

# Debt Landscape and Fiscal Management Issues in Pacific Small Island Developing States

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## **About this paper**

This paper is an input to the discussions at the Pacific Regional Debt Conference co-organized by ESCAP and PIFS on 5-8 April 2022.

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## I. OVERVIEW

1. **This paper has been prepared as background for the Regional Debt Conference for Pacific Small Island Developing States (PSIDS)**, being co-convened by the Government of Fiji, the Government of Tuvalu, the Pacific Islands Forum Secretariat and the United Nations Economic Commission for Asia and the Pacific, from 5-8 April, 2022.
2. **The first part of the paper reviews the evolution of public debt in PSIDs prior to the Covid pandemic, as well as during the Pandemic.** While there was a wide range of public indebtedness prior to the Pandemic, the average level of public debt/GDP was fairly low by global standards, at a little over 30 percent. Nonetheless, IMF/World Bank Debt Sustainability Analyses (DSAs) classified most PSIDS as being at high risk of debt distress, given their very limited access to international financial markets and low institutional capacity. During the pandemic, most countries in the region experienced sharp declines in export earnings and growth, reductions in government revenues and rising spending needs. In most countries, deficits were met through increased grants from bilateral donors as well as borrowing from international financial institutions (IFIs) and bilateral lenders, which raised average debt/GDP ratios to well over 40 percent by 2021, according to provisional estimates.
3. **The second part of the paper focuses on forward-looking strategies for managing debt in the Pacific.** Key points include:
  - **Current Debt/GDP levels for most PSIDS are uncomfortably high.** In many cases, debt ratios are above nationally mandated levels, and DSAs classify them as high risk. Achieving debt sustainability over time will require fiscal measures on several fronts. Slower growth and higher real interest rate prospects may make the task more difficult;
  - **PSIDS also seek to pursue sustainable development goals (SDGs) and adapt to climate change.** Restoring and increasing expenditure in these areas while, at the same time increasing fiscal space, will require improving the efficiency of spending, enhancing revenues, and increasing access to external grants;
  - **Ensuring fiscal sustainability over the medium to long term will require improvements in expenditure and revenue management.** Gradual fiscal adjustment would be facilitated by a multi-year budgeting approach. On the expenditure side, efficiency savings can be realized by strengthening procurement frameworks, and improving the monitoring, reporting, and transparency of public spending. On the revenue side, updating of non-tax revenue frameworks can yield more revenue, as can elimination of tax breaks and tax expenditures. Improved revenue administration could generate significant additional revenues as well; and
  - **Public debt management needs to be strengthened in almost all countries.** Debt management units in Finance ministries are often under-staffed and lack

adequate authority or resources to collect comprehensive and timely information on public debt on a whole-of-government basis. Reporting requirements for state-owned enterprises (SOEs) and statutory and provincial authorities should be strengthened or enforced, and borrowing approval processes may also need strengthening;

- **PSIDS need to actively engage with donors and IFIs to strengthen access to finance.** Spending needs for implementation of SDGs and climate change adaptation are likely to exceed reasonable estimates of spending efficiency gains and revenue increases. Increases in access to grant-based external financial support also needs to be part of the strategy.

#### 4. **Major fiscal and debt management risks and challenges going forward include:**

- Global macroeconomic developments and, especially, medium-term prospects for growth and real interest rates. These will greatly influence the effort required to achieve sustainable debt/GDP ratios;
- Climate change and natural disasters. These will tend to lower average growth rates and have adverse effects on budget positions. Governments will need to work to find funding for climate change adaptation, as well as build buffers and look for other approaches to deal with disasters;
- SOE financial risks. Poorly performing SOEs represent significant financial risks to government, both through costly budget subsidies, and through contingent liabilities; and
- Access to finance. To achieve fiscal consolidation while also addressing the costs of climate change and natural disasters, PSID governments need to have access to very low-cost borrowing, and also greater and easier access to external grants. Stronger public financial management can help, but donors and lenders also need to make access easier for PSIDS and fragile states.

## II. **EVOLUTION OF DEBT IN PSIDS**

### A. **Evolution of Debt Prior to the Pandemic**

5. **Levels of public debt varied considerably among PSIDs prior to the Covid-19 pandemic.** As shown in Table 1, levels of (un-weighted) public debt averaged just over 32 percent of GDP in 2019, prior to the Covid-19 pandemic, but ranged from as high as 62 percent of GDP in Nauru to as low as 8.2 percent in Solomon Islands. Over the preceding five years, slightly more than half brought their debt/GDP ratios down (especially Nauru and Tuvalu), but for the group as a whole, the median debt/GDP change was very small.

Table 1: Public Debt in Pacific Island Countries 2015-2021							
	Public Debt in percent of GDP				Change in Public Debt percent of GDP		
	2015	2019	2020	2021	2019/2015	2021/2019	2021/2015
Nauru	105.8	62.1	59.9	58.2	-43.7	-3.9	-47.6
Fiji	43.0	48.9	70.8	86.7	5.9	37.8	43.7
Samoa	57.8	47.4	46.7	49.0	-10.4	1.6	-8.8
PNG	33.8	46.7	49.7	51.2	12.9	4.5	17.4
Vanuatu	35.8	46.2	50.1	47.4	10.4	1.2	11.6
Tonga	51.4	41.3	42.3	46.3	-10.1	5.0	-5.1
Palau	14.9	30.4	52.4	73.6	15.5	43.2	58.7
Kiribati	20.0	23.0	28.0	35.0	3.0	12.0	15.0
RMI	34.3	21.5	21.9	21.4	-12.8	-0.1	-12.9
Cook Is	20.3	20.0	40.9	45.7	-0.3	25.7	25.4
FSM	25.7	18.5	16.7	15.3	-7.2	-3.2	-10.4
Tuvalu	57.0	11.6	7.3	6.0	-45.4	-5.6	-51.0
Solomon Is	7.9	8.2	13.1	16.2	0.3	8.0	8.3
<i>Average</i>	<i>39.1</i>	<i>32.9</i>	<i>38.4</i>	<i>42.2</i>	<i>-6.3</i>	<i>9.7</i>	<i>3.4</i>
<i>Median</i>	<i>34.3</i>	<i>30.4</i>	<i>42.3</i>	<i>46.3</i>	<i>-0.3</i>	<i>4.5</i>	<i>8.3</i>

Sources: IMF Country Reports; Cook Islands Budget documents

6. **Key drivers of debt have reflected both demand and supply factors.** PSIDS governments, in general, have limited access to domestic sources of debt financing, and very limited scope for borrowing from foreign commercial lenders. Consequently, most are heavily reliant on lending by a handful of foreign bilateral lenders and IFIs. This means that, in contrast with countries with ready access to domestic and external financial markets, public debt in PSIDs reflects both country developments and lenders' policies.
7. **Natural disasters have boosted the need for borrowing in several PSIDs, while favorable export developments have tended to cut debt financing needs in others.** Over the 2015-2019 period, a series of natural disasters, including earthquakes, droughts and cyclones, wreaked havoc in several countries in the region. Governments, facing revenue shortfalls and increased spending needs for disaster relief and rebuilding, found bilateral donors willing to provide both grants and loans. As a result, the rise in public indebtedness in several of the countries over the 2015-2019 period directly reflects the willingness of donors and IFIs to support recovery and rebuilding efforts. In addition, such disasters have also increased the supply of finance for building climate change resilience. Favorable events have worked in the opposite direction. The introduction of the Vessel Day Scheme under the Parties to the Nauru Agreement (PNA) on Pacific fisheries management has boosted revenues significant in several PSIDs, allowing them to retire debt and, indeed, to boost Sovereign Wealth Funds

(SWFs), as in Kiribati, Tuvalu, and RMI. In Solomon Islands, the low debt/GDP ratio has substantially reflected debt forgiveness.

## **B. Macroeconomic Performance and Debt during the Pandemic**

8. **The pandemic had large adverse effects on external balances and GDP growth in most Pacific Island economies in 2020-21 (Table 2).** Economies particularly dependent on tourism exports, including Cook Islands, Palau, Fiji, Samoa and Vanuatu, were especially hard hit as international travel was suspended. Falling global demand and lower commodity prices also adversely affected earnings by PNG and Solomon Islands, while fish exporting economies such as Tuvalu and RMI saw significant losses of revenues. The spillover effects of these income losses on domestic economies were compounded by measures taken by the authorities to minimize the risks of the introduction and local spread of Covid-19. For the region as a whole, average GDP growth in 2020-2021 was nearly 8 percentage points lower than the average for 2015-19, while current account balances were weaker by an average of 11 percent of GDP. It may be noted that this figure understates the magnitude of the external shock, as the declines in GDP also cut imports, and current account positions benefited from rises in external grants.
9. **The sharp weakening of activity reduced government revenues in most countries, but was significantly offset by higher transfers.** Direct tax revenues in most jurisdictions fell during the period, even allowing for the decline in GDP. In most countries, however, increases in external grants provided significant offsets to the declines in domestic revenues. Indeed, although non-grant revenue, relative to GDP, fell nearly 3 percentage points in 2020-2021 compared with 2015-2019, official grants rose by close to 5 percentage points.
10. **Almost all countries saw substantial increases in government spending/GDP ratios compared with earlier years,** with the average rising by 8.1 percentage points. In part this reflects the fact that payroll expenses did not decline with falls in GDP. But it is also the case that most countries had to make significant additional outlays for healthcare expenditure, as well as for transfers to households to help sustain living standards. A notable offset to these increases in current spending by governments, however, were decreases in most countries in capital spending, partly because of the difficulty of importing investment goods and skilled labor, but also because of the need to re-prioritize expenditures as revenues weakened.



**Table 2: Impact of the Pandemic on Macroeconomic Performance in PSIDS 2020-2021**  
(2020-2021 average percent of GDP compared with 2015-2019 average)

	External Current Account Balance	GDP growth	Government Revenue (ex. Grants)	Grants	Government Current Expenditure	Fiscal Balance	Change in Public Debt 2019-21
Cook Is	-51.6	-18.0	5.4	..	20.6	-21.9	25.7
Palau	-35.5	-14.5	-6.4	8.2	26.2	-25.7	43.2
Fiji	-7.6	-13.1	-5.9	1.6	5.4	-11.3	37.8
Samoa	-1.4	-7.8	0.1	3.7	7.6	0.7	1.6
Vanuatu	-5.9	-5.8	2.8	4.5	11.1	-2.0	1.2
Solomon Is	1.4	-5.2	-7.5	-1.2	-2.0	-1.4	8.0
Tonga	-1.2	-5.2	-0.4	5.2	8.0	-0.7	5.0
RMI	0.0	-5.1	-0.8	14.2	12.2	-2.1	-0.1
Tuvalu	-3.9	-4.5	-12.4	4.2	-7.8	-11.9	-5.6
PNG	-4.2	-4.2	-1.8	-0.4	0.5	-4.4	4.5
Kiribati	..	-3.4	..	..	..	..	12.0
FSM	..	..	..	..	..	..	-3.2
Nauru	..	..	..	..	..	..	-3.9
<i>Average</i>	<i>-11.0</i>	<i>-7.9</i>	<i>-2.7</i>	<i>4.4</i>	<i>8.1</i>	<i>-8.0</i>	<i>9.7</i>
<i>Median</i>	<i>-4.0</i>	<i>-5.2</i>	<i>-1.3</i>	<i>4.2</i>	<i>7.8</i>	<i>-3.2</i>	<i>4.5</i>

.. indicates unavailability of data

Sources: IMF Country Reports; Cook Islands and PNG Budget documents

**11. Public debt, mostly external, has increased rapidly during the pandemic.** Despite the notable increase in grants by bilateral and IFI partners, increased borrowing – largely external – has been essential to meeting budget financing needs in PSIDs. Rises in public debt/GDP ratios have broadly reflected the magnitudes of the external and domestic activity shocks experienced in the region. As a consequence, (un-weighted) debt/GDP ratios in most countries in the region have risen significantly relative to GDP, so that the average debt/GDP ratio is now over 40 percent of GDP, a nearly 10 percentage point increase since 2019.

### C. Features of Debt

**12. For most PSIDs, public debt is largely external debt to official lenders.** For PSIDs, external commercial borrowing is either not feasible or very costly, and domestic debt markets are very limited. This means that most borrowing is external, and from either IFIs such as ADB, World Bank, and IMF, or from bilateral official lenders including Australia, New Zealand, Japan, and China. Terms on such loans tend to be very favorable, although strings may be attached and, in some cases, lending through PPPs may be opaque and costly. During the pandemic, the reliance on external debt has increased, as borrowing needs far exceeded domestic funding sources.



13. **Domestic debt is largely held by National Provident Funds.** In several countries, including Cook Islands, Nauru, Samoa, and Tuvalu, the Provident funds do not hold public debt, but in several others, including Fiji, PNG, Solomon Islands, Tonga, and Vanuatu, holdings of government debt securities are a significant percentage of total assets.<sup>1</sup> The appetite for government debt is somewhat artificial, as most provident funds face limitations on the proportion of their portfolios able to be held offshore or in foreign currencies, while good domestic investment opportunities may be limited. In current circumstances, with governments having boosted borrowing and partial withdrawals of savings for unemployed pension fund members during the Pandemic, the scope for Provident funds to absorb more government debt may be very limited, constraining governments' options in the event of any future disasters.
14. **Coverage of debt statistics and contingent government liabilities is weak.** In most jurisdictions, the domestic and external debt statistics cover only the central government. They do not generally cover the debts of Statutory Authorities and contingent liabilities associated with SOEs, which may be substantial in some countries.

### III. DEBT SUSTAINABILITY AND FISCAL MANAGEMENT

#### A. Debt sustainability

15. **The sharp rise in public debt in the Pacific since 2019 raises the question of how much debt is sustainable.** Pressures to borrow and spend on recovery from the pandemic, on development and in strengthening resilience to climate change also beg the question of how much debt can be carried safely by governments in the region. Higher debt, especially external debt, increases macroeconomic vulnerabilities. Increased borrowing and debt makes governments more exposed to disruptive changes in the cost and supply of financing, and reduces budget flexibility in addressing revenue and expenditure shocks. However, there is no simple formula to determine optimal debt for any economy, especially PSIDS.
16. **The DSA framework, developed by the IMF and World Bank, provides a consistent, empirically based framework for assessing risks of debt distress.** PSIDs are mostly assessed using the low-income country version of the framework, in which countries are not assumed to have ready access to international financial markets.<sup>2</sup> The framework compares staff projections for debt variables against empirically estimated

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<sup>1</sup> Holdings of government securities as a percentage of total assets as of 2020/21 are: Fiji National Provident Fund (42.4%), Papua New Guinea NASFUND (32.1%), Solomon Islands National Provident Fund (7% of total gross invest fund portfolio), Tonga Retirement Fund (12.8%) and Vanuatu National Provident Fund (9.3%).

<sup>2</sup> Exceptions being Fiji, Nauru, and Palau.

benchmarks for similar kinds of countries to assess the likelihood of debt distress.<sup>3</sup> These benchmarks reflect a number of factors, including a composite indicator of the country's institutional capacity, the international reserves/imports ratio, and the remittances/GDP ratio. Countries are then classed as being at low, moderate, or high risk. Although the framework does not specify an appropriate level of public or external debt, it does provide some guidance on risks associated with a country's debt profile. Even before the Covid-19 pandemic, most PSIDs were classified as being at high risk of debt distress (exceptions being Solomon Islands and Vanuatu).

**17. Assessing debt sustainability also requires adding region- and country-specific judgement.** In the Pacific, three features are particularly important in assessing appropriate levels of public debt:

- **Size.** PSIDs are small in economic size, population, and land area compared with most low-income countries. This means in particular that domestic financial markets are very limited in most countries, and that production and export bases are narrow. Consequently, most government borrowing is external, and GDP, exports, and government revenues are quite volatile.
- **Climate change.** PSIDs are exceptionally vulnerable to natural disasters and climate change. This vulnerability, which is likely to increase substantially further in coming years, will adversely affect trend growth and debt carrying capacity in PSIDs, and also increases their need to build fiscal space and buffers to cope with natural disasters.<sup>4</sup>
- **Contingent liabilities.** The public debt figures used in this paper do not include contingent government liabilities for debts of SOEs or potential losses of national provident funds. In part this reflects weaknesses in monitoring and evaluation of such liabilities, as discussed further below. In several PSIDs, these potential liabilities are large relative to the size of the economies.

**18. These considerations suggest that PSIDs should continue to aim for relatively low public debt/GDP ratios, as well as explore the scope for improved access to concessional and grant-based finance.** In most PSIDs, governments have tried to maintain public debt ratios of under 30 percent. The pandemic has, as seen in Table 1, boosted (un-weighted) debt/GDP levels to over 40 percent in most countries. By global standards, a debt/GDP ratio of 30 percent is low, and under current circumstances seems appropriate for the region. The choice of a target public debt/GDP ratio has important

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<sup>3</sup> Variables include debt/GDP, debt/exports, debt service/exports, debt service/government revenue, and public debt/GDP.

<sup>4</sup> Lee, Zhang, and Nguyen (2018) "The Economic Impact of Natural Disasters in Pacific Island Countries: Adaptation and Preparedness," *IMF Working Paper 18/108*, estimate the average impact of natural disasters on PSID economies at 14 percent of GDP. Nishizawa, Roger, and Zhang (2019) "Fiscal Buffers for Natural Disasters in Pacific Island Countries," *IMF Working Paper 19/152*, estimate the average fiscal cost of natural disasters at 14-21 percent of GDP, and the median cost per year at 1.1-1.5 percent per year.

implications for fiscal policy. In particular, it provides a long-run anchor for the budget position. In several countries in the region, it may be noted, long-run debt/GDP targets or ceilings of 30 percent are mandated by law.

19. **PSIDS can also take measures to strengthen their debt carrying capacity.** As noted earlier, the DSA framework used by the IMF and World Bank to assess debt carrying capacity takes into account countries' institutional capacity, as reflected in the World Bank's Country Policy and Institutional Assessment (CPIA) composite indicator. To the extent that PSIDS can strengthen their institutional and policy making capacity, this would raise the assessment of their debt carrying capacity.
20. **The sustainable level of public debt is ultimately constrained by the government's ability to service that debt.** Higher debt means higher debt servicing costs. High interest rates also raise the cost of debt service. To cover that cost, governments need to run operating surpluses, on average, at least as large as their debt service costs. In the long run, this implies that:

$$d = \frac{(1+g)}{(r-g)} pb \quad \text{or, equivalently,} \quad pb = \frac{(r-g)}{(1+g)} d \quad (1)$$

Where  $d$  is the debt/GDP ratio;  $g$  is the long-term real growth rate;  $r$  is the long-term real interest rate; and  $pb$  is the average primary fiscal balance/GDP ratio.<sup>5</sup> As the equation shows, for a particular primary balance/GDP ratio, the sustainable debt/GDP ratio can be determined, or, for a particular level of the debt/GDP ratio, the necessary size of the primary balance/GDP ratio can be derived. Table 3 illustrates how this equation can be used to help determine primary budget balances consistent with long-term objectives for public debt.

21. **Real interest rate and growth rate scenarios in PSIDs indicate that sustaining debt at even relatively low levels may be challenging.** Through the decade up to the pandemic, PSIDs borrowing from official bilateral and multilateral lenders faced very low real interest rates. Fiji's rates were higher owing to some commercial borrowing. This made it easier for countries to cover debt service costs. Some countries also

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<sup>5</sup> Equation (1) is derived as follows:

Debt in this fiscal year ( $D_t$ ) rises if, in the previous fiscal year, the government's operating budget balance ( $OB_{t-1}$ ), comprising the primary balance ( $PB_{t-1}$ ) and interest on existing debt ( $i_{t-1}D_{t-1}$ ), was negative:

$$D_t = D_{t-1} - OB_{t-1} = (1 + i_{t-1})D_{t-1} - PB_{t-1} \quad (1.1)$$

Dividing through the terms in equation (1.1) by GDP, we can see in equation (1.2) not only that the public debt/GDP ratio,  $d_t$ , rises if the previous period's primary balance was negative, but also that it increases to the extent that the nominal interest rate on its debt,  $i_{t-1}$ , exceeds the nominal growth rate of the economy,  $n_{t-1}$ :

$$d_t = \frac{(1+i_{t-1})}{(1+n_{t-1})} d_{t-1} - pb_{t-1} \quad (1.2)$$

Equation (1) is based on the long-run version of equation 1.2, in which variables stabilize at their long-run values.

experienced fairly robust GDP growth, essentially allowing them to ‘grow out’ of debt burdens. In addition, primary budget balances in several PSIDs were strong through the period, as revenues were boosted by strong receipts from fisheries, together with ongoing budget support from major donors. In the period ahead, with inflation picking up, and growth recovering, interest rates are likely to rise above recent lows. In Table 3, it is assumed that real interest rates faced by PSIDs will converge to 3.5 percent over the long term, significantly above the levels faced by most PSIDs over the past decade. In addition, growth rates in the region are likely to be adversely affected by accelerating climate change. In Table 3, real growth in PSIDs is assumed to be 0.5 percentage points lower than the average for 2008-19. Of course, there is great uncertainty surrounding these assumptions, but the likelihood is for a less favorable combination of real interest rates and real growth rates.

22. **Under these assumptions, Table 3 suggests that over the long term, primary budget balances would mostly need to move into small surpluses to be consistent with current levels (and targets) of debt/GDP ratios of 30-40 percent.** For several countries, these would represent smaller surpluses than typically experienced over the past decade, but a considerable narrowing from pandemic-induced deficits. For some countries, with public debt boosted to high levels during the pandemic, somewhat larger primary surpluses will be needed to bring debt down relatively rapidly.
23. **Additional resources are likely to be needed in all PSIDs to address costs associated with climate change and natural disasters.** These costs include the need for investment in climate change adaptation and building of fiscal space or buffers to cope with natural disasters. These are likely to be substantial. As noted in Nishizawa (footnote 2), the fiscal costs of future natural disasters may well exceed the historical average estimate of 1.1-1.5 percent of GDP per year, implying the need for even larger primary surpluses. External financing may be available to cover some investment in climate change adaptation, but self-financing is also likely to be needed. These considerations point to the need for larger primary surpluses than suggested in Table 3, as well as measures to strengthen revenue and expenditure management.

<b>Table 3: Public Debt Ceilings and Primary Fiscal Balances</b>						
	<b>Growth</b>	<b>Real Int. Rate</b>	<b>Public</b>	<b>Prim.</b>	<b>Growth 0.5% below 2008-19 Real Int Rate = 3.5%</b>	
	<b>%</b>	<b>%</b>	<b>Debt/GDP</b>	<b>Bal./GDP %</b>	<b>Prim.</b>	<b>Prim.</b>
	<b>(2008-19 median)<sup>1/</sup></b>	<b>(2008-19 median)<sup>2/</sup></b>	<b>% (2021)</b>	<b>(2010-19 median)</b>	<b>Bal./GDP % Debt/GDP = 30%</b>	<b>Bal./GDP % Debt/GDP = 40%</b>
Cook Is	6.3	0.8	45.7	-0.3	-0.7	-0.9
Fiji	3.3	3.5	86.7	1.2	0.2	0.3
FSM	1.3	0.7	15.3	8.5	0.8	1.1
Kiribati	2.3	0.8	35.0	10.6	0.5	0.7
Nauru	6.9	0.8	58.2	11.2	-0.8	-1.1
Palau	1.3	0.8	73.6	2.7	0.8	1.1
PNG	4.4	0.7	51.9	-2.4	-0.1	-0.1
RMI	2.5	1.2	21.4	3.0	0.4	0.6
Samoa	1.4	0.1	49.0	-3.1	0.8	1.0
Solomon Is	3.5	-0.5	16.2	-4.5	0.2	0.2
Tonga	2.7	0.1	46.3	1.0	0.4	0.5
Tuvalu	3.7	0.8	6.0	7.5	0.1	0.1
Vanuatu	2.1	0.9	47.4	-1.4	0.5	0.7
<i>Average</i>	<i>3.2</i>	<i>0.8</i>	<i>42.5</i>	<i>2.6</i>	<i>0.2</i>	<i>0.3</i>
<i>Median</i>	<i>2.7</i>	<i>0.8</i>	<i>46.3</i>	<i>1.2</i>	<i>0.4</i>	<i>0.5</i>

Sources: IMF DSA data, Cook Is. Budget documents, Author's calculations

1/ For Cook Is 2015-19

2/ For Cook Is., Kiribati, Nauru, Tuvalu, real interest rate is average for other countries

24. **Countries with debt ratios above their long-term trends may need to run higher primary surpluses or lower deficits.** Table 3 focuses on the long run, not the adjustment path. The primary balances shown represent the sustainable budget positions once debt ratios have been brought to the target rate. For most PSIDs, debt ratios are above 40 percent, meaning that they would need to run higher primary surpluses for some time to get debt ratios down to the target level. How large those surpluses would need to be depends largely on how quickly they want to adjust. As an example, consider the case of PNG. Currently, its public debt/GDP ratio (not including contingent liabilities) is substantially in excess of its long-run statutory target. In the long run, if its sustainable growth exceeds the assumed real interest rate, then it could run a small primary deficit. However, to get its debt down to a target of 30-40 percent of GDP, it will need to run significant primary surpluses for several years. If contingent liabilities are included, the needed adjustment is even greater. Table 3 shows that several countries in the region face a similar adjustment challenge.

25. **How quickly countries should aim to bring debt ratios down to long-run targets involves difficult trade-offs.** A rapid pace of adjustment implies higher taxes or lower spending, in order to build up primary surpluses with which to pay down debt. Too rapid an adjustment may be economically difficult and politically unsustainable. A slow pace of adjustment may be easier, but leaves the countries with relatively little fiscal space to deal with increasingly frequent natural disasters or other shocks. Too slow a pace of adjustment may also undermine support from donors and lenders.

## **B. Expenditure Management**

26. **Careful expenditure management will be needed to create some fiscal space and ensure fiscal sustainability over the medium-term.** Many countries in the region now have levels of public debt/GDP significantly exceeding national targets, or which leave little or no fiscal space for dealing with natural disasters. For these countries, a sustained period of careful expenditure management will be needed as growth recovers. To facilitate a progressive strengthening of fiscal sustainability, a multi-year budgeting approach would be helpful for prioritizing spending, planning multi-year projects, especially in relation to public investment, and for underpinning donor support. Introducing a strategic phase, together with a medium-term perspective, into the budget process can foster a greater appreciation of priorities, and helps to reconcile costs against available resources. It also enables more detailed scrutiny of budget proposals by sector ministries, the ministry of finance, and political decision makers.<sup>6</sup> In this context, adoption of simple fiscal rules can be extremely helpful in linking spending to prospective revenues and to a long-term fiscal balance target consistent with the debt/GDP target or ceiling. Such rules provide guidance in a manner that is consistent over time while maintaining necessary flexibility in implementation.

27. **Ensuring good expenditure management will require strengthening public financial management (PFM) practices.** Improvements in PFM are generally needed in several areas:

- Budgeting processes. Medium-term fiscal strategies to achieve orderly fiscal consolidation, while at the same time making room for investment in climate resilience will require moving towards an integrated, multi-year budgeting approach.
- Strengthened procurement practices. With the prospect of tighter budget environments, ensuring efficient public spending on goods and services, as well as investment, is crucial. More rigorous application of good procurement practices, and increased transparency of processes will not only help contain costs and boost quality, but will also enhance policy credibility, which will be essential for sustaining support for fiscal adjustment.

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<sup>6</sup> See ESCAP/PFTAC (2018) “Improving the Links between National (and Sector) Plans and Budgets for Sustainable Development in Pacific Island Countries—A Guidance Note.”

- Enhanced accountability for spending. Efficiency in procurement needs to be complemented with measures to strengthen monitoring of implementation of spending plans. Increased transparency is also needed to underpin the effectiveness and credibility of increased accountability.
- Statistics. Meaningful fiscal and budget policymaking is only possible if policymakers have comprehensive, high quality, and timely statistics upon which to make decisions or adjust decisions in line with new developments. In most PSIDs, although there have been improvements in the availability and coverage of budget statistics, significant improvements are still needed, notably in broadening coverage to include statutory authorities and state-owned enterprises.
- Communication. Implementation of multi-year fiscal adjustment is always challenging, but especially so if the government's plans are not well-understood or believed by the public and the business community. Good communication of policy measures being taken, for example in budget documents, as well as a high degree of transparency in critical processes such as procurement and project implementation, play a key role in building and sustaining policy credibility.

**28. Strengthened PFM on the expenditure side will also help to increase donor confidence and access to external financial support.** Donors always want strong transparency and accountability in government spending, as it helps them to justify taxpayer-funded grants and lending to their political masters. In addition, high standards of PFM practices in particular areas may be key to improved use of national systems for delivery of grants, including through budget support, and enhancing access to climate finance from international organizations.<sup>7</sup>

#### **D. Revenue Mobilization**

**29. Enhanced spending management needs to be matched by stronger revenue policies and administration in most PSIDs.** Numerous measures to strengthen revenues could be considered, all of which would work to ease pressures on cutting spending to achieve fiscal consolidation:

- Tax base broadening. In PSIDs that have not yet adopted consumption-based taxes like GST, consideration should be given to doing so. Countries should also, in general, avoid eroding the tax base through use of tax breaks as a means of financing investment in public infrastructure. Collecting taxes and then paying subsidies is likely to be far more efficient and transparent.
- In most PSIDs, measures have been taken to strengthen tax administration, including by moving from an adversarial relationship with many taxpayers to a more cooperative and self-compliance-oriented relationship. In several countries, revenue authorities may be understaffed, and collection systems require automation, and additional staff and stepwise investment in appropriate technologies would more than pay for themselves in increased revenue. Fiji's

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<sup>7</sup> See, e.g., Fouad and others (2021) "Unlocking Access to Climate Finance for Pacific Island Countries," *IMF Department Paper 2021/020*.



experience with its ongoing reform of tax administration, in particular use of point-of-sale technology for collection of consumption-based taxes and large taxpayer compliance strategies may serve as a model for other countries in the region.

- Resource based taxes remain critical for some PSIDs, with potential to build on the success of Parties to the Nauru Agreement for higher fisheries revenue.
- Non-tax revenues are important in most PSIDs. In some, fees and charges are likely out of date and should be reviewed and updated. Samoa's experience suggests that many charges can be eliminated, but that overall non-tax revenues may increase substantially.
- Budget support by bilateral donors is a major source of revenue for many countries in the region. In the context of fiscal consolidation efforts, it would be extremely helpful to fiscal authorities in the region to have clear medium-term commitments on the part of donors to facilitate their own revenue and expenditure management.

## **E. Public Debt Management**

**30. Public debt management needs to be strengthened in most PSIDs.** PSIDs need to have a comprehensive overview of their domestic and external debt situations, as well as a clear strategy for managing debt over time. Measures that can be taken include:

- Debt management capacity. Debt management units in most PSID ministries of finance operate with small numbers of qualified staff, as well as high staff turnover, and have difficulty in obtaining necessary information and cooperation from other government agencies, statutory authorities and SOEs, as well as provincial authorities where applicable. Countries should ensure that they have an adequately resourced debt management office with sufficient authority to collect domestic and external debt data from all government departments.
- Governments often do not have a centralized, clear, and accountable process for approval and monitoring of all public external debt, whether by central government entities or by SOEs. This undermines efforts to manage debt in a systematic fashion, creates unnecessary financial risks, and facilitates corruption.
- The fiscal authorities, in cooperation with the central bank, should develop a debt management strategy to ensure that the country seeks advantageous terms, minimal risk, and a sensible debt service profile.
- With limited debt management capacity, PSIDs may have a bias towards seeking bilateral loans in preference to loans from IFIs. IFIs tend to have complex, lengthy approval and monitoring processes, which can overwhelm borrowers with limited capacity. Loans from bilateral lenders, including Export-Import banks, tend to be less time and resource consuming and may be favored for those reasons. PSIDs should be wary of the terms and conditions associated with such loans, especially project lending.

#### IV. FISCAL RISK MANAGEMENT

31. **Fiscal authorities in PSIDs face several major areas of risk**, including: (i) global macroeconomic developments; (ii) climate change and natural disasters; (iii) losses by SOEs; and (iv) access to external finance. These are discussed below.
32. **Global macroeconomic developments have a major impact on most PSIDs.** In addition to year-to-year developments affecting trade, investment, and financial assistance, there are also longer-term developments that determine long-term real interest rates and growth rates in major trading partners and, indirectly, in the PSIDs. As discussed earlier, these long-term trends in growth and interest rates substantially determine what level of fiscal surpluses or deficits can be sustained over the long haul. Forecasting these trends is almost impossible, so trends need to be evaluated regularly and targets adjusted accordingly.
33. **Climate change and natural disasters are a major challenge for PSIDs for the foreseeable future.** Climate change is increasing the frequency and severity of weather-related disasters, including cyclones and droughts in PSIDs. More slow-moving effects are also present, including increases in sea levels and temperatures, which may also become more volatile. In addition, Pacific islands are also vulnerable to volcanic eruptions, earthquakes and tsunamis. The challenge for PSIDs is to adapt, where possible, and to build capacity to recover quickly. From a fiscal perspective:
- Climate change adaptation requires investment in resilient infrastructure, and this will need to be a sustained long-term effort. PSIDs need to make space in their own budgets for such adaptation, supported by external financing. As noted earlier, countries can do much to enhance their access to climate finance through improvements in relevant aspect of PFM.
  - Disaster recovery. Even with adaptation efforts, including better disaster preparedness, natural disasters will still wreak human and economic havoc. Governments will face losses in revenue and need to meet increased spending needs. Donor assistance is important, but how much will be received is uncertain, and PSIDs need to be wary of borrowing too much, even on generous terms. For these reasons, PSIDs need to consider setting aside funds or buffers for disaster recovery as part of the regular budget process.<sup>8</sup>
34. **SOEs in some PSIDs present major fiscal risks.** These risks are two-fold:
- First are the contingent liabilities associated with possible public guarantees of SOE debts, as well as the losses that could be realized by national provident funds holding major stakes in SOEs.<sup>9</sup> IMF estimates indicate that public guarantees of

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<sup>8</sup> See Nishigawa and others (2019) *Op Cit*.

<sup>9</sup> Badia and others (2021) "Debt Dynamics in Emerging and Developing Economies: is R-G a Red Herring?" *IMF Working Paper 21/229*, note that contingent liabilities of SOEs may completely and rapidly swamp the more

SOE debt vary widely in the Pacific, from as little as 2 percent of GDP in Tonga, to as much as 17 percent in PNG, and a median value of 7.2 percent of GDP. ADB estimates also show worrisome levels of contingent liabilities in several countries.<sup>10</sup> Differences in estimates reflect the opacity of information on SOE debts and the government's liability.

- Second, ongoing financial losses by SOEs may be a major drain on national budgets. In Kiribati, Nauru, and Samoa, for example, annual financial losses by national airlines exceeded 1 percent of GDP, even before the Pandemic. During the Pandemic, of course, nearly all airlines in the region have experienced very serious losses, as have publicly owned hotels, resorts, and other enterprises, leading to costly rescue packages.

**35. SOE financial risks to the budget may be reduced with improvements in institutional governance, and stronger public accountability.** Balasundharam and others (2021) argue that governance arrangements should be strengthened to give SOEs greater responsibility for their actions (less political involvement) while requiring stronger accountability and transparency both with respect to government support for SOEs, as well as in more timely monitoring, reporting, and auditing of SOEs.<sup>11</sup>

## V. KEY ISSUES FOR DISCUSSION

### A. Fiscal Management & Sustainability

**36. Public debt/GDP ratios in most PSIDs have risen significantly during the pandemic.** Although this may have been appropriate, most countries now need to begin restoring debt sustainability. A recovery in regional growth will certainly help, as will access to concessional finance. But several countries may also need to take measures to rein in fiscal deficits in order to build essential fiscal space for dealing with future emergencies such as natural disasters. Achieving such reductions will take time and will require developing integrated medium-term budgeting strategies, with good public communications, monitoring and transparency, in order to win sustained public support and donor and lender confidence.

**37. Fiscal strategies need to be based on realistic assumptions about long-term prospects for GDP growth and real interest rates.** Average growth rates in PSIDs may be adversely affected by climate change, while global real interest rates are

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conventional macro effects of changes in growth and real interest rates, even where central government debt appears sustainable.

<sup>10</sup> ADB (2022) "Estimating Contingent Liabilities in the Pacific: Toward Managing Macro-Fiscal Risks to Recovery from Covid-19", *mimeo*.

<sup>11</sup> Balasundharam and others (2021) "Managing Fiscal Risks from National Airlines in Pacific Island Countries," *IMF Working Paper 21/183*.

unlikely to remain as low as they have been over the past decade. As a consequence, fiscal balances needed to support debt obligations are likely to rise.

38. **Ensuring fiscal sustainability will require strengthening PFM processes in procurement and implementation of budgets.** Essential elements of expenditure control strategies include stronger planning, monitoring, and accountability frameworks. These will also have the important benefit of increasing access to donor funding, including for climate adaptation.
39. **PSIDs should also look at strengthening revenues.** In some countries there may be scope for enhancing revenues by broadening tax bases, by eliminating tax expenditures and concessions, and by updating and modernizing non-tax revenue frameworks (e.g., Samoa). Most countries can also increase revenues by strengthening tax administration (e.g., Fiji).

## **B. Public Debt Management and Access to Finance**

40. **Debt management in most PSIDs is hampered by inadequate staff resources, weak mandates, and important data gaps, and onerous donor requirements.** Authorities should ensure that their debt management units have sufficient staff for the tasks, and the authority to obtain necessary data on debt on a whole of government basis. PSIDs should also develop explicit debt management strategies.
41. **IFI lenders and bilateral donors should consider the scope for simplifying and accelerating lending or grant approval processes for PSIDs and other fragile states.** This could include more harmonized eligibility and reporting requirements across donors/lenders in order to reduce the burden on PSID authorities. Donors could also consider assisting with provision of necessary technical assistance or capacity supplementation in areas where PSIDs typically lack adequate capacity, for example in both internal and external audit.
42. **Restoring fiscal sustainability at the same time as investing in climate change adaptation and pursuing SDGs is very challenging.** Spending more efficiently and boosting revenues can make room for building financial buffers to cope with disasters, and for climate change adaptation, but is likely not enough. External finance will need to play a role. Additional external borrowing for climate change adaptation undermines cutting public debt. But lowering the cost of such debt would help. This is an important area for discussion between PSIDs and the IFIs as well as bilateral lenders. The best solution for PSIDs would be to shift from loans towards more grant-based support for climate change adaptation. Here, strengthened PFM in project planning, procurement, monitoring, and reporting can play a crucial role in gaining greater access to grants. In addition, Donors should also look at shifting more of their financial support to grant finance and highly concessional lending.

43. **External financial support for PSIDs has been critical but is uncertain.** In the North Pacific, extension of US financial support for Compact Trusts is uncertain beyond 2023. In the South Pacific, financial support, principally grants by Australia, New Zealand, and the EU, has been essential to fiscal sustainability. Without such support, many countries would face budget catastrophes. While donors have made clear that they are committed to long-term support, the level of support is uncertain. So too is the amount of assistance provided in the event of natural disasters.
44. **Administrative requirements for grant finance should be streamlined.** Project planning, tendering, monitoring, and reporting requirements, notably in accessing climate change funds, are major impediments to PSIDs' access. Donors can assist PSIDs in building up the necessary institutional capacity to meet requirements, but donors should also consider carefully how to better tailor and streamline their requirements to facilitate access by small and fragile states.
45. **SOEs are an important source of financial risks for PSIDs, and the risks need to be carefully managed.** Realization of contingent liabilities of the government for SOE debt can quickly undo years of careful fiscal management. And poorly performing SOEs can become a major drain on the budget. Governments need to monitor more carefully, frequently, and transparently, the financial situations of their SOEs so that they are not caught off-guard and can intervene well before troubles become serious. In some PSIDs, governance arrangements may also need to be modified to bolster SOEs' operational autonomy, and at the same time strengthening accountability and transparency requirements.