

**FOUNDATION OF
ECONOMIC FREEDOM**

A Policy Statement

**The Caribbean Tiger:
A Development Strategy
for the Bahamas**

by

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Table of Contents

	Page
I. Executive Summary	1
II. Policy Objectives	3
II. Trends	4
IV. Chamber of Commerce Survey	6
V. Economic Theory	8
VI. Proposed Strategy: The Caribbean Tiger	12
VII. Venture Capital & Private Enterprise	15
VIII. Labor Productivity and Unions	17
Notes and Acknowledgements	19
Graph and Table	20

I. Executive Summary

Over the past 25 years the Bahamian government has grown continuously in absolute size and has "socialized" the economy. It has reached the same crisis point as many other countries; namely, it has exhausted its financial options and the economy has become increasingly non competitive. Unwilling to cut expenditures, the government has raised taxes and fees sharply; many of these have reached the point where they produce diminishing revenue. More alarming, tourism and the financial sector became marginal in world markets.

The Progressive Liberal Party and then the Free National Movement began new initiatives. It is the contention of this policy statement that the FNM must pursue an entirely new overall policy. Alone neither changes in the present duty structure nor the creation of a new sales tax will solve the crisis.

The country needs to concentrate on those policies that will convert the Bahamas into the "economic tiger" of the Caribbean. This entails a gigantic change from the liberal/socialist policies and programs of the past 25 years. The broad outline of the "Caribbean Tiger" strategy follows:

Reduce and Refocus. The country cannot avoid the need to reduce the total size of government; greater taxation and borrowing are no longer viable options. It should sell its interests not only in the hotels but also in Bahamasair, commercial banking, utilities and post office. Private enterprise can manage these activities more efficiently and the public interest can be protected.

The country must refocus its efforts on public safety and justice, public works and quality education tailored to the nation's needs.

Venture Capital & Private Enterprise. It is widely perceived that the Bahamas has a business climate that is hostile to both local and foreign private enterprise. If it wants greater private enterprise job creation, it must change this situation. It must create a climate that is favorable to private capital and foster a public confidence in the free enterprise system. There should be an end to public attacks on the investment community and major changes should be made in every government entity that deals with local and foreign investors.

Labor Productivity. The government needs to provide leadership in improving labor productivity. This means that it should continue its program to raise the quality of the education system. It also requires a clear public indication by the government of its commitment to improved labor productivity in both the government and private sectors.

The Caribbean Tiger policy confronts reality, directly and honestly. The illusion that the Bahamas was moving from "a third world to a first world status" has been shattered. It was shattered by recession, new challenges, labor problems and failed government policies.

The world of the future will not be easier. In fact, the government is proposing that the Bahamas be an active member in a more competitive hemisphere. At the same time legislation is being presented to Parliament that creates more government regulation and control. Clarity and consistency in policy are essential for long term economic success.

The country desperately needs a strategy for the move into the next century. The right policy is the **Caribbean Tiger** strategy. Unfortunately, it contains no public relations gimmick that may be sold easily to voters; and acceptance may

come only after much thought and the passage of time. Nevertheless, it is essential in this instance for the FNM to take "The Road Less Traveled".

II. Policy Objectives

The FNM in 1992 published its Manifesto outlining the policies and objectives that it would carry out if elected. Like all political documents of this type it contained something of interest to every sector of the electorate. It contained, however, a core philosophy that differed significantly from its predecessor, the PLP. The FNM declared its intention to provide every citizen "the opportunity to be all that he or she wants to be, assured of upward mobility in an open society fuelled by a market-driven economy."

In the 1994/95 budget the Minister of Finance listed what the government would do to carry the country in this new direction:

- . Release entrepreneurial skills,
- . Encourage honest endeavor and enterprise,
- . Create a more highly skilled and educated work force, and
- . Provide incentives for investment in specific areas.

This was a clear break from liberal/socialist orthodoxy. The individual would have the initiative and means to provide for his own needs, not the government. For the FNM "Deliverance" was from government initiative, welfare and dependency. Also it was from a party that appeared to focus on its own financial gain as shown in the proceedings of the Commission of Inquiry.

The Manifesto '92 also stated the FNM conviction that the current level of taxation was "more than sufficient to meet the needs of the country." The budget also sought to eradicate deprivation and distribute prosperity more equitably. It used these goals to justify the planned tax increases.

III. Trends

In recent times and without exception the government has increased spending year after year. Please note the attached graph and the compounded annual growth of the economy, government expenditures and revenues shown below (in per cent per annum):

	From 1980 to 1992	From 1992 to 1994/95 Budget
Total Expenditures	7.4%	6.2 %
Total Revenues	5.8%	7.2%
Gross Domestic Product	6.4%	Nil ¹

During the PLP years spending grew faster than revenues and the deficit was consistently financed with ever increasing debt. On taking office the FNM continued to increase spending, funding it with significantly increased taxes and further growth in indebtedness (see attached table). The economy peaked in 1990, declined in 1991, '92 and '93 and appears to have recovered somewhat in 1994.

The economic consequences of these trends are as follows:

¹ The economy probably declined in 1993 and recovered in 1994.

- Interest Payments increased at an annual compound rate of 9.5% from 1980 to the present fiscal year. They grew from 50% of non current spending, principally capital expenditures, to 115%.
- From 1980 to 1990 government expenditures grew at the same rate as the economy as a whole, but grew much faster after 1990.
- The recession and limits on borrowing forced the FNM to increase tax revenues. Tax revenues dropped from \$534.2 million in 1992 to \$524.6 million in 1993, down 2%, but are planned to rise 16.9% in fiscal 1994 (see attached table).

The recession and its resultant impact on government funding was in large part due to world developments. Its impact was, however, clearly exacerbated by the loss of Bahamian competitiveness in tourism and international banking. The travails of tourism are well documented. The rapid expansion of cruise ship vacations, other new tourist destinations, the high cost of Bahamian operations and the poor quality of its product adversely affected tourist earnings.

In international financial markets the Bahamas steadily lost ground to new off-shore financial centers. This was most clearly evident after the U. S. invasion of Panama when the migration of business was exclusively to the Cayman and the British Virgin Islands. Only the modernization of Bahamian laws and financial services in the latter years of the Pindling administration arrested the deterioration.

These two international businesses are fiercely competitive. The Bahamas became an increasingly marginal player but important beginnings of a recovery have been laid in both industries.

IV. Chamber of Commerce Survey

At this point it is important to note the response of the mercantile members of the Chamber of Commerce to an informal survey. They are the real tax collectors since they collect from their customers the import duties and stamp taxes they pay to Customs.

Crime and a perceived lack of protection against crime were identified as the greatest threat to retail business and tourism. One member estimated that losses through stealing and the out-of-pocket costs of security guards added 5% to consumer prices. He recommended the removal of all import taxes from electronic surveillance equipment for at least one year. "The job of the police will be greatly simplified with businesses and homeowners providing live video of criminals in action."

The most consistent major idea developed was the application of the concept of diminishing returns to taxation; there is a point where increases in tax rates reduce total revenue.

Some evidence of this principle at work was given. At one extreme is the experience with the cigarette duty. When the duty was raised to 300%, the business shifted from duty paying merchants to smugglers. Almost no duty is now collected; and a new opportunity for corrupt practices was created.

At the other end of scale was the preliminary assessment of the impact of duty free shopping. An analyst retained by the Duty Free Promotion Board reported in November 1993 that the government "received more revenue per stopover visitor equivalent in 1992, the year when most duty was removed, than in 1991 when duty was collected. Essentially, the removal of duty on luxury items and liquor combined with the shift to stamp tax and an increase in the departure tax in 1992 has yielded a net gain to government in 1992 of \$27.2 million

from the tourism economy. Not only did the shift not produce a loss in revenues -- it apparently produced a solid gain".

The concept of diminishing returns in taxation is an economic fact of life and the following quotes from the members should be noted.

"There is no justification for import + stamp tax to be higher than 60%! A few exceptions might be: guns, ammunition, cigarettes.

"All duties are out of hand and must be reduced. No duty above 20% would in two years totally revitalize the local market...stopping the daily trips to Miami. Not only Bahamians would shop and stay at home but tourists would buy that much more.

"I can confirm that when "Duty Free" was introduced, and the Tariff went down, our sales increased because our prices reflected the reduction. Since the increase in the Stamp Tax our goods have become more expensive. Our sales are down for the past quarter. Perhaps the increase in prices is the explanation.

"The government recently increased the stamp tax from 5% to 10% on real property transactions. When you include the legal fees, realtor fees, and stamp tax the cost of real property transactions are prohibitive. Particularly if somebody is trying to better themselves and sell one house and buy another, since the fees must be born twice.

"Excessive import duty on items imported into the country when an equivalent product is made here cannot be used as an excuse for local inefficiency and over-pricing."

Then there were the comments on "big government".

- . "The business community cannot be used to pay for government mismanagement and over-employment.
- . "Cut government spending by reducing the size of the public service. Close unnecessary embassies, sell off those businesses such as the national airline, hotels & public corporations. Reduce the number of representatives in the House of Assembly, sell Batelco to private companies. (Batelco provides a questionable service at high cost - we have to be competitive in this area in today's world if we hope to attract new business.) Such a program must be carefully thought out because it will take considerable time so as not to impose undue hardship on those who must find alternative employment in the private sector."

V. Economic Theory

In this country as in all countries seeking the benefits of a free market economy, there is a policy conflict between economic reality and political needs.

- . Should free markets determine how resources are divided?
- . The proponents of free market economies note that every day there are far too many transactions occurring for anyone even to describe. The individual, for instance, on any given day may decide to consume or alternately to save (delay consumption) and invest. The latter transaction fits M. Scott Peck's concept of "discipline" as described in The Road Less Traveled: A New Psychology of Love, Traditional Values and Spiritual Growth.² The proponents observe that in this

² Published by Simon and Schuster in 1978, it has been on the New York Times Paperback Best Sellers list for 579 weeks(11.1 years) as of December 11, 1994.

and in all other transactions each party generally ends up better off, a win-win result. Even critics marvel at how free markets work.

To the critics, such markets appear impersonal and generally produce results that are deemed unequal and unjust.

Should the government take resources from some and give these resources to others?

To the liberal/socialist such programs are compassionate.

To the critics such programs do not deal with the loss of the private property rights of the involuntary giver. Nor do they speak to the long term and often subtle adverse effects on the program beneficiaries, the diminution of individual responsibility and discipline. To the critic such programs are public plunder and thievery, acts that help politicians get re-elected.

This conflict is not new; in this century it is rooted in the depressions in Great Britain that began in 1925 and in the U.S. in 1929. Both were epic events that generated profound and lasting debates over causes and remedies.

The English economist John Maynard Keynes and The General Theory of Employment, Interest and Money produced the "solution". He observed a link between aggregate demand and overall employment and the existence of unutilized manpower and productive capacity. He provided an economic rationale for governments to transfer money to consumers and to borrow the needed funds without levying new taxes. All this was done for the greater good of the country.

- . Keynes admitted that inflating demand in this way to increase production was a short run solution. And, in fact, such short term measures could produce serious adverse effects in the long run. When pressed on this, his reply was that "'Since in the long run we are all dead', government policy should be guided...by short-term considerations."³
- . Although debt could create a problem for future taxpayers, he claimed that this really was not a problem at all. He dismissed the problem of debt repayment and service with the phrase, "we owe it to ourselves."

It is easy to see why these ideas were embraced and became the liberal/socialist orthodoxy. Governments dismissed free markets as the most efficient mechanism to organize production and award entrepreneurship, capital and labor. Business cartels and trade unions were accepted and encouraged. The immediate income effect on wages in union jobs was more important than the adverse impact on product prices and overall employment. Governments avoided the pressing need for freer markets and more flexible cost structures.

What Keynes did not see is that--

- . Governments would not exercise discipline in spending. His system called for more spending at certain phases of the business cycle and less at others, creating surpluses or deficits as appropriate. In the Bahamas, as in most other countries, spending just continuously expanded.
- . Income transfers designed to deal with short term personal needs ended up creating social structures, values

³ F A Hayek, A Tiger by the Tail: The Keynesian legacy of inflation, Second Edition, Institute of Economic Affairs, 1978, p. 34.

and behavior that were destructive to both a healthy society and economy.

Government support of powerful trade unions increased both industrial strife and labor costs while reducing productivity.

The results of Keynesianism were inflation, skyrocketing debt and/or economic decline. The decline was either absolute, as in some countries in Africa and Latin America, or relative, as in Great Britain and the United States.

It took a long time to recognize it, but the economic policies of Keynes failed wherever seriously implemented; and his critics, principally Frederick Hayek and Milton Friedman⁴, were right.

The eminent economist Walter Williams dealt with these issues with Bahamian audiences in April 1994. He discussed the observed wealth of some nations and the poverty of others. He concluded that people are poor for one of three reasons:

1. They do not have the knowledge and skills to produce those things or services that are valued by others.
This implies a lack of education, on-the-job training or ability to migrate.
2. They can produce such things or services but are prevented from doing so.

Minimum wage laws, union hiring practices, licensing and discrimination prevent them from getting a job, or from getting on the bottom rung of the job ladder. Thus one is not able to benefit fully from one's labor.

⁴ Frederick Hayek is best known for The Road to Serfdom.

3. They can choose to be poor.

It is regrettable that government social benefits or taxes can make this choice the attractive alternative.

Walter Williams concluded that the Bahamas should--

- . Promote private property rights,
- . Provide for high quality education, and
- . Allow and encourage the labor market to function freely.

VI. Proposed Strategy: The Caribbean Tiger

Governments and electorates consciously and subconsciously choose the type of country they ultimately get. This is most often the result of many decisions over a long period of time. Today do the Bahamian government and the electorate want to tread water in a pack of mediocre performers? Or do they want a country that is a dynamic force of growth and opportunity for its citizens and the "economic tiger" of the Caribbean?

The goals stated in Manifesto '92 held out that hope for the future. But the achievement of that hope will require no less than the transformation of Bahamian society, government and the electorate, and not more of the same old politics. This will require a bold program that abandons the liberal/socialist orthodoxy of the past. It will need leaders who share the vision and have the determination to implement it. Of greatest importance is the political courage to provide leadership for programs that will bring short term uncertainty and hardship for some just as it creates new opportunities for others.

The government cannot continue to do what it has done in past,

take ever increasing amounts of money from its taxpayers to secure an ever expanding unproductive government share of the economy. This is basically immoral. Furthermore, it produces and perpetuates mediocrity.

To become the "economic tiger" of the Caribbean -

- . ***The Bahamas must reduce the total size of government and concentrate government expenditures in those areas where it has the greatest chance of being productive.***
- . ***The government must do what it does best -***

Public safety

Crime has become the society's number one problem that demands the country's best efforts. A comprehensive program can be crafted with professionals agreeing on many aspects. For instance, the construction of a maximum security prison on a family island is necessary to separate the hardened criminal from lesser offenders held at Fox Hill. This would be a big and important step.

Public Works

Since August 1992 the Ministry of Public Works has made very substantial improvements that have gone far to eliminate the trashy look on New Providence. This trashy look clearly identified the Bahamas as a mismanaged third world country. Its elimination is essential to a reviving tourist industry; and it is also critical to the sense of pride and identity of every Bahamian.

Furthermore, investments in infrastructure can be highly productive. But the government should seek to avoid

"white elephant" investments by making its investments in roads, airports, ports, waste disposal facilities and parks complimentary to private sector investments. Good examples of the potential are San Salvador where Club Med has created a new viable mini-economy and Abaco where the long overdue north-south highway should enhance materially both agricultural and tourist development.

Education

The Asian tigers, South Korea, Japan, etc., are societies that value teachers and learning. These countries produce far more graduates with much higher linguistic, numerical and mechanical skills than is the case in North America and the Caribbean. The business community finds the average Bahamian graduate lacking in this regard. The aim must be the raising of performance levels of both teachers and students. This may entail an increased employment of foreign teachers in the short and intermediate term.

The government should liquidate its interests in Bahamasair, the Hotel Corporation, Batelco, Bahamas Electricity, Water and Sewerage and the Post Office.

The government should get out of those businesses that have absorbed so much of its resources in the past. The management of these companies should be completely separated from political considerations and the sale of the entire government interest in them is likely to achieve this end.

VII. Venture Capital & Private Enterprise

Critical to the Caribbean Tiger strategy is the roll of the private sector, particularly the process of saving, investing and taking entrepreneurial risks.

The Bahamas is perceived as having a business environment that is hostile to the investor, Bahamian and foreign. The barriers encountered by the prospective investor, Bahamian and foreign, include too much bureaucracy and inefficiency; too many political agendas, personal considerations and favors; too few written regulations and too little enforcement of those regulations that do exist. Business licensing has been described as "Dickensian in its setting". The perception is that government hostility exists for all who have not struck the "right deal". In economic terms a deal is a private tax that reduces the yield to the investor.

It is very difficult to dramatize just what the investor has faced and just how much the economy has lost. One example is the experience of a charter flight service and aircraft maintenance center at Marsh Harbor, Abaco.⁵ The owner is a U.S. and U.K. qualified commercial pilot, mechanic and aircraft inspector who is quite possibly the best aircraft mechanic in the country.

In April 1984 he applied for a lease of crown land at the Marsh Harbor Airport for the construction of a hangar. This is necessary for an aircraft maintenance center to meet the requirements under both Bahamian and U.S. regulations for providing "certified" repairs on commercial aircraft. Under the PLP and the FNM, Bahamian civil aviation approved only one such center, Bahamasair.

⁵ "Aviation couple's decade of frustration", Dianne Penn, The Tribune, June 16, 1994, page 1.

For ten years the lease application languished in the Ministry of Public Works, the Department of Lands and Surveys and Civil Aviation. For ten years the company serviced its customers in a rough clearing, in the open air, without public utilities, without a paved taxi-way to its "service area" and from two Ro-Ro cargo trailers. In the end the FAA ruled that repairs made by the company on its own commercial aircraft were not acceptable because they were not done in a certified center. Therefore, the operator's charter aircraft could no longer land in the U.S.

A short term solution to the aircraft servicing problem came 22 months after the FNM came to power and then only after a front page article in a major newspaper. As of the date of this publication the FNM government still has not completed the lease transaction.

In this case the operator, civil aviation, Abaco and the Bahamian economy were diminished by this ten year bureaucratic delay. Yet politicians in both parties find it useful to criticize the commercial banks, the "Bay Street Boys" and the "White Knights" for not investing in new ventures.

It is safe to assume, however, that entrepreneurs, both Bahamian and foreign, will invest if free to do so. What is clear is that in a hostile environment they will not or will do so on a reduced scale. Facing such hostility the typical capitalist/entrepreneur, unlike the Abaco entrepreneur described above, simply votes with his feet; he takes his capital and his bright idea and goes elsewhere; or he leaves his funds on deposit in a commercial bank. One can cite situation after situation where this has happened. Unfortunately for the Bahamas no one has constructed an index or list of investments not made because of political and bureaucratic intimidation. One only perceives a need for more jobs and investment.

If a Caribbean Tiger strategy is to succeed -

- The government must create a climate that is supportive of risk taking and cease and desist from public attacks on potential investors, including the "Bay Street Boys" and "White Knights".*

In addition, to succeed -

- This program most certainly will require organizational and personnel changes at every government entity that investors encounter.*

VIII. Labor Productivity and Unions

How a labor market works is very critical in a country like the Bahamas. In this case one industry, tourism, produces about half of both the gross domestic product and total government revenues.

Unfortunately for the hotelier, the government and all Bahamians, the international market for vacation services is very competitive and periodically seems to produce entirely new competitive threats. The cruise ship is a floating hotel with a casino. Cuba is a re emerging tourist destination. The past and possible future impact of these are known to all who are interested. They give national importance to hotel operating costs and service quality.

In this industry a militant union has dominated hotel operations. Often this has not been to the benefit of the industry, the country or the government.

For instance, the "mandatory" 15% gratuity is a union benefit that has the effect of removing the employee from the discipline of the labor market. Separate from other factors, the

market cannot channel the employee's self-interest into providing superior service. In fact, his self-interest may be best served by union or political activity rather than by providing superior service to the tourist. For years tourist departure interviews have documented the prevalence of poor service. Without the discipline of the market the employee has turned a deaf ear to exhortations for better service.

Furthermore, it is reported that unionized restaurants have up to 50% more employees than non unionized.

What is clear is that the price of labor has been high, service quality poor and productivity low. In order to be competitive with tourist destinations in lower wage countries the Bahamas must raise productivity to levels higher than the regional average. This is a problem of national importance.

The government should do the following:

- . Allocate a large part of its effort in education at producing quality candidates for entry level as well as lower and middle management positions in tourism.***

The objective must be the attainment of world class standards.

- . Take specific actions signaling a government determination to bring about increased labor productivity.***

This must be done by the government in public corporations, in the civil service and in any mediation or arbitration of labor disputes in the private sector.

Notes:

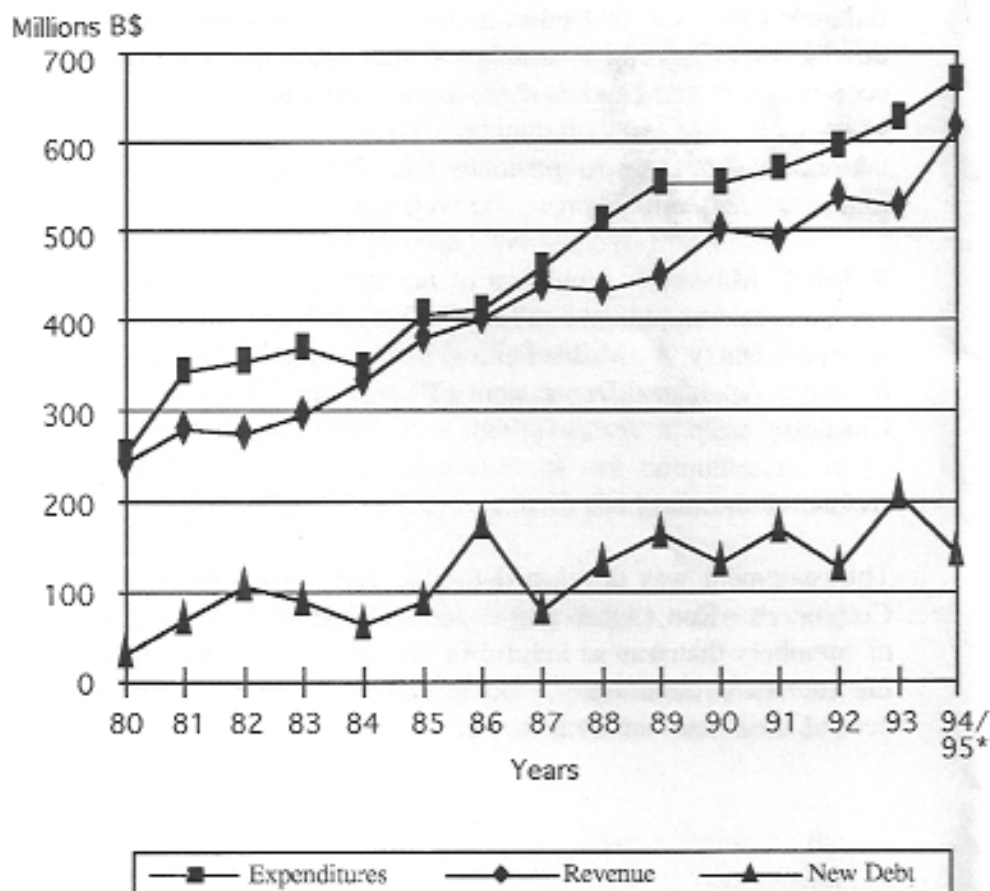
The Foundation for Economic Freedom is an independent Bahamian research and educational institute that promotes in the Bahamas an understanding of free markets. It brings economists, writers and analysts to the Bahamas to confer with key members of the community. With this publication it is taking another step to promote free markets as the most important device to improve the well-being of Bahamians.

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Government Expenditures, Revenue & Debt



Source: Central Bank of the Bahamas

*Note: 1994/95 data is fiscal year and 1980/93 data is calendar year

Government of the Bahamas: Finances

Millions of B\$

	1990	1991	1992	1993	Revised 1994/95 Budget*
Current Revenues	498	490	534	525	613
Current Expenditures	486	505	524	534	593
	-----	-----	-----	-----	-----
Current Surplus/ (Deficit)	12	(15)	10	(9)	20
Capital Expenditures & Net Lending	84	99	91	93	109
	-----	-----	-----	-----	-----
Net Surplus/(Deficit)	(72)	(114)	(81)	(103)	(89)
	-----	-----	-----	-----	-----
Debt:					
New Debt	134	169	128	204	144
Debt Repayment	48	48	55	89	55
	-----	-----	-----	-----	-----
Debt Incr./(Decr.)	86	121	73	115	89
	-----	-----	-----	-----	-----
Cash Incr./(Decr.)	14	7	(8)	12	0
	=====	=====	=====	=====	=====

Source: Central Bank of the Bahamas

* Note: 1994/95 data is fiscal year and 1990-93 data is calendar year basis