IMPACT EVALUATION OF A.I.D. POLICY REFORM PROGRAMS IN DOMINICA AND GRENADA

A.I.D. IMPACT EVALUATION REPORT NO. 72

by

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FOREWORD

In order to learn more about the effectiveness and developmental impact of it’s policy reform programs, the Agency for International Development (A.I.D.), Center for Development Information and Evaluation has launched a series evaluating policy reform in Central America and the Caribbean and in Africa. Completed evaluations include the Central America and Caribbean evaluations (Costa Rica, Jamaica, Honduras, and the Dominican Republic); the Africa evaluations (The Gambia, Mali, Senegal, Malawi, and Cameroon) will be published shortly.

This impact evaluation (which is based on fieldwork completed in September 1989) analyzes A.I.D.-supported policy reform programs in Dominica and Grenada. By looking at two countries with similar economies it is possible to compare two quite different programming approaches and to identify factors related to success.

In the early to middle 1980s, both Dominica and Grenada experienced an economic slowdown, large and unsustainable Government budget deficits, and a lack of private investment. To solve those problems a number of policy reforms were implemented, and economic growth accelerated, budget deficits were sharply reduced, and private sector activity picked up. By nearly all economic measures, the reforms supported a successful economic restructuring. The evaluation examines how, in Dominica, the careful selection of reforms and the use of a phased implementation plan proved much more successful and sustainable than the opposite approach, used in Grenada, of major reforms that were implemented in a short period of time.

While success in improving economic conditions is important, of particular interest for this evaluation are the institutional and programming issues of policy reform and the implementation process. The evaluation places major emphasis on those issues and identifies factors that will be of interest to those working on similar issues in other countries.

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SUMMARY

Why Dominica and Grenada?

This Impact Evaluation examines policy reform programs supported by the Agency for International Development (A.I.D.) in two small Caribbean island countries, Dominica and Grenada. Some might doubt the utility of such an evaluation, as these two countries seem so different from other A.I.D. recipients. However, both Grenada and Dominica have policy problems similar to those faced by other developing countries. In addition, Dominica and Grenada present an almost ideal comparison and contrast of two quite different approaches to policy reform. This evaluation shows that, even where A.I.D. had the chance to wipe the slate clean and implement a total package of basic economic reforms, as it did in Grenada, there can be major implementation problems.

In dealing with policy reform in most countries, A.I.D. faces a generic set of problems: the host government fails to see the need for reform and fails to fully accept the technical package proposed by A.I.D., the World Bank, and the International Monetary Fund; often political objections from the opposition party and objections from within the government itself occur; the government is timid and slow to implement the package of reforms; there is resistance, and some of the reforms are not implemented; and, finally, A.I.D. usually lacks the funds required to fully back the total reform effort. But what if this litany of problems could be avoided? For example, what if (1) the government accepted the total reform package; (2) there was no political, bureaucratic, or economic opposition; (3) the reforms

were implemented in a timely manner; and (4) the country was small enough so that A.I.D. could fund the total reform effort? The scenario may sound like a policy reformer’s dream, but that was the case in Grenada.

<u>Policy Reform in Grenada</u>

In October 1983 the United States led a military intervention that toppled an unpopular Marxist government. The country was clearly ready for a change--there had been 17 years of political repression and instability along with excessive state economic control and regulation. Now, with the introduction of democratic political reforms, it was possible to reform the economy.

At the time of the intervention, Grenada was suffering from large Government budget deficits, slow economic growth, and very low levels of private sector investment. Major policy reforms were clearly needed. The new Government was willing to make a major shift to support a private-sector-led growth policy, and A.I.D. policy reform efforts supported that change by focusing on two key problems: reducing the Government budget deficit while providing incentives to support private sector investment.

Tax reform was a major A.I.D. initiative that included the immediate elimination of personal and corporate income taxes and the introduction of a new value-added tax (VAT). This measure was expected to increase employment and investment and decrease consumption. Additional reforms included a new property tax and a major reduction in civil service employment. It was expected that a smaller government bureaucracy, along with a new and simpler tax system that provided effective economic incentives, would encourage private sector growth.

The new economic policy changes were far from successful, for a number of reasons: they were implemented too rapidly, they did not mesh with local business practices (most businesses are small, operate on a cash basis, and do not have the records necessary for a VAT), the Government staff was inadequately trained to implement the reforms, public support and compliance were inadequate, and even within the Government there was a lack of support and understanding. The new reforms represented an innovative technical approach, but, without adequate business records, adequate training of Government staff, and a good public education program, they were not accepted by the business community or the Government bureaucracy. The pace of implementation--immediate, without discussion, trial, phase-in, or training--added to the problem.

There were similar problems with the major reduction in civil service employment. The wrong people--highly skilled managers--left the civil service; the process confused and demoralized the staff, harming Government efficiency; severance payments were expensive; and, after an initial dip, Government employment increased.

A number of attempts were made to change the VAT through a series of new regulations and procedures, but that only created more confusion and uncertainty for both the private sector and government tax collectors. By 1989, after many modifications, the Grenada VAT has become more like a sales/customs tax and is not a true value-added tax. It is regressive and does not provide investment incentives and it makes imports more expensive and protects domestic industry. The final part of tax reform, the property tax, was never successfully implemented.

Although Grenada’s policy reform program was clearly not successful, the economy still turned in a very strong growth performance. From 1984 to 1989 economic growth averaged 5 to 6 percent a year, led by large-scale public and private sector investment that included a boom in private sector construction activity. Largely because of the confusion with tax reform, tax revenues did poorly through 1987. After a series of ad hoc adjustments and the introduction of new taxes (which failed to provide good economic incentives but were very successful at raising new revenues), the budget deficit started to close in 1988 and 1989.

This impact evaluation was able to identify some of the reasons why Grenada’s economy did so well when policy reform did so poorly. Much of the credit would have to go to the change in business climate after the October 1983 military intervention. Flight capital, skilled workers, and entrepreneurs had been leaving Grenada for over a decade; but now, with private investment encouraged and protected, the flow was dramatically reversed. U.S. investors started to open factories in Grenada, and tourism, which had been almost nonexistent, enjoyed strong growth. Foreign demand for and prices of banana exports were high, and there was a sharp increase in the export prices for two of Grenada’s most important exports, cloves and nutmeg. A final factor was the very large level of U.S. assistance--over $1,000 per capita during the 5-year reform period.

Policy Reform in Dominica

In Dominica, devastating hurricanes in 1979 and 1980 destroyed many of the banana trees (bananas are the major export crop) and much of the country's infrastructure. The Dominican Government attempted to rebuild its capital base with an extensive investment program, but the country lacked the domestic production and export earnings to finance the effort. Instead, the Government relied on large-scale deficit financing, which was clearly unsustainable.

Dominica had many of the same problems as Grenada: civil service salary increases had been excessive and civil service management needed to be reorganized; the tax system was inelastic and incapable of raising the volume of revenue that the Government needed; the tax system was also complicated, and it failed to provide adequate economic incentives; tax collections were inefficient; and, finally, a major portion of the economy, agriculture, was untaxed. As in Grenada, A.I.D. concentrated on tax reform along with efforts to improve civil service efficiency.

A.I.D. focused its initial efforts on the implementation and administration of the existing tax system and did not try to introduce new taxes or to change basic policies. A.I.D. provided training, computers, and advisory staff to improve capacity, efficiency, and staff confidence while increasing tax yields. As the A.I.D. project progressed, the Dominican Government became aware of problems, and discussions on possible reforms began. The Government then implemented a series of tax reforms to simplify the tax system and to provide better economic incentives. Progressive agriculture taxes were introduced, and a sales tax was established. Civil service reform was the only area that lagged. The reforms successfully increased revenues, improved Government tax collection efficiency, and encouraged productive investment. Economic growth picked up sharply and has remained strong throughout the reform period. By any economic measure, the Dominica reform program is a success.

Gradualism Versus Revolution

In Dominica and in Grenada, A.I.D. followed two quite different approaches to policy reform. In Dominica the approach was first to improve the management of the existing system and only later to work on incremental tax changes and new taxes. In contrast, in Grenada change was not gradual or incremental. There, new and radically different policies were introduced first, completely overhauling the system with new taxes and civil service reforms; and only later did efforts shift to improving tax administration and management.

The sequential and gradualist approach used in Dominica proved to be much more effective than the revolutionary reforms used in Grenada. This approach allowed the Dominican Government to steadily build its administrative strength and capacity. Only after that capacity was in place were new reforms considered, and then reforms were introduced only after the Government had a chance to build a broad consensus for reform in both the private and public sectors. The reforms that were implemented were evolutionary rather than revolutionary. The steady pace of a series of small but steady reforms proved to be much more sustainable than the dramatic structural reforms that were tried in Grenada.

Policy Reform and Economic Growth

Dominica now has in place a tax system that provides good economic incentives, while Grenada does not; policy reform was much more successful in Dominica. Intuitive economic logic would seem to indicate that good economic policies are better than bad policies and good policies should generate better economic growth. However, during the reform period, both countries were able to sharply improve their economic growth rates; and Grenada, the policy reform failure, had a growth rate that was slightly higher than that of Dominica, the policy reform success.

In a sense, economic policy is like religion. It takes an act of faith to do good deeds now, when the rewards lie only in the future or the hereafter. In fact, the confusion and disincentives built into Grenada's tax system already seem to be taking a toll on business confidence and business investment. In contrast, in Dominica, agricultural diversification, new manufacturing ventures, and a strong construction boom all reflect confidence in the economy. In Grenada, business is locked in a continual battle of confrontation with a politically unstable Government, while in Dominica there is a spirit of cooperation with a popular Government that has strong ties with all sectors of the economy. Finally, policy reform in Grenada has been seen as an externally enforced failure, while in Dominica it has been viewed as an internal success. When the next economic shock comes and it is time for more reforms, it is

Dominica’s Government that will probably be better able to deal with the policy issues and the needed reforms.

PROJECT DATA SHEET

Projects Evaluated in Dominica and Grenada

1. The Dominica and Grenada components of the Public Management and Policy Planning (PMPP) project.

   Project no.: 538-0096
   Amount authorized: $8.5 million
   Authorization date: April 11, 1985
   Completion date: September 30, 1989

   a. The Primary Component--Technical assistance of $6 million, designed to help improve economic policies in seven Eastern Caribbean States. Dominica directly received $918,000 and Grenada received $627,000. The remaining funds supported regional and bilateral programs in other Eastern Caribbean States.

   b. The Grenada Fiscal Reform Component--$2.5 million to support a comprehensive reform of Grenada's fiscal system.

2. Cash Transfer Structural Adjustment Programs

   a. Grenada Structural Adjustment

      Project no.: 538-0141.01
      Amount authorized: $5 million
      Authorization date: July 21, 1987
      Completion expected: May 30, 1990
      Purpose: To assist the Government of Grenada to reduce its recurrent expenditures by developing improved personnel planning, controlling the

Government wage bill, and improving the organization and staffing of the Inland Revenue Department.

b. <u>Dominica, Structural Adjustment Programs</u>

<u>Dominica Structural Adjustment I</u>

Project no.: 538-0141.02
Amount authorized: $1.5 million
Authorization date: September 15, 1987
Completion date: September 14, 1988
Purpose: To support structural adjustment under the Tight Consultative Group. Reforms include improved fiscal policy, control of the Government’s wage bill, and efforts to increase the recurrent account budget surplus.

<u>Dominica Structural Adjustment II</u>

Project no.: 538-0141.03
Amount authorized: $1.6 million
Authorization date: September 30, 1987
Completion expected: May 31, 1990
Purpose: To support structural adjustment under the Tight Consultative Group. Reforms include civil service reform, wage restraint, and increased Government savings.

SELECTED ECONOMIC AND SOCIAL INDICATORS

	Dominica	Grenada
Life Expectancy at Birth (years)	71	65.5
Doctor/Population Ratio	1:2524 (1981)	1:2848 (1987)
Percent of Age Group Enrolled in School		
Primary, Age 5-11	131[a]	125[a]
Secondary, Age 12-18	26	39
Open Unemployment Rates (%)		
1980	19	18
1985	NA	20
1988 Low Estimate	18	25
High Estimate	20	30

Labor Force Projections[b]

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[a]The percent primary enrollment is greater than 100 due to the enrollment of students from outside the age group 5-11.

[b]Cash Transfer PAAD 538-k-604D, August 1989. Assumptions underlying projections: Dominica No. 1 assumes a total fertility rate (the average number of live births a woman will have in her lifetime) of 3.4, and an annual emigration of 800 persons. For No. 2 the respective figures are 2.6 and 400. Grenada No. 1 assumes a total fertility rate of 3.5 and an emigration of 1,800. For No. 2 the respective figures are 2.6 and 900. (These figures are taken from: Regional Development Office/Caribbean, Country Development Strategy Statement, 1990-1994, Annex I.)

1980 #1	25,136	30,752
#2	25,136	30,752
1990 #1	32,903	31,382
#2	34,694	37,265
2000 #1	36,447	33,760
#2	41,157	46,161

<u>Annual Labor Force Increases, 1990-2000</u> (%)

Assuming current fertility and emigration rates	1.0	0.7
Assuming large decreases in fertility and emigration rates	1.7	2.2

<u>Stayover Tourist Arrivals</u>

1985 (thousands)	21.5	52.0
1987 (thousands)	26.7	57.4
Annual Growth Rate, 1980-1987 (%)	8.0	8.7

N.A = Data Not Available

Note: The currency used in Dominica and Grenada is the Eastern Caribbean Dollar (EC$). EC$2.7 = US$1.

GLOSSARY

A.I.D. - Agency for International Development

EC$ - Eastern Caribbean Dollar

GDP - gross domestic product

GNP - gross national product

IBRD - International Bank for Reconstruction and Development (the World Bank)

IMF - International Monetary Fund

PMPP - Public Management and Policy Planning project

VAT - value-added tax

MAP OF THE CARIBBEAN

1. INTRODUCTION

Since the early 1980's, A.I.D. has relied heavily on policy reform assistance to help developing countries improve their economic performance. The rationale for policy-based assistance is that frequently, a major underlying cause of poor development performance is unsound government economic policies. When a government's policies cause market prices to deviate sharply from "true" economic prices, and where there are structural barriers to economic change, development is difficult. In such cases it makes the most sense to go to the root of the problem, to change the inappropriate policies.

This impact evaluation examines A.I.D. efforts to support policy reforms in Dominica and Grenada over the period 1985-1989. It has two key objectives: (1) to assess how well A.I.D. is doing in reaching its objective of supporting improved LDC economic policies and; (2) to help focus A.I.D. management attention on the programming and management issues of policy reform. This impact evaluation identifies the economic benefits of A.I.D.'s policy reform programs and critical factors that can guide future planning and management of policy reform programs in these and other countries.

The typical impact evaluation examines one project in one country. This impact evaluation is somewhat different--it looks at a number of A.I.D. policy reform programs that were implemented in two developing countries. The two countries are island nations that are geographic neighbors, with similar sized economies and population. The evaluation examines the two types of policy-based assistance used in each country--structural technical assistance projects. This makes it possible to assess the overall policy reform impact of both types of aid (project and non-project assistance), including the differences and complementaries of each approach. In addition, by looking at two countries, it is possible to compare two quite different programming approaches to policy reform and to identify the critical factors related to success.

2. SETTING

While every country is unique, in the case of Dominica and Grenada the similarities are striking and provide almost a laboratory case study of policy reform in two very similar countries. Grenada and Dominica are small, Caribbean island countries. Each is a small island with: a per capita GNP of roughly $1,200; a population of just under 100,000; high unemployment rates (over 20 percent); a large public sector; similar inflation and GNP growth rates; economies based primarily on agriculture and heavily dependent upon agricultural exports; and thus, heavily dependent upon the uncertainties of weather and foreign demand for export commodities. Even though there are these similarities, each country followed a different route of misadventure to finally reach the point where major policy reforms were required.

2.1 Dominica

Recent Dominican history has been dominated by the need to recover from two back-to-back hurricanes in 1979 and 1980 (e.g., the real value of banana production did not recover to the 1977 level until 1987). The hurricanes devastated most of the banana trees, homes and the country’s limited infrastructure. With a major loss of export earnings, and the need to sharply increase investments to replace lost capital, the trade and budget deficits increased dramatically. At its peak the overall government deficit was equal to 20 percent of GDP, despite a revenue effort that 15ok nearly 30 percent of GDP. Things were made even more difficult by a series of large civil service pay raises along with a poorly managed and inelastic tax system that failed to raise adequate revenue. In addition, the tax system did not tax agriculture, the country’s major economic sector.

2.2 Grenada

In Grenada the problems leading to policy reform were quite different. Throughout the 1960s and 1970s political instability and increased state regulation and control of the economy put a damper on investment and economic growth. By the early 1980s, Grenada was suffering from large government budget deficits, slow economic growth, and inadequate levels of productive public and private sector investment. Following the U.S.-led military "intervention" of 1983, the new government dramatically reversed economic policies to support free-markets and private sector led growth. To support the reform effort, there was a need to increase government revenues and to reduce the budget deficit while providing the maximum incentives to increase private sector investment and productivity.

3. DESCRIPTION OF THE A.I.D. POLICY REFORM PROGRAM

Both the Dominica and Grenada governments needed to devise policies and incentives that would effectively encourage private sector growth. In addition, they needed to increase government revenues, improve government management efficiency, and control government expenditures. A.I.D. assistance focused on those two problem areas--(1) improving policy planning capabilities and; (2) improving the financial side (introducing new taxes, improving tax administration, improving expenditure controls, and better budgeting).

3.1 Dominica

The "Tight Consultative Group" was established by the Government of Dominica and the major donors (A.I.D., the World Bank, IMF and the Caribbean Development Bank) to develop a program of structural adjustment reforms. A.I.D. provided technical assistance to help the government improve its tax administration and then, to enact tax reforms and a major organization and management study of the civil service. A.I.D. cash transfer conditionality required the government to take steps to control the public sector wage bill, increase public sector savings, improve management of the recurrent budget (increase revenues and reduce expenditures) and to move from a recurrent budget deficit to a surplus. The A.I.D. supported reform effort included three elements:

3.1.1 <u>A more efficient Inland Revenue Department and Customs Department</u>

A.I.D. provided technical assistance, training and computers which supported a reform of the administrative systems and procedures in the Customs and Inland Revenue Departments. Tax evasion was reduced, and tax yields increased. The effectiveness and efficiency of the existing system was greatly improved.

3.1.2 <u>A simplified tax structure with fewer and lower rates, and a broadened base that generates more revenue while providing better economic incentives</u>

To encourage production a number of changes were made: the export tax and export stamp duty were rescinded; the corporate income tax was reduced from 45 percent to 30 percent for manufacturing firms; personal income taxes were simplified, rates were lowered and the base broadened; and the tax on bank deposits was eliminated. To discourage consumption a number of new taxes were introduced: a sales tax was established, the taxes on motor vehicles and petroleum were increased and various licenses and fees were increased. The agricultural sector, which was previously untaxed, was now subject to a progressive tax on banana exports.

3.1.3 Initiation of a major organization and management study of the civil service

Success in this area was limited, although salary increases were moderated and employment did not increase.

3.2 Grenada

The Grenada Government did not establish a consultative group and was unable to reach agreement with the IMF or the World Bank on a structural reform program--A.I.D. was the key donor supporting policy reform. The A.I.D. cash transfers and technical assistance focused on three objectives:

3.2.1 Close the fiscal gap

In order to close the recurrent budget deficit, to increase revenues, and to improve economic incentives, the existing corporate and personal income taxes were eliminated and a new Value Added Tax and property tax were introduced. The tax reform was a bold effort to improve economic incentives, increase economic growth, and ultimately increase tax revenues. The tax reform assumed that by not taxing incomes, production and employment would be encouraged while consumption would be taxed and thus, discouraged. The new property tax was designed to encourage the most efficient use of land, while generating additional tax revenues.

3.2.2 Reduce the public sector wage bill

The civil service was clearly bloated and inefficient. A.I.D. supported a Manpower Control and Monitoring Plan which included a major reduction in personnel strength and encouraged the government to put limits on public sector wage increases. A 25 percent personnel retrenchment plan was immediately implemented and an attempt was made to put a limit on the total wage bill as a percent of government revenues.

3.2.3 Improve the organization and staffing of the Inland Revenue Department

Expert advisors and consultants worked to implement the systems and procedures for the new Value Added Tax. Limited training was also provided.

4. A.I.D.'s APPROACH TO POLICY REFORM

In Dominica and Grenada A.I.D. followed two quite different programming approaches to policy reform. In Dominica A.I.D.

focused first on improving the management of the existing system and only later did it work on incremental tax changes and new taxes. In contrast, in Grenada new and radically different policies were introduced first and then efforts shifted to improving tax administration and management.

In Dominica A.I.D. focused its initial support on the implementation and administration of the existing tax system and did not try to introduce new taxes or try to change fiscal policies. The technical assistance project provided training, computers, and advisory staff designed to build capacity, efficiency and staff confidence. As the project progressed, the government was made aware of problems and anomalies and a dialogue started. As the government realized the inadequacies of the existing system it became interested in reforms and changes, and at that point A.I.D. was ready to help provide advice on new taxes.

The Grenada case was quite different. When A.I.D. entered the scene after the "military rescue intervention", there was an unique opportunity for major changes. The country had seen the end of 17 years of state control, regulation and socialism and was ready for a move to private sector, market-led development. A.I.D.-funded experts analyzed and identified optimal policy solutions; and then the system was overhauled as new taxes and new policies were introduced. The object was to completely reorient the economy in a very short time frame from a slowgrowth, over-regulated economy to a private sector-led, rapid growth economy. The system was completely overhauled as the new taxes and civil service reforms were rapidly pushed forward. It was not gradual or incremental as in Dominica.

5. ECONOMIC FINDINGS AND IMPACTS

5.1 Economic growth

Since 1986 Dominica has sharply accelerated its economic growth (real per capita GDP has been growing at roughly 6 percent a year) and exports are booming. The government has reduced its domestic borrowing, which has freed-up resources for the private sector. Agricultural production has grown strongly and agricultural diversification is starting to move forward.

In Grenada economic growth has also been strong (roughly 5-6 percent a year), led by a large-scale public sector infrastructure program and high levels of private investment which includes extensive construction activity. The agricultural sector has been a major source of growth. While economic growth remains strong, in the last year, political and economic uncertainties seem to be sapping the strength of the private sector.

5.2 <u>Increased revenues and reduced budget deficits</u>

Dominica has improved the efficiency and yield of existing taxes while introducing new taxes that have been well accepted by the business and agricultural community. The tax structure now provides a good set of economic incentives, raises substantial new revenues and has eliminated the budget deficit.

In Grenada tax revenues did poorly through 1987, but in 1988 and 1989 they picked up strongly. The large fiscal deficit is rapidly being closed. While the tax system could be more effective, it is raising needed revenues and is more broadly based than the old system. However, the frequent changes and shifts in tax policies have created much uncertainty and mistrust which is in part responsible for the private sector's hesitancy to invest.

5.3 <u>Tax reforms</u>

A.I.D.-supported tax reforms have helped Dominica increase its tax receipts

-- Customs tax procedures have been reformed and a computerized program of records and compliance has been introduced.

-- Inland Revenue procedures have been improved and the data base is now on a computer.

-- A new tax ID system and a tax masterfile allow crosschecking of all taxpayers and a reduction in evasion and noncompliance.

-- Agriculture previously paid no taxes, now a small development levy provides a progressive tax on banana exports.

-- A new sales tax and property tax are in place and both are generating new revenues.

-- Income tax rules have been greatly simplified, rates reduced, and many low income people are now off the tax rolls.

-- Tax prepayment and self-assessment has been reasonably successful.

In Grenada the centerpiece of tax reform was the elimination of all income taxes and the introduction of a new Value Added Tax (VAT) and a new property tax. These taxes were designed to raise adequate revenue while discouraging consumption and encouraging investment in efficient industries. However, due to a number of structural and implementation problems, the economic benefits of the new taxes were not achieved.

The reforms (particularly the VAT) ran into a number of problems: the tax changes were implemented too rapidly and the changes were too drastic; staff were inadequate in number and training to implement the new VAT; and public support and compliance was a problem since the government failed to consult and educate the general public and the private sector. A continual series of changes in the VAT regulations and procedures created confusion and uncertainty for private enterprise. By 1989, after many modifications, the Grenada VAT has become more like a sales/customs tax and not a true Value Added Tax. It is regressive and lacks investment incentives while it makes imports expensive and protects domestic industry.

The property tax was unsuccessful, due to a number of problems: inadequate staff; inadequate training; tax rates set too low; and a long delay in implementing a cadastral survey.

Since the VAT and property tax failed to raise needed revenues, a number of additional, ad hoc taxes were introduced. The most important is the business levy which is much like a corporate income tax.

5.4 Private sector environment

In Dominica a simplified and equitable tax system, a massive public infrastructure investment program and governmental emphasis on rural development have provided the basic enabling conditions for the private sector. A major boom in private construction and an expansion of private agricultural production has taken place. However, industrial and manufacturing investment is small and has shown limited growth.

In Grenada things are much improved over the pre-1984 conditions. There has been a major improvement in public infra structure (ports, roads, utilities, etc.) and a major boom in private investment and private construction activity. However, the lack of coherence and continuity in governmental policies, and in particular tax policies, has left the private sector unsure about "the rules of the game." While the A.I.D. sponsored reforms were designed to "level the playing field", many of the private sector players are unsure where the boundaries are or where the goals posts are. Political uncertainty in 1989 has put a further damper on the private sector.

5.5 Privatization

In Dominica privatization has moved very slowly with only the electric and water companies privatized. In Grenada 49 percent of the telephone company has been sold and a government hotel has been leased to a private company. Grenadian state owned companies and agricultural estates are still operating, with many losing money. Neither the Grenada nor Dominica governments seems very interested in moving government enterprises into the private sector.

6. INSTITUTIONAL IMPACTS--REFORMS DESIGNED TO IMPROVE THE EFFICIENCY OF GOVERNMENT OPERATIONS

6.1 Civil service reform

In Grenada a drastic personnel retrenchment plan has demoralized the staff, required expensive severance pay and encouraged the best and the brightest to leave government service. Government operations have clearly suffered. By 1989, new personnel reform efforts have been more successful in relating staffing levels to functions and responsibilities and have successfully reduced employment levels.

Dominica did not have a major personnel layoff or retrenchment. Staff numbers were brought down slightly by reorganizing functions and by not filling vacancies. Further civil service reform, including merit pay, has been delayed for some time.

6.2 Institutional capability

Institutional capability relates to the capacity of an organization to assess its problems, to analyze alternative solutions, to prepare new programs, and then to implement those new programs. It is directly dependent upon trained manpower, good managers, and good organizational systems.

In Dominica institutional capabilities have greatly improved. The departments responsible for taxes are clear about their functions and they understand their role. However, there is still a high staff turnover rate and a lack of effective training programs. Unless staff capabilities are continually maintained and upgraded, effectiveness and efficiency will start to decline. There are indications that staff capacity is already starting to decline.

In Grenada the civil service retrenchment resulted in the departure of some the most skilled and senior tax personnel. They have not been fully replaced. In addition, the constant changes in tax policies have tended to confuse and demoralize the staff.

The Grenada policy reform program focused almost all attention on the development of a new set of taxes. It failed to recognize that the government lacked effective capacity to administer the old taxes, and was hard pressed to take on a set of unfamiliar new tax procedures. While there has been much criticism of the VAT system, the problem may not have been the type of tax but the Grenada government’s inability to implement a new tax system. The A.I.D. project failed to build and maintain adequate staff and management capacity to administer the new taxes.

6.3 <u>The process of introducing new taxes</u>

The Dominica Government did an excellent job of making sure that new tax policies were set in a collaborative framework and that they were then followed by an active public relations campaign. When the government was considering new policies or taxes, it held meetings with businessmen and farmers to discuss various options and approaches. Of course the government could not satisfy all special interests, but it was able to make them feel that their ideas were being considered and, therefore, the process helped build consensus.

In Grenada, top civil service and political leaders worked behind the scenes to develop new taxes. The problem was their lack of communication with the civil service staff that would have to implement the new taxes and the lack of contact with private economic interests. All too often, a new tax law would be announced only to find that it had technical and administrative flaws. Private sector special interest groups would then raise complaints and demand changes and, after a few months, the government would usually announce modifications to the original tax plan. Again there might be new complaints and the cycle would repeat itself once more.

7. SUSTAINABILITY--THE CONTINUATION OF BENEFITS AFTER DONOR ASSISTANCE ENDS

7.1 The political environment

The Dominica government is extremely popular and has strong ties to the business community and the rural sector. Communications with those groups are good and they consider the government reasonably competent and interested in their welfare.

In Grenada the situation is much different. Within a few years of the U.S. "intervention" the government started to lose the confidence and support of the business community. Confrontation, rather than cooperation, was often the case as new tax policies ran into strong opposition from special interest groups. Government commitment and public support are critical to sustainability and those elements are strong in Dominica but weak in Grenada.

7.2 <u>Viable institutions</u>

New policies and procedures must be institutionalized if they are to be sustained. Strong institutions will also be able to adapt and change the policies as future conditions evolve. In Grenada the Customs Department is in good shape but the Inland Revenue Department remains weak. In Dominica both Customs and Inland Revenue are able to competently operate the existing program. However, for both countries the critical mass has not yet been reached. There is a danger that the reforms will not become fully institutionalized since each country’s tax departments suffers from high staff turnover and a lack in-service training programs.

8. THE SOCIAL IMPACT OF POLICY REFORM

In many developing countries the poor have had to bear much of the cost of policy adjustment. However, that was not the case in either Dominica or Grenada. In both Dominica and Grenada the reforms included major efforts to reduce the government's budget deficit. Even with budget stringencies, the two government's made a concerted effort not to reduce services that had an important impact on the poor (mainly education and health care). An analysis of the budgets and staffing levels for the education and health ministries indicates that Dominica and Grenada were successful in protecting those services from cuts and funding and staffing levels were not reduced.

Increased tax revenues were an important part of the reform package and it is important to identify who was hit with the new taxes (the poor, farmers, importers, urban, etc.). The problem is that there have been no surveys or data collected on tax incidence either before or after the reforms. While the data do not exist, it is possible to make some very general judgements on the equity impact. In Dominica, the introduction of the Sales Tax and the Development Levy and the reduction in income taxes has made the tax system slightly more regressive. In Grenada, the elimination of the income tax, the introduction of the VAT and the Business Levy has also made that tax system more regressive. In both countries higher-income individuals and corporations are paying much lower taxes on their incomes while lower income people (who under the old system were generally not subject to income taxes) are now paying new consumption and sales taxes.

In both countries there has been strong economic growth and greatly increased employment opportunities. Employment growth has been very strong in the construction sector which has generated rapid growth in jobs for many low income people. In fact, rapid economic growth in both countries has created labor shortages and driven up the wages of skilled and semi-skilled workers in construction and manufacturing.

On balance, while some government social services could have been increased, and while the tax reform did have a reverse equity tilt, the level of welfare and income increased for all income groups and the poor did not suffer from policy reform. Much of the credit is due to the fact that economic growth was strong throughout the reform period.

9. FACTORS INFLUENCING PERFORMANCE AND IMPACT

9.1 The Advantages of a Multi-Donor Assistance Program Coordinated by a Consultative Group

From A.I.D.'s perspective a multi-donor assistance effort helps to spread the aid burden; it allows donors to specialize and focus their programs; and it allows the IMF and World Bank to play a major role in fiscal, monetary and structural reforms. That approach worked in Dominica (where there is a successful donor consultative group) while in Grenada, it did not.

The IMF/World Bank "seal of approval" on Dominica's development program provides legitimacy that in turn encourages other donor support and commercial investment. It also means that A.I.D. will not have to take the lead with fiscal, monetary and structural reforms. In Grenada A.I.D. was by far the largest donor, funding development in most areas of the economy. It clearly would have been easier for A.I.D. if there had been a multi-donor effort, similar to the Dominica consultative group. A multi-donor effort might have prevented the errors A.I.D. made when it took on reform of the whole economy and was alone in pushing and funding the unsuccessful VAT and personnel retrenchment).

9.2 <u>The Selection and Implementation of New Policies</u>

Grenada and Dominica present two quite different approaches to policy reform implementation. In Dominica new policies are implemented slowly only after they have been discussed with all affected parties. In contrast, in Grenada new policies (such as the VAT, property tax and personnel retrenchment) are put in place and then differences are worked out afterwards. Typically a new change is announced by the Grenada government; affected groups object; and then ad hoc adjustments are made. It represents a process of dramatic new policies, a period of backing off, further modification and then additional modifications. The Grenada approach has encouraged a climate of confrontation and continual pressure by special interest groups who have learned that it pays to complain.

In Grenada the most frequent complaint from government administrators and the private sector is not about the actual policies but the unstable economic environment that results from frequent changes in tax laws and regulations. The more traditional, gradualist approach used by Dominica has provided a stable and known system where both the private sector and government administrators know the rules and can get down to business.

9.3 Linking Technical Assistance Projects And Cash Transfers

During the 1980s A.I.D. provided policy-based cash transfer assistance to a large number of developing countries. A problem in many cases was selecting the most critical reforms and then setting the implementation pace. All too often, the LDCs lacked the analytical skills and trained manpower needed to design and implement the policy reforms. While A.I.D., World Bank and IMF teams could help develop reform programs, they were outsiders and policy reforms imposed from the outside rarely succeed. If a reform program is to be successful it needs to be developed and accepted by all economic groups. The degree of host government cooperation, collaboration and commitment has been shown to be a key factor in successful programs. However, there is a problem in countries (like Dominica and Grenada) that lack the indigenous capacity to set an analytically sound policy reform agenda.

The Grenada and Dominica Cash Transfer reforms would probably have run into serious problems since governmental capacity was thin. The Public Management and Policy Planning (PMPP) technical assistance project improved the economic management capacity of the two governments and thus meshed perfectly with the objectives of the cash transfer economic reform program.

The PMPP project supported the cash transfer structural adjustment program in three ways:

1. Often a Cash Transfer identified problem areas but the specifics on the magnitudes and rates of change were not clear. The Cash Transfer would call for a study (which PMPP would fund) to pin down the specifics. The PMPP studies would then generate a package of options and recommendations which the host government could use to select new policies that would satisfy Cash Transfer conditionality.

2. PMPP long-term advisors worked closely with their Grenadian counterparts on day-to-day operations. Short-term advisors played a similar role in Dominica. They were often able to identify broader, systemic problems which could be addressed through Cash Transfer conditionality or through additional PMPP

assistance. PMPP findings and analysis helped set the Cash Transfer reform agenda.

3. PMPP provided extensive management training at all levels of government operations; it helped improve the operation of exist- ing systems; and introduced new techniques and equipment (e.g., computers) to improve efficiency. All of these efforts increased the policy capacity of the Dominica and Grenada governments and helped build longer-term sustainability into the policy reform effort.

When designing a policy-based cash transfer program, A.I.D. should carefully assess host government capabilities. If they are weak a policy oriented technical assistance and training program could directly complement and support the cash transfer policy reform effort.

9.4 Aid dependency

After the 1983 U.S. military intervention, the U.S. provided Grenada with substantial economic assistance. From FY 1984 to FY 1989 U.S. assistance totaled $115 million which, in a country of roughly 100,000 people, is a massive input (over $1,000 per capita).

The immediate elimination of income taxes and the introduction of the VAT represented a dramatic tax change that had not been attempted elsewhere. It appears that many Grenadian government officials did not fully appreciate the difficulty of implementing the reforms. There was little support or understanding in the private sector and there was no real effort to build a consensus.

When a developing country is heavily dependent upon one donor, it is hard to have a truly collaborative development relationship. In such a situation, when a donor offers advice on major reforms and provides the money to implement the reforms, it is hard for the recipient to say no. In the case of the VAT and civil service reforms, Grenada went along with the A.I.D. recommendations, even though it didn't fully understand or support the reforms. Ultimately, the reforms failed. When A.I.D. is a major donor in a country it needs to be particularly careful to build real consensus and support for policy reforms.

10. LESSONS-LEARNED--THE GENERIC FINDINGS

THAT A.I.D. CAN USE IN OTHER PROGRAMS AND OTHER COUNTRIES

-- During the period of A.I.D. assistance, both countries achieved strong economic growth. In Dominica it was mainly due to agriculture's recovery from poor weather conditions and sharply higher foreign demand and prices for its banana exports. In Grenada, excellent growth in agricultural exports and a boost in tourism earnings gave the economy a major boost. A.I.D.-sponsored reforms helped improve economic efficiency but external conditions were the real force behind the boom. *A.I.D. needs humility; good policies are important but external factors can give a boost, or alternatively overwhelm even the best of policies.*

-- In Grenada, prior to the A.I.D. policy reform, 17 years of statist controls, excessive regulations and political uncertainty had depressed economic activity. After the U.S.-led military rescue mission there was a surge of confidence, flight capital returned to Grenada and private investment accelerated. However, by 1989 political uncertainty was again a problem and business investment was on the wane. In contrast, in Dominica a popular government, with strong ties to the business and rural sectors, provided a stable political environment. Over the long-run Dominica has clearly benefited from a stable political environment while in Grenada the lack of stability has harmed growth. <u>Political stability is essential for development</u>.

-- Both Dominica and Grenada sharply reduced very large recurrent account budget deficits. They used different approaches and different taxes but each demonstrated that <u>with good economic growth, a committed government can eliminate its budget deficit</u>.

-- A.I.D. used an incremental approach in Dominica that developed manpower and institutions before starting to reform policies. <u>The Dominica phased and sequential technique represents a better tactical approach than the major system overhaul that was done in Grenada.</u>

-- A Value Added Tax (VAT) by its very nature discourages consumption and encourages investment. However, a VAT system requires a sophisticated tax department and businesses must main- tain books and accounting records. Many developing countries are like Grenada--tax administration is weak and most businesses are small and operate on a cash basis without accounting records. Under such conditions a traditional VAT is unlikely to succeed.

-- Developing country governments suffer from weak manpower and limited institutional capabilities. An efficient institution is probably more critical than optimal policies. Grenada provides an excellent example of the problems that develop when a country lacks strong institutions. If there is a weak tax institution, new tax policies will not solve the problem.

-- In many developing countries A.I.D. cash transfers stand alone. In contrast, in Dominica and Grenada A.I.D. linked policy-based technical assistance to its structural adjustment cash transfers. The two forms of assistance worked together to do more than either could do by itself. In countries where institutions are weak, A.I.D. should consider linking technical assistance to policy reform cash transfers.

-- In Dominica A.I.D. assistance was part of a multi-donor Consultative Group that included the World Bank and IMF. In Grenada there was no Consultative Group and the World Bank and IMF did not provide assistance. The U.S. had to carry the reform effort alone. <u>The U.S. can encourage better LDC performance and achieve better technical balance if the country receives multi-donor support</u>.

-- Privatization efforts did not succeed in either country since the two government's felt that the public sector should control key economic enterprises. <u>A.I.D. should not assume that developing countries share our view on the efficiency of the private sector.</u>

-- The government tax departments in each country suffer from high staff turnover rates. An on-going training effort will be required if institutional capabilities are to be maintained. <u>In institutional development projects A.I.D. should support the development of indigenous or regional training capabilities</u>.

-- Consistent and well understood tax policies are important if government employees are to be able to do their jobs properly. The same holds true for the private sector taxpayers. As Dominica demonstrated, staff education and the mobilization of public support for policy reforms is as critical to success as the technical soundness of the programs.

-- The U.S. funded the resurrection of Grenada's economy and in the early years, Grenada may have been too eager to agree to reforms that it did not fully understand or believe in. If A.I.D. is by far the major donor, there is a danger of developing a client-state mentality of dependency.

-- Institutional and policy reform takes time, but in both Dominica and Grenada A.I.D. expected to achieve major tax and institutional reforms in just four years. The program was too short to build solid institutional capacity and additional assistance is necessary if the institutions are to reach longrun viability. When building policy and institutional capacity, A.I.D. needs to think beyond the standard project life of four or five years to possibly six to ten years.

APPENDIX A

PUBLIC MANAGEMENT AND POLICY PLANNING PROJECT, PRIMARY COMPONENT TECHNICAL ASSISTANCE ACTIVITIES IN DOMINICA AND GRENADA*/

PROBLEMS ADDRESSED AND OUTPUTS ACHIEVED

DOMINICA

Activity #1: Dominica Tax Administration

Performance Period: 12/1/85 to 12/31/86

Cost: US$200,000

Problem. A disorganized and overwhelmed Inland Revenue Division.

Solution. Hired a tax advisor.

Output. The Inland Revenue Division was reorganized, tax laws were altered to emphasize voluntary tax compliance, morale improved, and a major initiative was launched to computerize the income tax system and develop a tax identification system.

Follow-up included efforts of two additional advisors, and delinquent taxpayers were identified and computer forms developed to notify the delinquents.

Activity #4: Dominica and St. Lucia Tax Administration

Performance Period: 5/15/86 to 5/31/87

Cost: US$200,000

Problem. A disorganized and overwhelmed Inland Revenue Division.

Solution: Hired consultants to address questions of organization and procedures.

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*Note: The PMPP "Primary Component" provided technical assistance to seven Eastern Caribbean States and to the regional programs of the OECS Economic Affairs Secretariat. In addition, there was a separate $2.5 million Fiscal Reform Component in Grenada. Grenada received technical assistance from both the "Primary Component" ($627,000) and from the Fiscal Reform Component ($2.5

million). Dominica received assistance only from the "Primary Component" ($917,564).

<u>Output</u>. Consultants accomplished the following: (i) reorganized and decentralized the reporting structure; (ii) tax laws were altered to emphasize voluntary tax compliance; (iii) a drive was initiated to computerize the income tax system and develop a tax identification system; (iv) delinquent tax payers were identified and computer forms were developed to notify the delinquents.

Activity #5: Dominica Planning Advisor

Performance Period: 1/1/87 to 12/31/87
Cost: US$200,000

<u>Problem</u>. To improve the government's planning and budget processes.

<u>Solution</u>. Hired an advisor to work with counterpart.

<u>Output</u>. Several documents were produced by the planning advisor, and several seminars held.

Activity #10: Customs Advisor

Performance Period: 10/15/86 to 11/30/86

Cost: US$65,000

Problem: To improve customs enforcement and reduce valuation fraud.

Solution: Technical advisors were hired to instruct the Customs Administration workers and management.

Output. A filing system and a generic seizure report were created. It was recommended that customs officials visit the premises of traders to detect undervaluation of imports. The recommendation was adopted and implemented.

Activity #13: Technical Assistance on Reforming the Revenue System

Performance Period: 10/15/86 to 3/31/87

Cost: US$220,000

<u>Problem</u>. A tax system which generated insufficient revenue and which was judged to be unfair.

<u>Solution</u>: A technical advisory team was hired to make recommendations on tax reform.

<u>Output</u>. Several background papers were produced which contained options for government consideration, and a revenue estimation model was developed.

Activity #18: Implementation of Tax Reforms in Dominica

Performance Period: 9/6/87 to 2/29/88

Cost US$32,564

<u>Problem</u>: A tax system which acted as a disincentive to productive economic activity.

<u>Solution</u>: Two advisors were provided to the government to assist it in implementing changes in the tax system designed to reduce the disincentive effects of the system on productive economic activity.

Output: The outputs of this project were (i) a draft of legislation for the Dominica sales tax, and (ii) a report on investment tax credits. The sales tax recommendations were implemented in the draft Sales Tax Act of 1989 which provides for a 3 percent tax on the sale of goods and services.

GRENADA

Activity #15: Private Sector Investment Program Analysis

Performance Period: 10/30/86 to 11/30/86

Cost: US$50,000

Problem: A study was needed to gain access to IMF and IBRD structural adjustment lending.

Solution: Hired a technical advisory team to perform an assessment of Grenada’s Public Sector Investment Program.

Output: A report was produced which was used by the IBRD.

Activity #16: Analysis for a Proposed IBRD Structural Adjustment Program.

Performance Period: 2/1/87 to 3/16/87

Cost: US$45,000

<u>Problem</u>: A World Bank preappraisal mission required data for analyzing economic scenarios for Grenada during the 1987-1989 period.

<u>Solution</u>: Provided an agriculture expert and a macroeconomist to participate on an IBRD team.

<u>Output</u>. A report was written which provided the basis for a policy framework paper which is a prerequisite for an IBRD appraisal

Activity #17: Assessment of Implementation of VAT in Grenada

Performance Period: 9/6/87 to 10/31/87

Cost: US$26,970.

Problem: The Government of Granada reformed its tax system in 1986 by abolishing all income taxes and introducing a Value Added Tax (VAT) as the center-piece of the new tax structure. However, the revenue yield of the Value Added Tax fell significantly below projections, and the need arose to determine the reasons for the revenue shortfall.

Solution: A fiscal economist was provided for five weeks to determine the reasons for the shortfall, to provide short-term projections, and to sketch possible remedial measures for consideration by the government.

Output: A study was prepared setting recommendations for increasing the value-added-tax yield in the short-run. The report was intended as exploratory, subject to further study.

Activity #19: VAT and Business Levy Administration in Grenada.

Performance Period: 11/1/87 to 9/30/88

Cost: US$291,412

Problem: The administration of the tax system, in particular the Value Added Tax, and the business levy, were perceived by the government to be inefficient.

Solution: A senior tax administration advisor, a masterfile tax advisor, and a computer programmer, were provided.

Output: The senior tax advisor prepared a report which lists a number of major conditions which are disincentives which inhibit improved tax administration.

Activity #24: Grenada Tax Advisory Support

Performance Period: 2/8/89 to 9-30-89

Cost US$213,765.

Problem: The government lacked the internal capacity to competently administer its tax system.

Solution: A tax policy advisor, a tax administration advisor, and a short-term advisor were provided to assist the government in areas of revenue policy formulation, development of a long-range revenue plan, legislative drafting, personnel development, organization and staffing, and the development of a revenue enhancement master file system.

<u>Output</u>: The advisor assisted in reorganizing the Inland Revenue Department and developed documentation and reports on key tax issues.

Annex B

DOMINICA AND GRENADA

CASH TRANSFER CONDITIONALITY

DOMINICA

Project No. 538-0141.02

Amount authorized: $1.5 million

Authorized Sept. 15, 1987

Completed Sept. 14, 1988

Purpose: To assist the government in ongoing structural adjustment program in conjunction with the Tight Consultative Group which included the IMF, IBRD, and other donors.

Conditions (one tranch):

1. A plan for responding to the findings and recommendations of the fiscal technical assistance team.

2. Evidence of drafter or enacted legislation to regulate public sector wage negotiations in a manner that will assist the government in meeting specified wage targets.

3. Best effort covenant to restrict public sector wage increases to no more than 3 percent a year until 1989/1990.

4. Best effort covenant to produce a current account budget surplus at least equal to 3.5 percent of current revenue in FY1987/1988 and 3.7 percent in FY1988/1989.

Project No. 538-0141.03

Amount authorized: $1.642 (as amended)

Authorized Sept. 30, 1987

Completion expected May 31, 1990

Purpose: To assist the government in its ongoing structural adjustment program in conjunction with the Tight Consultative Group, including the IMF, IBRD, and other donors.

Conditions: (one tranch):

1. The government must establish separate US dollar and local currency accounts with no co-mingling of funds.

2. Evidence of satisfactory progress in implementing the Civil Service Reform program in cooperation with the organization and management technical assistance team.

3. Evidence of satisfactory progress toward wage and salary and of public savings targets specified in the agreement.

4. Covenant to use US dollars for importation of US goods.

5. Covenant to restrict growth of wage bill and to aim for specified savings targets in current and future fiscal years.

Conditionality Achievements

The cash transfer conditions were fully met. The Government of Dominica agreed to restrict public sector wage increaeses to no more than 3 percent a year until 1989/90, and agreed to achieve a current account budget surplus at least equal to 3.5 percent of current revenue in FY1987/88 and 3.7 percent in FY 1988/89. The first target was achieved in FY 1986/87 largely due to the elimination of the system of automatic civil service wage increases. The second target was more than surpassed (see Table 1, Annex E for details).

Another condition stipulated that the government would come up with a plan for responding to the findings and recommendations of the fiscal technical assistance team. As a result, the Inland

Revenue Department and the Customs Administration were reorganized in FY 1986/87, and a tax reform program was implemented in FY 1987/88 (it reduced personal income tax rates, rationalized indirect taxes, and imposed a levy on windfall gains from banana exports as a way to tax agricultural income). As a result, tax revenues, which had previously been very unresponsive (inelastic) to changes in econmic growth, now increased rapidly as GDP increased. In fact, tax revenues not only kept up with rapid GDP growth, but increased faster than GDP growth; Tax revenue rose to 27 percent of GDP in FY 1987/1988, from an average of 26 percent in the four preceding fiscal years.

GRENADA

Project No. 538-0141.01

Amount authorized: $5 million

Authorized July 21, 1987

Completion expected May 30, 1990

Purpose: To assist the government to reduce current expenditures to facilitate entry into a medium-term structural adjustment program.

Conditions (three tranches):

First tranch: $1.2 million

A plan describing how the fiscal gap will be closed.

Second tranch: $2 million

1. Evidence that Cabinet has approved the Manpower Control and Monetary Plan.

2. Evidence that wage bill at end of 1988 is consistent with the above plan.

3. Evidence that the government has a time-phased plan for organizing and staffing the Inland Revenue Department.

Third tranch: $1.8 million

1. Evidence that wage bills for January and February are consistent with wage bill ceiling.

2. Evidence that approved budget estimates for 1989 contain realistic projections of current revenues and are consistent with wage bill and public saving targets.

<u>Conditionality Results</u>

Grenada has satisfied, often after much delay, the Cash Transfer conditionality. Government employment and the wage bill were brought under control, and the government’s budget deficit was significantly reduced.

After several years of serious budget deficits, the government managed to produce an FY 1988 current account surplus amounting to about 2.3 percent of GDP. Prospects for 1989 remain very problematic both on the revenue side (collection lags) and the expenditure side (an announced increase in civil service wage rates of almost one-third).

In his annual budget speech of April, 1989, the Prime Minister announced appointment of "a small Committee to undertake a comprehensive review of the civil service pay and grading structure ... for the purpose of removing the anomalies that had crept into the structure over the years since the last Salary Review in 1970...." In October the government announced wage increase for government workers retroactive to January 1 of 1989 of almost one-third. Apparently, this goes beyond correcting anomalies, and obviously will be a setback, both in terms of wage restraint and the current budget deficit.

In two major respects, however, conditionality was met only in the most nominal sense. For one thing, the cash transfer required evidence that the Cabinet had approved the Manpower Control Plan. The Plan was approved, of course, but as discussed elsewhere in the text, it was a policy disaster. In a word it was a blunt administrative instrument which accomplished no reduction in employment while simultaneously causing extraordinary political disturbance, and it left a legacy of mistrust and apprehension among government employees.

Second, there is considerable controversy and concern within A.I.D. over whether the budget estimates for 1989 contain realistic projections of current revenues and are consistent with targets for the total wage bill and public savings. Perhaps the essential problem is the growing disarray in the tax system, as the VAT has been eliminated in fact (but not in name) and replaced by a consumption tax. As a result, by 1988 recurrent revenue were still below 1985 levels.

Annex C

INSTITUTIONAL IMPACT OF ASSISTANCE

THE DOMINICAN EXPERIENCE

1. Sustainability

The Dominican public service has been effectively strengthened and the conditions necessary for a technical assistance program to have a continuing beneficial effect have been met: the Government has the political will to support new policies; it is willing to give new policies adequate time to work; the government knows how to work closely with the private sector to gain their support for reforms, and public officials have been trained to implement the existing and new tax system.

However, a short-term technical assistance program cannot realistically be expected to satisfy the long-term, institution building needs of Dominica nor can it be assumed that the gains achieved will be automatically maintained. Indeed, the heavy staff turnover due to emigration and the retirement of senior officers will have a negative impact on the benefits derived from the PMPP project. The Dominica Government therefore needs to introduce a civil service reform program that is conducive to the recruitment and retention of high caliber officials. It also needs to move beyond the Ministry of Finance and Planning, the departments of Customs and Inland Revenue and improve the structure of other key agencies. There is also a need to ensure that a formal training program is designed to develop and maintain the skills of government employees.

2. <u>Mobilization of Public Support for Policy Reform</u>

The main private sector organization, the Chamber of Commerce, does not possess a secretariat capable of preparing issues papers on the economy. This weakness means that it is very dependent on the Government for information. Fortunately, the private sector is in general agreement with the philosophy and policies of the Government and is prepared to give those policies a chance to work.

A good example of the cooperation between the public and private sector is the introduction of the development levy (a tax on banana exports). When the government was considering ways of taxing agricultural incomes, farming and business groups were consulted, and after much discussion of various alternatives, the development levy was accepted by all parties.

While nobody likes to pay taxes, there has been strong public support for tax reform since the reforms have been seen as reasonably "fair" and they have been evolutionary rather than revolutionary. They were more easily digestible and less threatening than they would have been if an attempt had been made to radically transform the system. Lastly, there was an effective administrative structure in place that was capable of implementing the changes in the tax system. The confusion caused by the introduction of the changes was minimized and the private sector had fewer reasons to complain.

3. Civil Service Reform

Civil service reform was to include a merit pay system that would replace the present incremental pay system. Implementation is lagging due to the high cost of merit pay.

While Dominica realizes the need to reduce its wage bill as a means of improving its fiscal balance, it has not introduced a retrenchment program. The civil service is not large and the Dominica authorities view the social costs of a retrenchment program as too high since there are limited employment opportunities in the private sector. Therefore, they have chosen a more gradual approach of freezing vacant posts and keeping tight controls on new appointments.

GRENADA’S EXPERIENCE

1. Sustainability

While there was interaction between the top senior government officers and the consultants hired to develop the new tax system, the mid-level technical officers of the Inland Revenue and Customs Departments, whose function it is to administer the tax system, had minimal contact with the consultants. No provision was made for the technical officers of the revenue collecting departments to receive and comment on the consultants’ reports or to make inputs, on a consistent basis, on the proposed new tax laws. From an institution building point of view therefore, the Grenadian government technical officers have not benefited fully from the expertise that was available.

As a result of the proposed personnel reductions and the continual change in tax rules and procedures, staff morale and productivity at the Department of Inland Revenue remains low. There is a need to develop a formal training program which should include the training of trainers. This training program would in any case be necessary, but it is particularly required since many of the senior officers of the department did not have a close association with the consultants. Finally, a technical assistance program which would allow consultants to advise and assist the operation of the installed systems and procedures over a period of time is needed. These measures are needed to sustain the system and to enable the Department of Inland Revenue to become efficient and effective.

2. Mobilization of Support for Policy Reform

The ultimate objective of the Grenada tax reforms is the creation of an environment that will support the growth of a dynamic private sector. It follows therefore, that the private and public sectors must be partners in the quest for economic growth and collaboration and cooperation must be key features of this partnership.

When the new tax system, particularly the Value Added Tax (VAT), was put in place a spirit of collaboration and cooperation was absent. The Government shrouded the Value Added Tax in secrecy and presented the private sector with a fait accompli. The educational process which should have taken place prior to the implementation of the new tax was belatedly started long after its implementation. The administrative system which had inefficiently administered the old tax system was incapable of administering the new one. Consequently, officers of the Customs and Inland Revenue Departments were learning about the new tax system at the same time that they were trying to explain it to the private sector. The result was confusion and resentment of the new system by the business community. In other countries, where the Value Added Tax has been introduced, the general practice has been to have a long period of public education prior to the introduction of the tax and, in some cases, to have a phased implementation of the tax. Neither course was followed in Grenada.

As a result of these problems, the Government has had to try a series of ad hoc amendments to the VAT system: The projected effectiveness of the tax has not been realized; the business community has been operating in an environment of uncertainty which is not conducive to investment; and the system that has evolved is not a true value added tax but more of a sales tax.

To improve the dialogue between the government and the private sector, the Grenada Chamber of Commerce formed a Private Sector Economic Affairs Committee. It represents all major private organizations (except the trade unions) and meets with senior government officials on a quarterly basis to discuss matters relating to the functioning of the economy. It appears however that there is mutual suspicion and a spirit of cooperation and collaboration is missing.

The Government is starting to recognize the errors of the past and in the future plans to solicit the views of the private sector prior to the implementation of new policies. In preparing for its 1989 budgetary proposals the Government (in addition to its on-going discussions with the Private Sector Economic Affairs Committee) carried out a Business Opinion Survey. The Government has also announced that its development strategy for the period 199O to 1994 will be formulated and published for national discussion.

The Grenadian private sector considers itself to be strong with a capacity to develop rational proposals for the consideration of

Government. This confidence may derive from the fact that the private sector has been able to rollback many of the reforms and feels that it has been winning in the game of confrontation with the government. Private sector organizations by definition represent special interest. In Grenada the need exists for the private sector organizations to develop their sectional interests within the macroeconomic framework. Only then will Government and the private sector be able to work together collaboratively to promote the national good.

3. Civil Service Reform

The impetus for Grenada's civil service reform, including retrenchment, had its genesis in a study conducted for the 1983 Interim Government which found that the public service was overstaffed and management techniques were out of date.

When pressure was placed on the Government to reduce its fiscal deficit, the obvious choice for an expenditure reduction was the public service wage bill which absorbed 50 to 6O per cent of Government revenues. The Government and A.I.D. reached the conclusion that out of a 7,500 person civil service, 25 percent or 1,800 persons could be cut and that A.I.D. would provide the budgetary support needed for this retrenchment. As in the case of tax reform, the Grenada Government and A.I.D. considered the retrenchment program as drastic but necessary surgery required for the revitalization of the economy. Disbursement of A.I.D. funds was directly tied to retrenchment performance.

When the Government instituted the retrenchment program there was no record of the total number of persons in the public service or the number of persons in various government occupational categories. It was a mistake, therefore, to decide that the public service could be reduced by 25 percent without knowing which categories of workers could be cut and how government services would be affected.

1. INTRODUCTION

Since the early 1980s, the Agency for International Development (A.I.D.) has relied heavily on policy reform assistance to help developing countries improve their economic performance. The rationale for policy-based assistance is that frequently, a major underlying cause of poor development performance is unsound government economic policies. When a government's policies cause market prices to deviate sharply from "true" economic prices, and where there are structural barriers to economic change, development is difficult. In such cases it makes the most sense to go to the root of the problem, to change the inappropriate policies.

This impact evaluation examines A.I.D. efforts to support policy reforms in Dominica and Grenada over the period 1985 to 1989.[3] It has two key objectives: to assess how well A.I.D. is doing in reaching its objective of supporting improved developing country economic policies, and to help focus A.I.D. management attention on the programming and management issues of policy reform. This impact evaluation identifies the economic benefits of A.I.D.'s policy reform programs and critical factors that can guide future planning and management of policy reform programs in these and other countries.

The typical impact evaluation examines one project in one country. This impact evaluation is somewhat different--it looks at a number of A.I.D. policy reform programs that were implemented in two developing countries. The two countries are island nations that are geographic neighbors and that have similar-sized economies and populations. The evaluation examines the two types of policy-based assistance used in each

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[3]Additional information, data, and analysis from this evaluation are available in A.I.D. Working Paper No.   , which can be obtained from the A.I.D. Library.

country--structural adjustment cash transfers and technical assistance projects. This approach makes it possible to assess the overall policy reform impact of both types of aid (project and nonproject assistance), including the differences and complementarities of each approach. In addition, by looking at two countries, it is possible to compare two quite different programming approaches to policy reform and to identify the critical factors related to success.

2. SETTING

While every country is unique, Dominica and Grenada have striking similarities. Thus they provide almost a laboratory case study of the effects of different policy reform approaches. Grenada and Dominica are small island countries in the Caribbean Sea. They are alike with each having a per capita gross national product (GNP) of roughly $1,200, a population of just under 100,000, high unemployment rates (over 20 percent), large public sectors, similar inflation and GNP growth rates, and economies based primarily on agriculture and heavily dependent on agricultural exports, and thus heavily dependent on the uncertainties of weather and foreign demand for export commodities. In spite of their similarities, each country followed a different route of misadventure to finally reach the point at which major policy reforms were required.

2.1 Dominica

Recent Dominican history has been dominated by the need to recover from two severe hurricanes in 1979 and 1980. The hurricanes devastated most of the country’s banana trees, its homes, and its limited infrastructure. The real value of banana production did not recover to the 1977 level until 1987. With a major loss of export earnings and the need to sharply increase investments to replace lost capital, the trade and budget deficits increased dramatically. At its peak the overall government deficit was equal to 20 percent of gross domestic product (GDP). The situation was made even more difficult by a series of large civil service pay raises. In addition, the poorly managed and inelastic tax system failed to raise adequate revenue and did not tax agriculture, the country’s major economic sector.

2.2 Grenada

In Grenada the problems that led to policy reform were quite different. Throughout the 1960s and 1970s, political instability and increased State regulation and control of the economy had inhibited investment and economic growth. By the early 1980s, Grenada was suffering from large Government budget deficits, slow economic growth, and inadequate levels of productive public and private sector investment. Following the United States-led military intervention of 1983, the new Government dramatically reversed economic policies to support free markets and private-sector-led growth. To support the reform effort, there was a need to increase Government revenues and to reduce the budget deficit while providing the maximum incentives to increase private sector investment and productivity.

3. DESCRIPTION OF THE A.I.D. POLICY REFORM PROGRAM

Both the Dominica and Grenada Governments needed to devise policies and incentives that would effectively encourage private sector growth. In addition, they needed to increase Government revenues, improve Government management efficiency, and control Government expenditures. A.I.D. assistance focused on two problem areas: improving policy planning capabilities, and improving the financial side (new taxes, improved tax administration, improved expenditure controls, and better budgeting).

3.1 <u>Dominica</u>

The "Tight Consultative Group" was established by the Government of Dominica and the major donors (A.I.D., the World Bank, the International Monetary Fund (IMF), and the Caribbean Development Bank) to develop a program of structural adjustment reforms. A.I.D. provided technical assistance to help the Government improve its tax administration and then to enact tax reforms and undertake a major organization and management study of the civil service. A.I.D. cash transfer conditionality required the Government to take steps to control the public sector wage bill, increase public sector savings, improve management of the recurrent budget (increase revenues and reduce expenditures), and move from a recurrent budget deficit to a surplus. The A.I.D.-supported reform effort included three elements: a more efficient Inland Revenue Department and Customs Department, a simplified tax structure, and a major organization and management study of the civil service.

3.1.1 Inland Revenue Department and Customs Department Management

A.I.D. provided technical assistance, training, and computers to support a reform of the administrative systems and procedures in the Customs and Inland Revenue Departments. Tax evasion was reduced and tax yields increased. The effectiveness and efficiency of the existing system was greatly improved.

3.1.2 Simplified Tax Structure

To encourage production, a number of changes were made in the tax structure: the export tax and export stamp duty were rescinded; the corporate income tax was reduced from 45 percent to 30 percent for manufacturing firms; personal income taxes were simplified, rates lowered, and the base broadened; and the tax on bank deposits was eliminated. To discourage consumption a number of new taxes were introduced: a sales tax was established, the taxes on motor vehicles and petroleum were increased, and various licenses and fees were increased. The agricultural sector, which was previously untaxed, was now subject to a progressive tax on banana exports. The overall result was a tax structure with fewer and lower rates and a broader base, which generates more revenue while providing better economic incentives.

3.1.3 Organization and Management Study of the Civil Service

Success in the area of civil service reform was limited, although salary increases were moderated and employment did not increase.

3.2 Grenada

The Grenada Government did not establish a consultative group and was unable to reach agreement with the IMF or the World Bank on a structural reform program. Thus A.I.D. was the key donor supporting policy reform. The A.I.D. cash transfers and technical assistance focused on three objectives: closing the fiscal gap, reducing the public sector wage bill, and improving the management of the Inland Revenue Department.

3.2.1 Fiscal Reform

In order to close the recurrent budget deficit, increase revenues, and improve economic incentives, the existing corporate and personal income taxes were eliminated and a new value-added tax (VAT) and property tax were introduced. The tax reform was a bold effort to improve economic incentives, increase economic growth, and ultimately increase tax revenues. It was based on the assumption that, if incomes were not taxed, production and employment would be encouraged while consumption would be taxed and thus discouraged. The new property tax was designed to encourage the most efficient use of land while generating additional tax revenues.

3.2.2 Civil Service Personnel Reduction

The civil service was clearly bloated and inefficient. A.I.D. supported a Manpower Control and Monitoring Plan that included a major reduction in personnel strength and encouraged the Government to limit public sector wage increases. A 25-percent personnel retrenchment plan was immediately implemented, and an attempt was made to put a limit on the total wage bill as a percentage of Government revenues.

3.2.3 Inland Revenue Department Management

Expert advisers and consultants worked to improve the organization and staffing of the Inland Revenue Department, and to implement the systems and procedures for the new VAT. Limited training was also provided.

4. A.I.D.'S APPROACH TO POLICY REFORM

In Dominica and Grenada, A.I.D. followed two very different programming approaches to policy reform. In Dominica, A.I.D. focused first on improving the management of the existing system, and only later did it work on incremental tax changes and new taxes. In Grenada, by contrast, new and radically different policies were introduced first, and then efforts shifted to improving tax administration and management.

In Dominica, A.I.D. focused its initial support on the implementation and administration of the existing tax system and did not try to introduce new taxes or to change fiscal policies. The technical assistance project provided training, computers, and advisory staff to build capacity, efficiency, and staff confidence. As the project progressed, the Dominican Government became aware of problems and anomalies in the existing system, and it became interested in reforms and changes. At that point A.I.D. was ready to help provide advice on new taxes.

The Grenada case was different. When A.I.D. entered the scene after the military intervention, there was a unique opportunity for major changes. The country had seen the end of 17 years of excessive State control and regulation, and it was ready for a move to private sector, market-led development. A.I.D.-funded experts analyzed and identified optimal policy solutions, and then the system was completely overhauled as new taxes and new policies were introduced. Change was not gradual or incremental as in Dominica.

5. ECONOMIC FINDINGS AND IMPACTS

5.1 Economic Growth

Since 1984 Dominica has experienced sharply accelerated economic growth (real per capita GDP has been growing at 4.3 percent a year), and exports are booming. The Government has reduced its domestic borrowing thus freeing up resources for the private sector. Agricultural production has grown strongly, and agricultural diversification is starting to move forward.

Grenada has also experienced strong economic growth (5.5 percent a year from 1984 to 1987), led by a large-scale public sector infrastructure program and high levels of private investment, including extensive construction activity. The agricultural sector has been a major source of growth. Although economic growth remains strong, for the past year or so, political and economic uncertainties seem to have been sapping the strength of the private sector.

5.2 Increased Revenues and Reduced Budget Deficits

Dominica has improved the efficiency and yield of existing taxes while introducing new taxes that have been well accepted by the business and agricultural community. The tax structure now provides a good set of economic incentives, raises substantial new revenues, and has eliminated the budget deficit.

In Grenada tax revenues did poorly through 1987, but in 1988 and 1989 they picked up strongly. The large fiscal deficit is rapidly being closed. While the tax system could be more effective, it is raising needed revenues and is more broadly based than the old system. However, the frequent changes and shifts in tax policies have created much uncertainty and mistrust, a situation that is in part responsible for the private sector’s hesitancy to invest.

5.3 Tax Reforms

The following A.I.D.-supported tax reforms have helped Dominica increase its tax receipts:

-- Customs tax procedures have been reformed, and a computerized program of records and compliance has been introduced.

-- Inland Revenue procedures have been improved, and the database is now on a computer.

-- A new tax identification system and a tax master file allow crosschecking of all taxpayers and a reduction in evasion and noncompliance.

-- Agriculture previously paid no taxes; now a small development levy provides a progressive tax on banana exports.

-- A new sales tax and property tax are in place and both are generating new revenues.

-- Income tax rules have been greatly simplified and rates reduced, and many low-income people are now off the tax rolls.

-- Tax prepayment and self-assessment have been reasonably successful.

In Grenada the centerpiece of tax reform was the elimination of all income taxes and the introduction of a new VAT and a new property tax. These taxes were designed to raise adequate revenue while discouraging consumption and encouraging investment in efficient industries. However, the economic benefits of the new taxes were not achieved because of a number of structural and implementation problems:

The tax changes were too drastic and were implemented too rapidly, personnel to implement the new VAT were insufficient in number and inadequately trained, and public support and compliance was a problem since the Government failed to consult and educate the general public and the private sector. A continual series of changes in the VAT regulations and procedures created confusion and uncertainty for private enterprise. By 1989, after many modifications, the Grenada VAT has become more like a sales/customs tax and not a true value-added tax. It is regressive and lacks investment incentives, and it makes imports expensive and protects domestic industry.

The property tax was also unsuccessful because of a number of problems: inadequate staff, inadequate staff training, tax rates set too low, and a long delay in implementing a cadastral survey.

Since the VAT and property tax failed to raise needed revenues, a number of additional, ad hoc taxes were introduced. The most important is the business levy, which is much like a corporate income tax.

5.4 Private Sector Environment

In Dominica a simplified and equitable tax system, a massive public infrastructure investment program, and Governmental emphasis on rural development have provided the basic enabling conditions for the private sector. A major boom in private construction and an expansion of private agricultural production have taken place. However, industrial and manufacturing investment is small and has shown limited growth.

In Grenada things are much improved over the pre-1984 conditions. There has been a major improvement in public infrastructure (ports, roads, utilities, and so forth) and a boom in private investment and private construction activity. However, the lack of coherence and continuity in Governmental policies, and particularly in tax policies, has left the private sector unsure about "the rules of the game." While the A.I.D.-

sponsored reforms were designed to "level the playing field," many of the private sector players are unsure where the boundaries are or where the goal posts are. Political uncertainty in 1989 has put a further damper on the private sector.

5.5 Privatization

In Dominica, privatization has moved very slowly: only the electric and water companies have been privatized. In Grenada, 49 percent of the telephone company has been sold, and a Government hotel has been leased to a private company. Grenadian State-owned companies and agricultural estates are still operating, with many losing money. Neither the Grenadian nor the Dominican Government seems very much interested in moving Government enterprises into the private sector.

6. INSTITUTIONAL IMPACTS--REFORMS DESIGNED TO IMPROVE THE EFFICIENCY OF GOVERNMENT OPERATIONS

6.1 Civil Service Reform

In Grenada, a drastic personnel retrenchment plan has demoralized the staff, required expensive severance pay, and encouraged the best and the brightest to leave Government service. Government operations have clearly suffered. By 1989, new personnel reform efforts have been more successful in relating staffing levels to functions and responsibilities and have successfully reduced employment levels.

Dominica did not have a major personnel layoff or retrenchment. Staff numbers were brought down slightly by reorganizing functions and by not filling vacancies. Further civil service reform, including merit pay, has been delayed for some time.

6.2 Institutional Capability

Institutional capability relates to the capacity of an organization to assess its problems, analyze alternative solutions, prepare new programs, and then implement those new programs. It is directly dependent on trained personnel, good managers, and good organizational systems.

In Dominica, institutional capabilities have greatly improved. The departments responsible for taxes are clear about their functions and understand their role. However, there are still a high staff turnover rate and a lack of effective training programs. Unless staff capabilities are continually maintained and upgraded, effectiveness and efficiency will decline. In fact, there are indications that staff capacity is already starting to decline.

In Grenada, the civil service retrenchment resulted in the departure of some the most skilled and senior tax personnel. They have not been fully replaced. In addition, the constant changes in tax policies have tended to confuse and demoralize the staff.

The Grenada policy reform program focused almost all attention on the development of a new set of taxes. It failed to recognize that the Government lacked capacity to administer the old taxes and was hard pressed to take on a set of unfamiliar new tax procedures. The VAT system has been much criticized, but the problem may not have been the type of tax but the Grenada

Government's inability to implement a new tax system. The A.I.D. project failed to build and maintain adequate staff and management capacity to administer the new taxes.

7. SUSTAINABILITY--THE CONTINUATION OF BENEFITS AFTER DONOR ASSISTANCE ENDS

7.1 The Political Environment

The Dominican Government is extremely popular and has strong ties to the business community and the rural sector. Communications with those groups are good, and they consider the Government reasonably competent and interested in their welfare. In Grenada the situation is much different. Within a few years of the U.S. military intervention the Government started to lose the confidence and support of the business community. Confrontation, rather than cooperation, was often the case as new tax policies ran into strong opposition from special interest groups. Government commitment and public support are critical to sustainability, and those elements are strong in Dominica but weak in Grenada.

7.2 <u>Viable Institutions</u>

New policies and procedures must be institutionalized if they are to be sustained. Strong institutions will also be able to adapt and change the policies as future conditions evolve. In Grenada the Customs Department is in good shape, but the Inland Revenue Department remains weak. In Dominica, both Customs and Inland Revenue are able to operate the existing program competently. However, for both countries the "critical mass" has not yet been reached. There is a danger that the reforms will not become fully institutionalized because both countries' tax departments suffer from high staff turnover and a lack of in-service training programs.

8. <u>THE SOCIAL IMPACT OF POLICY REFORM</u>

In many developing countries, the poor have had to bear much of the cost of policy adjustment. However, that was not the case in either Dominica and Grenada. In both countries the reforms included major efforts to reduce the Government's budget deficit, but even with budget stringencies, the two Governments made a real effort not to reduce services that had an important impact on the poor (mainly education and health care). That the budgets and staffing levels for the education and health ministries were not reduced indicates that both Dominica and Grenada were successful in protecting those services from cuts.

Increased tax revenues were an important part of the reform packages, and it is important to identify who paid the new taxes (the poor, farmers, importers, urban dwellers, and so forth). The problem is that no data on tax incidence were collected either before or after the reforms. It is, however, possible to make some very general judgments on the equity impact. In Dominica, the introduction of the Sales Tax and the Development Levy and the reduction in income taxes have made the tax system slightly more regressive. In Grenada, the elimination of the income tax and the introduction of the VAT and the Business Levy have made that tax system more regressive. In both countries, higher income individuals and corporations are paying much lower taxes on their incomes, while lower income people (who under the old systems were generally not subject to income taxes) are now paying new consumption and sales taxes.

Both countries have experienced strong economic growth and greatly increased employment opportunities. The construction sector, in particular, has generated many new jobs for low-income people. In fact, rapid economic growth in both countries has created labor shortages and driven up the wages of skilled and semiskilled workers in construction and manufacturing.

On balance, while some Government social services could have been increased, and while the tax reform did have a reverse equity tilt, the levels of welfare and income increased for all income groups, and the poor did not suffer from policy reform. Much of the credit is due to the fact that economic growth was strong throughout the reform period.

9. FACTORS INFLUENCING PERFORMANCE AND IMPACT

9.1 The Advantages of a Multidonor Assistance Program Coordinated by a Consultative Group

From A.I.D.’s perspective, a multidonor assistance effort helps to spread the aid burden; it allows donors to specialize and focus their programs; and it allows the IMF and World Bank to play a major role in fiscal, monetary, and structural reforms. A multidonor approach worked in Dominica, where there is a successful donor consultative group; but in Grenada, it did not.

The IMF/World Bank "seal of approval" on Dominica's development program provides legitimacy that in turn encourages other donor support and commercial investment. It also means that A.I.D. does not have to take the lead with fiscal, monetary, and structural reforms. In Grenada A.I.D. was by far the largest donor, funding development in most areas of the economy. It clearly would have been easier for A.I.D. if there had been a multidonor effort similar to the Dominica consultative group. A multidonor effort might have prevented the errors A.I.D. made when it took on reform of the whole economy and was alone in pushing and funding the unsuccessful VAT and personnel retrenchment.

9.2 The Selection and Implementation of New Policies

Grenada and Dominica present two very different approaches to policy reform implementation. In Dominica, new policies were set in a collaborative framework and were then followed by an active public relations campaign. When the Government was considering new policies or taxes, it held meetings with business people and farmers to discuss various options and approaches. Of course the Government could not satisfy all special interests, but it was able to make people feel that their ideas were being considered and, therefore, to build consensus.

In contrast, in Grenada, top civil service and political leaders worked behind the scenes to develop new policies. They failed to communicate either with the civil service staff that would have to implement the new policies or with the private interest groups. All too often, a new law would be announced and then would be found to have technical and administrative flaws. Private sector special interest groups would then raise complaints and demand changes and, after a few months, the Government would usually announce modifications to the original policy. Again there might be new complaints, and the cycle would repeat itself once more.

The Grenada approach has encouraged a climate of confrontation and continual pressure by special interest groups that have learned that it pays to complain.

In Grenada the most frequent complaint from Government administrators and the private sector is not about the actual policies but the unstable economic environment that results from frequent changes in tax laws and regulations. The more traditional, gradualist approach used by Dominica has provided a stable and known system in which both the private sector and Government administrators know the rules and can get down to business.

9.3 Linking Technical Assistance Projects and Cash Transfers

During the 1980s, A.I.D. provided policy-based cash transfer assistance to a large number of developing countries. A problem in many cases was selecting the most critical reforms and then setting the implementation pace. All too often, the developing country lacked the analytical skills and trained personnel to design and implement the policy reforms. While A.I.D., World Bank, and IMF teams could help develop reform programs, they were outsiders--and policy reforms imposed from the outside rarely succeed. A successful reform program must be developed and accepted by all economic groups, and the degree of host Government cooperation, collaboration, and commitment has been shown to be a key factor. However, there is a problem in countries (like Dominica and Grenada) that lack the indigenous capacity to set an analytically sound policy reform agenda.

The Grenada and Dominica cash transfer reforms would probably have run into serious problems because Governmental capacity was thin. The Public Management and Policy Planning (PMPP) technical assistance project improved the economic management capacity of the two Governments and thus meshed perfectly with the objectives of the cash transfer economic reform program.

The PMPP project supported the Cash Transfer Structural Adjustment Program in the following three ways:

1. Often the cash transfer process identified problem areas but the specifics on the magnitudes and rates of change were not clear. The Cash Transfer Agreement would call for a study (which PMPP would fund) to pin down the specifics. The PMPP study would then generate a package of options and recommendations from which

the host Government could select new policies that would satisfy cash transfer conditionality.

2. PMPP long-term advisers worked closely with their Grenadian counterparts on day-to-day operations, and short-term advisers played a similar role in Dominica. These advisers were often able to identify broader, systemic problems that could be addressed through cash transfer conditionality or through additional PMPP assistance. PMPP findings and analysis helped set the cash transfer reform agenda.

3. PMPP provided extensive management training at all levels of Government operations, helped improve the operation of existing systems, and introduced new techniques and equipment (e.g., computers) to improve efficiency. All of these efforts increased the policy capacity of the Dominican and Grenadian Governments and helped build longer term sustainability into the policy reform effort.

When designing a policy-based Cash Transfer Program, A.I.D. should carefully assess host Government capabilities. If they are weak, a policy-oriented technical assistance and training program could directly complement and support the cash transfer policy reform effort.

9.4 Aid Dependency

After the 1983 U.S. military intervention, the U.S. provided substantial economic assistance to Grenada. From Fiscal Year (FY) 1984 to FY 1989, U.S. assistance totaled $115 million--a massive input in a country of roughly 100,000 people (over $1,000 per capita).

The immediate elimination of income taxes and the introduction of the VAT represented a dramatic tax change that had not been attempted elsewhere. It appears that many Grenadian Government officials did not fully appreciate the difficulty of implementing the reforms. There was little support or understanding in the private sector, and there was no real effort to build a consensus.

When a developing country is heavily dependent on one donor, it is hard to have a truly collaborative development relationship. If the donor offers advice on major reforms and provides the money to implement the reforms, it is hard for the recipient to say no. In the case of the VAT and civil service reforms, Grenadian officials went along with the A.I.D.

recommendations, even though they did not fully understand or support the reforms. Ultimately, the reforms failed. When A.I.D. is a major donor in a country, it needs to be particularly careful to build real consensus and support for policy reforms.

10. LESSONS LEARNED

1. During the period of A.I.D. assistance, both countries achieved strong economic growth. The growth in Dominica was due mainly to agriculture’s recovery from poor weather conditions and to sharply higher foreign demand and prices for its banana exports. In Grenada, the return of capital and excellent growth in agricultural exports and in tourism earnings gave the economy a major boost. A.I.D.-sponsored reforms helped improve economic efficiency, but external conditions were the real force behind the boom. A.I.D. needs humility; good policies are important, but external factors can help or alternately, overwhelm even the best of policies.

2. In Grenada, prior to the A.I.D. policy reform, 17 years of State controls, excessive regulations, and political uncertainty had depressed economic activity. After the U.S.-led

military rescue mission there was a surge of confidence, flight capital returned to Grenada, and private investment accelerated. However, by 1989 political uncertainty was again a problem, and business investment was on the wane. In contrast, in Dominica a popular Government, with strong ties to the business and rural sectors, provided a stable political environment. Over the long run Dominica has clearly benefited from a stable political environment. In Grenada recent growth has been excellent but the lack of stability may harm longer-run prospects. <u>Political stability is essential for development</u>.

3. Both Dominica and Grenada sharply reduced very large recurrent account budget deficits. They used different approaches and different taxes, but each demonstrated that <u>with good economic growth, a committed Government can eliminate its budget deficit</u>.

4. A.I.D. used an incremental approach in Dominica that developed personnel and institutions before starting to reform policies. <u>The Dominica phased and sequential technique represents a better tactical approach than the major system overhaul that was done in Grenada.</u>

5. VAT by its very nature discourages consumption and encourages investment. However, a VAT system requires a sophisticated tax department, and businesses must maintain books and accounting records. In many developing countries, as in Grenada, tax administration is weak and most businesses are small and operate on a cash basis without accounting records. Under such conditions a traditional VAT is unlikely to succeed.

6. Developing country Governments suffer from inadequately trained personnel and limited institutional capabilities. To have an efficient institution is probably more critical than to have optimal policies. Grenada provides an excellent example of the problems that develop when a country lacks strong institutions. If there is a weak tax institution, new tax policies will not solve the problem.

7. In many developing countries, A.I.D. cash transfers stand alone. In contrast, in Dominica and Grenada A.I.D. linked policy-based technical assistance to its structural adjustment cash transfers. The two forms of assistance worked together to do more than either could do by itself. In countries where institutions are weak, A.I.D. should consider linking technical assistance to policy reform cash transfers.

8. In Dominica, A.I.D. assistance was part of a multi donor consultative group that included the World Bank and IMF. In Grenada there was no consultative group, and the World Bank and IMF did not provide assistance. The United States had to carry the reform effort alone. <u>The United States can encourage better developing country performance and achieve better technical balance if the country receives multi donor support</u>.

9. Privatization efforts did not succeed in either country because the two Governments felt that the public sector should control key economic enterprises. <u>A.I.D. should not assume that developing countries share its view of the efficiency of the private sector.</u>

10. The Government tax departments in both countries suffer from high staff turnover rates. An ongoing training effort will be required to maintain institutional capabilities. <u>In institutional development projects, A.I.D. should support the development of indigenous or regional training capabilities</u>.

11. Consistent and well-understood tax policies are important if Government employees are to carry out the policies properly and if private sector taxpayers are to cooperate. As Dominica demonstrated, <u>staff education and the mobilization of</u>

public support for policy reforms are as critical to success as the technical soundness of the programs.

12. The United States funded the resurrection of Grenada’s economy, and, in the early years, Grenada may have been too eager to agree to reforms that it did not fully understand or believe in. When A.I.D. is the major donor, it must guard against the development of a client-state mentality of dependency in the recipient country.

13. Institutional and policy reform takes time, but in both Dominica and Grenada, A.I.D. expected to achieve major tax and institutional reforms in just 4 years. The program was too short to build solid institutional capacity, and additional assistance is necessary if the institutions are to reach long-run viability. When building policy and institutional capacity, A.I.D. needs to think beyond the standard project life of 4 or 5 years to possibly 6 to 10 years.

APPENDIX A

PUBLIC MANAGEMENT AND POLICY PLANNING PROJECT, PRIMARY COMPONENT TECHNICAL ASSISTANCE ACTIVITIES

IN DOMINICA AND GRENADA[4]

PROBLEMS ADDRESSED AND OUTPUTS ACHIEVED

1. DOMINICA

Activity No. 1: Dominica Tax Administration

Performance Period: December 1, 1985 to December 31, 1986

Cost: US$200,000

Problem: A disorganized and overwhelmed Inland Revenue Division.

Solution: Hired a tax adviser.

Output: The Inland Revenue Division was reorganized, tax laws were altered to emphasize voluntary tax compliance, morale

[4]The PMPP Primary Component provided technical assistance to seven Eastern Caribbean States and to the regional programs of the Organization of Eastern Caribbean States, Economic Affairs Secretariat. In addition, there was a separate $2.5 million Fiscal Reform Component in Grenada. Grenada received technical assistance from both the Primary Component ($627,000) and from the Fisical Reform Component ($2.5 million). Dominica received assistance from the Primary Component only ($917,564).

improved, and a major initiative was launched to computerize the income tax system and develop a tax identification system. Follow-up included efforts of two additional advisers, and delinquent taxpayers were identified and computer forms developed to notify the delinquents.

Activity No. 4: Dominica and St. Lucia Tax Administration

Performance Period: May 15, 1986 to May 31, 1987

Cost: US$200,000

Problem: A disorganized and overwhelmed Inland Revenue Division.

Solution: Hired consultants to address questions of organization and procedures.

Output: Consultants accomplished the following: (1) reorganized and decentralized the reporting structure; (2) altered tax laws to emphasize voluntary tax compliance; (3) initiated a drive to computerize the income tax system and develop a tax identification system; (4) identified delinquent taxpayers and developed computer forms to notify the delinquents.

Activity No. 5: Dominica Planning Adviser

Performance Period: Jauary 1, 1987 to December 31, 1987

Cost: US$200,000

Problem: To improve the Government's planning and budget processes.

Solution: Hired an adviser to work with counterpart.

Output. Several documents were produced by the planning adviser, and several seminars held.

Activity No. 10: Customs Adviser

Performance Period: October 15, 1986 to November 30, 1986

Cost: US$65,000

<u>Problem</u>: To improve customs enforcement and reduce valuation fraud.

<u>Solution</u>: Technical advisers were hired to instruct the Customs Administration workers and management.

<u>Output</u>: A filing system and a generic seizure report were created. It was recommended that customs officials visit the premises of traders to detect undervaluation of imports. The recommendation was adopted and implemented.

<u>Activity No. 13: Technical Assistance on Reforming the Revenue System</u>

<u>Performance Period</u>: October 15, 1986 to March 31, 1987

<u>Cost</u>: US$220,000

<u>Problem</u>: A tax system that generated insufficient revenue and that was judged to be unfair.

<u>Solution</u>: A technical advisory team was hired to make recommendations on tax reform.

Output: Several background papers were produced that contained options for Government consideration, and a revenue estimation model was developed.

Activity No. 18: Implementation of Tax Reforms in Dominica

Performance Period: September 6, 1987 to February 29, 1988

Cost: US$32,564

Problem: A tax system that acted as a disincentive to productive economic activity.

Solution: Two advisers were provided to assist the Government in implementing changes in the tax system designed to reduce the disincentive effects of the system on productive economic activity.

Output: Draft legislation for the Dominica sales tax and a report on investment tax credits. The sales tax recommendations were implemented in the draft Sales Tax Act of 1989, which provides for a 3-percent tax on the sale of goods and services.

2. GRENADA

Activity No. 15: Private Sector Investment Program Analysis

Performance Period: October 30, 1986 to November 30, 1986

Cost: US$50,000

Problem: A study was needed to gain access to International Monetary Fund (IMF) and World Bank structural adjustment lending.

Solution: Hired a technical advisory team to perform an assessment of Grenada’s Public Sector Investment Program.

Output: A report was produced that the World Bank used.

Activity No. 16: Analysis for a Proposed World Bank Structural Adjustment Program

Performance Period: February 1, 1987 to March 16, 1987

Cost: US$45,000

Problem: A World Bank preappraisal mission required data for analyzing economic scenarios for Grenada during the 1987-1989 period.

Solution: Provided an agriculture expert and a macroeconomist to participate on an World Bank team.

Output: A report was written which provided the basis for a policy framework paper that is a prerequisite for an World Bank appraisal.

Activity No. 17: Assessment of Implementation of VAT in Grenada

Performance Period: September 6, 1987 to October 31, 1987

Cost: US$26,970

Problem: The Government of Granada reformed its tax system in 1986 by abolishing all income taxes and introducing a value-added tax (VAT) as the centerpiece of the new tax structure. However, the revenue yield of the VAT fell significantly below projections, and it was necessary to determine the reasons for the revenue shortfall.

<u>Solution</u>: A fiscal economist was provided for 5 weeks to determine the reasons for the shortfall, to provide short-term projections, and to sketch possible remedial measures for consideration by the Government.

<u>Output</u>: A study was prepared that set forth recommendations for increasing the VAT yield in the short run. The report was intended as exploratory, subject to further study.

<u>Activity No. 19: VAT and Business Levy Administration in Grenada</u>

<u>Performance Period</u>: November 1, 1987 to September 30, 1988

<u>Cost</u>: US$291,412

<u>Problem</u>: The Government perceived the administration of the tax system, in particular the VAT and the business levy, to be inefficient.

<u>Solution</u>: A senior tax administration adviser, a master file tax adviser, and a computer programmer were provided.

<u>Output</u>: The senior tax adviser prepared a report listing a number of major conditions that inhibit improved tax administration.

<u>Activity No. 24: Grenada Tax Advisery Support</u>

<u>Performance Period</u>: February 8, 1989 to September 30, 1989

<u>Cost</u>: US$213,765

<u>Problem</u>: The Government lacked the internal capacity to competently administer its tax system.

<u>Solution</u>: A tax policy adviser, a tax administration adviser, and a short-term adviser were provided to assist the Government in revenue policy formulation, development of a long-range revenue plan, legislative drafting, personnel development, organization and staffing, and development of a revenue enhancement master file system.

Output: The adviser assisted in reorganizing the Inland Revenue Department and developed documentation and reports on key tax issues.

APPENDIX B

DOMINICA AND GRENADA
CASH TRANSFER CONDITIONALITY

1. DOMINICA

Project No.: 538-0141.02

Amount authorized: $1.5 million

Authorized: September 15, 1987

Completed: September 14, 1988

Purpose: To assist the Government in ongoing Structural Adjustment Program in conjunction with the Tight Consultative Group which included the International Monetary Fund (IMF), the World Bank, and other donors.

Conditions (one tranch):

1. A plan for responding to the findings and recommendations of the fiscal technical assistance team.

2. Evidence of drafted or enacted legislation to regulate public sector wage negotiations in a manner that will assist the Government in meeting specified wage targets.

3. Best effort covenant to restrict public sector wage increases to no more than 3 percent a year until 1989/1990.

4. Best effort covenant to produce a current account budget surplus at least equal to 3.5 percent of current revenue in FY 1987/1988 and 3.7 percent in FY 1988/1989.

Project No.: 538-0141.03

Amount authorized: $1.642 million (as amended)

Authorized: September 30, 1987

Completion expected: May 31, 1990

Purpose: To assist the Government in its ongoing Structural Adjustment Program in conjunction with the Tight

Consultative Group, including the IMF, the World Bank, and other donors.

Conditions (one tranch):

1. The Government must establish separate U.S. dollar and local currency accounts with no comingling of funds.

2. Evidence of satisfactory progress in implementing the Civil Service Reform program in cooperation with the organization and management technical assistance team.

3. Evidence of satisfactory progress toward wage and salary and public savings targets specified in the agreement.

4. Covenant to use U.S. dollars for importation of U.S. goods.

5. Covenant to restrict growth of wage bill and to aim for specified savings targets in current and future fiscal years.

Conditionality Achievements

The cash transfer conditions were fully met. The Government of Dominica agreed to restrict public sector wage increases to no more than 3 percent a year until 1989/1990 and to achieve a current account budget surplus equal to at least 3.5 percent of current revenue in FY 1987/1988 and 3.7 percent in FY 1988/1989. The first target was achieved in FY 1986/1987 largely by the elimination of the system of automatic civil service wage increases. The second target was more than surpassed.

Another condition stipulated that the Government would come up with a plan for responding to the findings and recommendations of the fiscal technical assistance team. As a result, the Inland Revenue Department and the Customs Administration were reorganized in FY 1986/1987 and a tax reform program was implemented in FY 1987/1988 (it reduced personal income tax rates, rationalized indirect taxes, and imposed a levy on windfall gains from banana exports as a way to tax agricultural income). As a result, tax revenues, which had previously been very unresponsive (inelastic) to changes in econmic growth, now increased rapidly as gross domestic product (GDP) increased. In fact, tax revenues not only kept up with rapid GDP growth, but increased faster than GDP growth: tax revenue rose to 27 percent of GDP in FY 1987/1988 from an average of 26 percent in the four preceding fiscal years.

2. GRENADA

Project No.: 538-0141.01

Amount authorized: $5 million

Authorized: July 21, 1987

Completion expected: May 30, 1990

Purpose: To assist the Government to reduce current expenditures to facilitate entry into a medium-term Structural Adjustment Program.

Conditions (three tranches):

First tranch: $1.2 million

A plan to close the fiscal gap.

Second tranch: $2 million

1. Evidence that the Cabinet has approved the Manpower Control and Monetary Plan.

2. Evidence that wage bill at end of 1988 is consistent with the above plan.

3. Evidence that the Government has a time-phased plan for organizing and staffing the Inland Revenue Department.

Third tranch: $1.8 million

1. Evidence that wage bills for January and February are consistent with wage bill ceiling.

2. Evidence that approved budget estimates for 1989 contain realistic projections of current revenues and are consistent with wage bill and public saving targets.

Conditionality Results

Grenada has satisfied, often after much delay, the cash transfer conditionality. Government employment and the wage bill were brought under control, and the Government's budget deficit was significantly reduced.

After several years of serious budget deficits, the Government managed to produce an FY 1988 current account surplus amounting to about 2.3 percent of GDP. Prospects for 1989 remain very problematic both on the revenue side (collection lags) and the expenditure side (an announced increase in civil service wage rates of almost one-third).

In his annual budget speech of April 1989, the Prime Minister announced appointment of "a small committee to undertake a comprehensive review of the civil service pay and grading structure...for the purpose of removing the anomalies that had crept into the structure over the years since the last salary review in 1970." In October the Government announced a wage increase of almost one-third for Government workers, retroactive to January 1, 1989. Apparently, this amount goes beyond correcting anomalies; the more obviously will be a setback in terms of both wage restraint and the current budget deficit.

In two major respects, however, conditionality was met only in the most nominal sense. For one thing, the cash transfer required evidence that the Cabinet had approved the Manpower

Control Plan. The plan was approved, of course, but as was discussed in the main text of this paper, it was a policy disaster. In a word, it was a blunt administrative instrument that accomplished no reduction in employment while simultaneously causing extraordinary political disturbance, and it left a legacy of mistrust and apprehension among Government employees.

Second, there is considerable controversy and concern within A.I.D. over whether the budget estimates for 1989 contain realistic projections of current revenues and are consistent with targets for the total wage bill and public savings. Perhaps the essential problem is the growing disarray in the tax system, as the VAT has been eliminated in fact (but not in name) and replaced by a consumption tax. As a result, by 1988 recurrent revenues were still below 1985 levels.

APPENDIX C

INSTITUTIONAL IMPACT OF ASSISTANCE

1. THE DOMINICAN EXPERIENCE

1.1 Sustainability

The Dominican public service has been effectively strengthened and the conditions necessary for a technical assistance program to have a continuing beneficial effect have been met: the Government has the political will to support new policies; it is willing to give new policies adequate time to work; the Government knows how to work closely with the private sector to gain their support for reforms; and public officials have been trained to implement the existing and new tax system. However, a short-term technical assistance program cannot realistically be expected to satisfy the long-term institution-building needs of Dominica, nor can it be assumed that the gains achieved will be automatically maintained. Indeed, the heavy staff turnover due to emigration and the retirement of senior officers will have a negative impact on the benefits derived from the Public Management and Policy Planning (PMPP) project. The Dominica Government therefore needs to introduce a civil service reform program that is conducive to the recruitment and retention of high-caliber officials. It also needs to move beyond the Ministry of Finance and Planning and the Departments of Customs and Inland Revenue and improve the structure of other key agencies. Further, it needs to ensure that a formal training program is designed to develop and maintain the skills of Government employees.

1.2 Mobilization of Public Support for Policy Reform

The main private sector organization, the Chamber of Commerce, does not possess a secretariat capable of preparing issues papers on the economy. This weakness means that it is very much dependent on the Government for information. Fortunately, the private sector is in general agreement with the philosophy and policies of the Government and is prepared to give those policies a chance to work.

A good example of the cooperation between the public and private sector is the introduction of the development levy (a tax on banana exports). When the Government was considering ways of taxing agricultural incomes, it consulted farming and business groups; and after much discussion of various alternatives, the development levy was accepted by all parties.

While nobody likes to pay taxes, there has been strong public support for tax reform because the reforms have been seen as reasonably "fair" and they have been evolutionary rather than revolutionary. They were more easily digestible and less threatening than they would have been if an attempt had been made to radically transform the system. Furthermore, Dominica had in place an effective administrative structure that was capable of implementing the changes in the tax system. The confusion caused by the introduction of the changes was minimized, and the private sector had fewer reasons to complain.

1.3 Civil Service Reform

Civil service reform was to include a merit pay system that would replace the present incremental pay system. Implementation is lagging because of the high cost of merit pay.

While Dominica realizes the need to reduce its wage bill as a means of improving its fiscal balance, it has not introduced a retrenchment program. The civil service is not large, and the Dominican authorities view the social costs of a retrenchment program as too high, as there are limited employment opportunities in the private sector. Therefore, they have chosen a more gradual approach of freezing vacant posts and keeping tight controls on new appointments.

2. THE GRENADIAN EXPERIENCE

2.1 Sustainability

While there was interaction between the top senior Government officers and the consultants hired to develop the new tax system, the mid-level technical officers of the Inland Revenue and Customs Departments, whose function it is to administer the tax system, had minimal contact with the consultants. No provision was made for the technical officers of the revenue collecting departments to receive and comment on the consultants' reports or to make inputs, on a consistent basis, on the proposed new tax laws. From an institution-building point of view, therefore, the Grenadian Government technical officers have not benefited fully from the expertise that was available.

As a result of the proposed personnel reductions and the continual changes in tax rules and procedures, staff morale and productivity at the Department of Inland Revenue remains low. There is a need to develop a formal training program, which should include the training of trainers. This training program would in any case be necessary, but it is particularly important because many of the senior officers of the department did not have a close association with the consultants. In addition, a technical assistance program that would allow consultants to advise and assist the operation of the installed systems and procedures over a period of time is needed to sustain the system and to enable the Department of Inland Revenue to become efficient and effective.

2.2 Mobilization of Support for Policy Reform

The ultimate objective of the Grenada tax reforms is the creation of an environment that will support the growth of a dynamic private sector. It follows, therefore, that the private and public sectors must be partners in the quest for economic growth, and that collaboration and cooperation must be key features of this partnership.

When the new tax system, particularly the value-added tax (VAT), was put in place, a spirit of collaboration and cooperation was absent. The Government shrouded the VAT in secrecy and presented the private sector with a fait accompli. The educational process that should have taken place prior to the implementation of the new tax was instead started long after. The administrative system that had inefficiently administered the old tax system was incapable of administering the new one. Consequently, officers of the Customs and Inland Revenue Departments were learning about the new tax system at the same time that they were trying to explain it to the private sector. The result was confusion about and resentment of the new system on the part of the business community. In other countries where a VAT has been introduced, the general practice has been to have a long period of public education prior to the introduction of the tax and, in some cases, to have a phased implementation of the tax. Neither course was followed in Grenada.

As a result of these problems, the Government has had to try a series of ad hoc amendments to the VAT system. The projected effectiveness of the tax has not been realized; the business community has been operating in an environment of uncertainty that is not conducive to investment; and the system that has evolved is not a true value-added tax but more of a sales tax.

To improve the dialogue between the Government and the private sector, the Grenada Chamber of Commerce formed a Private Sector Economic Affairs Committee. The Committee represents all major private organizations except the trade unions and meets quarterly with senior Government officials to discuss matters relating to the functioning of the economy. It appears, however, that there is mutual suspicion, and a spirit of cooperation and collaboration is missing.

The Government is starting to recognize the errors of the past; for the future, it plans to solicit the views of the private sector before implementing new policies. In preparing for its 1989 budgetary proposals, the Government carried out a Business Opinion Survey (in addition to its ongoing discussions with the Private Sector Economic Affairs Committee). The Government has also announced that its development strategy for the period 199O to 1994 will be formulated and published for national discussion.

The Grenadian private sector considers itself to be strong and to have a capacity to develop rational proposals for the Government’s consideration. This confidence may derive from the fact that the private sector has been able to roll back many of the reforms and feels that it has been winning in the game of confrontation with the Government. Private sector organizations by definition represent special interests. In Grenada, the private sector organizations must learn to develop their sectional interests within the macroeconomic framework. Only then will Government and the private sector be able to work together collaboratively to promote the national good.

2.3 Civil Service Reform

The impetus for Grenada's civil service reform, including retrenchment, had its genesis in a study conducted for the 1983 Interim Government that found that the public service was overstaffed and that management techniques were out of date.

When pressure was placed on the Government to reduce its fiscal deficit, the obvious choice for an expenditure reduction was the public service wage bill, which absorbed 50 to 6O percent of Government revenues. The Government and A.I.D. reached the conclusion that 25 percent, or 1,800 persons, could be cut from a 7,500-person civil service, and that A.I.D. would provide the budgetary support needed for this retrenchment. As in the case of tax reform, the Grenadian Government and A.I.D. considered the retrenchment program as drastic but necessary surgery required for the revitalization of the economy. Disbursement of A.I.D. funds was directly tied to retrenchment performance.

When the Government instituted the retrenchment program, it had no record of the total number of persons in the public service or the number of persons in various Government occupational categories. It was a mistake, therefore, to attempt to reduced the public service by 25 percent without knowing which categories of workers could be cut and how Government services would be affected.

When the personnel reductions took place, many key officers took large severance payments and left voluntarily. The problem was that these officers had to be replaced, and in effect there were retrenchment and recruitment programs operating concurrently. The retrenchment was neither administratively nor fiscally prudent. In any event, and as in the case of the tax reform, the Government lacked the administrative capacity to implement a retrenchment program of the proposed magnitude. The result was social and political instability. The Government halted the program after having cut only 400 persons.

In 1989 the Government of Grenada introduced a much more viable program of civil service reform that may help to increase productivity and control the public sector wage bill. Government Ministries and departments have been given fixed employment ceilings. The plan is to permit recruitment only to staff new productive sector activities and to reallocate existing staff to manage any expansion of social sector operations.

2.4 The Social Impact

The VAT now taxes lower income groups who were previously exempt from paying income taxes. While the VAT is regressive in nature, the regressivity of the tax system is mitigated to the extent that the Government has retained price controls on a limited number of consumer items and that some essential items are not subject to the VAT.

There are no data on income distribution, and it is not possible to compare the relative positions of the social groups before and after the imposition of the new tax system. With the economy growing strongly, an estimated 10,000 new jobs have been created during the period 1984 to 1988, a number that greatly exceeds the number of new entrants into the labor force.

It is not possible to compare expenditures on all social services from one year to another because of the constant reallocation of functions among ministries. However, total recurrent expenditures have increased from EC $111.7 million (US$ 41.4 million) in 1985 to EC $147.8 million (US$54.7 million) in 1988, and the indications are that the social services, including health, education, and housing, have been receiving increased allocations. During this period 59 schools and 15 health facilities were built or refurbished, and the numbers of teachers and nurses have been maintained or even slightly increased. Thus there is no evidence to suggest that the A.I.D.-supported reform program resulted in undue hardships to the less advantaged groups of the society.