



**FISCAL POLICY CONSTRAINTS AND CHALLENGES FOR A SMALL OPEN
ECONOMY: THE CASE OF BARBADOS**

By

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Central Bank of Barbados**

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1. Introduction

The problems of adjustment and growth in developing countries very often owe their genesis to excess domestic demand that originate from overly expansionary fiscal policies. Such policies usually lead to inflation and deterioration in the external current account. The usual responses to such situations in most developing countries have tended not to address the original fiscal problems, but often to impose domestic price controls and resort to restrictions on credit, trade and foreign exchange transactions. These measures, however, constrain further growth in the economy and exacerbate supply shortfalls, as the curtailment of imports could limit domestic capacity utilisation and exports. The cutback on retained imports could also weaken the tax base to the extent that those countries depend crucially on taxes on international trade. Thus, the ability to contain the fiscal deficits is further circumscribed.

In the post-central bank era, the Barbados economy has undergone three relatively short periods of recession (1974-75, 1981-82 and 1990-92) interspersed with long periods of positive growth. A common trait of these downturns was that they were either preceded or were accompanied by periods of relatively large fiscal deficits. These deficits triggered current account disequilibria, sometimes made worse by developments in the external economy. For instance, the four-fold increase in oil prices in 1974-75 exacerbated the first recession, as government's effort to increase expenditure to revive the economy further undermined the fiscal situation. Similarly, under the strain of the second oil price shock of 1979 and the accompanying rise in international inflation, the country was thrown into balance of payments problems, which persisted throughout the

first half of the 1980s, forcing the Government to borrow heavily overseas for balance of payment support. If the proximate causes of the recessions in 1974-75 and 1981-82 were external factors, the 1990-92 recession was brought on largely by domestic aggregate demand pressures.

The main objective of this paper is to describe the evolution of Barbados' public finances over the period 1971-2000, discussing, where appropriate, the underlying causes of any fiscal problems over this period. The paper begins with a discussion of the trends in fiscal performance during the period under study, then touches on the possible impact of Government's budgetary policy on resource allocations, income distribution and equity, as well as the key challenges that are likely to confront Barbadian authorities in the medium to long term. The final section provides a summary and conclusions.

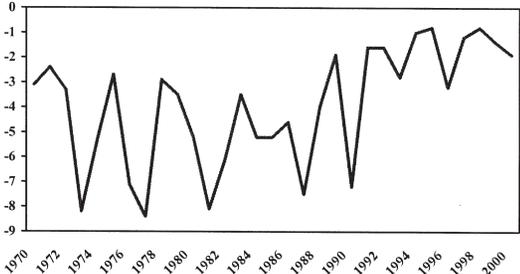
2. Fiscal Trends and Performance

A useful precursor to an analysis of the fiscal policies of any government is to examine the patterns of revenue and expenditure and their resultant impacts on the fiscal deficit. This section, therefore, dissects the fiscal performance of successive Barbadian governments over the past thirty years, focussing primarily on the evolution of revenue and expenditure outcomes.

Chart 1 displays the evolution of the fiscal deficit-to-GDP ratio over the period 1971 to 2000. In general, the first decade (1971-80) could be considered one of moderate to extreme fiscal disequilibrium, characterised by an average annual deficit-to-GDP ratio of 4.9% (see Table 1). Despite a healthy rate of revenue collections during this period, there was also a rapid increase in total government expenditure, which averaged around 19% per annum, almost three percentage points faster than the trend growth rate in nominal GDP at market prices. This was a period when public policy emphasised the use of the budgetary process to influence real economic activity in the country. In particular, capital expenditure grew at an average annual rate of 23.3%, more than five times the rate of increase recorded in the decade ending in 1970, as large infrastructural projects were

undertaken, including the expansion of the Deep Water Harbour and the airport, as well as the construction of the Barbados Community College, the Samuel Jackman Prescod Polytechnic and the Heywoods Village Resort. The strengthened infrastructural base firmly laid the foundation for the strong economic growth witnessed in the following two decades. Current spending also rose significantly, led by large increases in wages and salaries, especially in 1976 and 1980-81 when wage settlements were in the neighbourhood of 25% and 30%, respectively¹.

Chart 1: Fiscal Deficit to GDP Ratio (1971-2000)



In the decade that followed (1981-90), the operations of the central government resulted in greater fiscal imbalance, which could be considered a proximate cause of the economic downturn in 1990-92, the worst in Barbados' post-independence era. In these years, the deficit-to-GDP ratio rose to an average of 5.3% per annum. Expenditure growth exhibited the same pattern as in the 1971-80 period, as the rise in government expenditure (9.6%) continued to be higher than that of nominal gross domestic product (6.8%). However, unlike in the previous decade, the expansion in aggregate government expenditure was driven largely by sharp increases in current spending, the bulk of which were transfers to the social services (education, health, housing), followed by payments of wages and salaries. For instance, government expenditure on wages and salaries accounted for 44.2% of current expenditure in 1990/91, a rise of four percentage points from the 1981/82 level,

¹ See Annual Report (1976) and (1980), Central Bank of Barbados

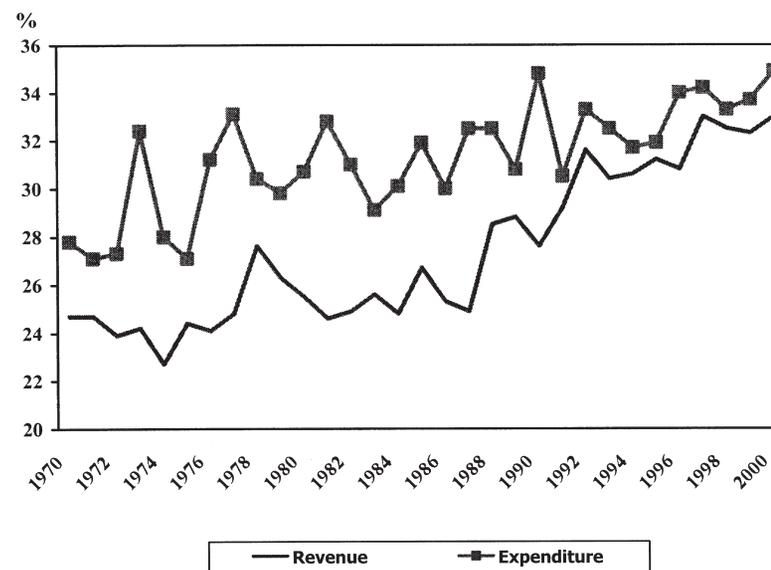
Table 1: Selected Indicators of Fiscal Performance

	Nominal GDP (Market Prices) \$M	Fiscal Balance	Fiscal Balance/ GDP (%)	Total Revenue (\$M)	Total Expenditure (\$M)	Total Revenue GDP (%)	Total Expenditure/ GDP (%)
1971	408.0	-9.7	-2.4	100.8	110.5	24.7	27.1
1973	516.5	-42.3	-8.2	125.1	167.4	24.2	32.4
1975	812.4	-21.6	-2.7	198.5	220.1	24.2	27.1
1977	993.5	-83.0	-8.4	246.2	329.2	24.8	33.1
1979	1348.3	-46.9	-3.5	354.3	401.2	26.3	29.8
1980	1730.5	-89.7	-5.2	441.1	530.8	25.5	30.7
1971-80	894.4	-43.9	-4.9	225.0	268.9	24.8	29.7
1981	1904.6	-154.9	-8.1	469.4	624.3	24.6	32.8
1983	2112.6	-73.4	-3.5	541.1	614.5	25.6	29.1
1985	2410.0	-125.6	-5.2	643.6	769.2	26.7	31.9
1987	2913.8	-219.7	-7.5	726.7	946.4	24.9	32.5
1989	3427.2	-66.5	-1.9	987.6	1054.1	28.8	30.8
1990	3440.1	-248.2	-7.2	949.5	1197.7	27.6	34.8
1981-90	2624.6	-137.5	-5.3	693.8	831.3	26.2	31.5
1991	3393.7	-53.5	-1.6	990.3	1043.8	29.2	30.8
1993	3308.9	-68.8	-2.1	1006.2	1075.0	30.4	32.5
1995	3742.4	-28.7	-0.8	1165.8	1194.5	31.2	31.9
1997	4412.6	-52.7	-1.2	1458.3	1510.5	33.0	34.2
1999	4970.0	-70.6	-1.4	1603.3	1673.9	32.3	33.7
2000	5200.9	-98.1	-1.9	1717.1	1815.2	33.0	34.9
1991-00	4043.2	-62.5	-1.6	1279.0	1341.4	31.5	33.0

Source: Annual Statistical Digest (various issues), Central Bank of Barbados

in part reflecting a steady expansion in public sector employment. In addition, this period also marked a nearly seven-fold rise in debt servicing charges, a result of the extensive foreign borrowings that were undertaken during that time. Government revenue improved after 1985 in tandem with the expansion in real economic activity; however, the growth rate of government expenditure was faster, resulting in a rise in the expenditure-to-GDP ratio from an average annual of 29.7% during 1971-80 to around 32% by the end of the 1981- 90 decade (see Chart 2).

Chart 2: Ratios of Revenue and Expenditure to GDP (at Market Prices) (1971-2000)



In contrast, the last decade under analysis (1991-00) was a period of relatively low fiscal disequilibrium, with a recorded fiscal deficit averaging only 1.6% of GDP at market prices each year. An important feature of this period was the realisation of eight successive years of real economic expansion, the longest in the economic history of Barbados. Compared with the previous two decades, total expenditure growth slowed considerably to an annual rate of 4.6% on average during the years of 1991-2000. Although employment in the public sector continued to grow strongly, especially between 1995-2000, overall recurrent expenditure expanded on average by 5.7%, owing to moderate public sector wage increases, commensurate with a relatively modest period of price inflation.

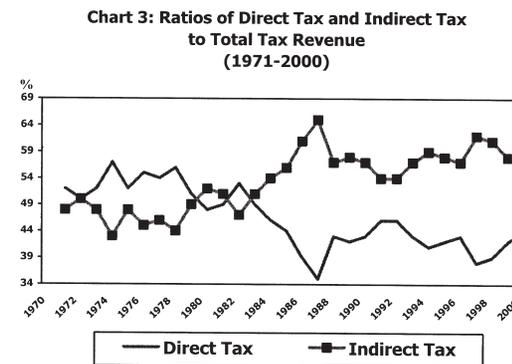
As shown in **Table 1**, by the end of 2000, the revenue-to-GDP ratio had risen to almost 32%, compared with 27.6% at yearend 1990, largely due to government's emphasis on discretionary changes rather than the natural responsiveness of the tax system to real GDP growth. In a recent study, the overall tax elasticity for the period 1977 to 1999 was estimated to be 0.88, compared to a tax buoyancy of about 1.29 (see Skeete, 2001). This suggests that the Barbadian tax system during this period was relatively inelastic, and that government was forced to rely on frequent discretionary changes for revenue to keep up with GDP growth.

3. Evolution of Reforms to the Tax System

Government taxation policy has undergone some changes during the thirty-year period under review. Between 1971-80, taxation policy initially focussed more on the government's role to facilitate economic growth and increase employment than on income distribution. Heavy reliance was placed on the direct mode of taxation and, while the income tax system was highly progressive, the threshold of income tax incidence was quite low. After 1977, trends in budgetary policy shifted in favour of direct redistribution of income. Although a new tax credit system was implemented in 1977 to decrease the tax burden on low-income earners, the tax system remained highly progressive, as taxable income of \$30,000 or more attracted a marginal tax rate of 70%.

In 1980, government fiscal policy was directed more towards expenditure taxation rather than income taxation. A new tax rate structure was introduced and there were sizeable reductions in personal income tax liabilities, as the top marginal rate was lowered to 65% by 1985. In 1986, further revisions were made to the direct tax system. The top marginal rate was lowered to 50% and personal allowances were raised from \$13,000 to \$15,000 in addition to the existing standard deductions for full mortgage interest payments and life insurance premiums. Also, from 1980 onwards, the scope of consumption taxes was gradually widened and by the end of 1990, the ratio of indirect tax to overall tax revenue averaged 56%, almost nine percentage points above the ratio in the previous decade (see

Chart 3). The emphasis on expenditure taxation continued into the decade ending in 2000, a period marked by important reforms in the taxation system.



As indicated earlier, discretionary changes in tax rates, income tax bands and concessions have been important components in the arsenal of fiscal tools that have been utilised to manage the fiscal system in Barbados. However, following the 1990-92 recession, major reforms of both the direct and indirect tax systems were undertaken as part of the measures to restructure various sectors of the Barbados economy.

Direct Tax Reform

Over time, the direct tax system had become highly complicated due a complex system of itemised allowances, an abundance of payroll taxes (levies) and concessions, which tended to be discriminatory to the extent that it appeared to favour the high-income group. The broad thrust of the 1992 direct tax reform was, therefore, to simplify the direct tax system, broaden the tax base, while reducing the scope of direct taxation further in anticipation of the intended introduction of the all-embracing value added tax.

Personal allowances were standardised to \$13,000 and most tax-exempt allowances, such as deductions for life insurance payments and full mortgage interest payments, were

removed. In addition, income tax bands were widened, the top marginal income tax rate was reduced from 50% to 40% and four levies comprising the training, health, employment and transportation were abolished.

While the reforms broadened the tax base and the abolition of itemised deductions introduced a measure of revenue efficiency in the tax system, there was little impact on the share of direct taxation, as the ratio of indirect taxation remained high at 58% over the period 1993-96. This was partly because personal allowances were raised again to \$15,000 in 1995 and deductions for mortgage interest payments were re-introduced with a cap in 1996. Moreover, provision was made for a reverse tax credit to those individuals that fell below the income tax threshold of \$15,000 while there was a 30% increase in the personal allowance for pensioners to \$30,000. Since 1998, budgetary policy refocused on resource allocation with a range of concessions for saving and investment. These included significant allowances for investment in venture capital funds and mutual funds, as well as an increased allowance for savings in credit unions.

An important facet of the direct tax system in the decade of the 1990s was its changing composition, marked by the growing importance of revenue from the international business and financial services sector, otherwise known as the “offshore” sector. Despite the relatively low tax rates (ranging from 0% to 2.5%) levied on the profits of international business companies, the evidence in 1998 and 1999 suggest that these tax revenues contributed in the neighbourhood of approximately 37% of corporation tax revenue or almost 4% of government’s total revenue². Without the contribution from the offshore sector, the dominance of indirect taxation in the overall tax intake would have been even more pronounced.

Indirect Tax Reform

Arguably, the most important change in the taxation system in Barbados was the introduction of the value added tax (VAT) in 1997, as part of the reform of the indirect

² See Harmful Tax Competition: Tax Convergence and other Possible Responses, Central Bank of Barbados, (2001).

tax system. The major justification for this change was that the indirect tax system had become complex, characterised by multiple rates, cascading, protectionism and non-transparency, which impaired the proper functioning of the tax system. With its simplicity of administration, neutrality and revenue efficiency, the VAT was considered the appropriate form of taxation to improve the functioning of the system. It replaced eleven taxes³ and was levied at a standard rate of 15% on all goods and services and 7.5% on hotel accommodation, with few exemptions and zero-ratings. Excise taxes were retained on alcohol and tobacco, motor vehicles, land and petroleum products.

4. Changes in the Tax Regime and their Impact on Equity

Governmental activities and revenue programmes usually affect the overall patterns of distribution of real income in the economy. There were a number of instances where taxation policy in Barbados was deliberately directed at redistributing income towards the lower income group. Nevertheless, to the extent that there may be unintentional distributional effects from fiscal policy measures, it is pertinent to discuss whether the impact of various taxation regimes served their intended purposes.

In an evaluation of the impact of the 1986 tax measures, Mascoll (1991) calculated the tax payable by representative individuals in the high, middle and low-income groups when account is taken of the existing regime of concessions and tax exemptions. Mascoll found that the measures gave rise to a sharp decline of more than 7 percentage points in the average effective tax rate (ETR)⁴ of individuals earning more than \$100,000 per annum, compared to declines of only 0.2 and 2.1 percentage points for the representative middle and lower income individuals, respectively. He, therefore, concluded that the middle-income representative carried a disproportionate tax burden in the aftermath of the 1986 direct tax revisions.

³ These were the consumption tax, surcharge on luxury imports, stamp duty on imports, public entertainment tax, hotel and restaurants sales tax, service tax, tax on quarriable minerals, travel ticket tax and tax on overseas telephone calls.

⁴ This is calculated as the ratio of income tax payable to total assessable income.

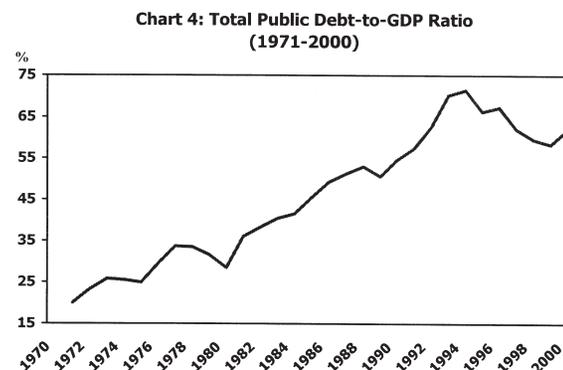
As a follow up to Mascoll's study, Howard and Mascoll (1994) intimated that the elimination of the various levies and the elimination of the plethora of allowances embodied in the 1992 direct tax reform introduced a measure of fairness to the system. While these reforms made the system less progressive, the fact that the effective tax rates fell by about six percentage points for the lower income individuals helped to ease the tax burden somewhat for this group. Additionally, the 1992 direct tax reform introduced a measure of revenue efficiency, as the tax yield improved. The average tax to GDP ratio for the period 1992 to 1996 (before the VAT was implemented) moved to 30.8 per cent from 28.4% for the period 1981 to 1992. However, it was the introduction of the VAT that boosted revenue performance even more considerably.

The VAT, which was designed to be nearly revenue neutral (in terms of the taxes it replaced), yielded about 35% more than the taxes it replaced (Dalrymple, 1998 p.72). However, with the gradual re-introduction of the itemised deductions that were phased out in 1992 and the subsequent introduction of a range of new direct tax concessions for savings and investment related instruments (which tended to favour the high income groups), the tax burden appeared to have shifted even more against the low income group. This point is reinforced by a recent study by Boamah, Byron and Maxwell (2002), which reveals an overall increase in income inequality over the period 1987 to 1999, as the distribution of income appeared to have favoured the middle and upper- income individuals. If due consideration is given to the known regressivity of the VAT system, the relative disadvantaged position of low-income individuals became even more pronounced.

5. Fiscal Policy and Public Debt

It is not unusual in many developing countries for total public debt to be determined largely by chronic fiscal imbalances. When such imbalances are financed by money creation in an atmosphere of falling demand for money, this could lead to inflationary

pressures in the economy. In Barbados, there has been more than a forty-fold increase in public debt since 1970. However, it was mainly during the period 1977 to about 1990 when the government's fiscal policy stance was deemed to have affected the overall indebtedness of the public sector. Chart 4 shows the growth of public debt over the period 1971-2000. Total public debt to GDP (at market prices) rose from about 20% in 1971 to a high of about 71% in 1994, accelerating sharply during the 1980s, as Government incurred large fiscal deficits. Between 1994 and 1999, when the country's access to external borrowing was limited, the debt-to-GDP ratio fell to approximately 58%, but by the year 2000, it had risen to 62%, the level that existed in the early 1990s, both with higher domestic and external debt.



In Barbados, domestic debt has usually been the largest component of public debt, although its share has varied according to the emphasis placed on the main sources of financing public sector deficits. For instance, during the period 1978 to 1988, when Government borrowed heavily overseas for infrastructural development and balance of payments support, the ratio of domestic debt to total debt gradually declined from 76% to about 50% (Table 2). During this period, the stock of external debt rose almost ten-fold to approximately \$820 million, as Government secured loans on the Japanese and

European markets and extensively used project fund inflows from international lending agencies. However, between 1988 and 1999, Government reverted to domestic sources for the bulk of its deficit financing and the share of domestic debt rose sharply to 76%, the level witnessed in the late 1970s. In addition, Government incurred large contingent liabilities in 1992 and 1994 when long-term debt instruments were issued to restructure the balance sheet of a public lending institution overburdened by the debt of the sugar industry.

Table 2: Composition of Total Public Debt

Year	Domestic	External	Total Debt	Total Debt/GDP (%)
1971	51.2	30.2	81.4	20.0
1972	71.9	32.0	103.9	23.3
1973	77.8	55.4	133.2	25.8
1974	136.2	42.7	178.9	25.5
1975	158.1	44.1	202.2	24.9
1976	208.5	49.5	258.0	29.5
1977	279.5	55.2	334.7	33.7
1978	282.9	89.2	372.1	33.5
1979	314.2	112.1	426.3	31.6
1980	329.3	163.9	493.2	28.5
1981	426.5	259.4	685.9	36.0
1982	475.5	286.9	762.4	38.3
1983	516.4	337.3	853.7	40.4
1984	590.2	365.2	955.4	41.5
1985	651.7	444.0	1,095.7	45.5
1986	713.0	588.3	1,301.3	49.2
1987	753.0	738.1	1,491.1	51.2
1988	821.0	817.0	1,638.0	52.9
1989	878.0	852.8	1,730.8	50.5
1990	1,020.6	859.4	1,880.0	54.6
1991	1,113.5	834.4	1,947.9	57.4
1992	1,236.6	755.0	1,991.6	62.7
1993	1,617.9	706.6	2,324.5	70.2
1994	1,777.8	714.4	2,492.2	71.5
1995	1,762.2	717.7	2,479.9	66.3
1996	1,967.0	722.0	2,689.0	67.3
1997	2,036.9	697.5	2,734.4	62.0
1998	2,141.4	684.3	2,825.7	59.5
1999	2,108.6	788.9	2,897.5	58.3
2000	2,204.1	1,021.9	3,226.0	62.0

Source: Central Bank of Barbados

Despite the recent increases in the public debt ratio, the Government of Barbados has, since 1991, been registering consistent primary fiscal surpluses, compared to the previous two decades when primary deficits of about 2% of GDP⁵ were registered. That gives a measure of sustainability to the island's public debt profile for the foreseeable future.

6. Current Reforms and the Challenges Ahead

Notwithstanding the fiscal discipline exhibited throughout the 1990s, the Barbados government faces important policy challenges on the threshold of the new millennium. Apart from managing the current economic recession largely attributable to recent global uncertainties, ongoing changes in the international economy are forcing Barbados, as well as other small, open economies, to implement accelerated structural reforms that show little recognition of the special characteristics of small size and economic vulnerability.

In this global environment characterised by increasing geo-political and economic uncertainties, chief among these challenges is the sustainable management of the globalisation process into 21st Century, particularly the maintenance of a sustainable fiscal position. Critical to the achievement of such an outcome must be tight controls on public recurrent expenditure, prudent debt management and the streamlining of the tax system to boost external competitiveness, while safeguarding the revenue base. For instance, the recent "Harmful Tax Competition" issue championed by the Organisation for Economic Cooperation and Development in 2000 has brought to the fore the need to address the present wide disparity between the tax rates applicable to domestic and "offshore" firms. Reinforcing the urgency for reform of the direct tax system is the fact that the present corporate tax rate of 37.5% still ranks among the highest in the region⁶ and warrants a downward adjustment to enhance the private sector's ability to effectively compete with its regional counterparts. In this regard, the Barbados government has

⁵ See Archibald and Greenidge (2002)

⁶ For instance, the corporate tax rate is 33% in Jamaica and 35% in Trinidad and Tobago.

embarked upon a phased reform⁷ of the direct tax system, with the view to reducing the corporate tax rate to 25% by the year 2006, while at the same time rationalising the existing regime of corporate tax incentives. Personal income taxes will also undergo a gradual reduction over a period of two years.

These reforms mean that in the medium term, the Government would have to rely more on indirect taxes to make up for the revenue shortfall arising from the direct tax reforms. Since expenditure taxes tend to be regressive in nature, there is likely to be a further increase in the inequities of the income tax system. While Government could address the growing inequities by expanding the social programmes targeted to the poor or raising the income threshold further, such policies would make it difficult to keep its fiscal deficit-to-GDP ratio within sustainable limits. Already the fiscal deficit has widened significantly during the period 2001-02, the result of a deliberate counter-cyclical policy stance to increase capital expenditure so as to ameliorate the impact of the present economic recession. Unless sustainable economic growth resumes in the shortest possible time, keeping the fiscal deficit within the desirable range of 2% to 3% of GDP, while maintaining a tax system that exhibits the desired characteristics of fairness, simplicity and equity will certainly be a challenge.

Another key requirement is for Government to implement appropriate reforms of the National Insurance Scheme (NIS) to achieve actuarial balance for its long-term viability. A recent actuarial review of the NIS pointed to the need for urgent action to maintain its viability. According to the study, changes in the age distribution of the population, declining fertility and increasing longevity of Barbadian citizens could reduce the contributory support ratio of the scheme from about 6 working-age persons per pensioner as at 1999 to only 2.5 by the year 2030⁸. Moreover, the projected reserve ratio⁹ of the Fund was expected to become insolvent by the year 2020, and, indeed, become negative by 2030. Therefore, the key issue is to implement appropriate reforms to ensure that the

⁷ These reforms were implemented in fiscal year 2002/03.

⁸ See Tenth Actuarial Report of the Operation of the Barbados National Insurance Scheme, p. 7.

⁹ The ratio of the Fund to one year's benefit expenditure and administrative expenses.

scheme provides a reasonable retirement income for eligible contributors in the years ahead.

In its Economic and Financial Policy Statement in 2002, Government announced plans for incrementally higher contributions plus an increase in the mandatory retirement age to 67 years over a period of 12 years beginning in 2006. In addition, persons would have the option to work until age 70. Obviously, this has adverse welfare implications, as prospective pensioners have to contend with likely welfare losses arising from having two fewer years to enjoy their pension. Even then, unless there is an attempt by the fiscal authorities to change the demographic profile of the adult population with a deliberate policy action, the problem of a dwindling contribution ratio is likely to be present again in the years ahead. Furthermore, the idea of a labour force supported by an increasing proportion of aging workers could have adverse implications for future real output in the economy. As Barr (2002) surmises, increasing real economic activity is the only effective way of assuring that future output can be converted into sufficient goods and services to meet the needs of pensioners. It appears, therefore, that policy makers would continue to grapple with the question of devising an appropriate social security system that is fair and viable for sometime yet.

7. Summary and Conclusions

The preceding analysis demonstrates how the Barbadian fiscal system has changed between 1971 and 2000, moving from a system characterised by relatively large fiscal imbalances in the first two decades to one of relative fiscal prudence. Growth in expenditure was initially driven mainly by an emphasis on infrastructural development, but there were periods, especially in the decade ending in 1990, when current spending dominated.

The tax system has also shifted from one dominated by direct taxation towards indirect taxation. There have also been major reforms of both the direct and indirect tax systems,

but there remain inherent inequities to the extent that the direct tax system appears to discriminate against the relatively worse off in the economy.

The improvement in Barbados' fiscal policy stance, especially since 1991, brought a measure of sustainability to the fiscal system. Nevertheless, there are some challenges that need to be addressed if the budgetary instrument is to continue to facilitate continued growth and development. Apart from the need to zero in on the inequities in the direct tax system, the fiscal authorities are faced with the task of adjusting the corporate tax rate to reduce the tax burden on the business sector, as well as the challenge of reforming the social security system to ensure its viability.

Government is making every effort to address these issues, but more needs to be done given an increasingly uncertain international economic environment.

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