financing the Fiscal Gap. Based on the RDO/C estimate of the probable budget outcome for 1986, the US$ 4.5 million (EC$ 12.2 million) proposed under this program combined with GOG domestic financing of EC$5.4 will leave an estimated unfinanced gap of EC$24.8 million. A deficit this large is unlikely to materialize since the domestic resources required to finance it are not available. This unfinanced gap may be narrowed by timely implementation of civil service cuts, cuts in other expenditures, and limited increased deficit financing. At this time RDO/C assumes that there has developed an unfinanced gap which must be analyzed during development of the PAAD for Economic Structural Adjustment I and a program designed by the GOG to eliminate whatever unfinanced gap is determined to exist. The conditionality proposed in this concept paper is designed with this in mind.

Table 1

Tax Revenues under the Reform Plan, 1986 and 1987[1/]
(Millions of EC dollars)
(US$1 = EC$2.70)

	Actual 1985	New System 1986	New System 1987	Old System 1986	Old System 1987
Import Duty	17.81	19.65	21.42	18.80	19.81
Excise Duty	0.05	0.01	-	0.05	0.06
Export Duty	0.35	1.49	-	3.59[2/]	1.60
Cons. Duty	8.57	1.13	-	9.04	9.54
Pkg. Tax	0.49	0.07	-	0.51	0.53
Pet. Profits	-	-	-	-	-
IAL [3/]	8.39	-	-	-	-
Gas Tax	-	1.14	1.25	-	-
Company Tax	6.88	1.79	-	7.30	7.73
Business Levy	-	2.00	2.20	-	-
Income Tax	13.76	3.15	-	14.27	15.13
Withholding	1.11	0.24	-	1.18	1.20
Stamp Duty	18.26	2.95	-	19.24	20.30
Entertainment Tax	0.14	0.01	-	0.12	0.13
MVT	3.88	4.60	5.01	4.46	4.86
Radio/TV	NIL	0.00	-	0.01	0.01
Hotel Occ.	0.42	0.10	-	0.51	0.55
Telecomm.	0.19	0.07	-	0.20	0.21
Ticket Tax	0.33	0.04	-	0.34	0.37
FET	6.77	3.69	4.02	7.14	7.53
Land Tax	0.78	0.80	-	0.80	0.86
Gen Rates	0.31	0.20	-	0.20	0.21
Inheritance	1.13	0.60	-	0.60	0.30
MLVT	-	-	12.00	-	-
VAT		40.10	54.50	-	-
Total Tax	89.61	83.83	100.40	88.36	90.93
IAL Extended[3/]				8.85	9.33
Total	89.61	83.83	100.40	97.21	100.26

1/ Estimates based on assumption of 4 percent per year inflation, and real growth of 1.5 percent under the old system and 4 percent per year under the new system.
2/ Includes arrears.
3/ . IAL expired by law December 31st, 1985.

Table 2
RECURRENT REVENUES
(In thousands of EC dollars)
(US$1= EC$2.70)

	Budget Estimate 1985	Actual Revenues 1985	Feb. 28 1986 Budget	March 31 USAID Estimates 1/
Taxes:				
Import Duty	13,952	17,808	21,892	19,940 2/
Excise Duty	147	49	67	100
Export Duty	2,814	356	1,496	550
Consumption Duty	7,067	8,572	1,130	1,130
Package Tax	454	489	70	70
Petrol Profit Tax	338	0	0	0
Internat Airp Levy	6,500	8,391	500	500
Gas Tax	0	0	1,140	1,050
Inc Tax Companies	6,650	6,878	1,790	1,790
Business Levy			6,300	3,000 3/
Inc Tax Individs	12,200	13,758	3,150	3,150
Withholding Tax	1,100	1,105	240	140
Stamp Duty	14,410	18,254	2,950	2,950
Entertainment Tax	60	137	10	20
Motor Vehicle Tax	2,250	3,877	4,600	3,910
Radio/TV Purchase Tax	10	3	0	0
Hotel Occupancy Tax	275	427	100	200
Telecommunications Tax	150	187	70	170
Ticket Tax	300	326	40	100
Foreign Exchange Tax	5,350	6,765	3,690	3,690
Land & House Tax	750	781	80	300
General Rates	93	313	20	160
Inheritance Tax	1,125	1,130	60	200
Value Added Tax	0	0	42,612	34,200 4/
Sub-Total	75,995	89,606	92,007	77,320
Licences and Other:				
Motor Vehicles	450	391	450	450
Drivers	120	128	120	120
Radio & Television	10	30	10	10
Hotels & Clubs	16	14	20	20
Liquor Licences	42	44	45	45
Motor/Spirit Licences	2	0	0	0
Insurance Companies	100	233	120	120
Trade Licences	400	441	400	400
Other Licences	140	155	300	300
Airport Dues:				
Landing Fees	476	456	6 5/	6
Parking Fees	2	1	0	0
Service Charges	1,645	961	264 5/	264
Navigational Aids	180	28	9 5/	9
Miscellaneous	158	2	0	0

<u>Other:</u>				
Fees of Government Depts	9,840	5,281	8,449	8,449
Repayments & Reimbursements	452	329	798	798
Miscellaneous	396	284	403	403
Post Office	3,224	1,911	4,513	4,513
Rent & Interest	1,329	144	86	86
Subtotal	18,982	10,833	15,993	15,993
TOTAL	94,977	100,439	108,000	93,313

<u>Notes to Table:</u>

1/ Estimates based on recalculation of revenues by Fiscal Reform Team after March legislative revisions.

2/ Estimate of import duty is limited to the 12 percent estimated increase in imports. The duty structure has not appreciably changed.

3/ Business levy reduced due to alteration of tax from a gross profit tax to essentially a net income tax.

4/ Value added tax, estimated to be EC$50 million per year at current economic levels, is estimated for 1986 on a 10 month basis. The reduction in RDO/C's estimates reflects a post-budget decision by the GOG to grant a 60 day holiday on VAT at the retail level to allow businesses to work down inventories on which old taxes were paid plus zero rating of certain goods under VAT.

5/ Levels are reduced over 1985 to reflect their shift to the Airport Authorities control.

Table 3

Budget Summary
(Millions of EC dollars)
(US$1= EC$2.70)

	1984 Actual	1985 Budget	1985 Actual	1986 Budget	1986 Probable 1/
Recurrent Revenue	87.3	95.0	100.4	108.0	93.3
Recurrent Expenditure	-86.7	-101.0	-100.1	-98.4	-107.1
Recurrent Costs	(75.9)	94.1	(90.1)	(87.3)	(96.0)
Interest	(10.8)	6.9	(10.0)	(11.1)	(11.1)
Recurrent Balance	0.6	-6.0	0.3	9.6	-13.8
Capital Expenditure	-77.4	-126.7	-77.3	-110.4	-85.5
Balance Before External Project Support	-76.8	-132.7	-77.0	-100.8	-99.3
External Project Support	68.0	122.5 2/	69.2 3/	105.0 2/	72.4
Balance Before Principal Payments	-8.8	-10.2	-7.8	4.2	-26.9
Principal Payments	-19.7	-22.1	-15.0	-27.6	-15.5
Balance Requiring Financing	-28.5	32.3	-22.8	-23.4	-42.4
Financing					
	28.5	32.3	22.8	23.4	-42.4
USAID	21.6	5.4 4/	20.7	-	12.2
Domestic Financing	6.1	4.1	-	5.4	5.4
Other/Omission	0.8	-	2.1	-	-
Unfinanced Gap	-0-	22.8	-0-	18.0	24.8

1/ Estimate as of March 31, 1986, for derivation see text.

2/ Includes projects budgeted for external financing not yet arranged.

3/ Includes ESG III funds attributed to capital budget.

4/ ESG II funds obligated but not disbursed in 1984.

Table 4

Grenada: Summary Balance of Payments
(Millions of U.S. Dollars)
Source: IMF Statistics

	Prel. 1984	Est. 1985	Est. 1986
Current account balance	4.2	1.7	-16.2
Merchandise exports	16.7	23.6	26.0
Merchandise imports	57.1	78.1	87.5
Of which: airport related	(5.0)	(9.0)	(--)
Services	8.4	14.6	18.1
Of which: tourism receipts	(17.8)	(25.1)	(29.1)
interest payments	(-2.2)	(-2.2)	(-2.4)
Private transfers (net)	11.7	12.0	12.4
Official transfers (net)	24.6	29.6	14.8
Capital account balance	4.5	2.1	10.9
Public sector borrowing (net)	3.8	-1.5	5.5
Commercial banks	-3.2	-0.9	-0.9
Private investment	2.8	3.0	6.3
Other (including errors and omissions)	1.1	1.5	--
SDR allocation	--	--	--
Overall balance	8.7	3.8	-5.3
Financing	-8.7	-3.8	-1.5
IMF (net)	-1.1	-2.4	-1.5
Change in imputed ICCB reserves	-8.6	-1.0	--
Change in government foreign assets	0.4	-0.4	--
Change in arrears 1/	0.6	--	--
Unfinanced gap	--	--	6.8
GDP 2/	89.7	96.1	103.4

1/ Includes arrears on contributions to regional and international organizations as well as possible delays in payments in respect of debts either in dispute or which the authorities are seeking to reschedule.

2/ Provided for reference.

C. Balance of Payments and Exchange Rate:

A final 1985 balance of payments estimate and current 1986 projection are not yet available. However, November 1985 projections by the IMF (see table 4) indicate an unfinanced gap for 1986 of US$6.8 million. The estimates in table 4 contain a wide margin of error. Capital inflows for 1986 are expected to be higher. IMF statistics are presented here only to demonstrate that a large unfinanced balance of payments gap is not expected to exist. RDO/C expects a more current balance of payments estimate to be available for inclusion in the PAAD.

From the preliminary projections available, a drop in external grants (official transfers) for capital projects will result in a negative current account balance in 1986. However, on capital account, public sector concessional borrowing is expected to compensate for the loss in project-related grants and private capital inflows are expected to approximately double, in connenction with tourism and manufacturing investment. These increased capital account inflows are not expected to make up the difference, and Grenada will be faced with an unfinanced balance of payments gap of nearly US$ 7 million in 1986. The proposed program assistance of US$4.5 million will cover two thirds of this. Rescheduling of amortization payments on external debt as discussed under the fiscal analysis above will close out the gap.

Grenada's real effective exchange rate has appreciated more rapidly than that of any other state in the Eastern Caribbean currency union, and Trinidad's devaluation late last year only served to further distance Grenada from Dominica's (the next most rapidly appreciating country) position. In part this situation is a reflection of Grenada's trading patterns, but more seriously affecting this outcome has been Grenada's rate of inflation in the 1980-85 period, the highest in the OECS. As a consequence, despite improvements linked to the 1985 depreciation of the US dollar, Grenada's real effective exchange rate has appreciated about 22 points, comparing 1985 with 1980.

However, because of Grenada's membership in the monetary union and because union-wide the appreciation is only 4 points (comparing 1985 with 1980), there is little likelihood that the union will elect to devalue in the near future. As a consequence, Grenada must seek alternative policy measures to improve its competitiveness. Various elements of the newly announced fiscal reform package are working precisely in this direction. First, the phased removal of export tariffs is a positive step. Second, other tax measures to encourage exports and discourage imports are positive steps. Finally, if Government is successful in holding the line on civil service wage increases, the demonstration effect on private sector wages should work to Grenada's competitive advantage.

D. Proposed Assistance Level

In recognition of the GOG's major tax reform efforts and to encourage the GOG to move toward multilateral program assistance in support of a medium-term structural adjustment program, RDO/C recommends that AID grant US$4.5 million in ESF funds to Grenada in FY 1986 to finance the major portion of the EC$14 million (US$5.2 million) shortfall identified in the fiscal analysis above. The conditionality outlined in this concepts paper, and to be further developed in the PAAD, is designed to concentrate efforts under the Economic Structural Adjustment Program to ensure effective implementation of the GOG's fiscal reform program in FY 1986 and encourage the development of a medium-term structural adjustment program.

V. Conditionality

As noted earlier, conditionality under the proposed ESAP I will focus on three items: (a)implementation of fiscal reforms, (b) prudent elimination of any unfinanced gap arising out of a higher than expected fiscal deficit and (c) development of a medium-term structural adjustment program.

A. Conditions precedent to Initial Disbursement

Conditions Precedent to first disbursement are designed to ensure timely use of funds in support of fiscal reform while at the same time providing the information basis needed to ensure adequate discussion of any fiscal problems.

In addition to standard CP's requiring opening of accounts etc., RDO/C will require, as a follow-on to the analysis carried out in developing the PAAD, the following CP's:

1. A statement describing the fiscal gap for 1986 that will remain after disbursement of the Grant and a clearly annotated monthly cash flow current to one month before disbursement, with projections through end-1986. The statement will include a description of the policies and actions the Government will pursue to eliminate any unfinanced gap that has been identified.

2. A mutually agreed upon list of Government of Grenada budget line items to which the local currency generated under the grant will be attributed.

3. A formal review of the fiscal reform program to identify actions required to complete implementation of remaining tax and other fiscal reforms.

B. Conditions Precedent to the Second Tranche

Prior to disbursement of the second tranche RDO/C will require the following:

1. A full review of the fiscal reform program and agreement on actions required to complete implementation of remaining tax and budget reforms by January 1987(e.g. institution of the Modified Land Value Tax). Participating in this review will be the GOG, RDO/C, and the AID financed Fiscal Reform Team.

2. Evidence satisfactory to A.I.D. that the GOG is taking the measures necessary to eliminate any remaining unfinanced gap for 1986.

C. Covenants

The GOG will be required to covenant the following:

1. Medium-term Structural Adjustment Program. The agreement will state that the parties concur in the understanding that any future AID program assistance to Grenada will be contingent upon AID's satisfaction that the GOG is making acceptable progress in seeking multidonor support for a medium-term structural adjustment program. The GOG will covenant to explore with AID and the IBRD the development of a structural adjustment program under the "Tight Consultative Group" mechanism. We will urge the GOG to move soon on discussions with the World Bank so that the program may be ready to enable the GOG to access the various facilities available during CY 1987 if necessary. In the initial PIL to the Program Agreement, RDO/C will clarify for the GOG what will constitute "acceptable progress" in seeking access to the TCG mechanism.

2. Bilateral Consultations The GOG will covenant to provide adequate cash flow and budgetary analysis and to continue bi-weekly consultations on fiscal reform measures and other structural reforms of mutual concern throughout Cy1986.

APPENDIX A

SUMMARY OF 1986 REVENUE REFORMS1/

In the 1986 Budget, the Government of Grenada included a major tax reform package which became effective March 1, 1986. In his Budget Speech, presented to Parliament on February 28th, the Prime Minister reiterated his 1985 promise that the 1986 budget would be a reform budget. His theme was, "The 1986 budget is built on a strategy designed to restructure the economy and reform the public finances aimed at raising the level of productivity, efficiency and competitiveness of all Grenadians." He stated that fiscal reform would be divided into two phases. The first deals with the creation of a wholly new tax structure. The second, basically to be carried out over the next year, will look at issues concerned with the development of output measurements for programs within the budget and improvement of budget presentation in order to improve the Government's ability to set priorities. The Government will also review the use of licences and user fees on Government services to increase the efficiency of the public sector on an equitable basis.

As discussed in the Concepts Paper, the new tax structure is designed to be fair, simple and conducive to economic growth. It replaces a complicated system which has stifled the capacity of the Grenadian economy to grow. The new system is a product of seven months of study by a working group in the Ministry of Finance, followed by lengthy deliberation and debate in Cabinet. Although we can expect modifications as the GOG reacts to political needs, as well as experience in implementing the reforms, the tax structure originally approved by Cabinet was in fact almost identical to that put forward by the RDO/C-financed Fiscal Reform Consultant Team.

Tax reform measures repeal the following taxes. Income tax withholding, the individual income tax, company tax, all export taxes, the stamp duty, excise duties, consumption duty, package tax, hotel occupancy tax, radio and TV tax, petroleum profits tax, entertainment tax, telecommunications tax, ticket tax, land and house tax, inheritance tax and four other general rates taxes are repealed. The international airport levy which expired december 31, 1985 will not be renewed.

Tax reform measures retain or revise the following taxes. The common external tariff (CET) is retained with modifications to be made in accordance with CARICOM agreements. The foreign exchange tax (FET), chargeable on purchases of foreign currency is retained and reduced from five percent to two percent. The motor vehicle purchase tax (MVT) is retained. The rate is 40 percent on the cost of private cars, taxis, rental cars and minivans and 15 percent on others such as hearses. Vehicles of certain public officials who travel, diplomats and vehicles used in agriculture, if approved by Cabinet on a case by case basis, are exempt.

1/ Reference to table 1 and 2 of the Concepts Paper may prove useful to the reader in putting each reform measure in context of the overall reform plan.

A value added tax (VAT) is introduced as the centerpiece of the new tax structure. The VAT is applied at the rate of 20 percent on sales of goods and services. It is expected to yield over half of total Government revenue once the system is fully implemented. The tax will apply to any firm or person whose sales of goods and services is more than EC$12,000 (US$ 4,444). Tax credits will be allowed on purchases of equipment, machinery and furniture. Vehicles will not be allowed a tax credit. A few items such as essential foods may be taxable at zero percent (zero rates). Multiple rates and large numbers of exemptions were avoided in writing the law. The object of obtaining a simple broad-based tax has been obtained.

A modified land value tax (MVLT) is introduced. The MVLT will replace the land and house tax and greatly increase revenues from real property. A rate of two percent will be charged on the value of all land (residential, commercial, industrial, agricultural, and vacant). For any property, an exemption of EC$15,000 (US$5,555) will be allowed. There will be a deferral provision to prevent hardship to farmers during periods of natural disaster and to older citizens whose tax exceeds their ability to pay. In his speech, the Prime Minister emphasized the tax was designed to discourage speculation and encourage the use of land to realize its greatest economic potential. Land surveys and preparation of property rolls are currently being carried out with the assistance of the AID financed fiscal reform team. Collection of property taxes will not start until January 1987.

A modified levy is introduced. The company levy was defined as a 10 percent tax on the gross profits of companies. The levy was a last minute measure added to the tax package because certain members of the Cabinet, including Prime Minister Blaize, were concerned that political opponents of the NNP would charge that the reform was too pro-business. Subsequent to its introduction, the concept of gross profits and allowance of appropriate deductions proved difficult to define. The business levy is now to be redefined to be more equivalent to a net profits tax with certain exemptions, such as business trips abroad and purchase of company cars, no longer allowable. Essentially, the tax now represents a reduction of the company tax from 50 percent to 10 percent with deductions for the most abused forms of operating expenses removed.

A gasoline tax is introduced. The gasoline tax is set at EC$0.50 (US$0.19) per gallon of gasoline sold. It replaces the petroleum profits tax levied on excess profits of petroleum importers. The price of gasoline will now be allowed to reflect world market conditions.

The reform package leaves Grenada with only seven taxes. All taxes will be collected from businesses except the MVLT which will be collected from property owners. Reform of the revenue system is not completed however. The Government has already initiated a study of licences and user fees which in 1985 accounted for 10 percent of the budget. The basis of this review will be to ensure the fair and equitable use of Government services. Additional fees may be considered such as the possibility of adding certain fees for health services.

APPENDIX B

AID'S PARTICIPATION IN THE "TIGHT CONSULTATIVE GROUP"

Early in 1986 the OECS Economic Affairs Secretariat, with country assistance, developed a proposal for an "Eastern Caribbean Development Facility." The ECDF was designed around the concept that the OECS states would engage in codified structural adjustment programs in return for budgetary support from the donors. However, because the majority of donors either could not provide budgetary support (by their own laws) or could not participate in such a pooling of program assistance (by their charters), the ECDF was declared unworkable at the March 1986 Caribbean Group meetings in St. Lucia and an alternative, the "tight consultative group" (TCG) concept, was tabled by the World Bank.

At the St. Lucia (March 1986) meetings the US delegation, under instructions from Washington, endorsed the TCG concept. Within RDO/C, we intend to use the resources planned under the "Structural Adjustment Support Program" (SASP) for FY87 and FY88 and beyond to support the TCG approach, either by directly contributing to a recipient that already has access to the SAF and IDA funds or by moving countries yet without access toward that access. The Mission plans to have in AID/W for review in July 1986 a concept paper for the SASP. The current program for Grenada is meant in part to move the GOG toward access to TCG resources.

The TCG concept is still evolving, but it holds promise as an effective means of focusing program and project assistance on structural adjustment problems in the OECS. The focusing of resources should greatly enhance the efficiency of their use in bringing about structural adjustment. Our current understanding of the TCG concept, and what appear now to be five component elements, is set out below.

(A) Tight Consultative Group Approach. CGCED donors and recipients have agreed, in principle, on a "tight consultative group" approach to coordinating structural adjustment programs in OECS states. For OECS countries interested in embarking on structural adjustment programs that make use of the IMF and World Bank program assistance, the TCG would likely replace the CGCED subgroup meetings held heretofore. The TCG is envisioned as a "tight" group in that participating donors would be limited to those that are actively and financially contributing to the structural adjustment program in the OECS state in question. In addition to the IMF and itself, the World Bank expects the US (as the only other donor able to provide program assistance) to participate in and be guided by the TCG in its decisions on not only program assistance but also project assistance to the OECS state in question. The World Bank also is looking forward to the participation in the TCG by those bilateral donors who expressed their inability to participate in the program assistance inherent in the Eastern Caribbean Development Facility (ECDF), but who said that they would strongly support structural adjustment efforts in the OECS in any other way they could. The TCG approach promises to better focus external assistance to the OECS states, although it potentially entails something of a loss of flexibility in deciding what projects to either continue or initiate.

(B) Medium-term Structural Adjustment Programs. In order to gain and maintain access to the resources available under the TCG approach, a country will have to agree to a medium-term (three-year) structural adjustment program. The MTSAP, as presently envisioned, will contain relatively clear-cut targets for the ensuing year and less clearly defined ones for remaining years in the program. The IMF, World Bank, and the recipient country--and presumably other donors participating in the TCG--will all have to agree on the program. The World Bank has offered to assist any country that so wishes to design the MTSAP. In the case of Dominica, the World Bank and the IMF will field a joint team (in early May) to begin working on that program.

(C) Structural Adjustment Facility. IMF has decided to make trust fund reflows (about USDOLS 2.7 billion) available to IDA-eligible LDCs worldwide on very concessional terms in a "Structural Adjustment Facility" (SAF). Funds equivalent to 20 percent of (IMF) quota would be available in the first year, with 13.5 percent in each of two subsequent years. (Grenada, with an IMF quota of SDR 6 million, would have access to SDR 1.2 million the first year for a total of nearly SDR 3 million.) The funds would be loaned at 0.5 percent interest, with 5-year grace periods and another 5 years to repay. Access by a given country to its share of the funds would be contingent on IMF and World Bank determination that that country has a "sound macroeconomic framework" in place and on that country's having agreed with the World Bank and the IMF on a medium-term (three-year) structural adjustment program. Performance targets would be more like World Bank targets than the strict quantitative targets imposed by the IMF in its normal stabilization facilities. IMF Board approved the SAF program in late March 1986.

(D) IDA VIII Program Assistance. World Bank has decided, pending Board approval, to make that amount of IDA VIII that will go to the OECS countries available for program (as opposed to project) assistance. According to rough estimates, that might amount to \$20-25 million over the IDA VIII period (July 1987-June 1990). As part of the impending OECS "graduation" from IDA, these funds would not be solely IDA, but would be mixed with regular IBRD resources, thus implying loan terms somewhat less concessional than those under the IMF SAF program. Again, access to these resources by any country would be contingent on IMF and World Bank determination that that country has a "sound macroeconomic framework" in place and on that country's having agreed with the World Bank and the IMF on a medium-term (three-year) structural adjustment program. The first such program will be with Dominica.

(E) Donor participation in program analysis and design. The World Bank has suggested that interested donors may wish to participate in the analysis and design work on the MTSAP. The World Bank's current thinking on this involvement is to have donors participate in the analysis of the public sector investment program (PSIP), with interested donors carrying out analysis in their particular sector of interest and expertise.

According to World Bank officials, the World Bank is tentatively thinking of the following order of implementation of the TCG concept: Dominica, St. Vincent, St. Lucia, Antigua, and St. Kitts. The World Bank has not yet decided where Grenada would appear on this list. The list is based upon dealing with "easier" cases first. The World Bank has indicated that between now and the end of this calendar year they will be able to design MTSAPs for only two states. Next year, another two (or perhaps three) would be done. We will be in contact with appropriate officials at the World Bank to learn what their impression of timing for a Grenada program is. A World Bank mission recently returned from Grenada after completing the intitial phase of preparation of an economic memorandum, and that team should be able to comment on where they believe Grenada will fit into the TCG concept in terms of timing.

Assuming that Dominica and St. Vincent are the first two countries to access the TCG-controlled facilities, we believe that the earliest that Grenada could hope to participate would be toward the end of our FY 1987. AID must, however, speed that process up as much as possible. In the interim, the Government of Grenada must be encouraged and assisted in making preparations for access to the facilities, both by continuing with economic policy reforms and by continuing to develop the medium-term development strategy prepared in first draft late in 1985. That strategy should serve as the basis for developing with the World Bank an MTSAP when the time comes.