EXAMINATION OF THE COMPONENTS OF THE FISCAL POLICY PAPER WHICH WAS LAID BEFORE THE HOUSES OF PARLIAMENT ON APRIL 28, 2011

REPORT BY

THE AUDITOR GENERAL OF JAMAICA

FINANCIAL YEAR 2011/12

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Auditor General's Comment on the Fiscal Policy Paper – 2011/12

1. I have examined the components of the Fiscal Policy Paper (FPP) of the Minister of Finance, which was laid before both Houses of Parliament on April 28, 2011.

Responsibilities of the Minister of Finance

2. The Minister of Finance is responsible for the FPP, including the underlying conventions and assumptions on which the principles of prudent fiscal management are based. As stated in section 48B(2) of the Financial Administration and Audit (FAA) Act:

   Upon presentation of the annual Estimates of Revenue and Expenditure, the Minister shall lay before both Houses of Parliament, a Fiscal Policy Paper setting out, in accordance with this –

   a) Macroeconomic Framework;
   b) A Fiscal Responsibility Statement; and
   c) A Fiscal Management Strategy

3. Section 48B(3-5) provides that the Macroeconomic Framework is to present an overview of the state of the economy, and an assessment of the prospects for economic growth including medium-term projections for the main macroeconomic variables. The Fiscal Responsibility Statement should specify the levels of fiscal balance and debt that are prudent in the opinion of the Minister, proposed fiscal-policy measures and a declaration that the Minister will adhere to the principles of prudent fiscal management. The Fiscal Management Strategy must provide an assessment of the current and projected finances of the Government, outline plans and policies for economic development and explain how such plans and policies conform to the Fiscal Responsibility Statement.

4. As outlined in section 48D of the FAA Act, the Minister shall act in conformity with the following fiscal management principles –

   a. the total debt is to be maintained at a prudent and sustainable level;
   b. guarantees and other contingent liabilities are to be managed prudently with particular reference to their quality and level;
   c. borrowings are to be geared toward productive purposes and the accumulation of capital assets; and
   d. expenditure is to be managed in a manner that is consistent with the level of revenue generated.

5. Section 48C of the FAA Act outlines fiscal targets for which the Minister of Finance should take appropriate measures to achieve by the fiscal year ending March 31, 2016. These include:

   a) Reducing the fiscal balance to nil;
   b) Reducing the total debt to 100 per cent or less of the gross domestic product;
   c) Reducing the ratio of wages paid by the Government as a proportion of the gross domestic product to 9 per cent or less;
   d) Maintaining or improving the above targets beyond March 31, 2016.

Responsibilities of the Auditor General

6. My responsibility, as set out in section 48B(6) of the FAA Act, is to examine the components of the Fiscal Policy Paper and provide a report to the Houses indicating whether –

   a) the conventions and assumptions underlying the preparation of the Fiscal Policy Paper comply with the principles of prudent fiscal management specified in section 48D; and

   b) the reasons given pursuant to subsection (5)(d)(ii) are reasonable having regard to the circumstances.

7. I conducted my examination in accordance with International Standard on Assurance Engagement (ISAE) 3000 – *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*. That standard requires me to obtain sufficient appropriate evidence to base my comments in line with the criteria, which are established in section 48D of the FAA Act.

Scope of the Audit

8. The examination included:
   - review of the provisions of the FAA Act;
   - review of Fiscal Policy Paper for financial year (FY), 2011/12;
   - meetings with representatives from the Ministry and the Public Service, the Bank of Jamaica and the Planning Institute of Jamaica;
   - meetings with external experts;
   - obtaining representations[1] from the Ministry and other stakeholders; and
   - performing such other procedures that is considered necessary in the circumstances.

9. The Act does not require me to comment on the **reasonableness** of the assumptions underlying the FPP. Further, I was not able to address the requirement under section 48B(6)(b) of the FAA Act given that the actual outcome of the fiscal indicators would not be available in the first year.

[1] Written confirmation of information provided

Findings

Criterion: Expenditure is to be managed in a manner that is consistent with the level of revenue generated.

RELATED TARGETS: To reduce the fiscal balance to nil by the end of the financial year ending on March 31, 2016 [FAA Act, Section 48C(a)]

To reduce the ratio of wages paid by the government as a proportion of the Gross Domestic Product to 9 per cent or less by the end of the Financial Year ending on March 31, 2016 [FAA Act, Section 48C(c)]

10. The FPP projects a fiscal deficit of 4.6 per cent of GDP for FY 2011/12, which is an improvement of 1.5 per cent over the FY 2010/11. However, contrary to the captioned related target, the FPP projects that there will be a fiscal deficit of $18 billion (1% of GDP) for the financial year ending on March 31, 2016. Nonetheless, the Ministry provided an explanation to support how this fiscal gap (1% of GDP) will be closed, in order to achieve the targeted fiscal balance of nil by March 31, 2016.

Table 1 Measures to Close Fiscal Gap

- Tax reform (both policy and administration) designed to promote stable and predictable levels of revenue and maintain the integrity of the tax system by minimizing special incentives, concessions and exemptions;
- Pension reform – implementation of a contributory pension scheme so as to partly transfer the cost of financing retirement benefits from the taxpayer to the ultimate beneficiary;
- Public Sector transformation – to generate efficiencies and contain the wage bill;
- Better management and closer monitoring of expenditure through effective use of the Project Prioritization Tool, implementation of the FRF and enforcement of sanctions; and
- Continuous assessment and management of fiscal risks and contingent liabilities.

Source: Fiscal Responsibility Statement/MoFPS

11. The FPP projects that there will be an improvement in the wage/GDP ratio from 10 per cent of GDP in FY 2011/2012 to 9 per cent of GDP by financial year ending on March 31, 2016.

Comment

12. In my opinion, based on the foregoing, the FPP complies with the principle stated in Section 48D(d) of the FAA Act, which requires that "expenditure is to be managed in a manner that is consistent with the level of revenue generated". However, the Minister should disclose, in subsequent FPPs, the timeline for the implementation of the measures to close the fiscal gap and the savings/revenue they are expected to generate/contribute.

Criterion: Guarantees and other contingent liabilities are to be managed prudently with particular reference to their quality and level.

Related Target: The Act did not specify a related target for this criterion.

13. A definition for 'quality' and 'level' as it relates to guarantees and other contingent liabilities could not be determined. Further, a correlation could not be made between this criterion and the targets specified in section 48C of the Act. Consequently, there was no means by which an audit determination could be made as to whether guarantees and other contingent liabilities, as provided by the FPP, will be managed prudently with reference to their quality and level. However, it was noted that the Fiscal Management Strategy indicated that legislative changes will be made to the Public Bodies Management and Accountability (PBMA) Act, which will require that *"the Minister of Finance shall not give his approval for any borrowing by a public body if he is not satisfied that the proposed borrowing is consistent with the debt reduction target specified in the FAA Act."*[2] Further, the Ministry has advised that a limit will be placed on the level of guarantees in a given year with the introduction of the proposed Public Debt Management Act.

Comment

14. A comment cannot be made on whether the FPP meets this criterion until a specific definition for 'quality' and 'level', and related target(s) have been provided.

Ministry's Response

15. *Since the FAA Act was amended in March 2010, further amendments have been tabled in Parliament. Though not yet passed by the Houses of Parliament, the FPP was prepared in line with the proposed amendments that are currently before Parliament. One such amendment is the substitution of the words "Guarantees and other contingent liabilities" with the words "fiscal risks". And fiscal risk means the possibility that actual fiscal outcomes will deviate from the fiscal outcomes expected at the time of the presentation of the annual estimates of revenue and expenditure arising from matters such as -*
    - *(i) economic assumptions;*
    - *(ii) the structure of public debt;*
    - *(iii) Government guarantees;*
    - *(iv) Public-private partnerships;*
    - *(v) Natural disasters & other acts of God, and*
    - *(vi) Contingent liabilities.*

16. *Given this definition for fiscal risks (the possibility of an event), no specific target can be set. Within this context, the intent is to continuously assess, monitor and manage these risks so as to minimize (a) the possibility & likelihood of these risks becoming a cost to*

[2] Fiscal Management Strategy, Pg. 36

the Government (quality of risks) and (b) the quantum of cost that could be transferred to the budget if the risks materialize (level of risks).

Criterion: Borrowings are to be geared toward productive purposes and the accumulation of capital assets.

Related Target: A related target was not established.

17. A correlation could not be made between this criterion and the targets specified in section 48C of the FAA Act. Nevertheless, the Ministry has indicated in the FMS (Table 3E), that for FY 2011/12, total programmed borrowing of $140.8 billion, is less than the overall Capital Budget of $192.7 billion (inclusive of amortization). Thus, the Ministry posited that for FY 2011/12, loans will be geared toward capital spending and recurrent expenses will be entirely covered by recurrent revenue. As indicated by the Ministry, Table 3E further shows that over the medium term, the forecast is that, on average, loans will be geared toward capital spending (including amortization).

Comment

18. In the absence of specific related targets, a comment cannot be made on whether the FPP meets this criterion.

Ministry's Response

19. *Since the FAA Act was amended in March 2010, further amendments have been tabled in Parliament. Though not yet passed by the Houses of Parliament, the FPP was prepared in line with the proposed amendments that are currently before Parliament. One such amendment is the substitution of the words "**productive purposes and the accumulation of capital assets**" with the words "investment activities that support growth"*

20. *This is a principle that means in general, the Government should not borrow to pay recurrent expenses and henceforth recurrent revenue should equal or exceed recurrent expenses. Accordingly, the Act does not state that borrowing "must be" for investment activities but rather that borrowing "are to be geared toward..." In this context, what is stated is a principle (an ideal) but no specific target has been set for this ideal. Setting a specific target for this could compromise the sustainability of fiscal operations. This position is further enunciated in the proposed Regulations, which have been approved by Cabinet, which states, "When debt has reached a prudent level (60 per cent of Gross Domestic Product or less) the Fiscal Policy Paper shall demonstrate that on average, over the medium term, current revenue should equal or exceed current expenditure".*

Criterion: Total debt is to be maintained at a prudent and sustainable level.

Related Target: To reduce the total debt to 100 per cent or less of GDP by the end of the financial year ending on March 31, 2016.

Long term objective: Reducing debt/GDP ratio and maintaining it at no more than 60 per cent of GDP.

21. 'Sustainable level', as defined by the Ministry of Finance (here after referred as the Ministry), is that level of a fiscal indicator that does not compromise the required fiscal

space necessary to meet socio-economic objectives[3]. As it relates to 'prudent', the Ministry has indicated that a prudent debt level is 60 per cent of GDP[4]. However, it was further stated by the Ministry that even if the debt does not reach this level, where the Government indicates a clear commitment and takes decisive and responsible action to move the debt on a path and in the direction toward that level, such actions of the Government can be considered prudent[5].

22. The FPP projects that the debt/GDP ratio will be reduced to 123 per cent in FY 2011/12, and trend towards 95 per cent by FY 2015/16, which is within the target specified in the FAA Act.

Comment

23. In my opinion, based on the foregoing, the FPP complies with the principle stated in Section 48D(a) of the FAA Act, which requires that "total debt is to be maintained at a prudent and sustainable level".

Additional Comments

24. The audit determined that the components of the FPP, that is, the Macroeconomic Framework, the Fiscal Responsibility Statement, and the Fiscal Management Strategy, comply with the requirements as outlined in Section 48B(3-5) of the FAA Act. It was noted that the Fiscal Management Strategy outlined the risk exposures to the Government for the achievement of the targets specified in Section 48C(a-c) of the Act. The Ministry also outlined risk response measures to mitigate the likelihood of the risks materialising and/or the impact. However, I could not determine whether the risk exposure was quantified and factored into the projections. I did not assess the appropriateness of the risks identified in the Fiscal Management Strategy.

Recommendations

25. The Ministry should clarify the following principles, and identify their related targets, to allow for an assessment of whether the FPP is in compliance therewith:
    a) Guarantees and other contingent liabilities are to be managed prudently with particular reference to their quality and level.
    b) Borrowings are to be geared toward productive purposes and the accumulation of capital assets.
26. Disclose in the FPP, the timeline for implementation of the measures to close the fiscal gap and the savings they are expected to generate.
27. Quantify, where possible, the risk exposure identified in the FPP.

Ministry's Response

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[3] Draft Amendment of Section 48A of the Principal Act (FAA Act)
[4] Pg. 2, Par. 5 - Fiscal Responsibility Statement
[5] MoFPS responses to AGD requisition

28. *It was the intention of the MOFPS to be more specific with respect to measures to close the fiscal gap. However, it was not possible to do this because of a number of policy issues that are yet to be decided, which will impact the fiscal accounts. Two critical issues are (i) tax reform and (ii) pension reform. A Green Paper on Tax Reform has since been tabled in Parliament and a Green Paper on Pension Reform is currently been developed. Since at this time, the final decisions to come out of the consultations and discussions are unknown, it would not have been possible to indicate specific timelines and expected savings from the policy decisions that will be taken. However, by the time the next FPP is to be tabled, there should be much clearer indications and likely policy decisions on most of the outstanding issues. Accordingly, the MOFPS anticipates more specific fiscal strategy measures will be detailed in the next FPP.*

29. *The MOFPS has been working on a matrix of Fiscal Risks, including guarantees and contingent liabilities. Some of these issues are however "market sensitive" and it might not be prudent to make them all public. However as a management tool, the MOFPS will be identifying, as far as possible, the fiscal risks over the short, medium and long term.*

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