Back to Economic Development

INTEGRATED DEVELOPMENT PLANNING

IDP DISCUSSION PAPERS
#29

-

PATHS TO ECONOMIC GROWTH
Searching for the right Mix

By
The Development Institute (TDI)
Team of Consultants
(July 21, 2003)

INTRODUCTION
There is a growing body of research confirming what we have all believed, that the key to rapid poverty reduction is a high and sustained economic growth rate. Thus, at a minimum, Dominica should aim at raising its growth rate back to 4 percent per year. This may look like an over-ambitious objective when we are facing gaping current account deficits year after year, as far as the eye can see. Like a very sick patient, we may feel that there must be some magic formula "contact-C, penicillin!" which would just automatically restore growth.

Unfortunately, there is no "body of case law" in economics based on the different experiences of countries seeking to recover from economic decline. The circumstances and the strategies for the working-outs of debt, changing leading sectors, reviving local demand, differ from country to country as circumstances, political environment and even the capacity of stakeholders differ. If there is one clear lesson which is emerging from the documented experiences that the IDP Team has read, it is that the diversity of country situations means that there is no "silver bullet", no "one-size-fits-all" solution.

This means that each country must analyse its own situation, determine the most advantageous role for it in the global economy and introduce its own set of broad-based structural and institutional measures to achieve this goal. The challenge, therefore, is to identify **the right mix and sequencing of policies** which will create in Dominica a "virtual circle" that will generate investments, job creation and growth.

The fundamental assumption of the IDP Report is simply that, "***Government cannot do it alone***". Government cannot sustain fiscal stability by simply announcing its policy measures; Government cannot attract capital inflows without the support of the local private sector;

Government cannot increase the impact of Social Investments without the active participation of civil society. But this does not exonerate the Government from its responsibility for economic management and growth. If there is an equivalent singular responsibility of the Government, then it is the obligation to pursue the macroeconomic policy objectives of stability and growth within a transparent economic, social and financial policy framework, including the dissemination of comprehensive, accurate, and timely data.

GRADUAL VS SHOCK APPROACH

There is a false dichotomy between what is called the "Shock Approach" to economic recovery and the "Gradual Approach".

The "Shock Approach" is represented by proposals for drastic measures by the Ministry of Finance:

- Reduction of public expenditures (reduce civil service salaries)
- Increase in the collection of tax arrears
- Reduction in the Debt/GDP ratio
- Removal of Concessions
- Increase in fuel prices

The theoretical premise for the shock approach is that commodity and factor markets will absorb the adjustments, and even though they may produce some unemployment and dislocation during the process, what will emerge are new economic relationships in which Government and the private sector will both be able to re-establish healthy balance sheets. The theory assumes that economic activity, even somewhat reduced during the transition, will continue through the adjustment.

The theoretical premise for the 'gradual approach" is that we are not operating in circumstances in which the domestic markets are functioning well, international trade relations may or may not support the re-establishment of sound economic relationships. So there is still need for institutional intervention to ensure that economic relations do not unravel in an irreversible manner, stakeholders' roles are more clearly defined and that a minimum of social well-being is maintained during the transition.

Table 1: Contradictory Views on the Approach to Adjustment

Categories	Shock Approach	Gradual Approach
Adjustment Costs	Shock Approach leads to high adjustment costs but these are short-run costs and once incentives are apparent to reallocate resources, markets reestablish themselves and personal incomes recover	Gradual approach considers the labour and capital are not readily transferable. The starting points are close to economic destitution and collapse of confidence in the market must be prevented.
Credibility	Shock measures send clear unambiguous signals that the reforms are credible and stakeholders have no other choice but to adjust accordingly	Gradualism assumes that credible changes come from changing the roles that stakeholders play as well as introducing new measures
Feasibility	The shock approach relies less on any specific sequence of actions. Its approach is to Act and let the pieces fall in place.	The Gradual approach suggests that institutional capability and political good will may be needed to make the adjustment feasible. This not only takes

		time but should be made explicit to all stakeholders
Risks associated with each approach	Lower production; Higher unemployment; domestic capital flight; migration of skilled personnel; rural poverty and economic exclusion.	Ambiguous signals; no clear time frame; sequential successes important; susceptible to distortion and direction changes

The IDP considers the Shock vs Gradual dichotomy as a false choice. There are conditions that a Government, weakened by its own financial inabilities, must negotiate and accept if it is to mobilize external support from institutions like the IMF. These conditions usually fall in line with the "Shock" approach. The IDP sees such conditions as necessary[1], but not at all sufficient conditions for economic recovery in Dominica. The Report, however, seeks to move us towards the understanding that we need to strive to achieve a "right MIX" that fits our historical circumstances.

There are three important reasons why the IDP tends to move towards a more gradual approach:

a) We are not convinced that given measures that essentially reduce disposable income, households and businesses would be able to reestablish solvency in the short-run. The fear is that the economy can continue to spiral down into a case where another set of reforms would be necessary.
b) That the potential for a rapid expansion under such new arrangements as lower Government expenditures, more realistic petroleum prices, etc. is more illusionary than real, because of the open nature of the economy and the established migratory pattern of the country's labour and capital base.
c) The risk-aversion behaviour is a logical response for both savings and investment decisions given the loss of confidence in the resurgence of the domestic market. So where are the risk-takers to get us out of this situation?
d) That fiscal stability in the coming years will depend more on how we manage the economy than on the specific fiscal measures we introduce at the start. Thus credibility of the Budget requires both getting the numbers right in year one and managing the economy better in years two onwards

So The IDP responds by offering other options to be placed into the Mix of policies to set us on the path to recovery and growth:

- It include the concept of **Economic Inclusion** to the strategies for growth because if we are to grow by linking to a globalized world economy it is possible for achieve GDP growth in some sectors of the economy with the exclusion of other members of society.
- It targets domestic expenditures (Income support to the rural economy, boosting domestic demand) as a first step instead of focusing on domestic saving and investment. It is concerned that corporate and household balance sheets would deteriorate further with a shock approach to fiscal adjustment.
- It includes a Social Investment Fund to mobilize the concept of "Sharing costs of the delivery of social services across different levels of Governance".
- It includes the concept of local area Concept Plans initiated by non-state entities as we share the responsibility for re-generating economic growth.

The fact is the rules of the game for achieving economic growth in a globalized system are continuously changing. The International conventions (Kyoto, SIDS, WTO, FTAA), global events (9/11, Iraq, USA forced exemption from the International Court of Justice), attitude changes in donor countries (donor fatigue) and towards recipient countries (inept officials, petty personal games) have collectively changed the rules for succeeding in the world economy. Trade negotiations, Donor support, Fiscal Management and Decentralization all **require economic and social responsibilities** if they are going to succeed.

WHAT DETERMINES THE POLICY MIX

To understand the IDP and its implied mix of economic and social policies for recovery and growth, one has to become aware of what is happening on the forefront of knowledge with regards to the "deep determinants of income levels" between countries. Why are recovery programmes in some countries more successful than in others? Why is it that some countries can indulge in fiscal tightening *a la IMF Model* and come out fairly robust while other appear to spiral into deep economic coma? Are development outcomes to some extent **PRE-DETERMINED**?

There are some economists who have been studying these questions[2] and their findings will surprise most persons. The candidates for positively determining the differences in income levels among countries were:

- The level of investment
- The resources of the country (oil, minerals etc)
- The geographic proximity to major markets
- The quality of their institutions
- The level of trade integration (exports)

And the winner turns out to be the **QUALITY OF INSTITUTIONS!** Not only do institutions have a statistically significant influence on economic performance, but they can substantially increase the level of per capita GDP. Hali Edison, a Senior Economist in the IMF Research Department writes that "an improvement in sub-Saharan Africa's institutions from their current average quality to that of developing Asia would represent an 80 percent increase in per capita incomes in sub-Saharan Africa (from about $800 to over $1,400)[3].

Institutions are defined as formal and informal rules governing human interactions. Procedural devices, regulatory frameworks, planning mechanisms, structures for mobilizing investments, these are all institutional formats. But they do not occur only in the public sector. We also have to contend with the institutionalization of private sector behaviour. For instance, squatting can become an institutionalized solution to a settlement problem. The reason why we frown on such an arrangement is that it clashes with other formal institutional structures like private property rights etc., and inhibits the development of the land market. There is growing evidence that desirable institutional arrangements have a large element of **CONTEXT SPECIFICITY**. Again, there are no magic formulae. The IDP Team had to evaluate our context here in Dominica in order to propose the appropriate policy and institutional mix

FISCAL POLICY MIX

In our Situation Analysis the IDP analyses the recent structure of investments in the country. The Report observes that the structure of investments has changed. Private investment declined from 24% of GDP in 1997 to 16.3% in 2000. Public investment increases from 6.6% of GDP in 1997 to 13% in 2000. The concern is that an increasing portion of the burden of investment for renewed growth is being shifted onto the public sector at a time when the Government is finding it very difficult to raise investment funds. The IDP therefore attempts to counter this decline in public investment expenditure by enhancing the productivity of the PSIP by the institution of the MTPEF and by providing for investment funds through non-budgetary sources.

Fiscal Policy	Economic Institutions	Social Institutions
• Reduce Public Sector Investments on expensive projects	• The 10 non-budgetary Funds.[4]being used to Mobilize additional investment funds. • Medium-Term Public Expenditure Framework (**MTPEF**) to involve private sector in defining 3-year public investment goals and increasing the productivity of the PSIP by using the	• Local government bodies focusing on cooperative efforts to attract investments in adjacent areas. • Local area concept plans providing technical basis for civil society investments
• Stringent conditions to access short-term debt relief	• Code of Financial Practices to restore credibility in fiscal management and propose a credible exit strategy to donors	• A system of information sharing to rebuild confidence of the financial sector.
• Reduction in Social Sector expenditures.	• Social Investment Fund with donor support to allow local groups to share in delivery of social services.	• New spatial arrangements for organization of a cadre of service delivery units.
• Reduction in Government direct support to Economic sectors; ○ Agriculture ○ Tourism ○ Health	• Commission for Agriculture to integrate tourism and other sectors with agriculture. • Joint DHTA/Ministry of Tourism Visitors' Survey to support tourism investment decisions at all levels of participation. • Six (6) institutional measures to promote investment in "Wellness	• Creating Multi-enterprise zones to promote agricultural production under local conditions. • Co-management of national parks and eco-tourism sites to bring adjacent communities into the tourism service industry

ECONOMIC GROWTH POLICY MIX

Our Situation Analysis also noted that the social challenge of reducing the incidence of inter-generational poverty[5] has taken on a new dimension with the fallout from the Banana Industry. During the period 1990 – 2000, 4,265 farmers ceased to earn income from the Banana Industry. The accumulated loss of income from the seven (7) production divisions throughout the country was EC$29.188 million. The impact of this loss in banana farmers is estimated at 14,000 farm work opportunities[6]. This is not just a loss to the rural economy, agricultural workers and rural family households. It is also a loss to the national economy in terms of domestic demand.

The IDP, for the first time in Dominican economic history, raises the issue of Economic Exclusion as a challenge to any economic sector (Tourism) which would seek to replace Agriculture as the leading sector. The IDP suggests that this issue must be addressed by:

- promoting job creation in both Agriculture and Tourism sectors;
- sustaining Domestic demand in rural area;
- promoting local area planning and rational Land Use patterns;

Once again, the IDP recognized that this issue can only be effectively addressed by a combination of Policy and Institution building. Thus the IDP Growth Strategy, besides involving three sub-models, seeks to achieve this winning combination.

	Fiscal Policy	Economic Institutions	Social Institutions
Export Growth Model	• Stabilizing Banana export earnings.	• Broad-based participation in tourism industry;	•The emerging "Development Committees" as instruments of local investment.
Human Resource Development Model	• Targeting CARICOM Single Market to export skills and explore opportunities.	• Quality skills training	•Community programme to mobilize contributions from health and education workers who have migrated to the metropolitan countries.
Social Recovery Model	• Income support to poor and not-so-poor	• Mapping poverty locations and targeting education and health services	•Local enterprise initiatives responding to local area demand.

CHOOSING THE RIGHT MIX

Policy statements alone do very little for achieving the desired growth levels. The research is telling us that successful paths to economic recovery are identified by an amalgam of policy and institutional factors. The correlation between institutions and policies continues to point to the fact that "sound policies need to be supported and sustained by good institutions, while weak institutions may reduce the chance that good policies will be adopted or may undermine policy effectiveness"[7].

The IDP has sought to develop these links by proposing both policy and institutional behaviour that it hopes will create that "virtuous circle" to generate investments, job creation and growth. Here are some of the hoped-for "virtuous circles":

a) Fiscal Adjustments:

Reducing Government Budgetary Expenditures →seeking alternative sources of investment funds → financing local area investment plans → generating income-earning at the local level→ reviving domestic demand initiating a better outlook for growth.

b) Exports Promotion

Stabilizing Banana Exports →turning around the decline in export volumes →channeling funds into export services →mobilizing capital investment expenditures → generating new employment levels →resulting in economic growth.

c) Human Resource Development

Broad-base participation in delivery of Health and Education Services →countering any decline in education services →generation of human skills development →increase potential for skills in the service sectors → income earning opportunities →disposable income translates into consumption levels → local demand spurs local growth initiatives.

-

d) Social Recovery Programmme

Poverty Mapping and identification →Targeted Social & Economic Recovery Expenditures →Effective demand of poor & not-so-poor increases→Indigenous enterprises addressing employment and production →new Global market niche identified →Growth.

CONCLUSION

The Integrated Development Plan for Dominica recognizes that the core component of restoring economic growth in Dominica must come from sound economic management and well thought out policies. It squarely tackles the challenges of both public sector and private sector (corporate and household) balance sheet problems by providing the options for a viable mix of policies and institutional behaviour. In this respect, the IDP conforms to the most recent empirical findings within the specific context of the economy of Dominica.

---

[1] The IDP Programme for Fiscal Adjustment has five initiatives, the first of which is to seek short-term debt relief. To this extent it may be argued that the IDP accepts some of the shock measures as "necessary"

[2] **NBER Working Paper 9305, October 2002** "Institutional Rule: The Primacy of Institutions over Geography and Integration in Economic Development" by Dani Rodrik, Arvin Subramanian and Francesco Trebhi (Cambridge, Massachusetts: National Bureau of Economic Research); **IMF World Economic Outlook April 2003;** Chapter 3, prepared by Maitland MacFarlan, Hali Edision and Nicola Spatafora; **World Bank's World Development Report 2003**: Sustainable Development in a Dynamic World, prepared by a team led by Zmarak Shalizi and including Christian Eigen-Zucchi and Gunnar S. Eskeland.

[3] "The Primacy of Institutions" by Dani Rodrik and Arvind Subramanain, **Finance and Development**, June 2003, page 32.

[4] The IDP identifies ten "extra-budgetary" programmes such as the Basic Needs Trust Fund, Banana Trust Fund, Social Recovery Strategy, Dominica Rural Enterprise Project (DREP), etc.

[5] The persistence of poor living conditions through generations of siblings.

[6] The Social Impact Assessment Survey reported that the 1995 ratio employment opportunities (temporary and permanent) per banana farmer is reported at 3.45

[7] "Testing the Links: How strong are the links between institutional quality and economic performance?" by Hali Edison, **Finance & Development**, June 2003.

Back to Economic Development