ANNEX C

Background Note:

Calibrating the Proposed Fiscal Rules for The Bahamas

According to best practice, well-designed fiscal responsibility frameworks are structured around two (2) elements: a medium-term fiscal anchor, such as the debt to GDP ratio, and then one (or several) operational target(s) that would guide annual budgets towards this anchor. This note provides background information on the choice of the proposed fiscal anchor and operational targets for The Bahamas.

I. MEDIUM TERM ANCHOR

A debt to GDP anchor of 50% has been identified as appropriate for The Bahamas.

The central government's debt to GDP ratio is regarded as suitable for anchoring fiscal policy—to guide expectations and ensure the sustainability of the public finances. The next step in the exercise was to determine the "optimal" level for the debt to GDP ratio. While there is no consensus on the approach, the calibration exercise undertaken by the International Monetary Fund explored three (3) different methods to arrive at this "optimal" level.

1. ***Determining the median debt ratio among emerging markets with investment grade sovereign ratings across the three (3) major credit rating agencies.*** An examination of thirteen (13) countries in this economic grouping revealed a median debt to GDP ratio of 50%, with the minimum at 28% and a maximum of 74%.
2. ***The identification of an initial debt level such that negative shocks would increase debt above 70% of GDP—a level deemed risky for emerging markets by the IMF in terms of its debt sustainability analysis***. The probabilistic approach utilized yielded a debt anchor of 58%.
3. ***A look at the highest level of debt that could be sustained under a prolonged economic slowdown without requiring a primary surplus above 2% of GDP***. This approach to the "safe debt" estimate produced a debt benchmark of 71%.

To summarize, the estimated debt anchors ranged from 50% to 71% of GDP, depending on the approach utilized. Being mindful of the size of contingent liabilities, and the need to maintain a prudent level of debt for stability of the currency peg arrangement, the Government's preference is for an anchor at the lower bound of this range, i.e., 50%. This compares with the current level of 57% and would therefore represent an improvement in the debt path, and the creation of fiscal space to respond to shocks and maintain market confidence in the Government's fiscal policy.

II. OPERATIONAL TARGETS: DEFICIT CEILING AND CAP ON CURRENT EXPENDITURE

Having identified a debt anchor of 50%, the next step was to determine how to ensure that the annual budgets are consistent with the achievement of this target. In the design of fiscal frameworks, operational targets , such as the deficit and spending ceilings, are used to guide the budgets towards the medium-term fiscal anchor.

Through the calibration exercise, the Government has identified a deficit ceiling of 1 percent of GDP and a cap on current expenditure growth consistent with the rate of GDP growth as suitable operational targets.

a. **Fiscal Balance Rule**

- This is the most important part of the Bill; it is the under the direct control of fiscal policy and therefore underpins credibility of the framework.
- The target fiscal deficit is derived from a quantitative exercise that considered the initial stock of debt, the fiscal deficit, expected long-term nominal GDP growth, an assumed convergence horizon, and the debt target.
- A deficit target of 0.5 percent of GDP, binding from FY2020/21 onwards, has been determined as necessary to ensure convergence to the debt anchor by FY2027/28. This objective also provides the fiscal space for the savings fund, of 0.5% of GDP
- The 3-year transition period for this rule recognizes that the fiscal objectives for the debt and fiscal balance require significant fiscal adjustments in the FY2018/19 to FY2020/21 period—and that having a gradual adjustment would allow time for the public sector and the economy to achieve them in an orderly manner. As such, the fiscal objective for the fiscal balance for the years FY2018/19 and FY2019/20 should not exceed a deficit of 1.8% of GDP and 1.0% of GDP, respectively.
- The rule also recognizes that the fiscal measures are based on estimates and forecasts, which are subject to some degree of uncertainty about their impact on the fiscal balance. As such, a compliance margin, not to exceed 0.5% of GDP, is proposed for assessing whether the fiscal objective has been achieved.

b. **Expenditure Rule**

- After the fiscal deficit target of 0.5% of GDP had been attained, the fiscal objective for current expenditure is to be set at a rate equal to the expected potential nominal growth of GDP—currently estimated at 3 percent.

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